Chapter 1: East Asia Pacific At Work: Introduction and Roadmap

East Asia Pacific is like no other region in ways that strongly affect the supply and demand for labor and human capital, and the wellbeing people gain from work.

1.1 Talent, skills, and the ability to work are people's most important assets. For the majority of people the value of these assets is realized in the labor market, whether they sell their time to others or pursue their own enterprise. Work is often the channel through which the benefits of economic growth spread and living standards improve. This has been demonstrated dramatically since 1990, as the share of the world's population living in poverty has declined by half. The prospects of working people in East Asia Pacific countries are better than those of many living elsewhere. The flow of goods and services within the region, integration with the global economy, price stability, rule of law, and relatively unfettered markets all foster opportunities for advancement through work that people in other regions regard with envy. In the countries of East Asia Pacific, work has brought more people out of poverty and closer to middle-class prosperity faster during the past three decades than in any other place and at any other time.

1.2 Nevertheless, working people in many parts of East Asia Pacific feel some of the same pressures and face some of the same challenges as their peers elsewhere. The region has the second highest share of workers outside of wage and salaried employment and consequently beyond the reach of most forms of regulation and formal protection. In this regard, the countries of East Asia Pacific are surpassed only by countries in Sub-Saharan Africa. In some East Asia Pacific countries, youth inactivity and unemployment are growing problems, most starkly apparent in Indonesia, the Philippines, and the Pacific island countries. As rising indices of inequality in several East Asia Pacific countries show, these challenges are starting to threaten the viability of work as a means of advancement and a channel through which economic growth can be shared broadly. In addition, after more than two decades of rapid development, people in the region are beginning to experience moderating economic growth, often coupled with lagging productivity and slower gains in living standards than they have grown accustomed to. Not surprisingly, governments across the region are beginning to hear louder and more frequent calls for action to sustain the well-being—that is, the individual and social gains—that people can expect from their work.[1]

[1]. Economists are more familiar and comfortable with the term "welfare." Although "welfare" and "well-being" are synonyms, the latter is more typically associated with safety or psychological comfort than with the outcomes discussed in this report, namely economic development, material living standards, and social cohesion. In discussions of work, welfare is often used too narrowly in reference to social protection programs. Further, there is considerable evidence that individuals and communities draw benefits from their work that are neither strictly pecuniary nor a function of economic growth, many of which contribute to social cohesion and, in turn, to development.

1.3 *East Asia Pacific At Work* examines the changing world of work in a diverse, dynamic region and proposes how policy can support inclusive growth by creating a more enabling environment for working people. The report is motivated by and benefits from the spotlight shone on work and development by the *World Development Report 2013: Jobs* (henceforth WDR 2013; World Bank 2012a). Like the WDR 2013, this report is about a much broader variety of working forms than is typically understood by the word "jobs," including farm employment, unpaid family work in household market enterprises, self-employment, and casual labor. We use the more inclusive term "work" instead of "jobs" throughout this report to reflect a broader range of market activities than just full-time, salaried employment. We apply the conceptual and analytical tools presented in the WDR 2013 to East Asia Pacific countries in order to draw additional inferences and guidance for policy makers in the region.

1.4 This report adds value to the discussion initiated by the WDR 2013 in three specific ways. First, it grapples with issues that are of greatest urgency in the countries of East Asia Pacific. The economic and demographic changes in this region, as well as the nascent engagement of its governments in labor regulation and social protection, affect the demand for and supply of work in ways that are distinct from those in countries elsewhere.

1.5 Second, the report contributes to what is still a relatively small body of empirical evidence showing the impact of policies on employment in East Asia Pacific and proposing options for reform. With some notable exceptions (Betcherman and Islam 2001), there are still fewer policy reports on labor markets, work, and development with a regional scope in East Asia Pacific than in Europe, Latin America and the Caribbean, the Middle East and North Africa, or South Asia.

1.6 Third, in covering geography that extends from China to Tuvalu, the report takes closer account of the region's diversity. East Asia Pacific countries differ considerably in their size, natural endowments, demography, political institutions, and stage of economic development. In several countries, most people still live in rural areas and work in subsistence or small-scale agriculture; in others, rapid rural-urban migration has been taking place. In several East Asian countries, urbanization is already well advanced, and an ever-growing concentration of working people in cities is creating pressure on governments to broaden social protection and bring more economic activity into the regulated "formal" economy. In many parts of the region, the labor force is aging, particularly in the most populous countries—China, Indonesia, Thailand and Vietnam. In contrast, the labor force in most of the Pacific island countries is still very young, but the small size and remoteness of these countries present a host of unique challenges to work as an effective channel of development. Appreciating the exceptional diversity of East Asia Pacific is essential to understanding the challenges to sustaining the gains from work and to crafting policies to address these challenges.

1.7 In this chapter, we open the report by acknowledging how East Asia Pacific is like no other regions in ways that strongly affect work. Those who have spent time reading and writing about the countries of East Asia Pacific in the past thirty years have grown used to superlatives and with good reason. The region's dynamic context of economic and social change has had undeniable impacts on the demand and supply of labor and human capital. The first section of this chapter shows that several important factors set the region apart in shaping the context for work, including its sustained high growth and fast-rising prosperity.

1.8 Our discussion then turns to the question "*Has growth in East Asia Pacific been 'jobless'?*". With the highest rates of participation in market employment and the lowest rates of open unemployment, the question may seem odd to many readers. Nonetheless, evidence from our own analysis and that done by others shows how the relationship between employment and changes in output is not straightforward nor can it be taken for granted. But claims of so-called "jobless growth" in East Asia Pacific countries are just as overblown and simplistic as is complacency about what markets can achieve when left to their own devices. Although not sufficient, as a derived demand economic growth is certainly necessary to sustain the demand for work. That conclusion allows us in the chapters that follow to dedicate attention to the quality of work and whether and how it contributes to people's well-being.

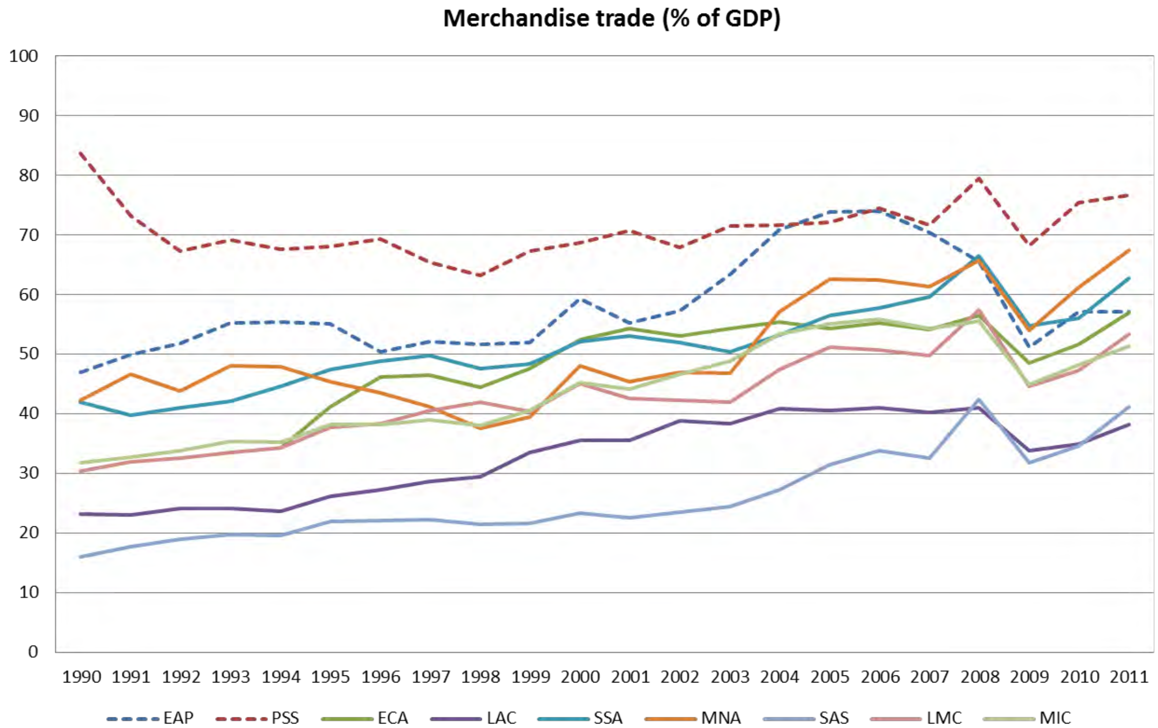
1.9 Finally, this chapter closes with a 'roadmap' of the report. We have divided the report's nine chapters into three parts. The first (chapters 1, 2 and 3) describes the context: what is unique about East Asia Pacific, how diverse the profiles of households and firms are within the region, and how the contribution of work to well-being is changing. The second part of the report (chapters 4, 5 and 6) is a review of policy that serves to take stock of the prevailing models in East Asia Pacific and how they affect the prospects and outcomes for working people. The third part of the report (chapters 7, 8 and 9) looks ahead at the policies governments in East Asia Pacific countries may wish to consider to sustain the transformative impact of work, even as growth in the region begins to moderate.

1.1 The context for work in East Asia Pacific

1.10 Several inter-related contextual factors differentiate the East Asia Pacific region, particularly East Asia, from other mainly low- and middle-income country regions in setting the environment for work. These contextual factors have facilitated the fast pace of structural change and influenced the returns to labor and human capital. The first factor is deeper economic integration with the global economy. Another is sustained high growth that has accelerated the pace of development. The third is economic resilience through the period of global financial crisis and economic contraction of 2008 - 2010. Finally, although growth in the region has not been especially volatile -with the exception of growth in the Pacific island countries- the entire region faces higher risks from natural disasters than faced by countries elsewhere, and has borne a heavier economic burden from these disasters. These contextual factors shape not only the speed of structural transformation, what most people do to earn a living, but also the relative returns to labor and human capital, the skills profile required to maintain productivity, and the vulnerability of working people to shocks. To each of these contextual factors in turn.

1.11 Economic growth in the region is characterized by a greater degree of export orientation and openness to world trade than elsewhere. This has been true for so long that it has become a popular caricature of East Asia Pacific countries. Figure 1.1 shows how merchandise trade as a share of global domestic product (GDP) has been rising in almost every region of the world. But in East Asia Pacific, the levels of economic integration measured by this statistic have been higher, around 50-60 percent, than in other low income and emerging market regions. This level of global integration has remained high throughout the last two decades. And to a much greater extent than in other regions, integration with the global economy rests on integration between East Asian countries and the flow of trade in intermediate goods (Gill and Kharas, 2007).

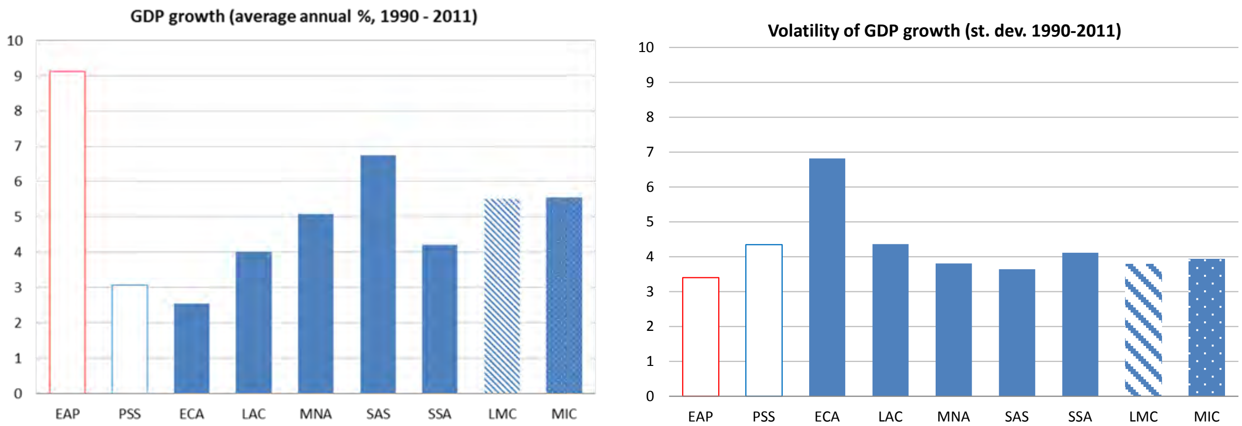
Figure 1.1 Countries in East Asia Pacific have sustained higher levels of global integration longer than countries in other regions.



Source: World Development Indicators

1.12 The East Asian countries have sustained higher rates of economic growth for much longer periods than high growth spurts elsewhere, resulting in fast-rising living standards. At average annual GDP growth of more than 9 percent between 1990 and 2011, East Asia far surpassed other regions (Figure 1.2). Average annual growth was almost 4 percentage points higher than the averages for lower- and middle income countries. What is more, economic growth in the region outside the Pacific island countries has not been particularly volatile: the volatility of GDP growth, measured by the standard deviation of average annual economic growth during the period 1990-2011, was lower than in any other developing country group. As a result, the region's share of world output and its share of output growth have both increased substantially (Figure 1.3). East Asia Pacific's share of global GDP went up from 6.7 percent in 1990-1992 to 17.4 percent in 2009-2011.

Figure 1.2 East Asia's high growth has not been particularly volatile.

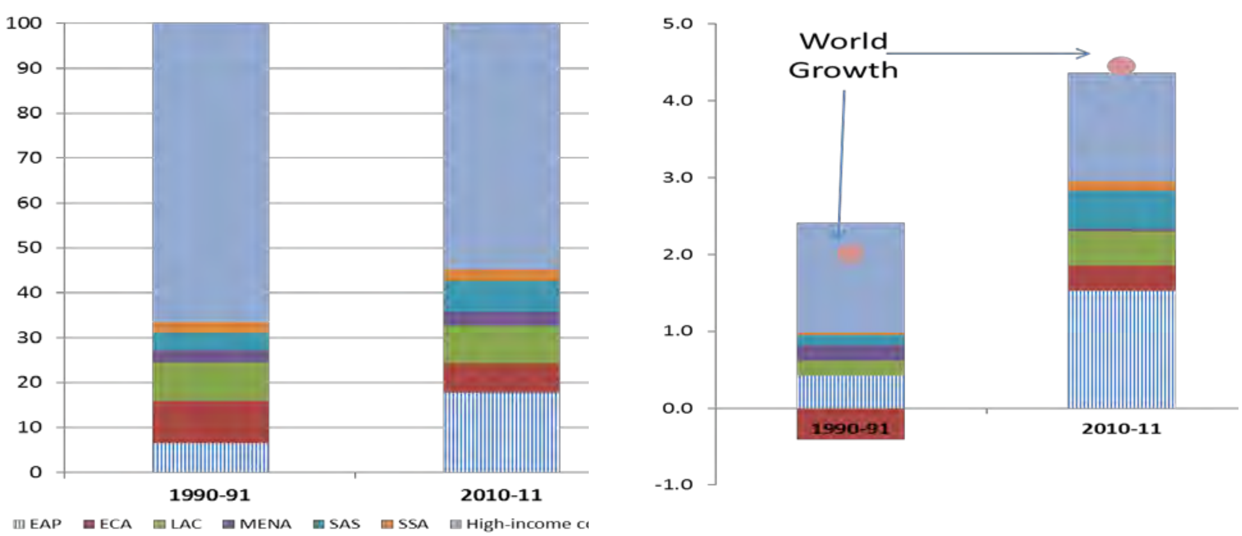


Source: World Development Indicators

Figure 1.3 East Asia Pacific's share in world output and growth has risen rapidly

(a) Share of global GDP (PPP, Constant 2005 International $), by group of countries

(b) Contribution to global GDP growth (PPP, Constant 2005 International $), by group of countries



Source: World Development Indicators

Source: World Development Indicators

1.13 But it is important to note the diversity of experience in East Asia Pacific, with large differences in the rate of economic and social progress. For example, although average annual GDP growth during the first decade of the 21st century was close to 10 percent in China, it was near zero in several small Pacific island countries. As shown in figure 1.2, the growth rate was much lower in the Pacific island small states, at 3 percent, than growth in East Asia. Furthermore, economic growth in the Pacific is significantly more volatile, and in this regard similar to growth in Latin America Caribbean and sub-Saharan Africa.

1.14 Countries in East Asia Pacific showed considerable economic resilience through the period of the global financial crisis and economic contraction of 2008 – 2010. Perhaps reflecting hard-learned lessons during the region's crisis in the late 1990s, a number of countries in East Asia continued to generate employment even during the global economic slowdown and contraction of 2009 and 2010, although with a substantial downward adjustment in earnings (as shown in Figures 1.4 and 1.5). This adjustment took place in part due to shifts of working people from registered, regulated work to unregistered "informal" contracts; shifts from full- to part-time work; and movement of people who lost jobs in firms and factories back to farms in rural areas. Amidst the more recent slow-down of growth, unemployment has remained steady in East Asia Pacific countries, relative to the rises seen elsewhere (Figures 1.6 and 1.7). In the recovery period, East Asia Pacific continues to remain resilient despite a perilous global economic context: developing East Asia Pacific, excluding China, is expected to grow by 5.7 percent in 2013, up from 4.6 percent in 2011 (World Bank 2013a).

Figure 1.4 Countries in East Asia Pacific did not experience large contractions in employment.

Changes in employment, crisis and recovery

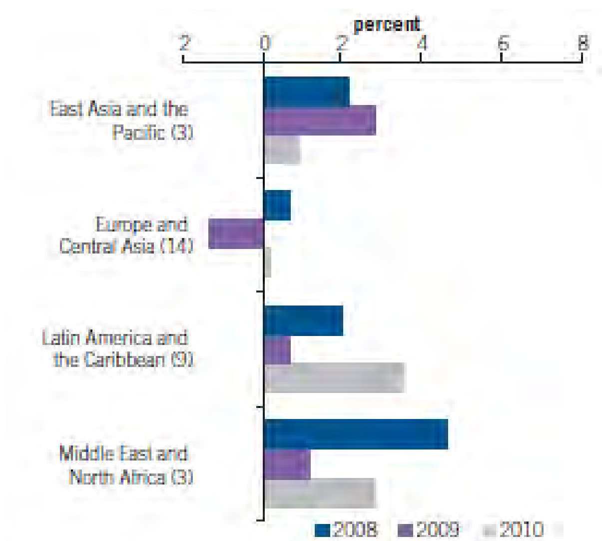


Figure 1.5 There was a downward adjustment in earnings.

Real changes in earnings, crisis and recovery

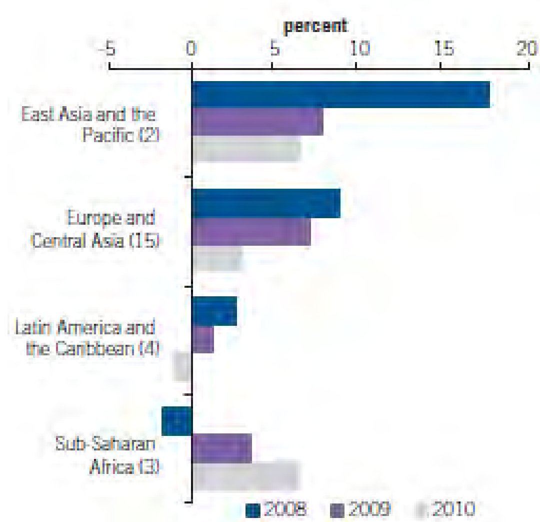
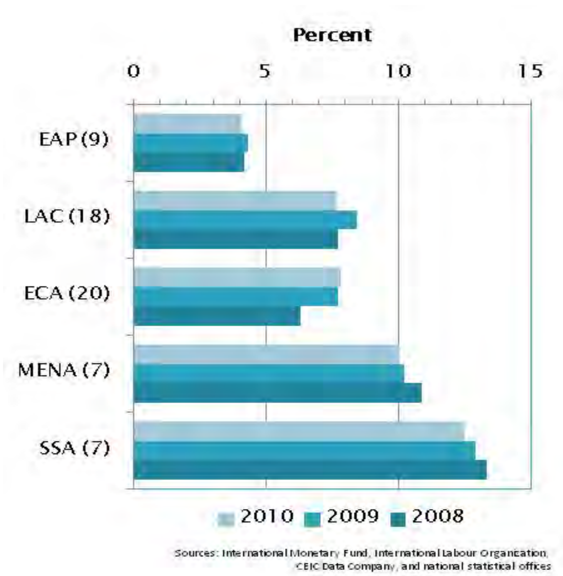


Figure 1.6 Unemployment remained low during the crisis.

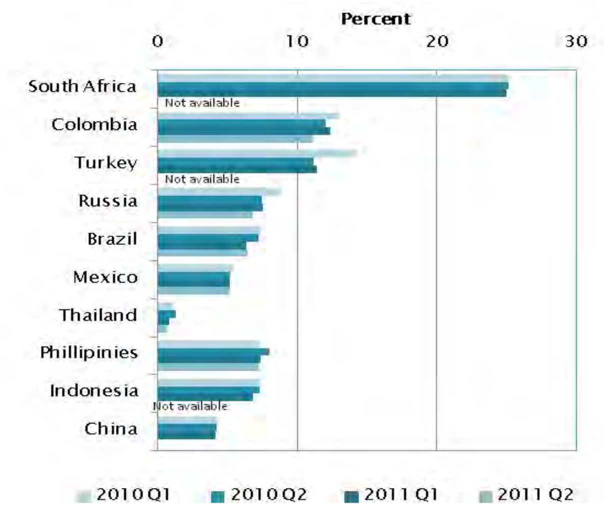
Changes in unemployment (annual),crisis and recovery



Source: World Bank 2011.

Figure 1.7 Recovery has been similarly slow.

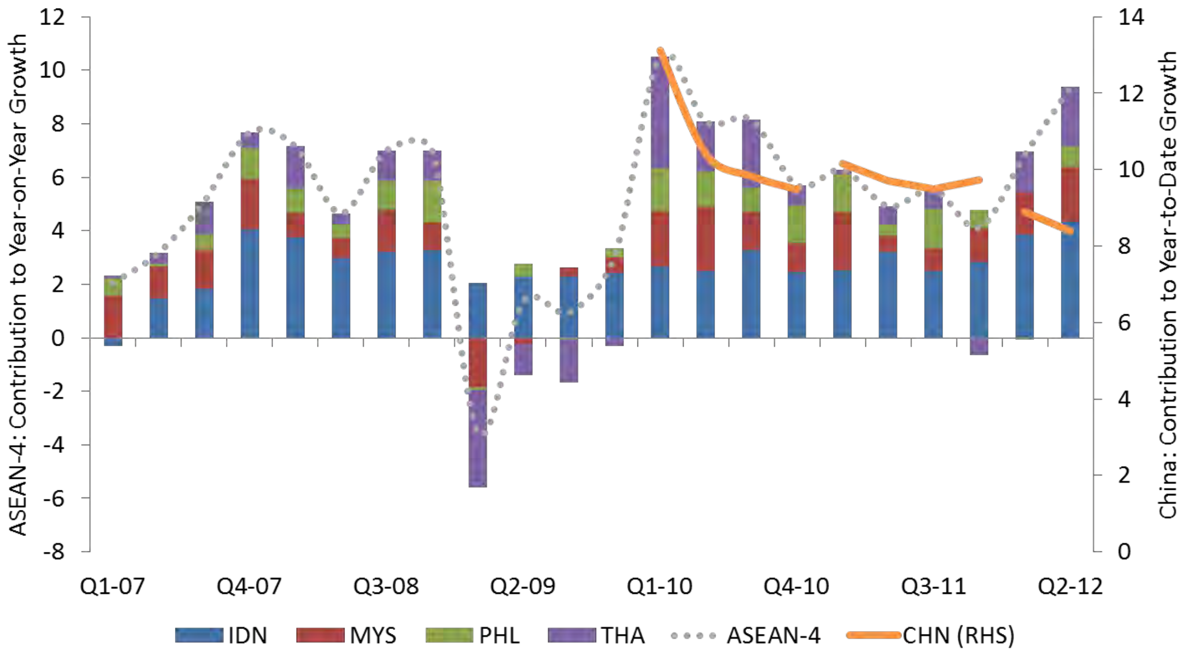
Quarterly unemployment rates during the recovery, selected low and middle income countries



1.15 Despite a positive outlook, the context in which firms demand and households supply labor and human capital is not without challenges. For example, in the wake of the global financial crisis sand economic contraction, the external economic environment continues to be weak, and will be so for the foreseeable future. Annual GDP growth in high income and developing country markets is expected to improve only slightly in the period to 2015. With slow recovery of demand from high-income countries, domestic consumption demand is becoming more important to sustain growth in East Asia Pacific countries. Indeed, consumption and services replaced investment and manufacturing as the dominant drivers of growth in China for the first time in 2013. Figure 1.8 shows domestic demand's contribution to year-on-year output growth for four countries in the Association of East Asian Nations (ASEAN), which has increased since 2007. In addition, with rising labor costs in China, parts of low-labor cost production in the global production chain are on the move. Garment production is moving in greater volume to Mexico, Bangladesh, Turkey and Morocco. The opportunity and challenge for the rest of East Asia is to leverage their comparative advantage in intermediary and final goods trade, and to integrate anew into the changing global supply chain.

Figure 1.8 Domestic demand is becoming more important to growth in East Asian countries.

ASEAN-4 and China: Domestic demand, contribution to year-on-year growth, 2007 – 2012, in percent



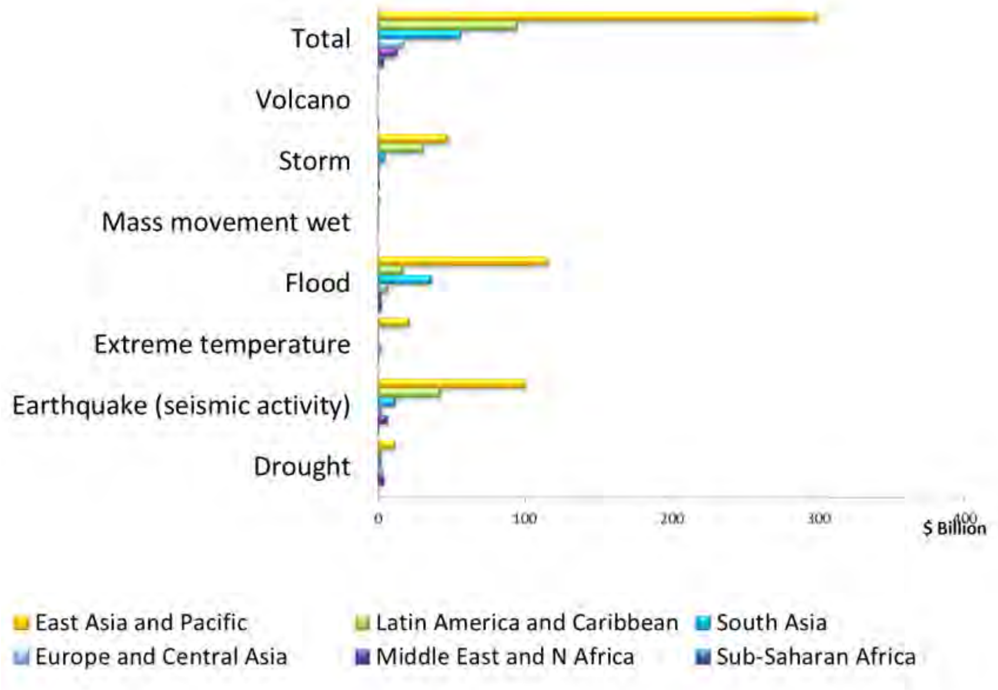
Source: Haver Analytics and China National Bureau of Statistics

1.16 In the midst of these shifting patterns of demand from markets abroad to consumers at home, there are risks to working people in East Asia Pacific that are much harder to assess. Countries in the region face significantly higher and increasing disaster risks which impose substantial economic costs. Disasters have cost the countries of East Asia Pacific more than 300 billion USD since 2000, almost 3 times the cost to countries in Latin America Caribbean (Figure 1.9). The region incurred 61 percent of global losses from disasters in the past 20 years; 40 percent of floods worldwide happened in the region in the past 30 years; and more than 1.6 billion people in East Asia Pacific countries were affected by disasters since 2000, as detailed in a recent World Bank report (Jha and Stanton-Geddes 2013).

1.17 Natural disasters disrupt growth and demand for work, and thus impact disproportionately on poor and lower-income people who rely on work the most. Natural disasters divert government budgets away from essential services and investment, and thereby lower longer term growth prospects. With rising numbers of people and more economic assets in places at risk, losses are likely to rise further. Indeed, with respect to natural disasters, 2011 was the costliest year on record: in the first 9 months, losses in East Asia Pacific amounted to \$259 billion, which was 80 percent of the global total. In relative terms, the Pacific island countries are the most affected globally, with average annualized losses estimated for Vanuatu and Tonga at 6.6 percent and 4.4 percent of GDP respectively (Jha and Stanton-Geddes 2013).

Figure 1.9 Countries in East Asia Pacific face much high disaster risk than elsewhere and bear the largest share of global losses.

(US$) per hazard, by region from 2000-2011

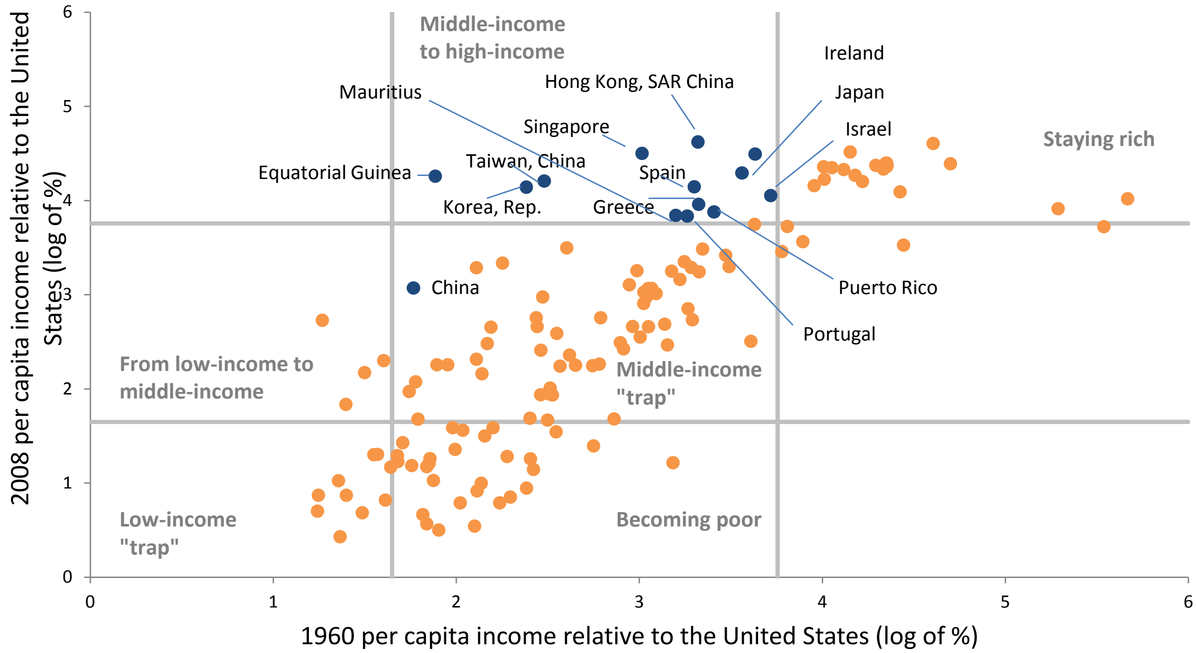


Source: EM-DAT

1.18 A final contextual factor worth mentioning is in many ways a combination and culmination of the previous factors discussed in this section, setting aside natural disaster risks. In the past sixty years, many countries have come into being as modern nation states with very little. Through a slow and painful process of trial and error, governments in these countries have attempted to improve the lot of their people, sometimes through direct measures aimed at spurring industry and employment. But there are still very few "success stories" of economic development, and indeed many stories of failure and back-sliding. Of the few success stories of countries making the difficult transition from low to high-income status, most are in the East Asia Pacific region (Figure 1.10). Why should this matter to working people today and to the governments that serve them? It matters that Japan, Singapore, South Korea, Hong Kong, SAR China and Taiwan, China succeeded, because their success shapes the aspirations of people in the region, what they expect from themselves and from their governments.

Figure 1. 10 : Few countries rose from low to high income, but among those that did, most are in East Asia Pacific.

Per-capita income relative to the United States, 1960 and 2008



Source: World Bank and Development Research Center of the State Council, Peoples Republic of China (2013)

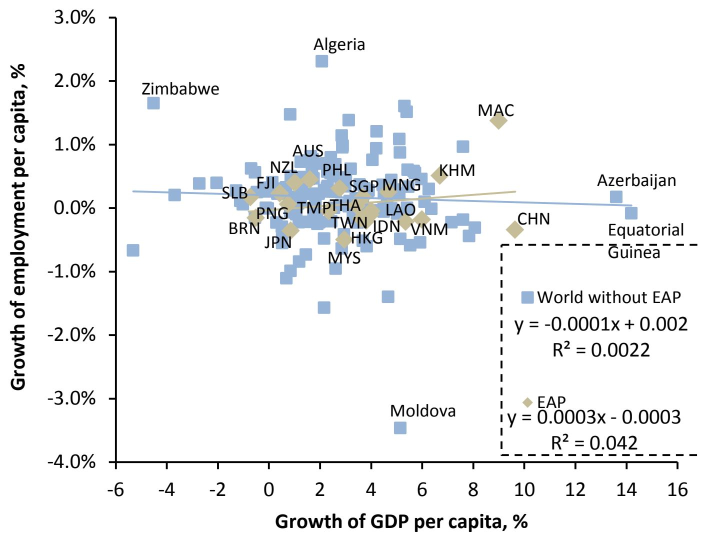
1.2 Has growth in East Asia Pacific been "*jobless*"?

1.19 The sustained high levels of growth in recent decades that set East Asia Pacific apart from other regions are expected to have tremendous impacts on work. Has growth indeed put more people to work? This section examines the empirical relationship between growth and employment and, by doing so, sheds light on whether East Asia Pacific has experienced "jobless growth." The demand for labor is derived from changes in output. While economic growth can affect employment, it matters less in the medium- and long-term than demographic trends and changes in the population dependency ratio (World Bank, 2012a). Changes in demography narrow the extent to which macroeconomic policies and outcomes can affect employment. In addition, for a region where large sectoral shifts in labor are a key part of economic success (discussed further in chapter 3), looking at growth and overall employment can give only a partial picture of the links between growth and work.

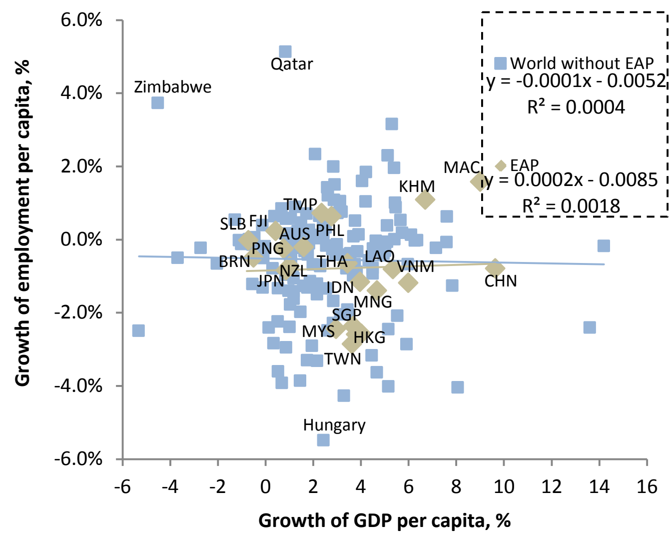
1.20 Following the WDR 2013, we examine the relationship between annual growth of GDP per capita and growth of employment per capita over the period 2000-2010, but for a larger sample of countries. While there is a slight relationship between growth and employment creation in the region, it is statistically very weak (Figure 1.11). As in most regions, the empirical relationship between economic growth and employment creation varies widely across the countries of East Asia Pacific. In the first decade of the 21st century, growth was more clearly associated with a rise in employment in some parts of the region than in other parts.

Figure 1.11 The simple correlation between growth and employment is weak

(a): Annual growth of GDP per capita and the adult employment rate (age 15 and older), 2000-2010



(b): Annual growth of GDP per capita and the youth employment rate (ages 15-24), 2000-2010



Source: Staff estimates based on data derived from World Development Database.
Note: Growth of employment per capita as a share reflects the growth of the employment-to-population ratio (the proportion of a country's population that is employed).

1.21 Among the 23 East Asia Pacific countries with available trend data, 11 experienced no growth or an actual contraction in employment per capita over the period 2000-2010. While the employment rate increased strongly from 2000 to 2010 at an average of 0.5 percent or higher a year in Cambodia and Macao, it dropped strongly at an average of -0.5 percent a year in Malaysia. While gross employment creation has been positive in all countries in the region except Japan, employment growth has kept pace with demographic forces in about half of countries. In the Solomon Islands, for example, in spite of contraction in economic output over the period 2000-2010, the country experienced net employment growth. To contrast, in China, about 74 million jobs were created over the 2000-2010 period, but the average annual growth rate of the ratio of employment to population was -0.34 percent over this period. The high productivity gains experienced in China combined with 0.6 percent annual average population growth have constrained net per-capita job creation in the country.

1.22 Similarly, economic slowdown during the global financial crisis adversely affected employment in some countries but not others. Korea, Taiwan, China, Hong Kong, SAR China, and Timor-Leste did not experience a fall in employment during the period 2000-2007, but they all experienced decline in the wake of the global crisis. This could be explained by their relatively high integration with global markets, and thus high vulnerability to the global contraction in demand. Other East Asian countries generally maintained low levels of unemployment, even in times of economic crisis. Disaggregated quarterly data at the national level indicate that in the Philippines, GDP growth fluctuated wildly over the 2008-2010 period, while the unemployment rate remained very stable and even fell slightly. Similarly, Indonesia experienced a reduction in its unemployment rate despite large fluctuations in GDP growth over the past decade. As economic growth contracted at the onset of the global financial crisis in late 2008, unemployment rates in the East Asia Pacific countries for which quarterly data are available (China, Indonesia, Myanmar, Philippines and Thailand), did not seem to have been affected. People may not have stopped working as a result of macroeconomic shocks but, rather, turned to unregistered and unmonitored 'informal' employment.

1.23 However, the elasticity of employment to changes in the size of the economy in East Asia Pacific countries shows a stronger positive relationship. Hanusch (2013) estimated the elasticity of employment to output in eight East Asian countries where employment trend data are collected with sufficiently high frequency. Table 1.1 presents the results based on a simple regression of the log of the employment rate on the log of real GDP, illustrating the percentage change in employment associated with a one-percent change in output. For the eight countries in the 2001-2011 sample, the effect of economic growth on the employment rate was about 0.3 percent (median: 0.32), ranging from 0.22 in the Philippines to 0.42 in Singapore. Employment creation in the wake of growth was fast in China, Malaysia, and Thailand from 2001 to 2011.[2] In addition, applying the same method as in Crivelli, Furceri and Toujas-Bernate (2012) to estimate the employment-output elasticity, but to a larger panel of countries, and extended the period of analysis from 1990 to 2010, we find that in East Asia Pacific, the average long run elasticity of employment to GDP growth is 0.23.

Table 1. 1 : Growth has had a positive impact on employment since 2001

Elasticities of employment to output, 2001-2011

Country	*Elasticity*
China	0.30
Hong Kong, SAR	0.36
Korea, Rep.	0.24
Malaysia	0.39
Philippines	0.22
Singapore	0.42
Thailand	0.33
Taiwan, China	0.31

Source: Based on data analysis conducted by Hanusch (2012) for this report.

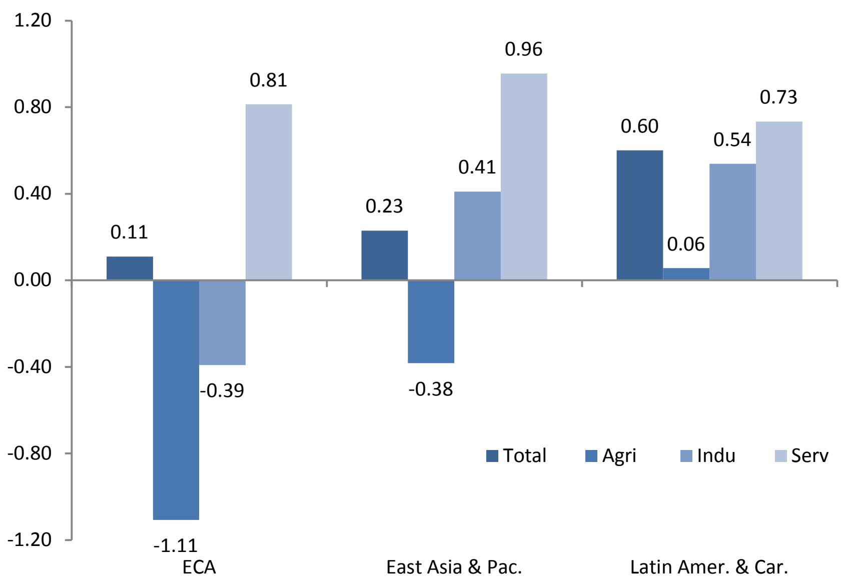
1.24 The elasticity of employment to output also varies considerably by sector. Figure 1.12 shows the results from a cross-country panel regression of the log of employment, total and by sector, on the log of GDP (in constant 2000 US dollars), with employment defined as all forms of remunerative economic activity. As shown in Figure 1.12, the services sector appears to have experienced the highest employment elasticity, and agriculture a negative elasticity in East Asia

[2] A study by Ball *et al.* (2013) examining data for the US since 1948 and for twenty advanced economies since 1980, found that Okun's law has a strong as well as stable relationship in most countries, which did not vary significantly during the global economic recession. The authors argue that their estimate of Okun's law coefficient—i.e. the effect of a change of 1 percent in output on the unemployment rate—differs largely between countries, in part explained by characteristics of the labor markets other than employment protection legislation.

Pacific. Similar differences across sectors are found for Europe Central Asia. With China's strong growth driving the East Asia Pacific average, the service sector, which is more labor-intensive than industry, surpassed industry in its contribution to overall GDP as of early 2013.

Figure 1.12 Growth creates more employment in the services sector than in other sectors

Elasticity of employment to economic growth by country groups, over the period 1990-2010



Source: Staff calculations using WDI data.

Note: MIC (Middle Income Country). It is worth noting that employment and GDP largely stagnated in Sub-Saharan Africa over this period. In the figure, data are disaggregated by sector for all regions with at least 17 observations out of the 21 years of data, i.e. comparisons with other regions are not possible given the limited number of observations.

1.25 There are three important messages for readers to take away from this section. First, the relationship between economic growth and employment is not something that can be taken for granted. Second, the statistical evidence is mixed, weak where it is significant, and can vary according to the tools applied to the data that are available. Third, and most importantly, prior analysis by others and that which we have conducted for this report is consistent on one basic conclusion: the demand for work is a derived demand. Thus while economic growth may not be sufficient for employment, East Asia Pacific's high rates of economic growth have certainly been necessary to sustain the improvement in employment outcomes.

1.3 Roadmap to the report

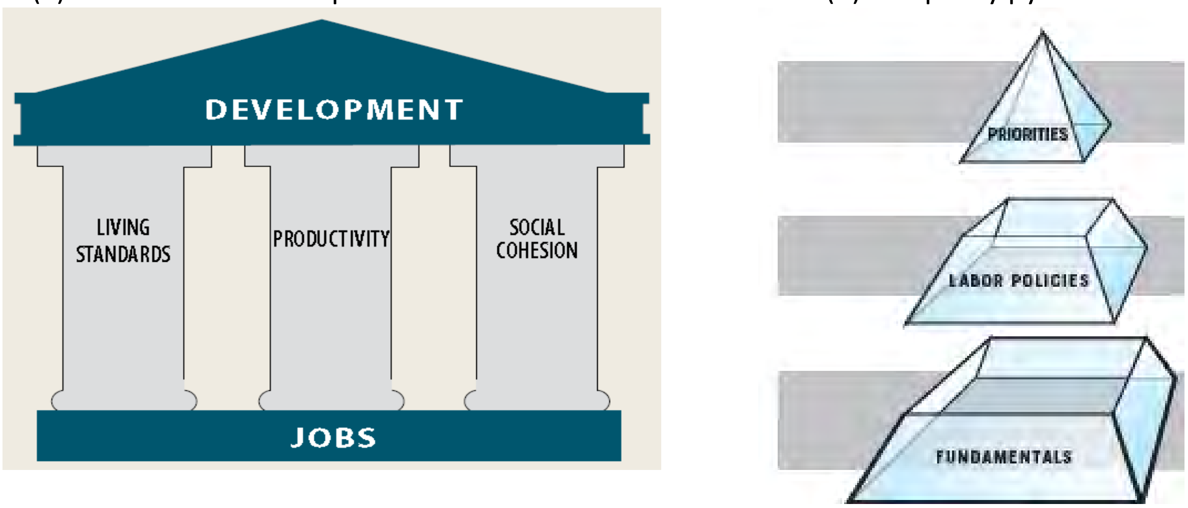
1.26 This chapter has shown that East Asia Pacific is exceptional in many ways, particularly in ways that influence the supply and demand for labor and human capital, and thus the wellbeing that people derive from work. High rates of economic growth in most East Asia Pacific countries have been important. However, despite undeniable economic progress and relatively favorable employment outcomes relative to countries elsewhere, the concern among policy makers in the region is not only for the quantity of work but the quality of work available to people. Households in East Asia Pacific countries and the governments that serve them are starting to question how policies can ensure that employment continues to improve wellbeing. Indonesia has experienced mounting pressure to increase earnings from work (World Bank 2012a). The Government of the Philippines has sharpened its focus on creating 'better' (higher-paying) jobs (World Bank 2013b). Governments in Vietnam, Laos and Malaysia are paying particular attention to productivity and the skills of their workforces. In the island countries of the Pacific that experience very different economic forces shaped by formidable geographic constraints, the substantial --even growing--share of youth in the population and the large number of these young people who are not working, provide similarly strong motivation for governments to pay increasing attention to employment.

1.27 The concerns and pressure on governments to focus on work and wellbeing are not surprising. The WDR 2013 argues that jobs are the channel of three critical transformations that drive development: higher productivity, rising living standards, and greater social cohesion. In the parlance of the WDR 2013, productivity gains happen through jobs. Jobs provide earning opportunities, lift people out of poverty, and contribute to life satisfaction. Lastly, jobs shape values and behavior, and affect the distribution of outcomes in society in ways that influence social cohesion. The WDR also proposes a policy pyramid for governments to structure their thinking and responses to the challenges faced by working people: starting at the base with policy 'fundamentals' (monetary and fiscal policy, the investment climate, and human capital policies), then labor and social protection policies, and at the top, policy priorities that vary widely according to countries' particular 'jobs challenges'. Readers who are familiar with the WDR 2013 will recognize these tools reflected in the structure of this report (Figure 1.13).

Figure 1.13 The WDR 2013 presents conceptual tools used to structure the arguments of this report.

(a) Jobs and the development transformations

(b) The policy pyramid



Source: WDR 2013

1.28 In the remainder of Part I of the report, chapter 2 presents a broad range of descriptive statistics to show the diverse profile of the region's demography, labor supply, and labor demand. It underscores the many ways and many places where people work. Wage and salaried employment is only a small segment of working people in emerging economies in the region. In chapter 3, we argue that the contributions of work to well-being in East Asia Pacific are starting to change. That chapter demonstrates the importance of work in bringing about all three development transformations - higher productivity, rising living standards, and greater social cohesion – in the countries of East Asia Pacific in recent decades. Chapter 3 also presents evidence of one or more of those transformations now starting to lag. We argue that these lags explain the mounting pressure on governments to become more activist to sustain the wellbeing people derive from work.

1.29 In Part II of the report, we take account of current policies and evidence of their impact on employment. Reflecting the bottom two layers of the WDR policy pyramid, Chapters 4, 5 and 6 examine monetary and fiscal policy, and the investment climate, human capital policies, and labor market institutions, regulations, interventions. The purpose of these chapters is to take stock of current policies, and determine whether on balance the framework governments have put in place is "pro employment". Where available, we have gathered evidence of the impact these policies have on the demand and supply of labor and human capital.

1.30 In Part III of the report, we discuss policy directions. The three final chapters discuss whether countries in East Asia Pacific need 'jobs strategies' and what these strategies might entail to foster a better environment for work in the region. Chapter 7 applies the WDR 2013 "jobs challenges" typology (Agrarian, Urbanizing, Formalizing, Aging; High Youth Unemployment, Resource Rich, Small Islands, Conflict-affected) by mapping the countries of

East Asia Pacific to these types using several empirical measures and thresholds to categorize countries. In doing so, the chapter highlights the relatively greater diversity in the East Asia Pacific region, compared to other low- and middle-income country regions. In East Asia Pacific at least one country can be mapped to every type, and a greater number of countries are likely to be mapped to more than one type. Chapter 8 delves deeper into the economic geography of the Pacific island countries; how the challenges faced by working people in these countries are not only unique in the region, but unique in the world; and what governments concerned with employment and wellbeing in this corner of the region can do given these challenges.

1.31 Finally, chapter 9 closes this report with a call for action, arguing that "business as usual" is not an option. The chapter points out that whereas governments in East Asia Pacific have been slower to intervene in the past (than for example, governments in Latin America Caribbean, South Asia, and in emerging markets in Europe Central Asia), the stage of development in which most countries in the region find themselves may make greater intervention necessary to surmount the challenges faced by working people and sustain wellbeing from work. The chapter argues, however, that intervention in East Asia Pacific countries need not take the form of outdated, imported models from other regions that tend to favor men in full-time, dependent employment in the manufacturing sector. Intervention can instead support all working people in East Asia Pacific, regardless of the location, sector or how they work, today and in years to come.

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Chapter 2: The demand and supply of labor and human capital

Countries in East Asia Pacific are especially diverse when it comes to where and how people work.

2.1 This chapter brings to bear available data to show the diverse profiles of firms demanding work and individuals and households supplying work in East Asia Pacific. Across and within countries of the region, we demonstrate the many different ways and places where people work, from micro and small firms to large corporations, from self-employment to wage dependence. Our description of demography, supply and demand for labor and human capital --including key characteristics and dynamic trends —also shows how East Asia Pacific as a region differs from other regions and how the countries that make up East Asia Pacific vary substantially from one another.

2.2 On the demand side of work, the private sector accounts for the majority of employment created, as in other parts of the world. A key exception to this general observation is employment in the small Pacific island countries, where demand from the public sector is substantial. Small firms are an important segment of employment creation across the region, albeit with a substantial degree of churning. Critically, only a few of these firms grow to sustain increased demand for work. On the supply side of work, the region's labor force has several distinct features: high rates of participation in markets, including the participation of women in market activities; substantial labor mobility within and between national borders; and adequate access to education. Many of those participating in the labor force work in the primary sector and outside of wage employment. More broadly, work in East Asia Pacific is characterized by a high degree of "informality" across several measures, explaining the growing concern of households and policy makers in the region not only for how much work is being created, but also where and how people are working.

2.3 The basic profiles of demand and supply that are presented in this chapter provide the foundation for deeper analysis of the development transformations propelled by work in Chapter 3. These profiles are a result of many factors--including growth, changes in technology, productive assets, the investment climate, and labor policy. The policies that shape demand and supply of labor and human capital are covered in Part II of this report. The diverse ways and places where East Asia Pacific people work will have important implications for policy to ensure that work continues to increase productivity, raise living standards, and strengthen social cohesion, a discussion taken up in Part III.

2.1 The demand for work: A profile from firm surveys

2.4 The private sector is the main engine of employment creation, accounting for 90 percent of employment in the world (World Bank 2012a). The private sector has led employment growth in China, for example, by a remarkable margin. From the early 1980s to early 2000s, China's private sector employment grew from 2.3 million workers to 74.7 million. In contrast, the volume of employment in state-owned enterprises (SOEs) dropped from 80 million to 74.6 million (Kanamori and Zhao 2004, cited in World Bank 2012a). Household survey data indicate that, for most countries in East Asia Pacific, the share of people working in the public sector is less than 5 percent. A significant exception to this pattern can be found in some of the small Pacific island countries, covered at length in Chapter 8. Within the private sector, the potential for net employment creation varies substantially across firms, depending on size and age of the firm, as well as on the gender of the owner.

2.5 Most working people in East Asia Pacific countries earn their living in micro, small and medium enterprises.[1] Figure 2.1 shows the share of employment by firm size using the World Bank Group's Enterprise Surveys. These surveys include only registered firms with at least 5 employees. In Lao PDR, Tonga, and Vanuatu, small enterprises are the major employers, while in Mongolia and Thailand, small and medium enterprises (SMEs) with fewer than 100 employees employ the most people. In Vietnam, the Philippines, Fiji, and Indonesia, large firms account for the majority of employment. But even in those economies, total employment is still spread out across all types of firms in different size categories.

2.6 It is important to note that these data do not provide the full picture of demand. Given the frame from which their samples are drawn, enterprise surveys censor very small, unregistered family enterprises. Based on a more representative sample of firms from firm censuses, small businesses account for a bulk of employment (Figure 2.2). In Thailand, the Philippines and Indonesia in particular, most people work in micro, small and medium enterprises, defined in figure 2.2 as having fewer than 200 employees.

2.7 Employment also varies by firm age and whether the owner is a woman or a man. For example, firms headed by women in East Asia Pacific are on average smaller than firms headed by men. Around 33 percent of small enterprises in Indonesia have a woman manager, while only 14 percent of large and 20 percent of medium firms, respectively, are run by women (World Bank, 2012b). In addition, more mature firms account for most employment in East Asia Pacific countries. Figure 2.3 shows the share of employment by a firm's age. In most countries of the region, firms that are more than 10 years old have at least 50 percent employment shares. Timor-Leste, where the largest employers are firms less than two years old, is a notable exception to this pattern.

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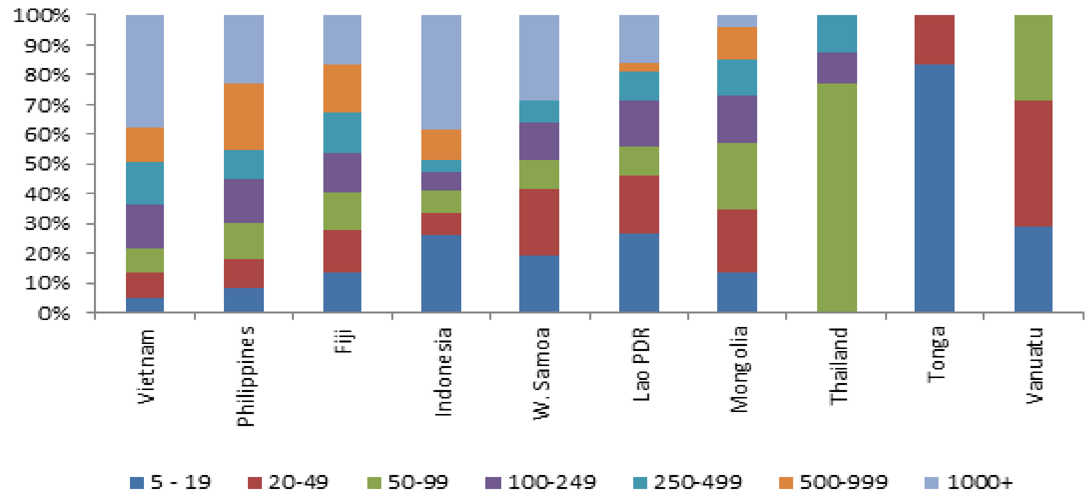
[1] Various definitions of small and medium enterprises (SME) exist. The typical SME categories include SME100, SME200, and SME250, which correspond to the maximum size thresholds of 100, 200, or 250 employees, respectively.

Figure 2.1 The share of employment in small and medium enterprises varies substantially across countries

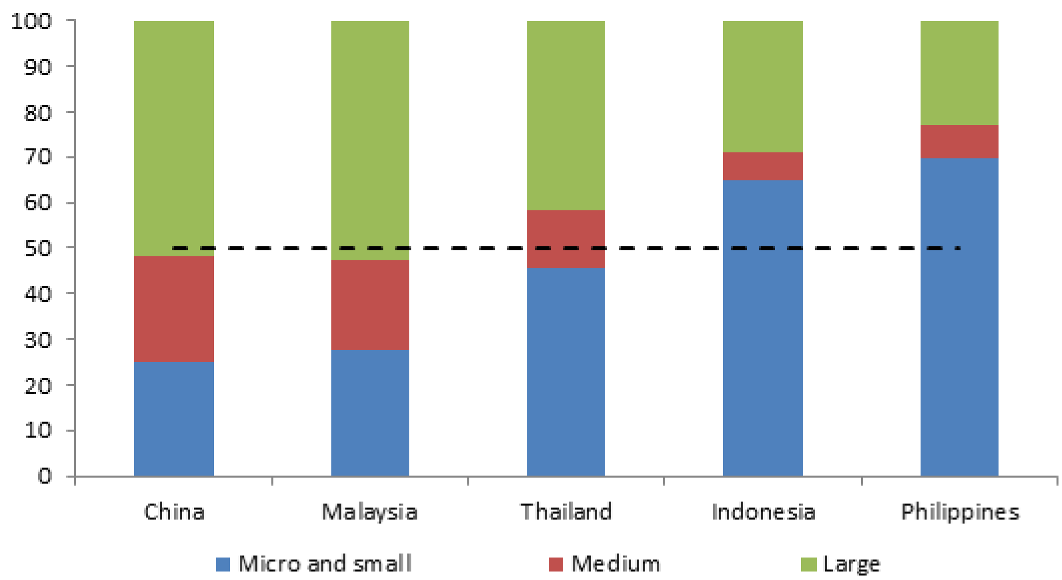
Share of Total Employment by Enterprise Size Category (%)



Source: Ayyagari, Demirguc-Kunt and Maksimovic (2011) based on World Bank enterprise surveys 2006-2010.
Note: In Thailand, the category 50-99 employees enterprises comprises all enterprises with size below 100.

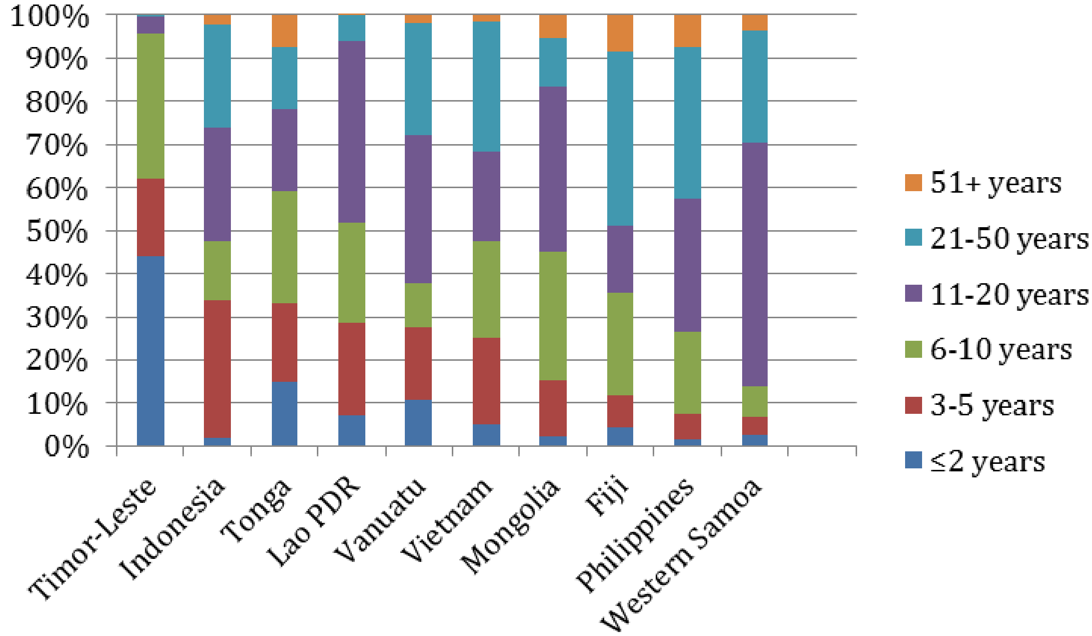
Figure 2.2 Micro, small and medium enterprises employ a large fraction of the labor force

Share of Manufacturing Employment by Enterprise Size Category (%)



Source: ADB (2009).
Note: Notes: Micro and Small: 1–49 workers in all countries except Thailand (1–50 workers); Medium: 50–199 in all countries except Thailand (51–200 workers); Large: 200 or more workers in all countries except Thailand (more than 200 workers). Data used: China: National Economic Census (2004); Indonesia: Economic Census (2006); Malaysia: Annual Survey of Manufacturing Industries (2005); Philippiens: Annual Survey of Philippine Business and Industry (2005); Thailand: Industrial Census (2007). Estimates for the Philippines, Thailand and Malaysia include imputation for the self-employed based on differentials between labor force survey and enterprise survey/census data.

Figure 2.3 Mature firms account for most employment in East Asia Pacific

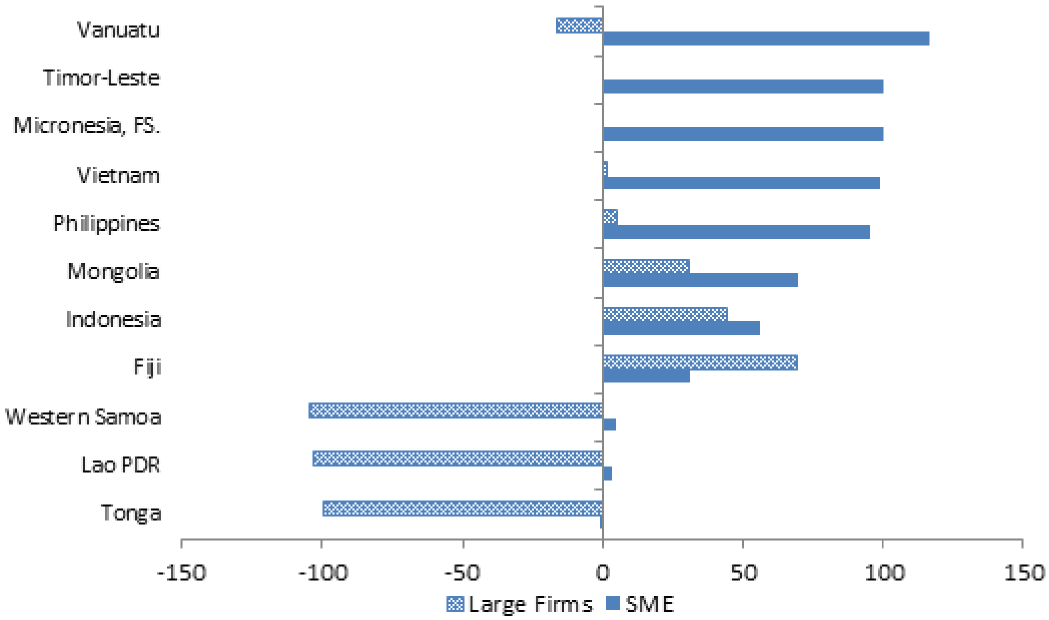


Source: Ayyagari, Demirguc-Kunt and Maksimovic (2011) based on World Bank enterprise surveys 2006-2010.

2.8 The segments of SMEs and young firms, together, account for the majority of new employment created in East Asia Pacific. Based on the enterprise surveys collected between 2006 and 2010, over 70 percent of the employment creation in the countries of East Asia Pacific happened in small firms with less than 20 employees (Ayyagari, Demirguc-Kunt and Maksimovic, 2011). SMEs accounted for most of employment creation in those countries with available data, while large firms accounted for the most employment destruction (Figure 2.4). More than half of new employment is created by firms that are less than six years old. This pattern is particularly stark in Indonesia, Timor-Leste, and Vietnam. Lao PDR, Samoa and Tonga experienced a net employment loss driven by the destruction of employment in relatively mature firms (Figure 2.5). These observations need to be taken with an important caveat: the data collected by enterprise surveys do not follow the same firms over time. As a result, the data include only the surviving firms but miss firms that have gone out of existence and the employment lost in firms that were liquidated between survey years. This important selection bias in the data makes it difficult to separate the employment creation of existing SMEs from new employment created by new entrants.

Figure 2.4 SMEs account for the majority of employment creation in East Asia Pacific countries.

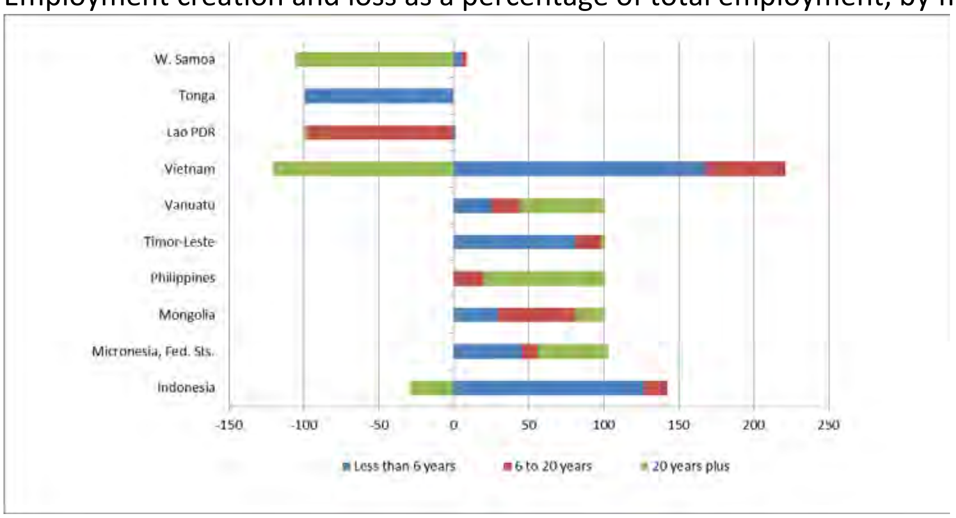
Employment creation and loss as % of total, by firm size



Source: Ayyagari, Demirguc-Kunt and Maksimovic (2011) based on World Bank enterprise surveys 2006-2010.

Figure 2.5 More than half of new employment is created in young firms.

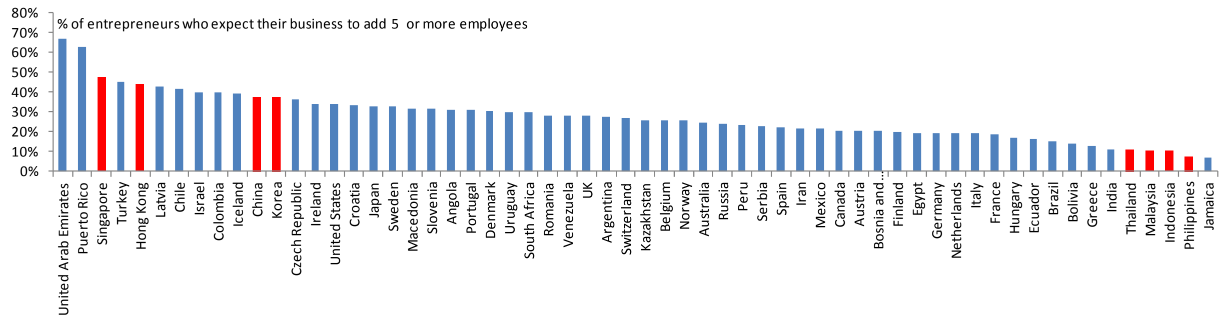
Employment creation and loss as a percentage of total employment, by firm age



2.9 Yet many firms in the region start off and remain small. The 2006-2009 enterprise surveys show that most registered firms stay at the same size category after three years. Small firms rarely grow into medium and large firms. In East Asia Pacific countries, 1.5 percent of small firms on average grew to medium size firms, and 3.3 percent of medium firms grew to large size firms after three years. Firms in Vietnam and the Philippines appear exceptional in this regard: 24 percent and 23 percent, respectively, grew to a larger size category. The Philippines also had an exceptional share of firms that grew from medium to large size: 27 percent. This performance was followed by Vietnam and Thailand with 10 percent and 9 percent of medium firms growing into large firms, respectively. Many of the firms that moved from the small to medium category in Lao PDR and the Philippines were in retail and wholesale trade. The firms that moved from the medium to large category were mostly in the garment industry in Lao PDR, retail and wholesale in the Philippines, and auto components in Thailand.

Figure 2. 6 Most new firms in middle-income East Asian countries do not expect to increase employment

Percentage of responding enterprises who expect to add five or more employees



Source: Global Entrepreneurship Monitor (2010)

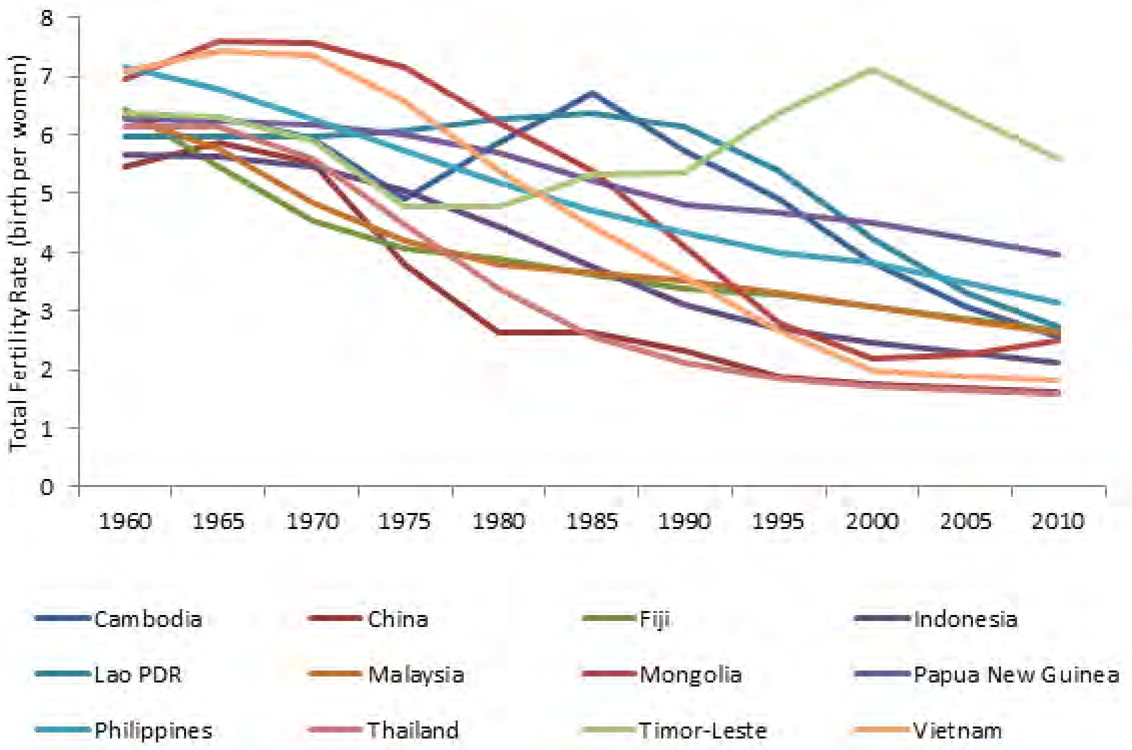
2.10 In fact, owners of small firms often have little intention to grow. This is in part because many have started out in business out of necessity, and as a substitute for dependent employment, rather than a desire or talent for entrepreneurship. The Global Entrepreneurship Monitor recently surveyed self-employed people in several countries, including China, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand. The survey results show that the share of adults who start their own business in middle-income countries of East Asia Pacific is high compared to countries in other regions. The share of those who report that they start a business out of necessity is also high relative to countries elsewhere. In China in 2002, 52 percent of self-employed people and employers claimed to be involved in entrepreneurship out of necessity. That share dropped to 37 percent in 2012 (GEM, 2013). In Vanuatu in 2010, 38 percent of self-employed and employers claimed to have their own enterprises by necessity, and only 4 percent expected to add more than five employees in the following five years (GEM 2013). Similarly low shares of entrepreneurs in Thailand, Malaysia, Indonesia, and the Philippines expect to significantly expand employment (Figure 2.6).

2.11 The lack of strong growth and further employment prospects among micro and small enterprises, despite being an important segment of the economy where people work, is a reflection of the business climate (International Finance Corporation, 2013). Chapter 4 will discuss this topic at length. The most binding constraints on firm growth and demand for employment vary by country. But some commonly reported obstacles in East Asia Pacific countries stand out, including lack of access to finance, a shortage of people with the right skills, problems with electricity supply, and competition from the informal economy (International Finance Corporation 2013, World Bank 2013a).

2.2 A profile of the labor force in East Asia Pacific: Who is working and where?

2.12 East Asia Pacific's demography is changing rapidly. Many East Asian countries will soon cease to benefit from the 'demographic dividend', a period in most countries' evolution when the share of dependent children and elderly relative that of working age is particularly low. Fertility rates in most of the countries that make up the East Asia Pacific region have been falling fast, causing their populations to "age" quickly (figure 2.7). Middle income countries in East Asia Pacific have the lowest average fertility rate among countries at this level of development. High income Korea has the lowest fertility rate in the world at 1.2 births per woman in 2011. Thailand and China are not far off.

Figure 2.7 Falling fertility is driving rapid population aging in many East Asia Pacific countries
Fertility rates in selected East Asia Pacific countries (average births per woman)

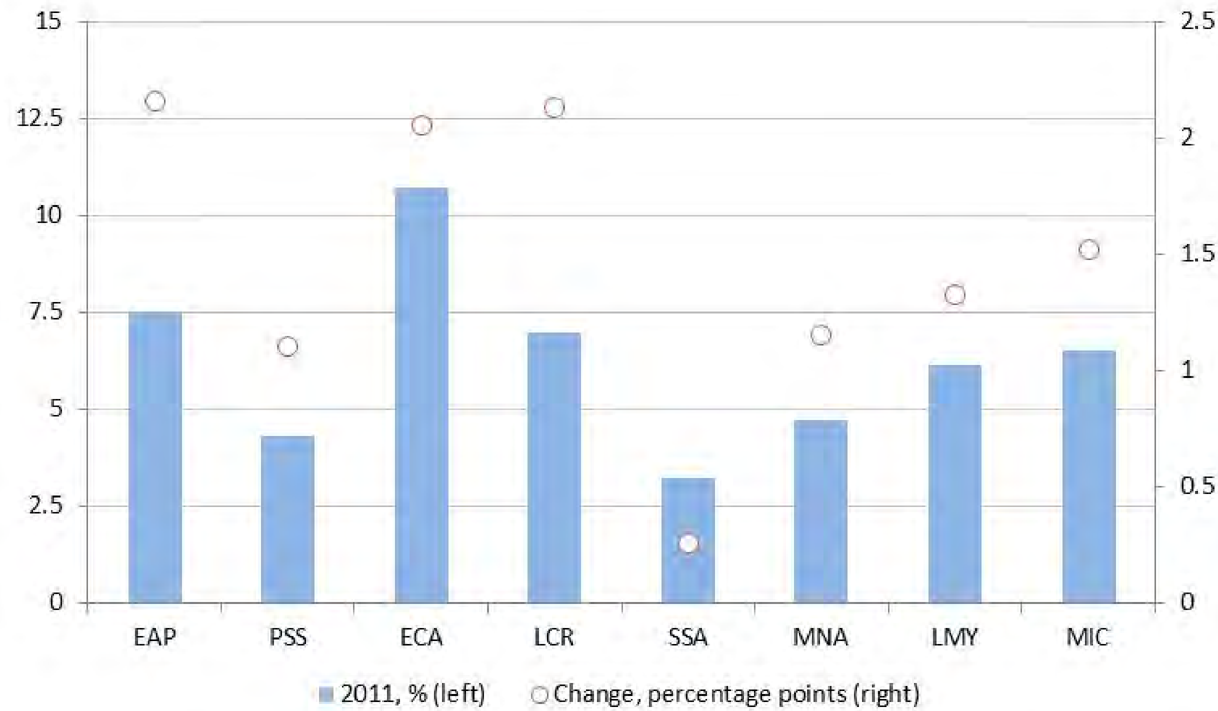


Source: World Development Indicators

2.13 The old-age dependency ratios –the ratio of the population 65 and older to that of working age- have been rising steadily, putting increasing pressure on the working-age populations. In the past couple of decades, the share of elderly people in the population has grown faster than any other low and middle income country region (Figure 2.8). High income Japan, with the highest average life expectancy in the world may be a preview of what many in the region can expect. These demographic factors shape the size and composition of the labor force and, in turn, influence employment and productivity in the economy. The rapid demographic shift is thus an important transition for the region that we return to in this report several times, and which heavily influences the conclusions and messages for policy makers presented in Chapter 9. Even in the Pacific island countries, many of which are still "young" and have yet to experience their demographic transition, governments are worried about rising dependency rates. Years of poor nutrition and bad habits have sparked an epidemic of non-communicable "life-style" diseases that can have a similar impact on the size and composition of the labor force as aging.

Figure 2. 8 The populations of countries in East Asia Pacific are "aging" faster than others

Population 65 and older, percentage of total population in 2011, and percentage point change 1990-2011



Source: World Development Indicators, 2013. Note: LMY, Lower middle income average; MIC, Middle income country average.

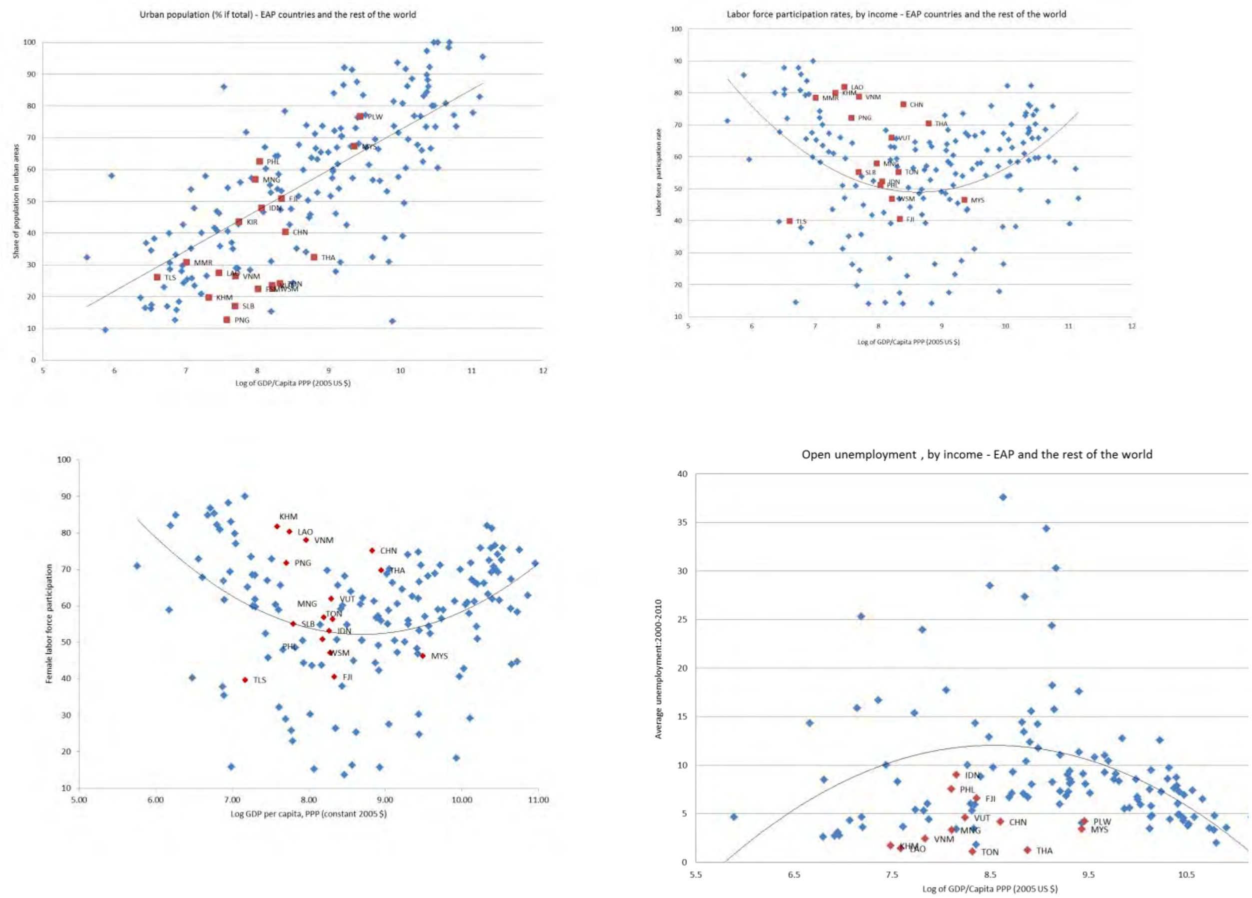
2.14 Who is working in East Asia Pacific countries? Figure 2.9 presents key demographic and labor force participation data in cross section for two reasons: first, to show how East Asia Pacific countries as a group are different from other countries; and second, to show how different East Asian countries -and particularly those in the Pacific- are from each other.

2.15 The first important characteristic to note is that most people in East Asia Pacific countries still live and work in rural areas. This is particularly apparent for Pacific island countries. The share of the population living in towns and cities –although growing faster in the period 1990-2011 than in any other region– remains lower than expected given levels of development (proxied by income per capita). The second important characteristic is that the share of the population participating in the labor force (working or seeking work), is higher in most of the countries of East Asia Pacific than in comparable countries elsewhere. Countries in East Asia Pacific have much lower rates of open unemployment than other countries at similar income levels. In the East Asian countries, young people (ages 16-25) are more likely to be economically active than elsewhere. So are older people (ages 56 and above). Inversely, Pacific island populations are younger and have lower youth participation rates. We take up the discussion of youth inactivity, unemployment and the implications for productivity and social cohesion in Chapter 3.

2.16 Another important distinction of labor supply in East Asia Pacific countries is that women represent a larger share of the labor force than in other parts of the world. Malaysia is the notable exception to this observation in East Asia, and so are a few other countries in the Pacific. Among younger cohorts of the population, labor force participation of women has risen over time. Women are increasingly moving out of household work and family owned enterprise, into non-agricultural employment and migrating to cities for employment opportunities. Yet wage gaps between men and women persist and tend to increase with age. These gaps can reflect many factors, including women's lower average levels of experience caused by gender differences in endowments, career interruptions during childbearing years, and occupational and sector segregation (World Bank 2012)

Figure 2. 9 : The labor force in East Asia Pacific is still very rural, participation in markets is high, particularly of women, and open unemployment is low

Population living in urban areas, labor force participation, women in the labor force, and open unemployment

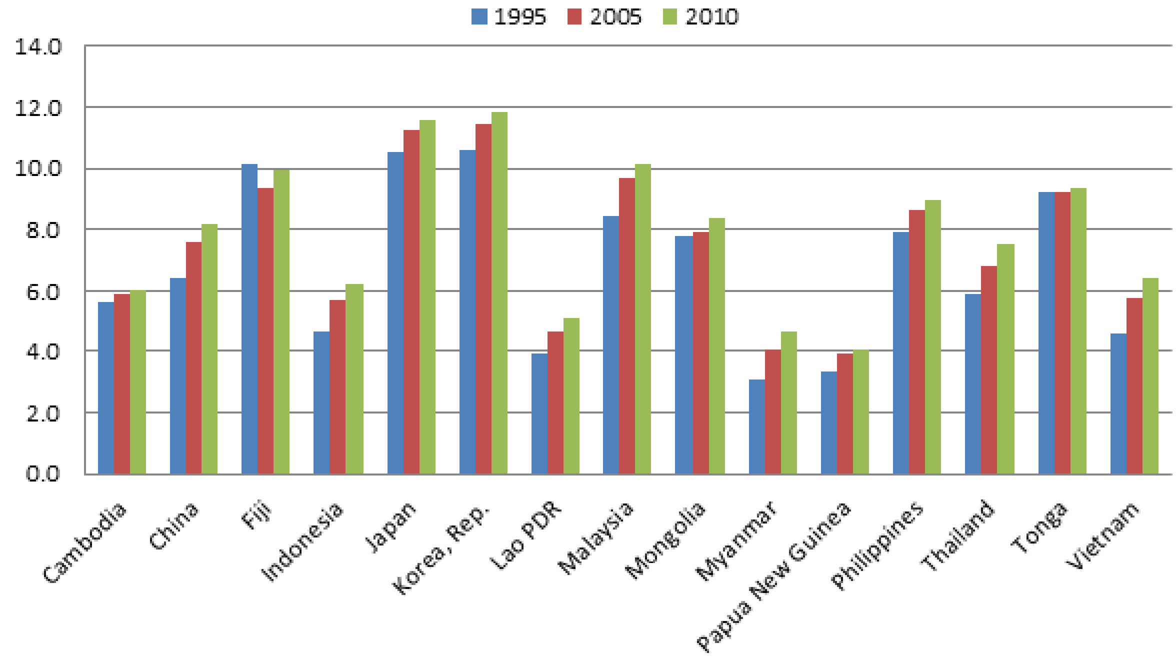


Source: World Development Indicators

2.17 The labor force in East Asia Pacific, both men and women, is relatively well schooled. Primary school completion rates are at least 80 percent for both girls and boys in most countries. The average years of schooling in the adult population has also increased in most countries (Figure 2.10). These achievements are a result of favorable economic growth and good human development policy in many parts of the region. Expanding and deepening education access, however, do not necessarily equate to an adequately skilled labor force. In Chapter 5, we present evidence of important ‘gaps’ in the abilities on offer and what employers say they need. In Chapter 5 we also discuss how human capital policies can help shape the optimal investment in skills and supply of skills in the labor force.

Figure 2. 10 Access to schooling and educational attainment has grown substantially in most East Asia Pacific countries

Average years of schooling in the population 15 years and older



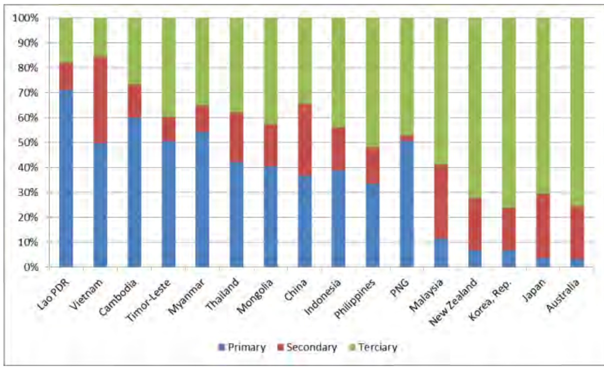
Source: World Bank 2012a Statistical Tables.

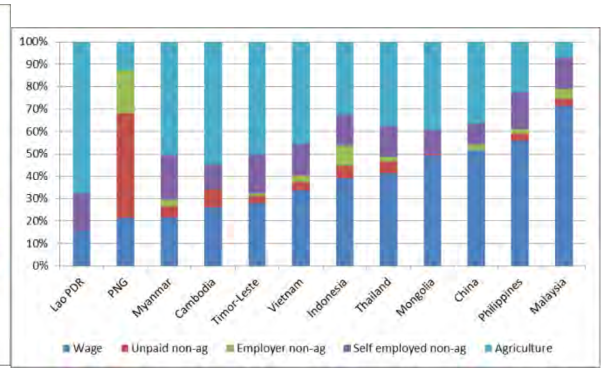
2.18 Where are people working? The composition of the labor force is certainly diverse within countries, spanning various types of economic engagement, and across countries in East Asia Pacific. A large share of the labor force still works in the primary sectors, specifically agriculture. This ranges from about 34 percent in the Philippines to 70 percent in Lao PDR (Figure 2.11a). Wage and salaried employment is a minority share of work: less than 40 percent of working people in low and lower-middle income East Asia Pacific today are in wage employment (Figure 2.11b). This share remains around 50 percent for the higher middle-income countries of East Asia, and surpasses 70 percent only in Malaysia.

Figure 2. 11 Many people are working in the primary sector and are not in dependent wage employment

(a) Distribution of employment by sector (circa 2010)

(b) Distribution of employment by status (circa 2010)



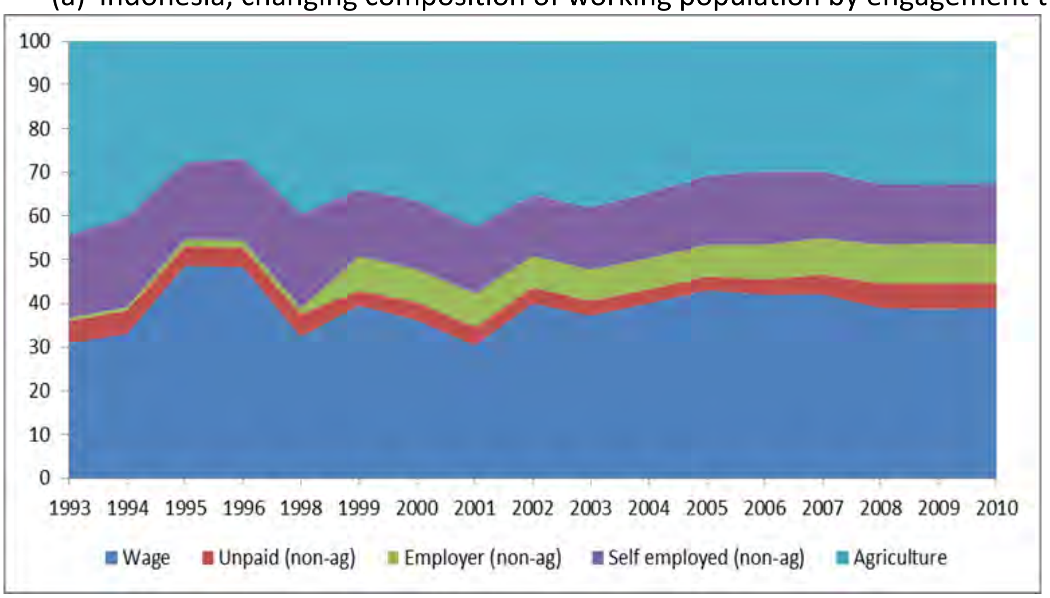


Source: I2D2, China NBS. Note (data for China is for urban areas only)

2.19 Overall employment share in agriculture has been on the decline over the past half century, but the speed of change varies across countries. The fraction of the region's workforce in agriculture fell from approximately 60 percent in 1991 to just above 40 percent in 2008. But in the countries where available survey data allow us to track changes, the profile of the labor force by type of economic engagement has remained fairly stable. In East Asia, only Indonesia and the Philippines offer an adequately long time series of comparable labor force survey data to shed light on workforce dynamics. Figures 2.12(a) and 2.12(b) suggest only small increases in the share working people in wage employment and, correspondingly small decreases in the share working in agriculture in Indonesia and the Philippines from the 1990s to 2010.

Figure 2. 12 The distribution of working people by type of engagement is fairly stable over time in Indonesia and the Philippines

(a) Indonesia, changing composition of working population by engagement type (%)



(b) Philippines, changing composition of the working population by engagement type (%)

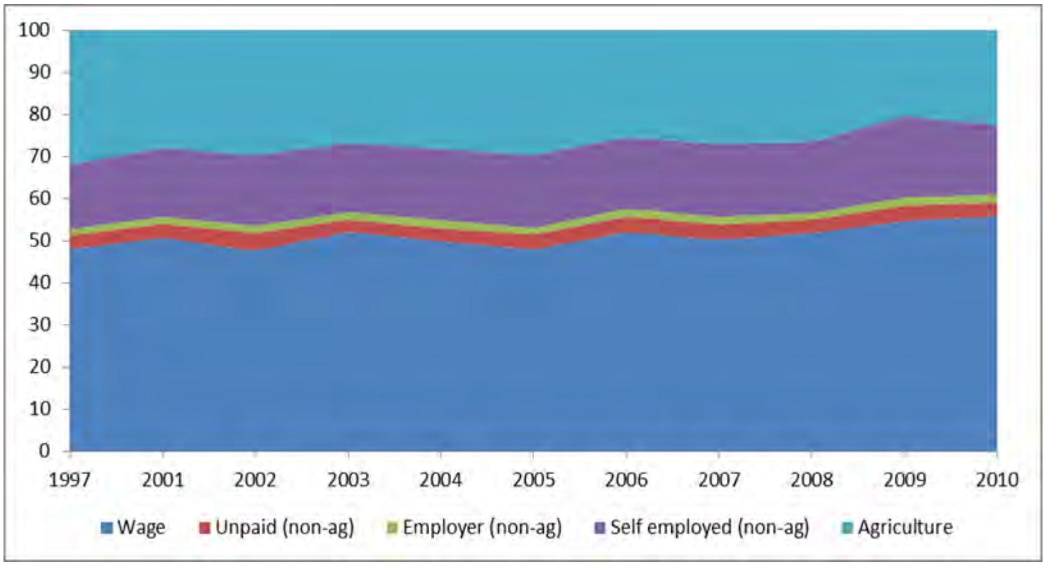
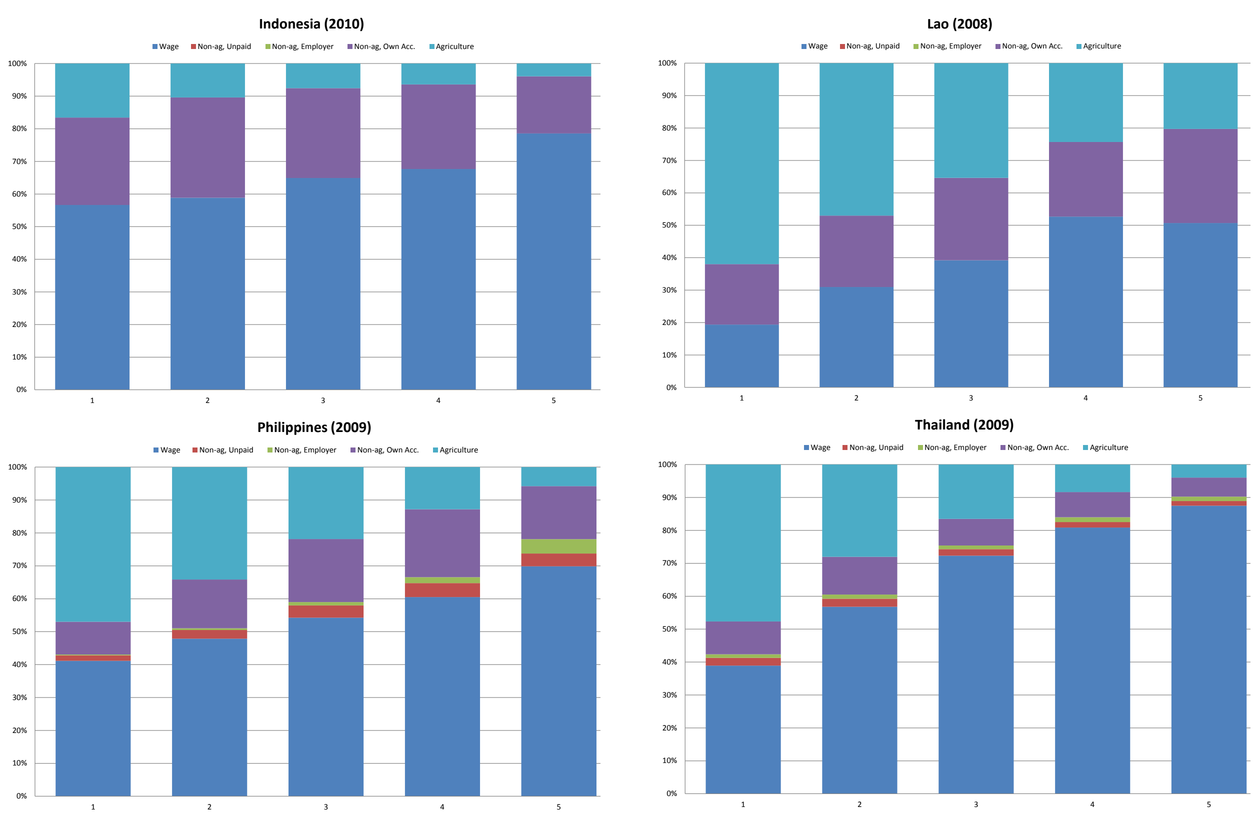
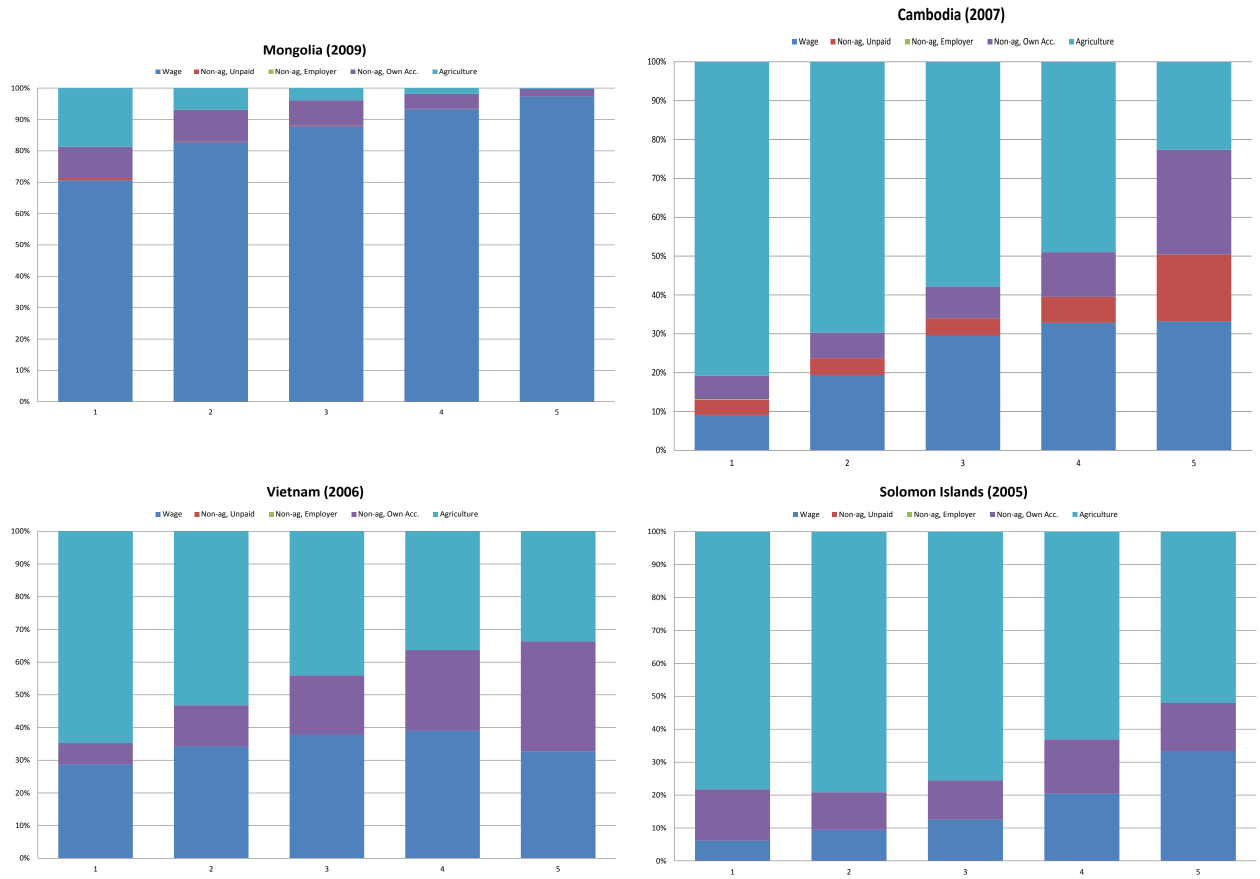


Figure 2. 13 Dependent wage employment is not the dominant form of economic engagement in East Asia Pacific

Form of work engagement (share of working people) by income quintile





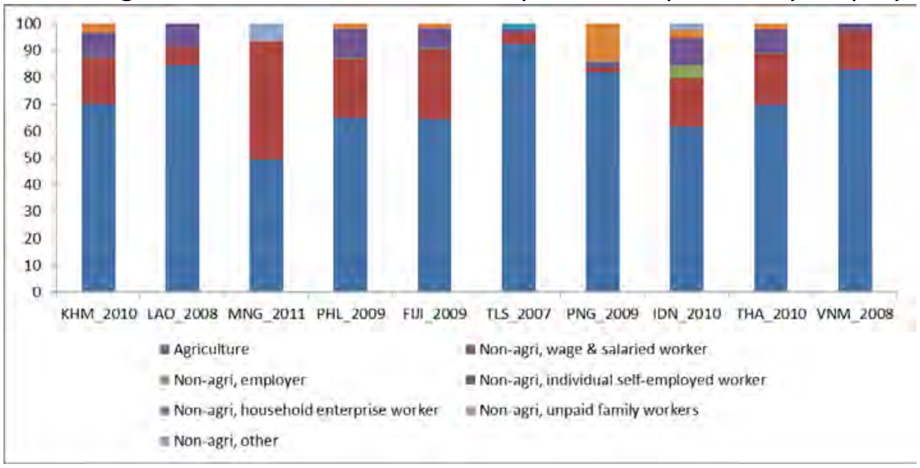
Source: I2D2

Within countries, the composition of the labor force by type of engagement also varies. In all of the East Asia Pacific countries with available data, those in lower income quintiles are more likely to be engaged in agriculture and less likely to have dependent wage employment (Figure 2.13). For example, the share in dependent wage employment among people in the top income quintile is more than twice that among people in the bottom quintile in Cambodia, Lao PDR, Thailand, and Solomon Islands. But even among people in the top income quintile, there are still diverse forms of work engagement, with the exception of Mongolia.

2.20 A closer look at people living in poverty and ethnic minorities, in particular, shows that the majority are still engaged in agricultural production. The share of people working in agriculture from households in the bottom quintile is particularly high, more than 80 percent in Lao PDR, Vietnam, Papua New Guinea and Timor Leste (Figure 2.14). Only a very small share of the poorest population works in dependent wage employment. The largest such share is in Mongolia. Other than in Indonesia, few people in the bottom quintile of consumption are self-employed and employers. In addition, people from ethnic minorities in Vietnam are more likely to be in the bottom consumption quintile, and their livelihoods depend almost exclusively on agriculture and forestry. Among poor people, ethnic majority poor are more diversified in how they work than ethnic minority poor; they have low-skill, low-paid off-farm employment in rural areas to supplement farm income (Badiani et al 2012). In Lao PDR, the Lao-Tai are more likely to work outside agriculture, especially when residing in urban areas. All other ethnic groups work mainly in agriculture, independently of the area of residence.

Figure 2. 14 Most people in the poorest households work in agriculture

Percentage of workers in the bottom expenditure quintile, by employment type



Source: World Bank staff estimates based on household surveys

2.21 East Asia Pacific's labor force is also notably more mobile than working people in other parts of the world. There has been substantial labor mobility within countries in the region. With the structural transformation process, large numbers of people have moved from rural areas to towns and cities. This movement is evident in the fast urbanization rates in several East Asian countries in the past decades. Even today, internal migrants account for a substantial share of the population in most East Asian countries (Table 2.1). Good and comparable data on internal migration are scarce since most of the available measures, such as many in Table 2.1, only show inter-province migration and underestimate the full volume of peoples' movements. These measures are also hard to compare across countries due to the differences in definitions of what constitutes 'internal migration'.

Table 2. 1 : Internal migration has been a defining force of employment in East Asia Pacific

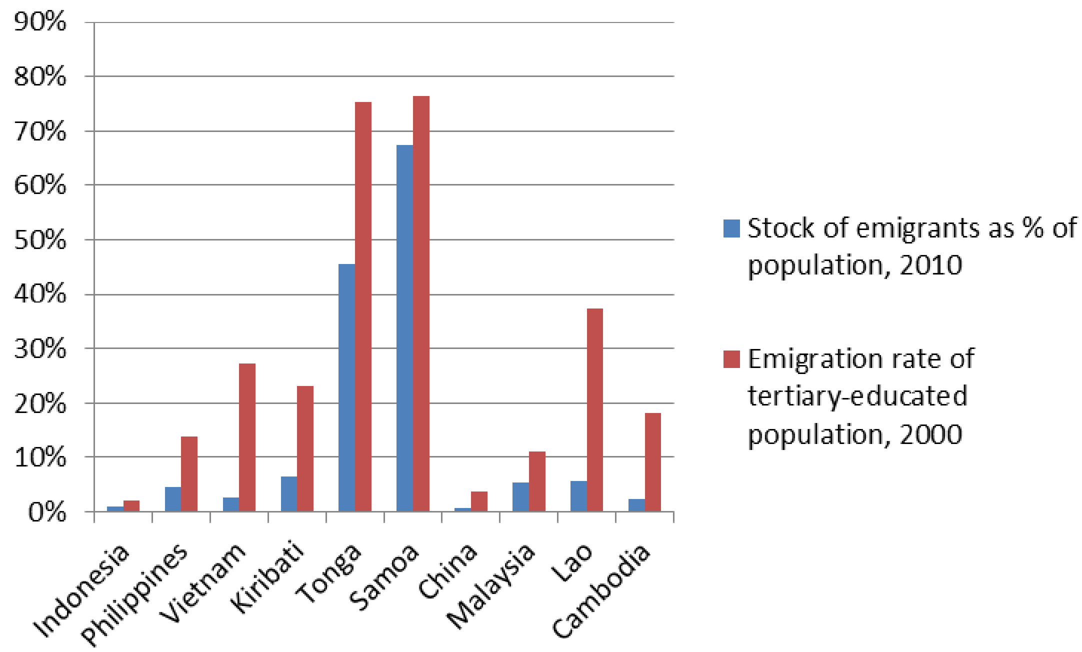
Country	Internal migrants as % of the population	Year	Definition	Source
China	19.6%	2011	Total migration rate: population with hukou registered to town/district other than the current one they live in	China Statistical Yearbook 2012 (National Bureau of Statistics of China 2012)
Indonesia	2.3%	2010	Living in a province different from province lived in 5 years ago.	Indonesia Statistical Yearbook 2012 (BPS 2012)

Vietnam	9.7%	2010	Inter-province migration: all moves across provinces in the calendar year	Statistical Yearbook of Vietnam 2012 (General Statistics Office 2012)
Thailand	2.0%	2009	Inter-province migration: in last 2 years, away for at least 1 month at a time, or permanently away	2009 Migration Survey (National Statistical Office 2009)
Mongolia	31.6% (of adult population)	2007	Ever having moved from "birthplace"	Shi (2011) – analysis of Household Economic and Social Survey of Mongolia 2007/8
Cambodia	12.2%	2008	Inter-province migration: ever having moved across provinces	Cambodia General Population Census (2008) - online tables (National Institute of Statistics 2008)

2.22 As important as movement of working people within national borders is their movement across countries. East Asia Pacific is both a host to a large number of immigrants, as well as a major exporter of labor to markets elsewhere. This characteristic reflects one of the contextual factors discussed in Chapter 1– the relatively greater degree of regional and global integration of East Asia Pacific countries when compared to countries in other parts of the world. As of 2010, East Asia Pacific countries hosted approximately 7 million immigrants, and received US$90 billion in remittances from up to 21 million emigrants (World Bank, 2013b). Pacific island countries like Samoa and Tonga lead in sending emigrants as a share of their small populations (Figure 2.15). The Philippines is probably the best known country for exporting labor. The wide disparities in wealth and earnings across low and middle income countries in East Asia Pacific, as well as the impacts of aging and labor shortages in high-income East Asian countries are strong forces pulling intraregional migration. Cross border labor mobility within the region has become so important that the Association of Southeast Asian Nations (ASEAN) Economic Community has set a goal to liberalize the mobility of skilled workers in ASEAN by 2015.

Figure 2.15 Several Pacific island countries have the highest emigration rates.

Emigration from selected countries in East Asia Pacific, 2010



Source: Migration and Remittances Factbook 2011

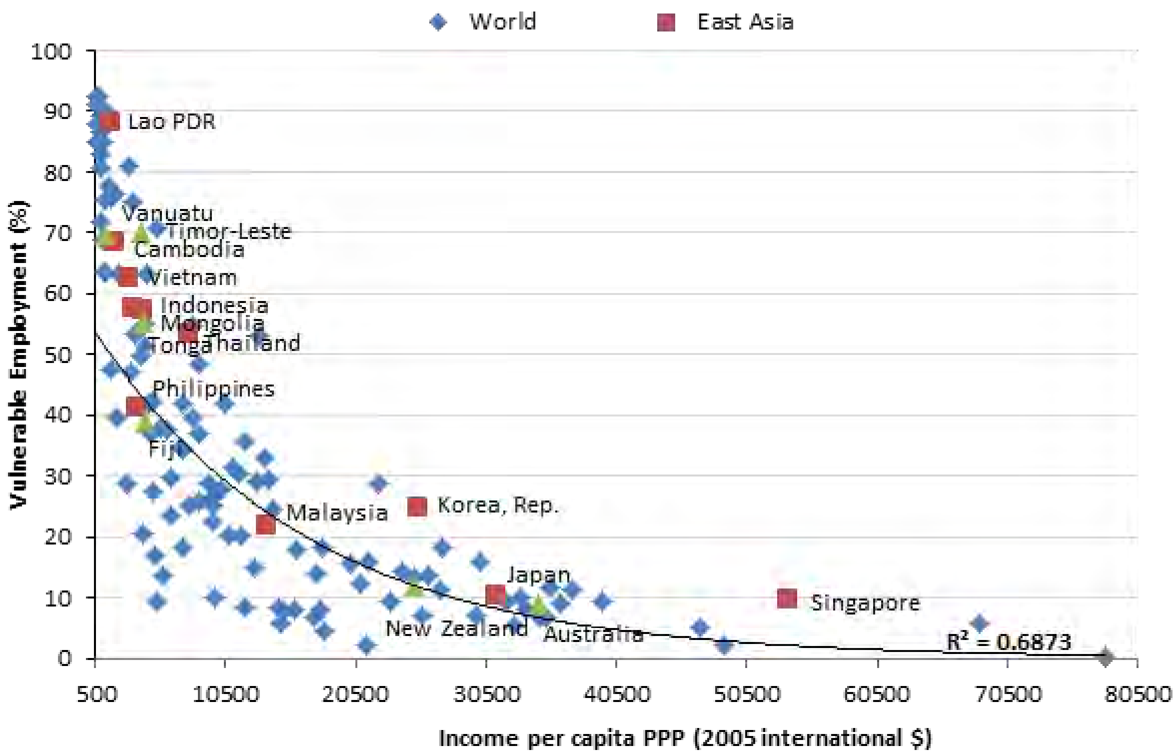
2.23 Finally, and critical to explaining why the impact of employment on well-being is such a fast growing policy concern in the region despite the lowest rates of open unemployment, work in East Asia Pacific is also characterized by a high degree of "informality" – that is, work or other transactions in unregulated and untaxed markets. Like the rate of population aging in East Asia Pacific, this observation is a topic that we return to repeatedly in this report, and for this reason, is the subject of a "spotlight" prior to Chapter 3.

2.24 A large portion of unregistered, untaxed work in countries like Lao PDR, Cambodia and Papua New Guinea can be thought of as *structural informality*, explained by a large share of the labor force still working in subsistence or small-share holder farming. In most countries, this portion of the informal economy decreases almost mechanically with economic growth and the structural change out of agriculture. Figure 2.15 shows that the share of "vulnerable employment" (defined as own account and unpaid family work) is negatively correlated with income per capita. Also evident in this figure is the fact that vulnerable forms of work are more common in East Asia Pacific countries than in other countries at similar income levels.

2.25 However, setting aside people who are self-employed farmers or non-paid workers in a family business -what labor economists sometimes refer to as 'residual beneficiaries'- in all middle-income countries, there is a persistent remainder that can vary widely in size. The remaining share of informal work – whether measured by proxies such as non-farm self-employment, the share of people working in micro-enterprises with five or fewer workers, or the workforce that is not contributing for social insurance coverage – is higher in many of the countries in East Asia Pacific than in other parts of the world at similar levels of income. Conversely, the share of the labor force in "formal" dependent wage and salaried employment in East Asia Pacific countries is among the lowest across low and middle income regions, surpassed only by countries in Sub-Saharan Africa. Subsequent parts of this report shed further light on informality. Chapter 6, in particular, examines the extent to which labor regulations and interventions in some countries intensify informal employment.

Figure 2. 16 "Vulnerable" forms of work are more common in East Asia Pacific than other countries at similar levels of development.

Own account and unpaid family workers as a share of the labor force, 2010



Source: World Bank staff estimates using World Development Indicators

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Chapter 3: Is work in East Asia Pacific *transformational*? Greater productivity, living standards and social cohesion

East Asia Pacific has reached a stage in its development when productivity gains, improvements in living standards and greater social cohesion from work -the so called "development transformations"- can no longer be taken for granted.

3.1 By economic convention, growth in output generates work since the demand for labor is derived from demand for final goods and services. However, the WDR 2013 argues that rather than just a product of the demand for output, jobs also propel the process of development by contributing to three important and interrelated objectives—economic growth, poverty reduction and cohesive societies. Toward these ends, people's work can act as a conduit for three transformations that drive a country's development: *increasing productivity, improving living standards,* and *strengthening social cohesion*. The arguments in the WDR 2013 are appealing. In reality, how effective is work as the channel of these three transformations? Are these gains from work always expected in a region with respectable economic growth like East Asia Pacific? These questions motivate a deeper discussion of employment and development than provided by the simple correlations between employment and growth, as well as the labor supply and demand profiles presented in Chapters 1 and 2.

3.2 This chapter presents evidence of the three development transformations in East Asia Pacific countries and the role of work in bringing them about. Work has indeed been an effective channel to support economic growth as well as individual and societal wellbeing in the region. During the past twenty years of remarkable progress, improvements in economic productivity, living standards and social cohesion have happened in tandem and reinforced each other in many parts of East Asia Pacific. In many parts of the region, rapid economic growth was fueled by shifts in the structure and factors of production to increase agriculture output and to support the rise of manufacturing and services in towns and cities, accelerating labor productivity. East Asia Pacific's ongoing and relatively successful urbanization process is an indication that the three transformations have on the whole been occurring simultaneously. Engagement in global markets through light manufacturing exports created substantial opportunities for employment, drawing rural migrants to towns and cities, creating access to better services and raising living standards. In many countries of the region, growth has promoted social cohesion, brought more women into market work, benefited poor people, those living in economically lagging and rural areas, and helped to prevent social fragmentation. In other words, consistent with the arguments in the WDR 2013, greater productivity has paved the way for rising living standards and stronger social cohesion.

3.3 But we also show in this chapter that the region is at a stage in its development where productivity gains, improvements in living standards and advances in social cohesion can no longer be taken for granted. One or more of these development transformations propelled by work are now starting to lag. Some East Asia Pacific countries experience direct threats to social cohesion, while others struggle to achieve sustained productivity growth, gains in living standards and to accelerate poverty reduction. During structural transformation, the movements of so many working people, while improving individual wellbeing, have also reshaped the distribution of welfare and opportunities in society. Increasing inequality in earnings, rising returns to skills, and disparities across geography and communities in different measures of well-being, are driving rising consumption or income inequality in China, Indonesia, Lao PDR and Vietnam. Several East Asia Pacific countries now have among the highest rates of youth unemployment and inactivity in the world. These signs cause concerns for social cohesion. In addition, a moderation of growth rates in many parts of the region is associated with slower gains in living standards than many people have come to expect over the past two decades. Emerging imbalances in the pace of the transformations are a challenge to wellbeing from work that East Asia Pacific countries cannot afford to ignore.

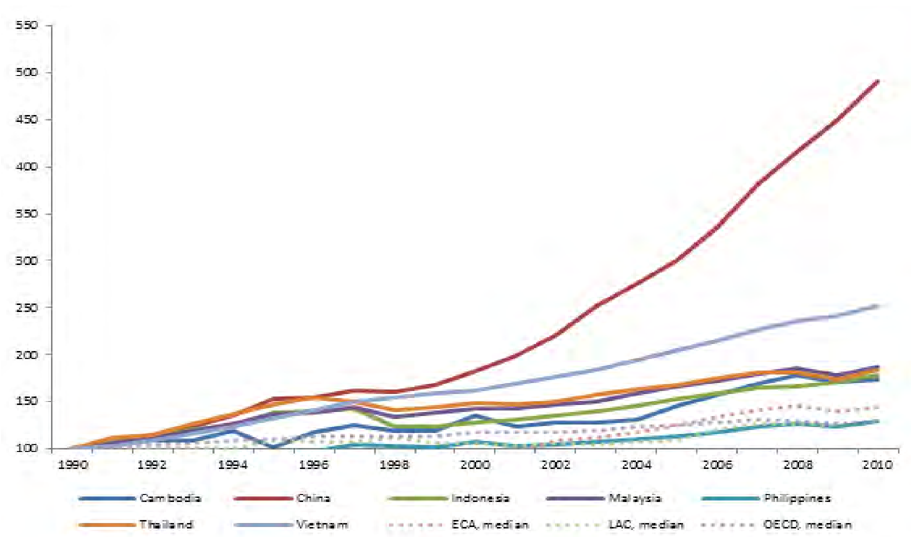
3.4

3.1 Work and productivity

3.5 Economies grow as people become more productive at what they do. Productivity gains also happen as less productive work disappears and more productive work is created. In low-income and lower middle-income countries, this process often takes the form of people moving from less productive to more productive sectors, such as from farms to firms, and labor being more effectively combined with land and capital. In the early phases of development, a large fraction of the population typically works in agriculture, and this sector accounts for a dominant share of economic output. At this stage, the share of employment in agriculture usually exceeds its output share (World Bank 2007). But as productivity in the agricultural sector increases and as industry starts to gain strength, labor is drawn from agriculture into industry equipped with more capital, and overall productivity and GDP increase.

3.6 Most East Asian countries, with a few exceptions, have experienced steady productivity improvements in recent decades, contributing to overall economic growth. Figure 3.1 demonstrates the substantial increases in labor productivity throughout the 1990s and 2000s in many countries in the region. China's three-fold productivity growth since 2000 was the most impressive, followed by Vietnam's nearly two-fold increase. Labor productivity growth was also notable in Mongolia, Malaysia, Indonesia and Thailand (Figures 3.1 and 3.4). However, productivity growth only started to take off in Cambodia in the mid-2000s. Labor productivity in the Philippines was stagnant for years up to 2002 and has been increasing the least among East Asian economies over the past twenty years. But on the whole, the region's impressive productivity growth was an important determinant of its output growth. A growth decomposition that quantifies the contribution of total factor productivity (TFP), capital, employment, and human capital accumulation, illustrates that for most East Asian countries, except for Indonesia, TFP growth accounted for a great fraction of overall output growth from 1997 to 2007 (World Bank 2012a). In particular, China's GDP growth from 1978 to 2007 can be primarily accounted for by productivity growth, while its pre-1978 growth was mostly due to growth in physical and human capital (Zhu 2012).

Figure 3.1 Labor productivity grew faster in most East Asia Pacific countries than elsewhere
GDP per person employed (1990=100)



Source: World Bank (2012c).

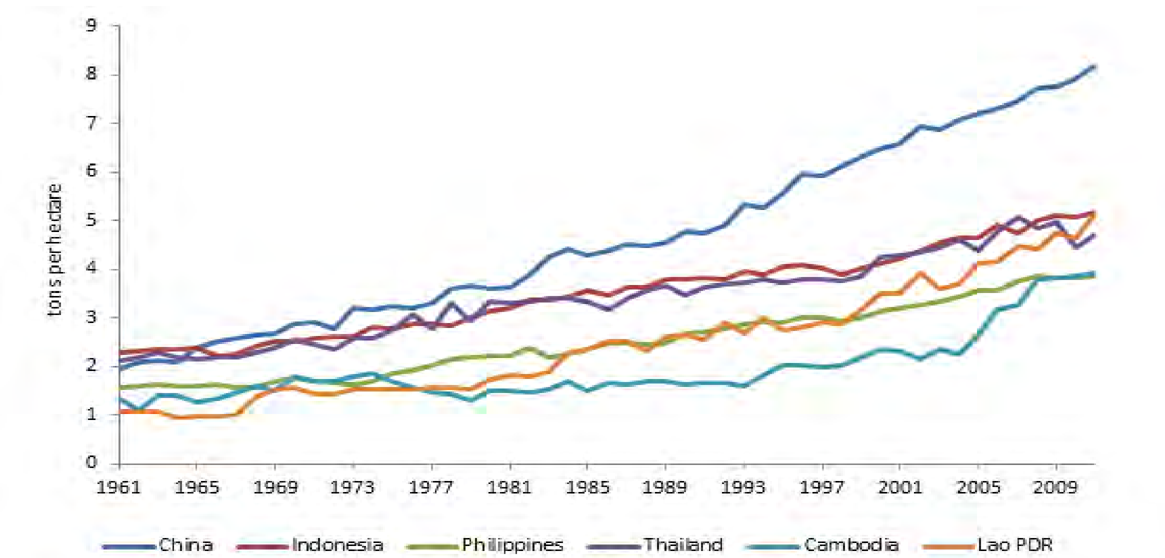
3.7 Work has been an effective conduit for productivity gains in East Asia Pacific, notably through people taking up more productive forms of work. This process, when led by enhancements in farm productivity, enabled successful structural transformation and contributed to better paid work and poverty reduction in many countries of the region. Increased farm productivity raised farmers' income, promoted downstream agricultural businesses, created demand for rural non-farm services, and released large amounts of labor from agriculture to join urban manufacturing and services. The reallocation of labor across sectors was a significant driver of labor productivity gains in most of the region. However, as slowing global demand leads to a moderation of economic growth, and as farm-to-firm movements decelerate, countries in the region can no longer take for granted the sort of productivity gains they have experienced until now.

Productivity on farms

3.8 Across most of the region, agricultural productivity has increased in recent decades. Figure 3.2 shows trends in crop yields (output per hectare) for six East Asian countries where data are available. Growth in land productivity has been especially impressive in China, but has advanced at a much slower pace in the Philippines. In Cambodia and Lao PDR, farm productivity growth started to take off at a later stage, resulting in a surge in crop yields that started in 2000.

3.9 Several factors contribute to changes in the productivity of agriculture. Farm size is widely viewed as an important correlate, since output per hectare is a combination of output per worker (labor productivity) and land per worker. A famous and recurring empirical observation documented in this literature is the inverse relationship between farm size and productivity. Studies from South Asia and Sub-Saharan Africa find that farm size is inversely related to productivity, implying that an increase in farm size results in a reduction in crop yields (World Bank 2012a). One commonly cited explanation for this relationship is that most farms in low income countries are household farms that may have an excess of domestic on-farm labor supply relative to other factor inputs, such as fertilizer and land, resulting in large household farms being relatively less productive (World Bank 2012a). However, this relationship is not always statistically robust. Between 1961 and 2000, average farm size decreased in China and remained constant in Thailand. During the same period land productivity grew by 2.9 percent in China and 2.5 percent in Thailand, while labor productivity grew at a lower rate. However, once soil quality and irrigation differences are taken into account, the inverse farm size-productivity relationship often breaks down (Fan and Chan-Kang 2005).[1]

Figure 3.2 Crop yields have increased substantially across the region
Output per hectare, 1961-2010



Source: FAOSTAT-Agriculture database (2013).
Note: Crop production comprises cerals, fibre crops, fruits, oilcrops, pulses, roots and tubers, treenuts and vegetables.

3.10 Far more important is the impact public policy can have on the productivity of agriculture. For instance, agricultural productivity growth from 1978 to 1984 in China was mostly driven by institutional arrangements and incentives for farmers rather than

[1] See Carletto, Savastano and Zezza (2011) on how measurement error of land size can affect the strength of the inverse farm size-productivity relation.

technological improvements. But after 1984, liberalization of the sector incentivized the adoption of new technologies by farmers (Zhu 2012).

3.11 Tenancy arrangements and ownership rights are fundamental institutions that affect household investments in land and, as a result, can contribute to agricultural productivity. Sharecropping, still a common tenancy arrangement in East Asia Pacific, correlates negatively with productivity (Ray 1998; Banerjee et al 2002). For instance, Shaban (1999) finds differences in input and output intensities between plots where households are owners versus those where they are sharecropping, even after differences in plot characteristics and irrigation have been taken into account. Similarly, Jacoby and Mansuri (2009) find that yields on sharecropped plots are about 2.3 percent lower, although this difference is not statistically significant. In terms of land rights, plots with legal documentation were found to have higher output and sales value per hectare in Cambodia (Markussen 2008). Analyzing the 1993 land law reform in Vietnam, Do and Iyer (2008) found that extending the coverage of land titling increased the cultivation area of long-term crops, as well as the time spent on non-farm activities. The World Bank's 2013 Philippine Development Report (2013a) argues that limited access to land by smallholder farmers in the Philippines has contributed to low agricultural productivity and high food prices.

3.12 The gender of the owner, farmer or manager of a farm can also matter to the productivity of agriculture in certain contexts, although there is less evidence of gender being a significant factor in East Asia Pacific countries. Within farm households, evidence from outside the region shows differences in yields between land plots controlled by men and those controlled by women, due to inferior and lower factor inputs on the plots farmed by women (see, for instance, Udry 1996; Kilic, Palacios-Lopez and Goldstein 2013; Andrews, Golan and Lay 2013). Evidence from East Asia Pacific on gender differences in farm productivity is scarce, but findings from China suggests that farms managed by women are as productive as those managed by men; and that women farmers face no substantial differences in land quantity or land quality, labor inputs and access to credit compared to men farmers (de Brauw et al 2008).

3.13 In most East Asia Pacific countries, gains in agricultural productivity, either through higher labor productivity or by switching to higher value crops, increased rural income and helped reduce poverty in the region (as discussed later in this chapter). Evidence from Indonesia shows that rising rural incomes were driven by increased value of agricultural production rather than productivity improvements for the same crop (Klasen, Priebe and Rudolf 2010). Similar observations can be made in Northern and North-eastern Thailand, where the returns from Jasmine rice are higher than from other rice varieties (Rahman, et al. 2008).

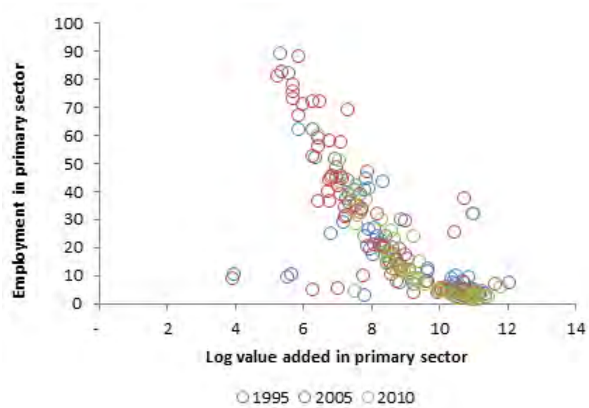
Structural transformation and productivity growth

3.14 As agricultural productivity increased, many East Asian countries experienced large-scale movements of labor away from agriculture toward labor-intensive manufacturing and services in towns and cities. Some countries in the Pacific have experienced similar structural dynamics, but at considerably smaller relative volumes. Surplus labor that was freed to move off of more productive farms was pulled to urban areas and into manufacturing as part of the export-led growth model of increasing global integration. This structural transformation has driven productivity gains in East Asia Pacific as people moved from less-productive to more-productive forms of work, and as the agglomeration effects of concentrating people and firms in towns and cities took hold (Gill and Kharas, 2007, World Bank, 2008).

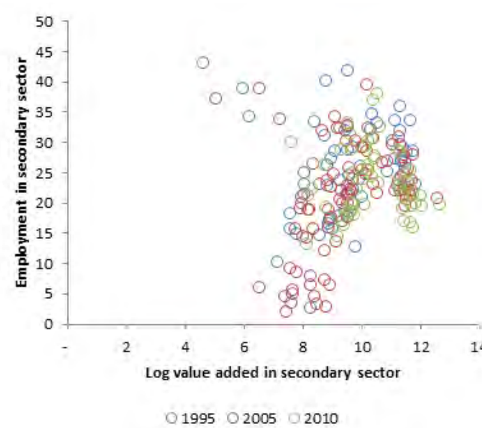
3.15 A shift of the factors of production away from the primary sector toward the secondary and tertiary sectors often results in an overall gain in productivity. The share of the workforce in East Asia Pacific region working in agriculture fell from approximately 60 percent in 1991 to slightly over 40 percent in 2008 (World Bank 2013b), reflecting a similar pattern in low and middle income countries in other regions. As farming became more productive, employment in agriculture fell. As productivity rose in manufacturing and services, more people took up work in these activities. Figure 3.3 shows the dynamic relationship between employment shares and productivity by sector from 1995 to 2010. As shown in Figure 3.3(a), rising value added in the primary sector is correlated with a decline of employment in that sector. But the opposite is observed in the secondary and tertiary sectors, where rising value added is correlated with rising employment levels. The positive relationship is more significant and visible in the tertiary sector compared to the secondary sector. Value added in manufacturing and services went hand-in-hand with increased employment in these segments of the economy over time.

Figure 3.3 Productivity gains in agriculture spurred the shift of labor to higher value-added sectors

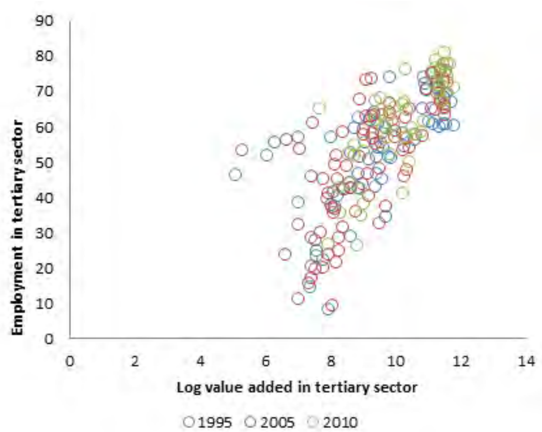
(a) Employment and value added, Primary



(b) Employment and value added, Secondary



(c) Employment and value added, Terciary

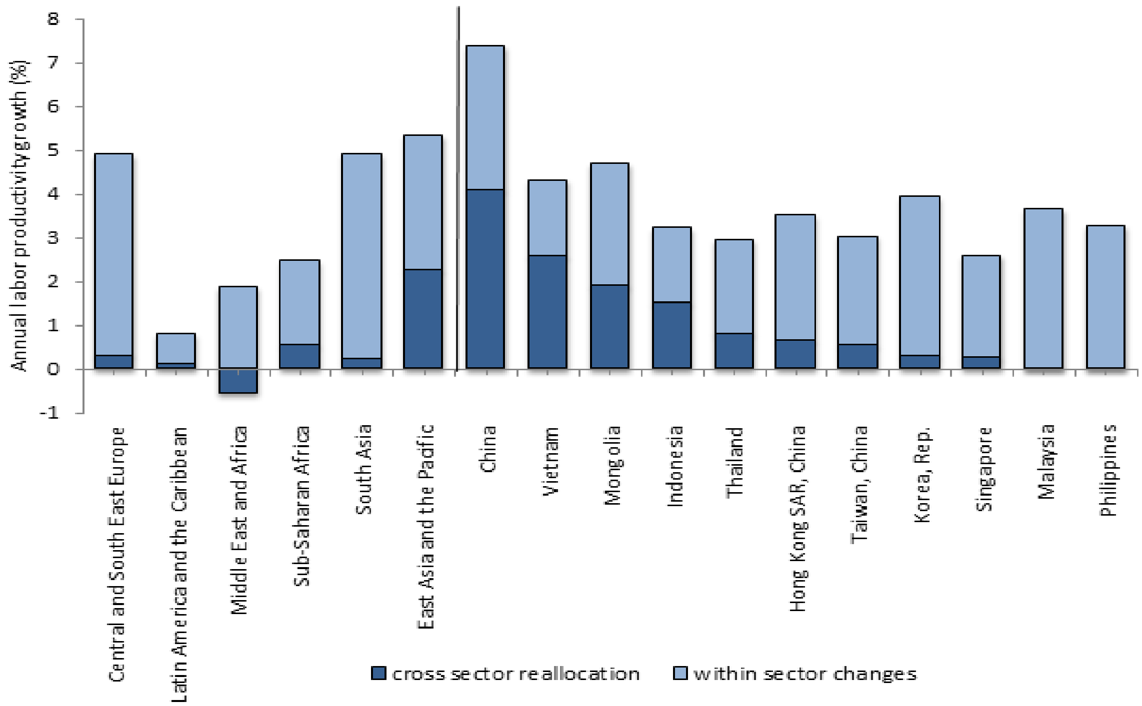


Source: World Bank staff estimates based on World Bank (2012a).
Note: Each circle represents a country, and the colors represent different points in time

3.16 Both within-sector and across-sector productivity changes were important to overall productivity growth in low and middle income countries the world over, but in East Asia Pacific countries, labor reallocation across sectors was a stronger contributor to higher productivity than in any other region. In other words, the contribution to overall productivity improvements of people moving from one form of work to another was particularly important to the rapid development of countries in East Asia Pacific. This is clearly illustrated in a decomposition of overall labor productivity growth into movements within and across sectors in 81 countries during the 1999-2008 period (Figure 3.4).

Figure 3.4 Movement of labor across sectors was a more important driver of productivity growth in East Asia

Labor productivity increase, by source 1999-2008



Source: Kucera and Roncolato (2012) in World Bank (2012a).
Note: The figure presents the decomposition of labor productivity growth in 81 countries over 1999–2008, into productivity changes due to changes within sectors and reallocation between sectors. Seven sectors are considered: agriculture, hunting, forestry, and fishing; mining and utilities; manufacturing; construction; trade, restaurants, and hotels; transport, storage, and communication; and other services. The regional growth rates are weighted averages, with weights based on a country's share in regional GDP.

3.17 From 1999 to 2008, labor productivity grew at a faster rate in East Asia Pacific countries than in any other region – 5.3 percent annually. The next fastest were South Asia and South Eastern Europe at 5 percent (Figure 3.4). The reallocation of labor across different sectors accounted for 2.5 percentage points of annual labor productivity growth in East Asia Pacific, surpassing the other regions both in absolute size and in terms of contribution to overall labor productivity growth. In China, labor reallocation across sectors accounted for 4.1 percentage points of the 7.3 percent annual growth in labor productivity. In Vietnam, it accounted for 2.6 percentage points of the 4.2 percent annual labor productivity growth. But this regional characteristic is not just a story of China and Vietnam: in two thirds of the countries depicted, cross-sectoral movement was a more important driver of labor productivity gains than other regional averages, where reallocation of labor within sectors was more dominant. [2]

[2] Structural change had a different impact on productivity in East Asia than it did in Latin America. Also via a decomposition of productivity growth into within-sector components and structural movements, McMillan and Rodrik (2011) argue that although structural change in Asia was "growth-enhancing" –in that labor moved from agriculture and other low-productivity activities to high-productivity activities - in Latin America, structural change was "growth-reducing" in the sense that people moved from high-productivity to low-productivity activities, in part explained by shrinking manufacturing and expanding, informally provided services.

3.18 The geographical redistribution of work that took place as part of the structural transformation in many East Asia Pacific countries also propelled productivity as people and firms concentrated in urban centers. Location matters for factor productivity, and urban '*agglomeration economies*' have had a substantial role to play in East Asia's advances (Gill and Kharas, 2007, World Bank 2008 and 2009a). Agglomerations can form when firms concentrate in the same location, leading to cost reduction from cheaper labor supply, competition between firms and knowledge spillovers; all resulting in higher-productivity. Concentration of people in cities can boost demand for products, provide a pool of labor, enhance returns on infrastructure investment, and reduce transportation costs. Growth then attracts more people and firms and so accelerates the process of agglomeration (World Bank 2009a). A 10 percent increase urban employment density can increase wages and firm productivity by about 0.2 to 1 percent, and larger cities produce more innovations per capita (Duranton 2012).

3.19 In East Asia, large volumes of labor migration into towns and cities led to productivity gains from agglomeration (Gill and Kharas, 2007, World Bank, 2009a). Chinese manufacturing became more geographically concentrated, specifically in coastal provinces, as economic transition proceeded in the past decades (He 2009 in World Bank 2009b). In Indonesia, economic activity shifted toward Java-Bali –centering in Jakarta- which was the fastest growing region between 1976 and 2004. Estimates from Korea suggest that firms that moved to a city could increase plant output by 20-25 percent while holding the input composition constant. In China firms are more productive in the more populated cities (World Bank 2009a), and income per worker rises as cities increase in size (Au and Henderson 2006).[3]

3.20 East Asia Pacific's high degree of economic integration creates employment in exporting and foreign owned firms, and in doing so, is likely to boost overall productivity. Integrating into the global economy can increase firm productivity since the global market provides scope for economies of scale and exposes firms to international competition and knowledge (Baldwin and Gu, 2004). Evidence from across East Asia Pacific suggests that exporting and foreign owned firms are more productive, without inferring causality (Hallward-Driemeier et al 2002). As the share of working people employed in these firms in East Asia Pacific rose, so did overall productivity. Using manufacturing census data from Indonesia, Amiti and Konings (2007) found that between 1991 and 2001, a 10 percentage point reduction in input tariffs was associated with a 12 percentage point increase in productivity for firms importing inputs, while a reduction in output tariffs by the same amount increased productivity by only 1 to 6 percent. Using panel data of manufacturing firms collected between 2001 and 2005 in China, Sun and Hong (2011) found that when exporting firms increase the ratio of export to sales by one unit, they increase output by 2.6 percent.

3.21 While export-led growth and structural transformation has spurred tremendous productivity growth in many parts of East Asia Pacific, continuing similar gains in the future can

[3] He (2009) in World Bank (2009b) demonstrates a positive relationship between industrial agglomeration, (measured as the Gini coefficient of gross industrial output) and labor productivity in China between 1980 and 2004, controlling for capital per worker.

be difficult, especially for countries where progress on this front has been slow up till now. For instance, geography and size constrain opportunities for export-led economic growth in the Pacific island countries (see Chapter 8 for more details). Evidence from the Philippines suggests an *'incomplete structural transformation'*: stagnant agriculture and manufacturing sectors have led most of the labor force that migrated from rural areas into cities to end up in low-productivity, informal service sector work (World Bank 2013a). Indeed, the contribution of cross-sector labor reallocation to productivity was negligible in the Philippines (Figure 3.4).

3.22 In addition, several East Asian countries are now at a stage of development where they face several possible obstacles to sustaining productivity gains from work. Less favorable global economic prospects (including the trend toward 're-shoring' and 'near-shoring' in textiles and other light manufacturing), more intense global competition, and eroding labor cost advantages are likely to imply a moderation in export demand and economic growth in East Asia in the coming years. For the East Asian countries that are now substantially urbanized, much of the large productivity gains associated with the transformation from agriculture to light manufacturing have already been realized. It is not easy to take the next transformational step toward higher value-added manufacturing and/or high-skill services (Gill and Kharas, 2007). In Indonesia, for example, the difficulty among manufacturing firms to move up the value chain and innovate is constraining the sectors' productivity and competitiveness. Stagnating growth in manufacturing is limiting the country's potential in creating demand for work (World Bank 2012e; World Bank 2012f).[4]

Firm dynamics and labor productivity

3.23 Supporting the large-scale structural shifts discussed earlier, are firm dynamics that involve constant reallocations of capital and labor. At the firm level, productivity growth involves the creation of some forms of work as well as the destruction of others. The structural and spatial changes experienced by most countries of East Asia Pacific unleashed 'creative destruction' that was a large part of increased productivity in the region. Productivity gains through innovation, while expected to enhance growth in the long run, may have positive or negative impacts on employment in the short or medium run. Product innovations usually create new businesses and new employment. They may also lead to firms downsizing or exiting in the short term if the new product substitutes existing goods and the new firm becomes monopolistic. Process innovations can reduce the amount of labor in immediate need. In the East Asia Pacific region, firm-level evidence from China suggests that over half of the growth in value added in the manufacturing sector from 1998 to 2007 can be attributed to total factor productivity growth stemming from existing firms getting more productive and net firm entry (Brandt et al 2012). Evidence from Indonesian manufacturing census data (1991-2001) suggests that creative destruction worked to a certain extent during the 1998 crisis: new firms were relatively more productive, which helped mitigate the fall in aggregate productivity. The crisis,

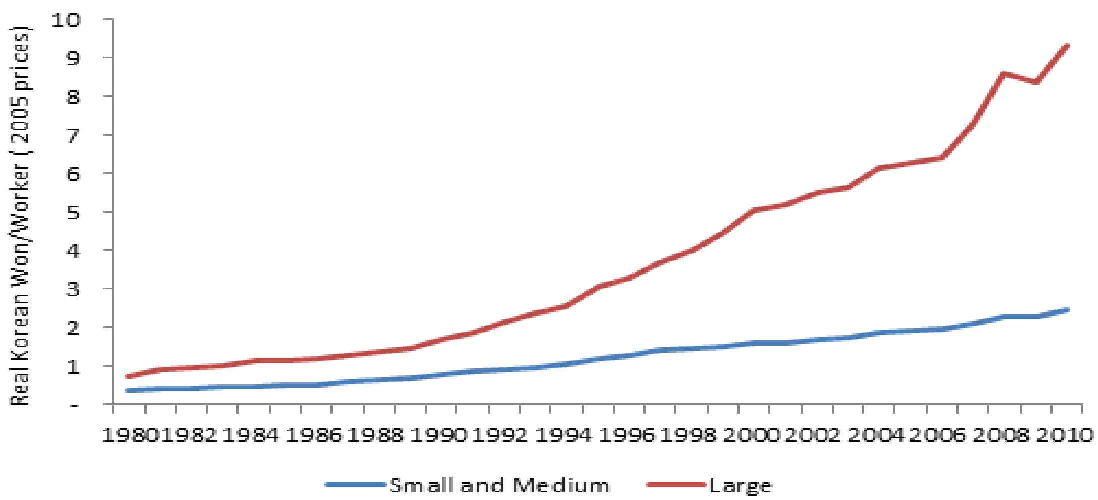
[4] World Bank (2012f) shows that the level of export sophistication in the manufacturing sector in Indonesia rose and converged with other countries in the region until 2000, but stagnated in the aftermath of the Asian crisis.

however, did not unequivocally improve the reallocation process, causing the exit of many productive firms (Hallward and Rijkers 2011).

3.24 Even though most people work in micro, small and medium enterprises (MSMEs) and most new employment is created in these firms (as shown in Chapter 2), they are not usually an engine of productivity growth. Evidence from developed countries indicates that bigger firms are relatively more likely to survive while many of the small firms that are created are quickly destroyed (Bartelsman, Haltiwanger and Scarpetta 2004). Data from the Small and Medium Business Administration database in Korea suggest that during the past decades, the productivity gap between large firms and SMEs has widened (Figure 3.5).

Figure 3. 5 The productivity gap between large and small firms in Korea has widened

Value added, by firm size category



Source: World Bank staff calculation based on Rostom, Song and Kim (in progress) using the Small and Medium Business Administration (SMBA) database in Korea.

Note: SMEs comprise in manufacturing fewer than 300 workers and a capital worth of 8 billion won or less; In Mining, Construction and Transportation fewer than 300 and a capital worth of 3 billion won or less; in Publication, Information and Communication, Administrative and Support Service Activities, Human health and social work activities, Professional scientific and technical activities fewer than 300 workers and sales worth 30 billion won or less; in Agriculture, forestry and fishery, Electricity, gas, steam and waterworks business, Wholesale and retail trade, Accommodation and food service activities, Financial and insurance activities, Arts, entertainment and recreation fewer than 200 and a sales worth of 20 billion won or less; in Sewerage, waste management and remediation activities, Education, Repair and other services fewer than 100 and sales worth of 10 billion won or less; in Real estate, rental and leasing activities fewer than 50 workers and a sales worth of 5 billion won or less.

3.25 Evidence from middle and low income countries is similar. For example, MSMEs account for over 90 percent of employment but only 36 percent of GDP in the Philippines (World Bank 2013a). Using the enterprise survey data from 99 developing countries, Ayyagari, Demirguc-Kunt and Maksimovic (2011) confirm that although SMEs account for a large share of employment and employment creation (permanent, full-time employment), this does not necessarily translate into productivity growth. Smaller and younger firms exhibit higher employment growth than larger and more mature firms. However, the latter segment has the highest productivity growth, both in East Asia Pacific and the full sample of developing countries. Controlling for firm size, younger firms have relatively higher productivity growth. Even in the segment of very small and informal family enterprises not covered by enterprise surveys, firm size and age matter for labor productivity. Evidence from the Indonesia Family Life Survey (IFLS) suggests that among household firms with up to five employees, labor productivity is higher in own-account and more mature micro firms (Figure 3.6 and Figure 3.7), even after controlling for a variety of factors such as industry and households effects (Badiani, Golan and Posadas, in progress).

Figure 3. 6 : In household enterprises, those with fewer workers are more productive

Distribution of firm productivity, by number of employees

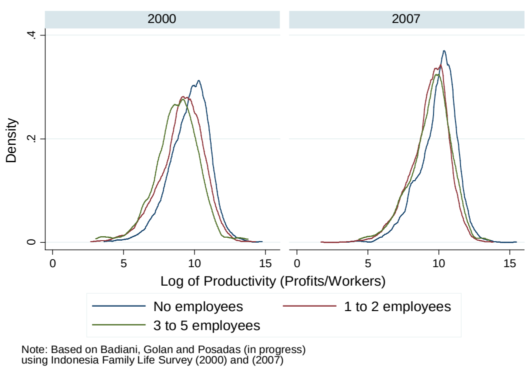
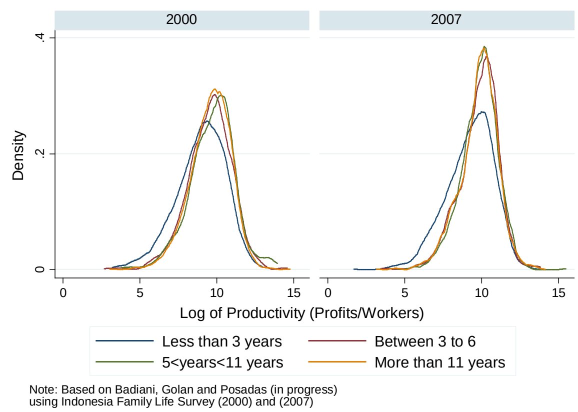


Figure 3. 7 Mature microfirms are more productive

Distribution of firm productivity, by firm age



3.26 Informal, micro firms in East Asia Pacific often emerge out of necessity rather than entrepreneurship and consequently tend to be less productive than larger, registered formal enterprises. Even though the marginal returns to initial capital investments are expected to be high for low capital stock informal enterprises, micro firms do not necessarily realize this great growth potential. Using panel data on formal and informal enterprises for 2004 and 2006 in Vietnam, Chi and Nordman (2012) find that informal household enterprises have lower value added per worker, fewer workers and a lower initial capital stock than formal enterprises. In the Philippines, informality was identified a major constraint to doing business by enterprises with 10 to 200 employees, (World Bank 2013a). As discussed in Chapter 2, high levels of self-employment in many middle income East Asia Pacific countries are more likely to result from working people trying to meet subsistence needs than transformational entrepreneurship. This phenomenon may explain the short life span and low productivity of household microbusinesses in many East Asia Pacific countries.

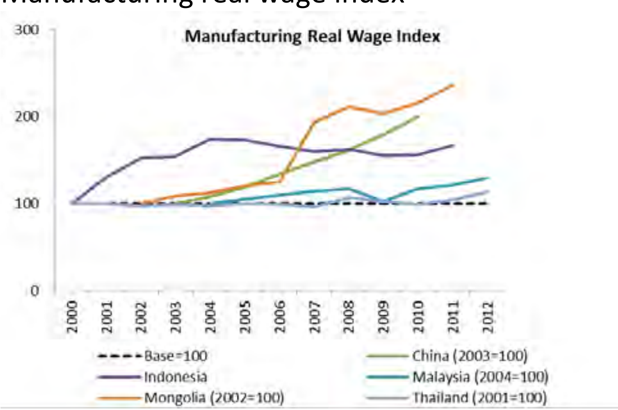
3.2 Work and living standards

3.27 The productivity gains described above have allowed more working people in East Asia Pacific to raise their welfare in the last two decades than in any earlier period. The share of the region's population living on less than US$1.25 a day declined from 56.2 percent in 1990 to 12.5 percent in 2010, from one of the highest to among the lowest across developing regions (World Bank 2013b). Impressive poverty reduction took place not only in China but also in many other countries including Thailand, Indonesia, Cambodia and Vietnam. However, the official poverty headcount has remained stagnant at around 26.5 percent in the Philippines since 2003. Any possible growth slowdown in the future will likely imply slower improvements in living standards than what many people in East Asia have come to expect.

3.28 From 2000 to 2012, real wages rose in several East Asian countries. Figure 3.8 shows this trend for the countries where data were available. In Indonesia, the manufacturing real wage increased quickly in the early 2000s, but then remained stagnant for several years, and only recently started to rise again. Thailand's real wages have been very close to their 2001 levels during the past decade and only recently started to rise substantially. However, in several other countries, manufacturing real wages have been rising rapidly. In Mongolia, real wage rises have been especially rapid since 2006. Malaysia and China saw improvements in the real wage index since 2004 and 2003, respectively. The annual wage of a Chinese urban worker increased from US$1,004 in 1978 to US$5,487 in 2010 (Li et al 2012), and manufacturers in China expect wages to rise by 9.2 percent in 2013 (Standard Charter Research 2013).

Figure 3.8 Real wages have been rising in many East Asian countries

Manufacturing real wage index



Source: CEIC database (2012) and China Statistical Yearbook (2011).

3.29 Remunerated work is the most important factor in determining peoples' living standards in low and middle income countries, for at least three reasons. First, as affirmed in the introduction of this report, people's most valuable assets are their talent, skills and ability to work. In low and middle income countries where few people are investors and where the welfare state is limited, the main source of household income is the return on these assets in the form of paid work. Second, work-related events drive economic mobility. For example, transitions out of poverty usually take place when family members are able to earn higher income from their current work, or by changing their occupation. Much of the gain in living standards in East Asia Pacific countries happens through migration for work. Third, living standards and wellbeing are not just measured in money. In addition to earnings, there are several other aspects of having work that affect living standards and life satisfaction. Income and consumption are commonly used measures of welfare, but access to services, security, freedom, and life satisfaction also matter, and correlate with living in a household in which adult family members have employment. For a detailed discussion of the role of work in life satisfaction, see the WDR 2013 (World Bank 2012a)

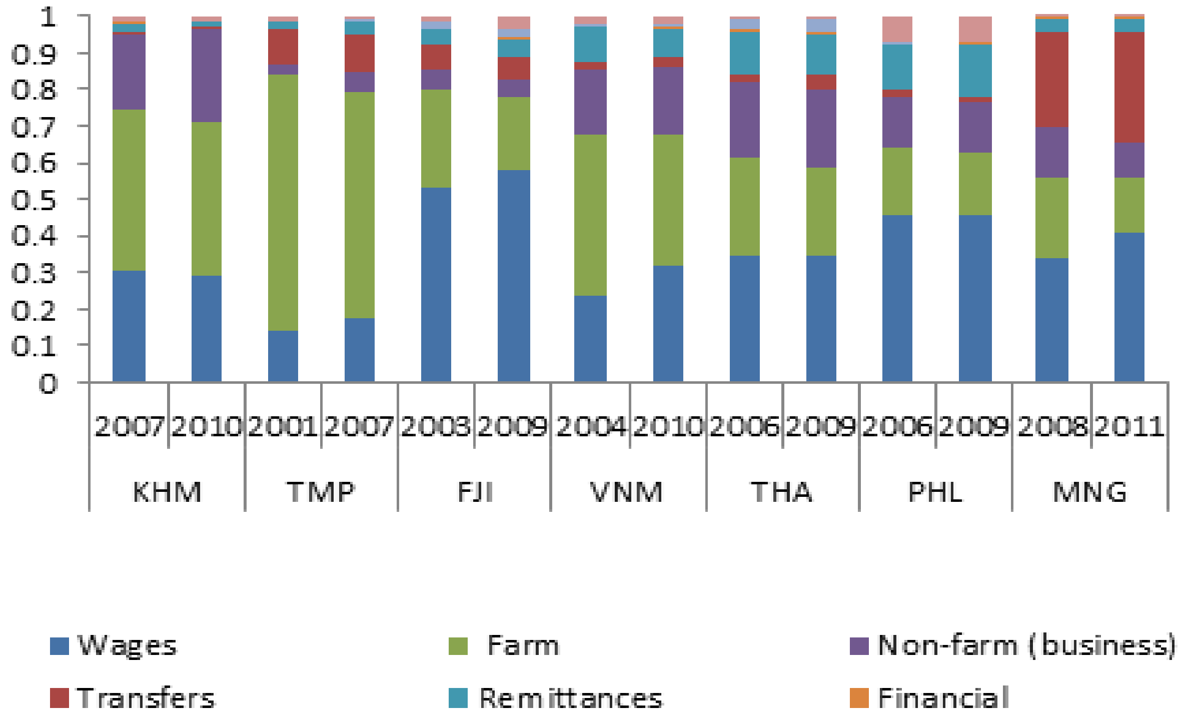
How important is income from work to living standards?

3.30 In East Asia Pacific countries, labor earnings are without doubt an important source of income. Figure 3.9 shows the composition of household income by source in a selection of East Asia Pacific countries where detailed data on income are available. Across all countries, labor earnings -incomes from the farm, own businesses and wages- constitute the main source of household income.

3.31 But there are important differences across countries, the nature of work, and how the characteristics of work change with economic development. As expected, for countries with a large share of population in agriculture, incomes from farm work or other types of self-employment constitute an important fraction of household income. Households in more developed and urbanized economies like the Philippines and Thailand derive a greater average share of household income from wages and salaries than places like Cambodia or Vietnam. Over the period examined, in most countries, the composition of household income moved away from farm production and towards wages from dependent employment (Figure 3.9). In the case of Cambodia, the share of income from non-farm businesses rose while incomes from wages remained constant. In a resource-rich country with generous social welfare like Mongolia, there was a relative reduction in the share of income from the farm and an increased share of income from transfers.

Figure 3.9 Labor earnings are an important source of household income

Income from different sources as a fraction of total income

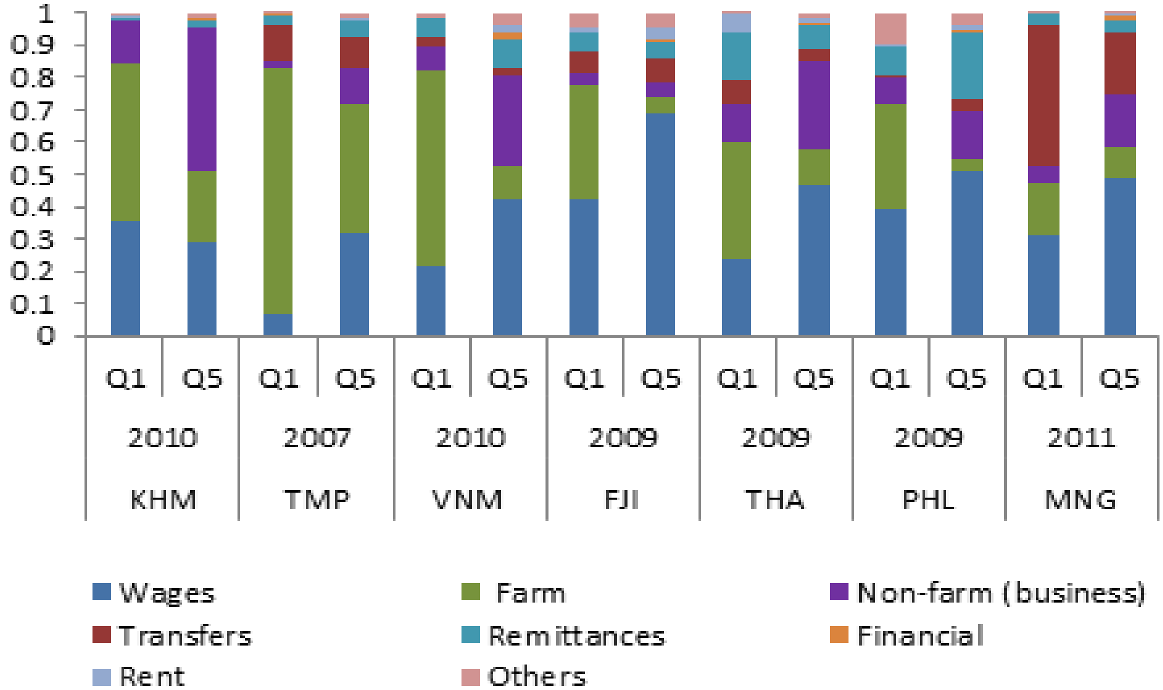


Source: World Bank staff estimates based on various Household Income and Expenditure Surveys.

3.32 Within countries, the share of income from work varies by gender and across wealth groups. The ratio of women and men's wages for similar work in the region ranges from 52 percent in the Republic of Korea to 81 percent in Mongolia (World Bank 2012b). And the type of work and related income differ between the poor and the rich, as shown in Figure 3.10. For all the countries we are able to analyze, the bottom income quintile (the poorest 20 percent) derives a greater fraction of its income from farm production, while the top income quintile (the richest 20 percent) derives a greater proportion from wages. In Cambodia, non-farm business incomes (more than wages) are a main source of income of the richest people, but the poorest people derive most of their incomes from farm production. In fact, in a cross-country study, Ligon and Sadoulet (2011) find that agricultural income growth is particularly beneficial for increasing expenditures of the poorest households: a one percent increase in incomes from agriculture is estimated to increase the expenditure of households in the poorest decile by about 1.65 percent. A similar increase in non-farm income did not have the same effect. Over time however, the share of agriculture in the overall income composition of the poorest group decreased, except for Timor Leste (Figure 3.11). Interestingly, in Mongolia, labor income plays a less dominant role among the poor compared to non-labor income. Nearly 50 percent of the income of the poorest consists of transfers, and their relative weight in the income composition of the poorest increased in recent years.

Figure 3.10 People in poor households derive a greater share of income from agriculture

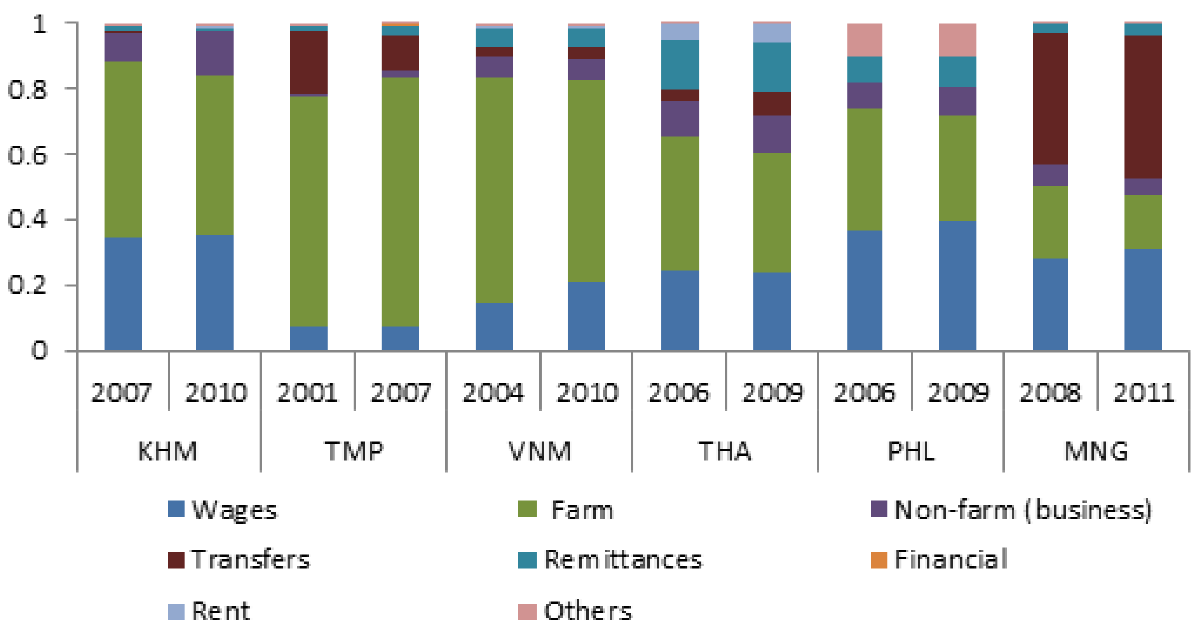
Income from different sources as a fraction of total income, by consumption quintile



Source: World Bank staff estimates based on various Household Income and Expenditure Surveys.

Figure 3. 11 The share of earnings from agriculture in overall income of the poorest group has fallen

Income from different sources as a fraction of total income, in the poorest quintile over time



Source: World Bank staff estimates based on various Household Income and Expenditure Surveys.

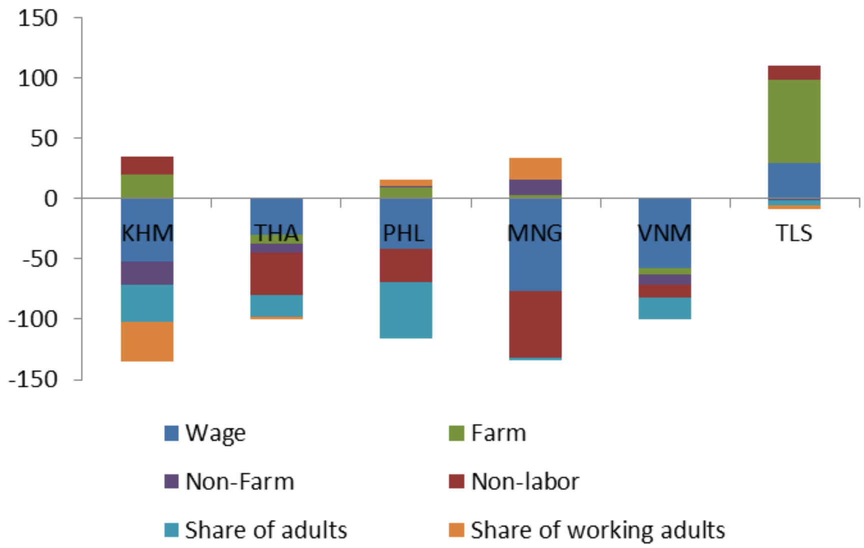
3.33 Income from work has been an important force for lifting people out of poverty and boosting prosperity in East Asia Pacific. But the channel is not automatic nor can it be taken for granted: many poor people work long hours and earn little income, which does not necessarily allow them to escape poverty. Nor is work the sole factor in overcoming poverty: multiple factors such as changes to household composition, assets and transfers, can also raise the likelihood of escaping poverty. One way to assess the contribution of labor income to poverty reduction is via a decomposition of poverty changes by sources of income. Using a statistical decomposition exercise, Badiani, Dewina, Golan and Nguyen (2013) decompose changes in income poverty into contributions of different income sources in East Asia Pacific countries. Figure 3.12 presents the results of the decomposition, and the sum of contributions from wage, farm, non-farm work, and the share of working adults represent the role of work and labor income. Non-labor income includes income from assets, private remittances, public social assistance or insurance, or other transfers. In all but one of the countries for which there is data to conduct the decomposition, income from work explains more than 40 percent of the observed reductions in poverty. In Vietnam and Cambodia, in particular, changes in labor income contributed to more than 70 percent. In Timor Leste, the loss of labor income from 2001 to 2007 explains almost all of the increase in poverty.

3.34 Not all sources of income for work have the same impact on poverty and living standards. The sector of work and the constraints of entering certain sectors, such as the non-agricultural sector, affect individuals' future income prospects. In the early years of the structural transformation, work in agriculture was a key driver of poverty reduction. For example, Glewwe, Gragnolatti and Zaman (2002) and Ravallion and Chen (2007) show that agricultural productivity gains and land reforms, rural infrastructure improvement, and off-farm activities were important to reduce poverty in the 1980s and 1990s in Vietnam and China. Higher farm incomes paved the way for individuals to engage in off-farm employment in China, which were associated with the most poverty reduction (de Brauw et al 2002).

3.35 More recent analysis shows that income from different types of work has had different effects on welfare. For instance, wage income has been an important contributor to poverty reduction in Vietnam and Cambodia. In Mongolia and the Philippines, increases in wage income have also been a key factor for reducing poverty, and the loss of farm incomes had an adverse impact. As observed in Figure 3.9 on the income composition, households in the Philippines experienced a small reduction in the share of farm incomes over the period 2006-2009. From 2007 to 2011 in Mongolia, agricultural production was adversely affected by severe weather conditions while social transfers increased and constituted an increasing fraction of the income of the poorest. Similar to Mongolia, in Thailand, non-labor incomes were very important for the observed poverty reduction. The income composition in Thailand has been relatively stable, but the share of transfers in aggregate incomes nearly doubled during the time and increased in importance for the poor. In Timor Leste from 2001 to 2007, the loss in farm income followed the loss in wage income, and contributed a large part to increases in poverty.

Figure 3.12 Income from work explains a large share of reduction in poverty

Results from a decomposition of poverty changes into different components



Source: World Bank staff estimates based on Cambodia Socio-Economic Survey (2007, 2010), Thailand Household Socio-Economic Survey (2006, 2009), Philippines Family Income and Expenditure Survey (2006, 2009), Vietnam Living Standards Measurement Survey (2004, 2010), Mongolia Household Socio-Economic Survey (2007/8, 2011), and Timor Leste Survey of Living Standards (2001, 2007)

Work and economic mobility

3.36 Work-related choices and events, broadly defined, provide opportunities to improve livelihoods in many parts of the world, including East Asia Pacific. In Indonesia, employment changes of the head of the household were important for explaining changes in household incomes (Fields, et al. 2003). Using data collected in 1985 and 2008 from villages in Central Luzon and Panay Islands of the Philippines, Estudillo, et al. (2012) found that formal wage incomes and overseas remittances were the largest component of rising rural incomes for those who exited poverty or remained non-poor. Evidence from the 1990s in Vietnam suggests that exiting poverty was related to employment growth in the export sectors. In rural Vietnam, work-related events accounted for 62 percent of the probability of escaping poverty during 1990s (Inchauste, 2012).[5] Evidence from rural Thailand suggests that there are earning gains from moving from the farm to the non-farm sector, but also that in recent years, there is limited mobility between sectors and upward mobility within the non-farm sector (see Box 3.1). Qualitative accounts from Cambodia, Indonesia the Philippines and Thailand, indicate that finding employment and starting new businesses are the most frequently offered explanations for households moving out of poverty (Narayan, Pritchett and Kapoor 2009).

[5] This said, Dang and Lanjouw (2012) show that the transition of households out of poverty in Vietnam took place predominantly through working people earning higher income in the same sector of work, rather than through shifting from farm to nonfarm work, as in other parts of East Asia Pacific.

Box 3. 1 : Non-farm labor market dynamics in rural Thailand

Combining rural village level census data and individual level panel data from rural Thailand, Chawanote and Barrett (2013) find that non-farm employers and employees earn more than farmers and own account self-employed in rural Thailand. The paper shows that between 2005 and 2010, occupational mobility was relatively limited and tends to be more downward than upward: individuals are more likely to transit from non-farm self-employment to farming rather than into non-farm employee or employer positions. While 28 percent of those who were in 2005 non-farm employers were found to be non-farm self-employed in 2010, only 3.3 percent of the initially self-employed turned into non-farm employers in 2010.

Regression analysis of changes in log real earnings controlling for base earnings, individual and household characteristics and different possible employment transitions, shows significant gains in earnings for those who were employed in non-farm activities and remained as such compared to those who remained working on the farm during the whole time interval. Accordingly, transiting from non-farm employment to farm employment is associated with earning losses for the non-farm self-employed and employees, while transiting into the non-farm sector correlates with higher earnings for farm workers (except when transiting into non-farm self-employment).

Source: Chawanote and Barrett (2013)

3.37 Adults' work can also have an important impact on the prospects and welfare of their children, therefore promoting economic mobility from one generation to the next. Children from wealthier families commonly possess better health and education outcomes since income helps pay for investments in children's human capital, strengthening their labor market prospects in the future. Evidence also shows that cross-border migration and remittances help improve consumption, benefit children's education, and reduce child labor, although counteracting effects on the family structure can be non-negligible (World Bank forthcoming). In addition, parents' form of work can be a predictor of that of their children. Using data from the Vietnam Living Standard Survey 1992/3, Emran and Shilpi (2010) find that having a mother (father) working in the non-farm sector increases the likelihood of daughters to participate in the non-farm sector by 22 percent (7 percent). For sons, whether a father or mother participates in the non-farm sector is important for predicting sons' participation in the non-farm sector. The study also finds that the intergenerational correlation in employment in the agriculture sector between parents and children can be accounted for by factors that are not observed, such as preferences.

3.38 While work-related choices and events can help people transition out of poverty, shocks transmitted through the labor markets can also make households vulnerable and affect their living standards. Shocks include the death of a working-age household member, sudden falls in commodity prices that cut into farmers' profits, economic downturns, and for countries heavily reliant on remittances from emigrants, recessions in migrant-receiving countries. The 1997-1998 East Asian crisis provides an example of the setback to living standards due to systemic economic shocks: this period is the only halt in an otherwise continuous downward trend of extreme poverty in the developing countries of East Asia Pacific since 1990. In the more recent global financial crisis, as discussed in Chapter 1, countries in East Asia Pacific were more resilient than other regions. Although employment remained steady, there was still a substantial downward adjustment in earnings.

3.39 Thus while work has been transformational in reducing poverty and raising the living standards of many people in East Asia Pacific, the small share of working people covered by social protection (see chapter 6) leaves many households without sufficient formal insurance against shocks to wellbeing transmitted through their work. In addition, a moderation of growth rates in several countries of the region is expected to translate into slower gains in living standards than many people have experienced over recent decades.

3.3 Work and social cohesion

3.40 What is social cohesion, and how is it influenced by work? Social cohesion is a very broad and mostly intangible public good, easier to identify when there is less of it or it is missing altogether. The term typically refers to the ability of all citizens to enjoy access to fundamental social and economic rights without discrimination and on an equal footing (Jenson 2010). The OECD defines a 'cohesive society' as one that "… works toward the wellbeing of all its members." (OECD, 2011 cited in World Bank, 2012a, p. 128). Social cohesion can be measured in several ways[6] and is shaped by many factors, including work. Work creates opportunities and shapes interactions between individuals and groups. It affects how people think of themselves and relate to others. Societies thrive where work connects people from different groups, and creates opportunities for them to fulfill their potential. Employment can also provide access to voice. The distribution of employment and earnings, and how people exchange in the labor market can shape their aspirations and perception of fairness. Work can influence social cohesion through all of these channels.

3.41 Given how broad the concept of social cohesion is, how it is affected by work will vary widely from country to country. Norms, value systems, and institutions matter (Kilroy 2012). In some countries, threats to social cohesion may arise along the rural-urban divide, or from the marginalization of youth and ethnic minorities. In other places, the threat may come from widespread unemployment leading to social unrest and conflict. In many countries social cohesion is threatened by high levels of welfare inequality, or unequal access to health, education and opportunities for advancement, which limits the extent to which a country's prosperity is shared.

3.42 Work has contributed to social cohesion in East Asia Pacific in recent decades. The region's remarkable progress in economic growth has led to improvements in the life of many people, including poor people and disadvantaged groups, mainly through their work. Income from work among people in poor households has risen. According to estimates using household survey data, the share of wages in total income for the poorest quintile rose by 44 percent in

[6] See World Bank (2012a) for a further discussion on measures such as trust and civic engagement.

Vietnam, 6.5 percent in the Philippines, and 3.4 percent in Mongolia. Li, et al. (2012) document that the annual average wage increases in China from 1978 to 2010 were broadly shared: wages increased for both skilled and unskilled workers, for people working in coastal and inland areas, and for workers in both exporting and non-exporting firms. Rural residents in many parts of the region have benefited. Rural migrants were able to find better work opportunities in towns and cities. And the remittances they sent back have contributed to improving the welfare and living conditions of their families, as well as better investment in the next generation. Economic growth and development in the region narrowed gender gaps in several areas such as access to education and health, and in part as a consequence, women in the region are more likely to participate in the labor force (World Bank 2012b).

3.43 All the above notwithstanding, in the remainder of this chapter we argue that the social cohesion transformation of work is starting to lag in several countries, especially (but not only in) the most populous, China and Indonesia. We focus our discussion on two measurable threats to social cohesion that are the cause of concern in those East Asia Pacific countries: youth inactivity and economic inequality. As discussed in earlier sections, economic growth has been the most important determinant of poverty reduction in East Asia Pacific through work. Prior to 1990, this occurred alongside improvements in equality across the region, from Japan, Korea and Taiwan China, to Indonesia, Malaysia, the Philippines and Thailand. However, since 1990, economic growth and poverty reduction were accompanied by greater inequality in a few countries, including China and Indonesia. While some inequality of economic outcomes can spur aspirations, endeavor and enterprise, past certain thresholds, high inequality limits the extent to which economic growth will pull people out of poverty. Youth unemployment and inactivity is a contributing factor to this process. Mounting evidence from high income and emerging market countries shows that how young people fare upon entry and in their first few years in the labor market can have a lasting impact on their prospects through the rest of their working lives. Empirical evidence of "scarring" from early and extended periods of unemployment and underemployment, make the high and persistent share of young people without work, discouraged and inactive all the more worrying. Although not as acute a problem in the whole of East Asia Pacific as in other regions (an important point shown in Chapter 7), youth unemployment and inactivity is still considered a threat to social cohesion by many governments in the region.

Youth unemployment and inactivity

3.44 Youth unemployment and inactivity is high in several East Asia Pacific countries. While open unemployment is generally low in the region, youth unemployment and the numbers of youth not in employment, education or training (NEET) in several Pacific island countries, Indonesia and the Philippines stand out, higher than in Southern European countries and close to the levels observed in a number of Europe and Central Asia countries (Figure 3.13). Low levels of employment among youth can be good or bad depending on the exact cause. In some countries, youth unemployment or underemployment is explained more by idleness rather than schooling. In others, youth spend more time pursuing higher education rather than entering the market in search of working early, or spend more time seeking employment or between jobs. But because every young person must find initial employment with limited search skills and little work experience, youth unemployment is a higher risk than unemployment for other age groups. To the extent that unemployment, extended periods of search for work or underemployment can have long-term, negative consequences on the future labor market prospects of young people, there is greater cause for concern.

3.45 A large body of research, mainly focused on high income countries, has identified the long run career impacts of periods of unemployment and employment in different types of work, particularly casual, unregulated 'informal' work. A spell of unemployment can increase a person's chances of being unemployed in the future and reduce earnings prospects (Heckman and Borjas, 1980; Arulampalam, Gregg and Gregory, 2001; Arulampalam, Booth and Taylor, 2000). This type of "scarring" is commonly identified from spells of unemployment among young people, who are at greatest risk of experiencing long term consequences of poor outcomes early in their experience of the labor market. For instance, evidence from the United Kingdom shows that having experienced more than 13 months of unemployment in their early careers reduces wages of prime aged men by 15 percent compared to those who did not experience unemployment in their youth (Gregg and Tominey, 2005). This wage penalty varies in size over time –from a higher penalty earlier and lower penalty later in working life. Furthermore, evidence of scarring has expanded to identify lasting prejudicial effects from particular types of employment in the first years of working life, such as self-employment (Hyytinen and Rouvinen, 2008), contingent (non-permanent) employment (Yu, 2012) and employment in the informal sector (Cruces, Ham and Viollaz, 2012). Empirical findings in developing East Asia Pacific are more limited. Recent research focused on Indonesia confirms the link between youth unemployment and the prevalence of informal work and actual segmentation in the labor market. Youth in Indonesia often enter the labor market through informal work, which lowers their chances of moving out of informal employment at a later stage in their working lives (see Box 3.2).

Box 3.2: Are young people 'scarred' from how they enter the labor market?

There are understandable reasons why the rate of market inactivity and unemployment among young people is typically higher than for the working-age population as a whole. Many people between the ages 15 and 24 are still building their human capital. Those who have ventured into the market have less experience looking for work or starting their own enterprise. If they have never worked before, they present a more risky prospect to employers or to financial supporters than otherwise similarly qualified applicants for employment or a business loan. When a significant number of young people are idle –not in employment, education and training, or NEET- there is more pressing cause for concern.

But even for those young people who overcome the foreseeable odds and find work, the earliest experiences in the labor market can have consequences that last long into their working lives. Some of the circumstances that shape market entry and early work experiences are 'systemic', for example an economic crisis or recession lowering the demand for labor and human capital overall. Others are 'idiosyncratic' obstacles, and sometimes reflect preferences. All can have a measurable impact on the welfare young people can expect to derive from work in later years, and for this reason can be important to crafting policy.

Recent research on the labor market in Indonesia shows evidence of the "scarring" effects of young people's early work experiences. Naidoo, Packard and Auwalin (2014) exploit the panel dimension of the Indonesia Family Life Survey (IFLS) extending from 1993 - 2007, and find very little mobility across sectors and types of work over time. Young people that are self-employed sole traders, for example, are likely to remain in this type of work well into their adult life. From 1993 to 2000, 3 percent of 15 to 24 year old men in the IFLS category self-employed sole traders ('self-employed without hired staff'), transitioned to self-employment with hired staff. For the period 2000 to 2007, only 2.6 percent of young men made this transition. The rates of transition are similarly low for adults and for women. Those that enter the market in registered dependent employment in the private or public sector are also likely to remain in these forms of work long into their working lives.

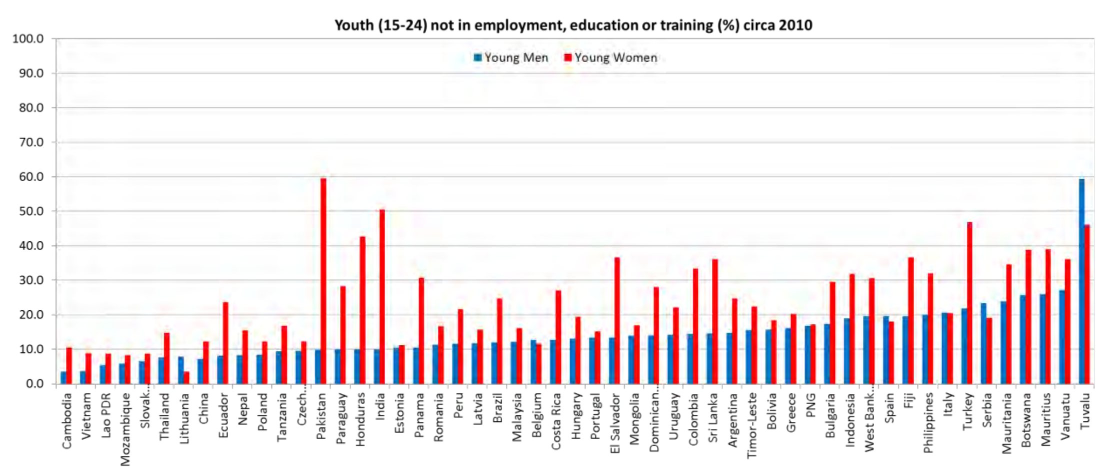
Low likelihood of mobility across sectors and types of work is consistent with scarring, but is not in itself evidence of scarring. Differences in ability, human capital and preferences may lead individuals to sort systematically into certain types of work and then to remain in these types of work. Using objective and subjective measure of 'job quality' (for example, a written employment contract; access to training opportunities; non-pecuniary benefits like housing and meals; reported levels of stress and satisfaction), self-employed sole traders in Indonesia appear to be in less desirable forms of work than other working people in the same age cohort. This is in contrast, for example, to young government employees and young private sector employees- 34 percent and 23 percent that work with the security of some type of contract, respectively, and 42 percent and 22 percent that receive employer provided training, respectively.

While the human capital implications of different types of work are not directly observable, the long run impact on wages of experience in different types of work can be measured. Naidoo, Packard and Auwalin (2014) find that certain forms of work in Indonesia, specifically sole-trader self-employment, is associated with human capital deterioration -or at least stagnation-resulting in zero or negative returns in later spells of employment. In addition to there being no detectable returns to self-employment and the lack of training and contracts, the median wage in 2007 for youth in such work was about 285,000 Indonesian Rupiah per month in contrast to government work and private sector work, for which it was 475,000 and 512,000 Rupiah, respectively.

Although far from definitive, as evidence grows of scarring from how young people enter the labor market and their early work experience, so to the public policy rationale for early intervention with employment-search and other work-related assistance programs for young people."

3.46 Another concern with high unemployment, youth unemployment and inactivity, -particularly in the Pacific islands countries- is the potential for an extreme breakdown of social cohesion, in the form of violence and conflict. Lack of work has been linked to broader social unrest. Collier and Hoeffler (2004) have argued that unemployed or inactive youth, lacking identity and social belonging, are more likely to engage in gangs or criminal activities. These threats to social cohesion and ultimately to stability, are at the forefront of concern in Papua New Guinea, the Solomon Islands, Timor-Leste and elsewhere. However, the empirical evidence linking unemployment and idleness to violence in East Asia Pacific countries is mixed (Box 3.3).

Figure 3.13 Youth idleness is high in some of the Pacific islands countries, Indonesia and the Philippines



Source: WDR statistical tables (World Bank 2012a) and the World Bank International Income Distribution Database (I2D2)

Box 3. 3: Unemployment and conflict: Is the link strong in East Asia Pacific countries?

Empirical evidence of a relationship between unemployment and the extreme breakdown of social cohesion in the form of conflict is limited and ambiguous. Cross-country evidence appears weak (Cramer 2010), and the evidence using microdata is mixed. For instance, although a larger share of unemployed people increases the likelihood of village-level conflict in Indonesia, where a "… 10 percentage point increase in unemployment is associated with a 0.6 percent point (…) increase in the likelihood of conflict" (Barron et al. 2004, p. 22); there is no clear link using province-level data from the Philippines during the period 1997-2006 (Berman, Callen, Felter and Shapiro, 2009).

The relationship between employment outcomes and conflict is also hard to pin down empirically because the causal links can run in both directions, i.e. unemployment can fuel frustrations that may eventually erupt into violence, or violence can raise risks that discourage the investment and enterprise that create employment. Indeed, qualitative accounts from the Philippines suggest that conflicts can influence employment by shaping the context in which entrepreneurs make investment decisions (World Bank 2013a). In 2011 'conflict provinces' in the Philippines had a lower unemployment rate than non-conflict provinces, but had a higher underemployment rate (23 compared to 17 percent). Also, employment was concentrated in agriculture as opposed to the service sector, and the fraction of self-employed and unpaid laborers was higher in conflict than in non-conflict provinces. Real wages in conflict provinces were lower than in non-conflict provinces (PHP 145 compared to PHP 191). Within conflict provinces, New People's Army (NPA) provinces exhibited lower real wages and higher unemployment and underemployment rates than Muslim provinces. These provinces also had higher shares of temporary workers. However, NPA provinces had a higher proportion of workers earning wages than works who were unpaid (49 compared to 33 percent for wage-earners, and 15 compared to 20 percent for unpaid workers). The level of industrial work was also higher (12 percent compared to 7 percent). Given that NPA conflicts have spanned over six decades and have had significant adverse impacts on the local business environment, these accounts suggest that recurring episodes of conflict, even if not reported in the headlines, can also have significant negative impacts on the quality of work (World Bank 2013a).

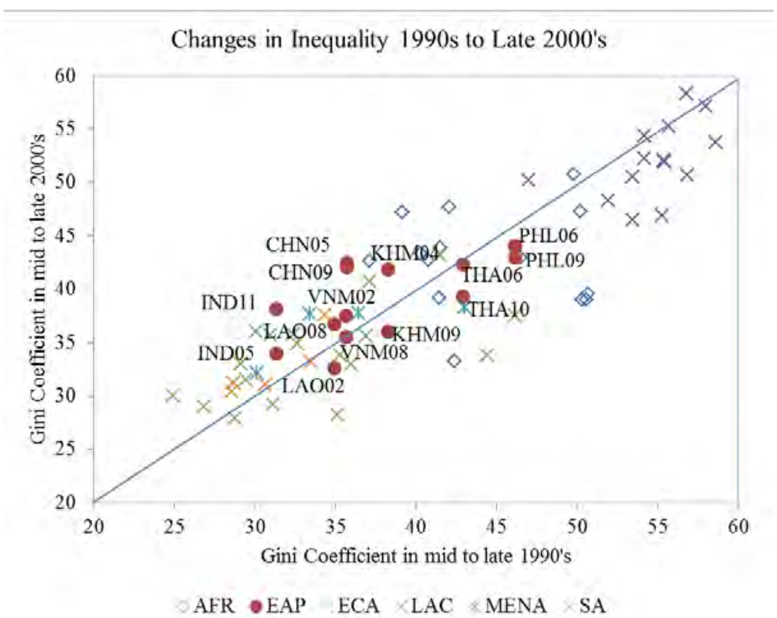
Understanding each particular context is crucial to explaining why unemployment is accompanied by social unrest in some instances but not in others. As Wietzke and McLeod (2012) argue "*Recent histories in the Arab World, North Africa and some high income countries suggest that even societies with relatively large differences between groups in the labor market can be remarkably stable over time, until latent tensions between groups quickly become politically salient as economic or political outlooks change. However, whether and when these tensions actually erupt into conflict appears to be driven by a multitude of other factors that are harder to predict with the quantitative data and methods available*".

Rising inequality

3.47 Inequality is a topic worthy of a report in its own right. Many factors underlie the aggregate measures of income and consumption inequality and how these change over time. The discussion in this section is contained to the linkages between inequality and the labor market.

3.48 Alongside the decline in poverty in the region, inequality has been on the rise in several East Asia Pacific countries. Figure 3.14 shows relative inequality as measured by either the consumption or income-based Gini coefficients, from the late 1990s to the late 2000s. The Gini coefficient has increased in Indonesia, Lao PDR, and China over this period. China's levels of inequality are among the highest in East Asia Pacific[7]. In China, Thailand, the Philippines and Fiji inequality is now comparable to the levels observed in Latin America and parts of Africa. Even in a country like Vietnam with little noticeable increase in the consumption Gini, income inequality has been rising (Badiani, et al. 2012). Although high relative to the rest of the region, inequality decreased in Fiji, Thailand and the Philippines. In terms of absolute inequality, there are stark differences in welfare between rural and urban areas, and between the poorest and richest parts of the population. The average per-capita consumption in urban China was at least 4 times that in rural China in 2008, with a similarly large gap within urban areas (NBS 2012). Per-capita consumption at the 90th percentile is 4 to 6 times that at the 10th percentile in the Philippines, Thailand, Vietnam, Mongolia and Indonesia (Figure 3.15).

Figure 3. 14 Inequality has been rising in several countries, including China and Indonesia
Consumption and income-based Gini coefficients (percent)

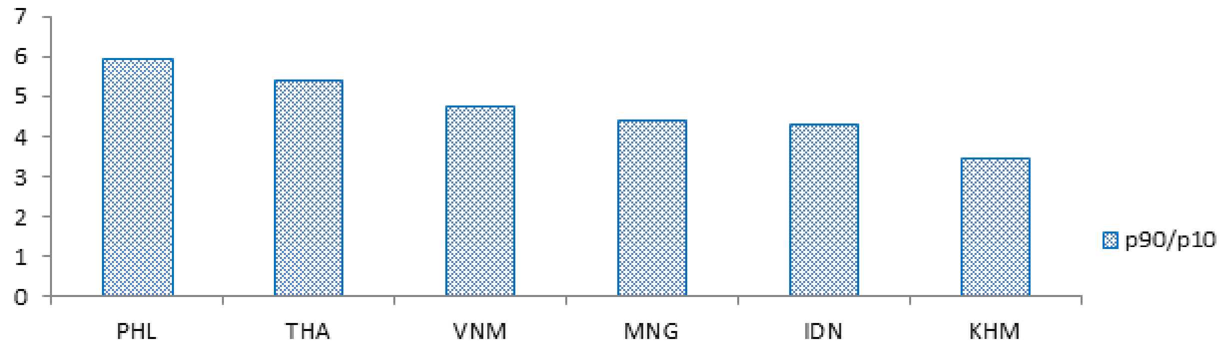


Source: WDI database.
Note: The figure shows the Gini coefficients at three points in time: country points lying above the 45-degree line imply an increase in inequality from the late 1990s to the labeled year in the late 2000s.

[7] According to official estimates quoted by Balakrishnan, et al. (2013), China's Gini coefficient rose from 37 percent in the mid-1990s to 49 percent in 2008. The same official sources estimate that the Gini has since fallen and stood at 47.4 percent in 2012.

Figure 3. 15 The rich-poor gap in welfare can be very large

Ratio of the 90th percentile to the 10th percentile of the distribution

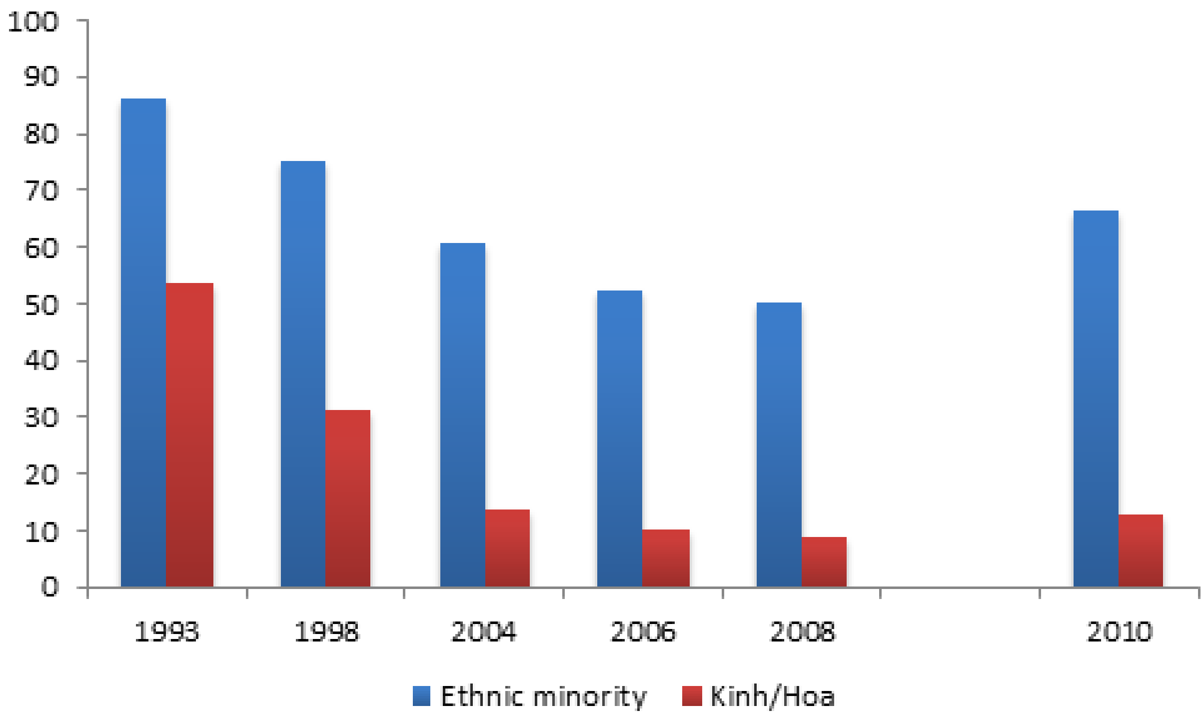


Source: World Bank Staff estimates based on national consumption aggregates for: Vietnam VLHSS 2010, Cambodia CSES 2011, Mongolia HSES 2011, Thaliand SES 2010. Estimates for the Philippines and Indonesia are for the year 2009 and 2010 and are from the EAP Poverty monitoring system.

3.49 Even though ethnic minorities have benefited from the economic success of the population as a whole, significant gaps in welfare between ethnic groups remain persistent. In Vietnam, for example, the Kinh majority exhibits a poverty headcount of about 10 percent while poverty amounts to nearly 70 percent for their ethnic minority counterparts - a gap that has been widening between the two groups (Figure 3.16). This gap relates to differences in types of work. Ethnic minorities in Vietnam depend almost exclusively on agriculture and forestry for their livelihoods. The Kinh poor have more diversified sources of income stemming from low-skill, low-paid off-farm jobs in rural areas to supplement farm income (Badiani, et al. 2012). Similarly, ethnic minorities in Lao PDR have poorer labor market outcomes. The Lao-Tai/Tai-Kada ethnic majority and the Chine-Tibet have higher average wages than the other ethnic groups (Figure 3.17). The Lao-Tai are also more likely to work outside agriculture, especially when residing in urban areas. All other ethnic groups work mainly in agriculture, irrespective of where they live.

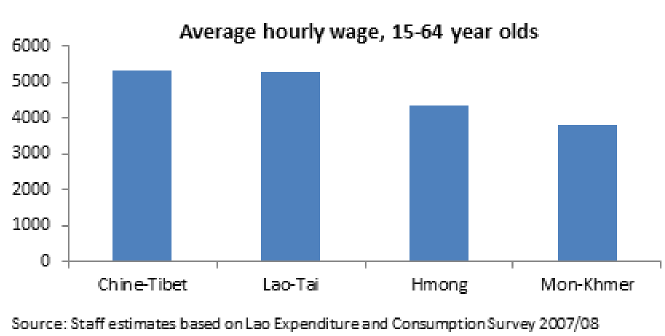
Figure 3. 16 The poverty rate among ethnic minorities and the majority in Vietnam has fallen over time, but the gap persists.

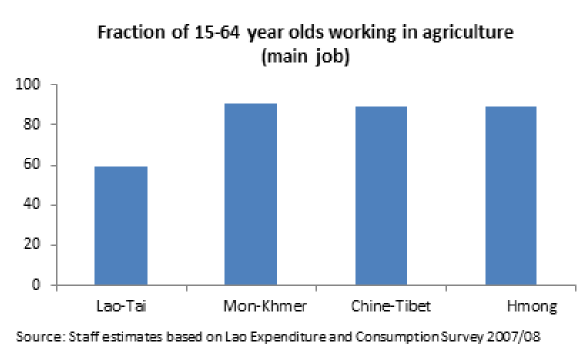
Poverty headcount (%), by ethnicity



Source: Badiani, et al. (2012).
Note: 2010 poverty rate is constructed based on new welfare aggregate and not strictly comparable to earlier years.

Figure 3. 17 Ethnic minorities in Lao PDR experience poorer labor market outcomes





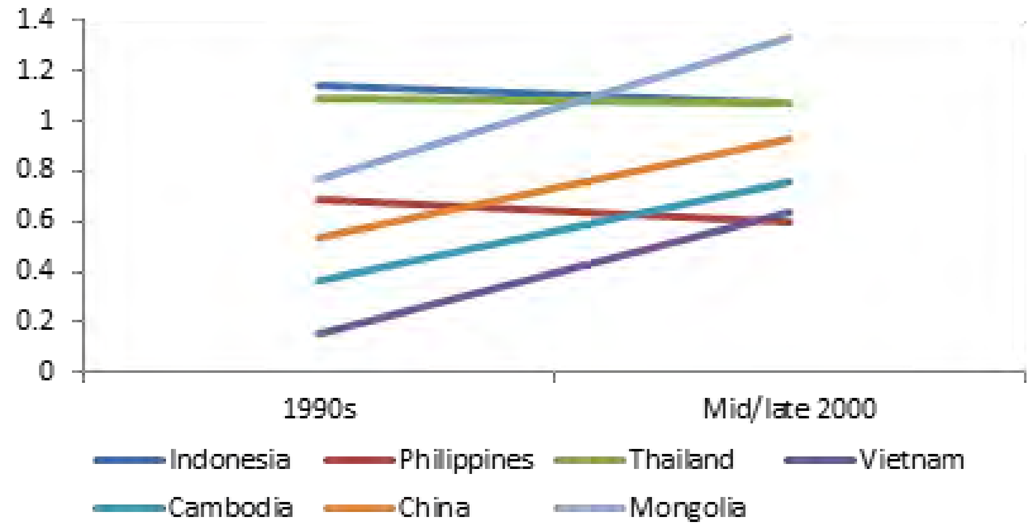
3.50 Should inequality be worrying? Some periods of rising inequality coincide with periods of fast economic growth, and for this reason, greater inequality on its own may not be problematic. However, a growing body of evidence shows that high and persistently rising levels of inequality can undermine development. Ravallion (2005) shows how high inequality impedes the potential for poverty reduction, even with rapid economic growth. Balakrishnan, Steinberg and Syed (2013) estimate that a 1 percent rise in the Gini coefficient directly offsets the beneficial impact of a 1 percent economic growth on poverty reduction.[8] Globally, income disparity and other manifestations of inequality in welfare, are now perceived as one of the most threatening risks (World Economic Forum 2013). In China, perception surveys show that the wide income disparity in the country is seen as undesirable, and that many citizens are concerned that such gaps can undermine social stability (Whyte 2010).

3.51 High levels of inequality have the potential to weaken social cohesion. Inequality affects people's expectations about their economic mobility, aspirations and perception of fairness, as well as their motivations and choices. Inequality can affect welfare directly in places where there are strong social norms and preferences for equity and can shape political outcomes through demands for redistribution. Inequality can also impede efficiency and growth. If inequality grows to such an extent that it eventually leads to elite groups controlling access to markets and political institutions, and constraining pluralistic democracy, the process of creative destruction can slow and even be brought to a halt, causing societies to go into decline (Acemoglu and Robinson, 2012). History is punctuated by instances of economic and social decline that were precipitated by extreme inequality and the consequent ability of elite groups to limit the contestability of markets through their control of political institutions.

3.52 Income and consumption inequality is closely linked to the labor market. Changes in inequality can arise from changes in the distribution of assets and characteristics (endowment effects), changes in the returns to assets (price effects), or changes in how individuals use these assets in their work (occupational choice effects) (Bourguignon, Ferreira and Lustig 2005). In East Asia Pacific countries, inequality linked to work is mainly driven by increasing returns to skills and consequently differences in labor earnings. The wage premium to higher education (relative to primary education) has risen sharply in several countries, such as in China, Vietnam, Cambodia and Mongolia since the mid-1990s (Figure 3.18). In these countries, the demand for skills is rising sharply and outstrips the available supply of skills in the workforce, a topic discussed further in Chapter 5.

[8] The authors show that an increase in the Gini coefficient of about 25 percent – as observed in urban China from 1995-2005- reduces the impact of a 1 percent increase in income, to about a 1.5 percent decline in the poverty headcount from a 2 percent decline, if the Gini had not changed.

Figure 3.18 Skills premia in labor earnings have risen sharply in many East Asian countries.
Estimated return to having tertiary versus primary education



Source: di Gropello and Sakellariou (2010).
Note: Estimates are based on an OLS regression of log wages that controls for basic individual characteristics and industry affliation for those who work for a wage. The wage premium is expressed as differential between the tertiary and primary returns (relative to no completed primary education).

3.53 Inequality in wages and other labor market outcomes can result from inequality of opportunity, that is, systematic differences due to factors beyond people's control. The circumstances into which an individual is born--such as location, gender, ethnicity and parental education—can also influence the opportunities that individual has early in life and later in the labor market. Abras et al (2012) quantify the contribution of these circumstances to explaining the observed differences in opportunity in the labor market (defined as having employment of 20 hours and more) for Europe and Central Asia countries and Mongolia. Their results attribute a significant share of this inequality in employment opportunity to circumstances beyond individuals' control. In the case of Mongolia, it is as high as 50 percent.

3.54 In most societies, people are content to see others succeed, do so through hard work, and within social norms, as long as they are afforded the same opportunities. But recent evidence shows discontent among people in many parts of East Asia Pacific about certain types of inequality which are perceived as unfair. A study of perceptions in China suggests that the average Chinese citizen is content to see others succeed based on merit, i.e. talent, hard work and education. But the same respondents have little tolerance for advancement based on connections, unequal opportunities determined by circumstances such as gender, family size, and household registration status (Whyte 2010). Similar perceptions studies in Vietnam and Mongolia suggest that there is widespread acceptance of inequality that arises from 'good' processes: *"Those who have talent and luck are conditioned to succeed. Those who have none just suffer. I heard no complaint about inequalities. Such is reasonable"* (village cadre group, Cam Hung commune, Hai Duong). There is considerably less tolerance for inequality of opportunities arising from “unfair” processes, such as and access to employment through personal connections*: “There are types of illegitimate riches and we do not accept these types, we see them as injustice."* (youth group, Chieng Khoa commune, Son La) (Badiani. et al, 2012). When this sort of discontent becomes widespread, the ability of work to create cohesive societies is compromised.

3.4 The transformative role of work in East Asia Pacific’s development can’t be taken for granted

3.55 Countries in the East Asia Pacific region have taken advantage of a prospering global economy, and in doing so, have themselves become more prosperous. Their success has come about mainly through working people. Work in East Asia Pacific has been the conduit connecting and enabling three critical and inter-related development transformations: rising *productivity, improvements in living standards, and greater social cohesion*. In this chapter, we have shown how in recent decades, households in much of East Asia Pacific have experienced these three development transformations in tandem. However, we have also shown evidence suggesting that this phenomenon could soon change, with several of the most populous countries in the region reaching a critical development threshold when economic growth and welfare gains from work cannot be taken for granted.

3.56 In some countries, economic success has been accompanied by rising income and consumption inequality. Despite gains in living standards on average, in the population ‘giants’ China and Indonesia, as well as in Lao PDR, welfare is more unevenly distributed than in the past. Furthermore, a number of East Asia Pacific countries are now facing challenges to building more inclusive societies through people’s access and ability to work, particularly young people. For the region as a whole, more than 30 percent of people aged 15-24 in East Asia Pacific are not in employment, education or training. Tuvalu, Vanuatu, Fiji, the Philippines, and Indonesia have among the highest rates of youth inactivity in the world. High levels of youth inactivity have been linked to violence and the erosion of social cohesion, providing a strong motivation for governments to pay closer attention to the opportunities for youth to work or build their human capital.

3.57 What might at first appear as growing challenges to social cohesion are also linked to a general slowing of economic growth in the region, which is more pronounced in countries where productivity and living standards have been lagging for a long time. For example, in the past decade, the Philippines experienced much slower poverty reduction than its neighbors, despite respectable economic growth. This stagnant progress in living standards is linked to the low productivity of most forms of employment created by the economy. Many economies, including Cambodia, Lao PDR, Indonesia, and the Philippines, need to find ways to create and sustain productive work, amidst more difficult global economic prospects and more intense international competition. With rising wages, the labor cost advantage that has for years enabled many East Asia Pacific countries to benefit tremendously from global markets are now starting to erode.

3.58 To face these challenges, Governments need to understand how current policies shape the environment for work, and how they can prejudice or promote productivity growth, living standards and social cohesion. It is to this discussion that we turn in Part II of this report.

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Chapter 4: The Fundamentals

On the whole -and relative to their peers in other emerging market countries- governments in East Asia Pacific have gotten the 'fundamentals' right, creating an enabling environment for demand and supply of labor and human capital.

4.1 Although most work arises from private demand, governments play a critical part in shaping the market for labor and human capital, by reducing uncertainty and providing public goods.[1] These include macroeconomic and regulatory stability, the rule of law, investment in basic infrastructure, and ensuring the contestability of markets. Because firms and households cannot cope effectively on their own against inflation, a country's macroeconomic policy environment is particularly important. Investment and employment creation can be harmed by erratic fluctuations in prices or exchange rates, onerous taxation structures and restrictive regulations on businesses. Thus getting these 'fundamentals' right is important to attract and sustain investment, and to minimize—or at least smooth—aggregate fluctuations in an economy's demand for work. Sound fundamentals may not be sufficient for strong and sustainable employment creation, but they are still necessary.

4.2 This chapter examines the extent to which fundamental policies –monetary, fiscal, and regulatory- currently in place in East Asia Pacific countries support enterprise and the demand for work. The chapter describes the policy environment that shapes the economy's demand and households' supply of labor and human capital. There is one underlying question this chapter seeks to answer: Are the policy fundamentals observed in East Asia Pacific "pro-work"? To answer this question, we examine how the macro policy levers are currently set, and whether the prevailing regulatory models ensure a competitive climate that attracts investment and encourages employment. Further, we discuss whether policies are geared toward preventing macroeconomic imbalances, instability, and crises that can translate into both lower real earnings and unemployment.

4.3 Each of these *fundamentals* is worthy of a report in its own right. And a large body of theoretical and empirical literature already exists, much of it illustrating the experience of East Asia Pacific countries in recent years. But beyond a general consensus favoring "sound outcomes" -price stability, prudence and predictability in public spending, rule of law and competitive markets- there is probably more argument than agreement over the specific policies governments should put in place to achieve these outcomes, such as the degree of central bank independence, whether to peg or float the exchange rate, or the relative intensity of taxes on income or profits versus taxes on consumption. History is littered with prescriptions and orthodoxies that, with the test of time, were found wanting. And economists have become

[1] An important caveat to this general observation can be found in the Pacific island countries, discussed in chapter 8.

more modest in their admission that it is more important that governments achieve these outcomes than how they are achieved. So to contain the discussion, we have limited this chapter to monetary and exchange rate policies; spending and taxation; and the regulatory environment for businesses. Rather than pretend to solve what are welcome and still active debates in the literature and in practice, the chapter highlights the points on each side that are most salient to the demand and supply of labor and human capital.

4.4 With regard to public spending specifically, this chapter is limited to a general review of the cyclicality of aggregate net spending. Other important aspects of fiscal policy that shape the demand and supply of human capital -such as spending on education and health, “active” labor market programs, and investments by government to support sectors of the economy deemed strategic- are taken up elsewhere in this report (see chapters 5 and 6 and spotlight 2). Furthermore, and also for the sake of brevity, other fundamentals such as public sector management and governance are treated only tangentially.

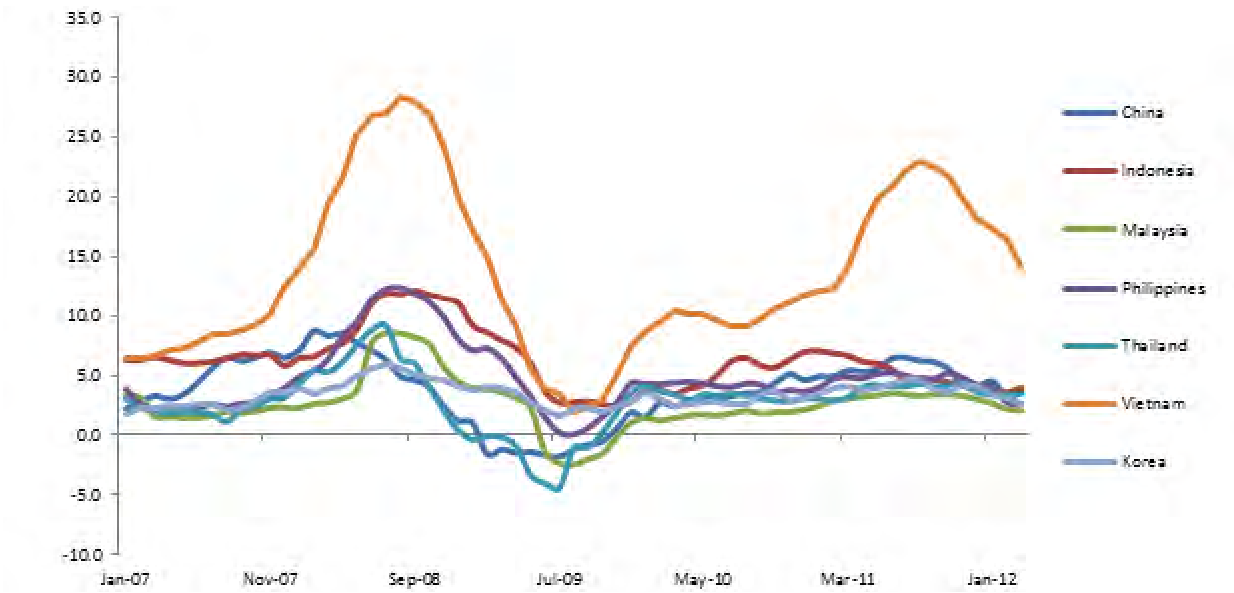
4.5 Across the region, there has been greater price stability, with inflation decelerating in recent years to low and stable levels. Contributing to stability and reflecting difficult lessons from the East Asian financial crisis in the late 1990s, exchange rate policies have shifted towards greater flexibility among the worst affected countries. A long track-record of fiscal prudence allowed East Asia Pacific countries to react quickly in the recent global fiscal crisis, sustaining support for aggregate demand, and even launching substantial fiscal stimulus packages that, along with more flexible exchange rates, helped contain the costs of the crisis borne by households. In terms of taxation, countries in the region stand out on the whole as places where firms seem neither overly burdened by the level of tax, nor by the costs of complying with tax obligations. This is in stark contrast to countries in Eastern Europe and in Latin America and the Caribbean. Turning to the business climate, on the whole, governments have created an encouraging environment for enterprise, although access to finance, skills shortages, unfair competition from informal enterprises, and insufficient and unreliable electricity may be unnecessarily constraining growth and demand for labor and human capital.

4.1 Prices and exchange rates

4.6 An economy generally relies on low, stable inflation. Employers require a certain degree of reliability concerning their investments in and returns from the production process. Volatile prices lead to greater risks for businesses, influencing medium and longer-term decisions about investment and their demand for human capital. This is true of all sectors: volatile prices influence the decisions that farmers make about which crops to plant, by vendors about what goods and services are most likely to sell and by larger firms about how many workers to hire for future production. Governments use monetary policy to help maintain economic and price stability through, in particular, interest rates, the money supply, and exchange rates, wielded by their central monetary authorities. It is important to note that although price stability sought through monetary policy is critical to sustaining investment and employment, decisions that are often taken can lower the demand for human capital in the short term.

4.7 Countries in East Asia are achieving greater price stability than in the past. Inflation has decelerated across the region. Even Vietnam, which has struggled with higher rates of inflation than its neighbors, is recently showing some progress in this regard.

Figure 4. 1 East Asian countries have achieved price stability.
CPI inflation trends before and during the global financial recession, in percent year-on-year



Source: Data derived from IMF IFS.

4.8 High inflation distorts price signals, blurring the link between an asset's productivity and its price. This can distort investment decisions, leading to either underinvestment due to cautiousness or to asset bubbles due to over-confidence. Savers will demand higher premiums when inflation is high. This results in an inefficient allocation of resources and further hampers investment. Finally, inflation may provide incentives for investors to put their money in safe but unproductive assets such as gold, reducing economic activity.[2] Thus, overall, high inflation can reduce long-run economic growth and demand for work through sub-optimal investment, while it can also cause large boom and bust cycles by aggravating business cycle fluctuations.[3]

4.9 A stable inflation environment can reduce structural unemployment (Freedman and Laxton 2009). Economic growth has exceeded inflation in most countries in the region with an average inflation rate below 3 percent. Conversely, higher levels of inflation have been associated with lower rates of growth. In high income countries, inflation beyond 3 percent can

[2] However, some economists argue that a looser rein on inflation in the shorter term could ease both indebted consumers and governments in meeting their obligations and at the same time support consumption (Bloomberg 2013). These arguments are less important in East Asia Pacific given the region's higher levels of savings and solid track-record of fiscal prudence.
[3] Baer 1967; Campos 1967; Mundell 1971; Dornbusch and Reynoso 1989; Freedman and Laxton 2009.

be harmful, while in low and middle income countries, when inflation rises to beyond 7-11 percent, growth can suffer (Khan and Senhadji, 2000).[4] The data in table 4.1 indicate that countries where inflation runs below 3 percent tend to have lower unemployment overall, as well as lower rates of youth unemployment.

Table 4. 1 : Countries with lower inflation also exhibit low unemployment in East Asia Pacific.
GDP growth rates and unemployment rates by inflation rates using 2000-2011 averages across East Asian and Pacific countries and developing regions

Avg. level of inflation, consumer prices (annual %)	Country / regional avg.	Inflation, consumer prices (annual %)	GDP growth (annual %)	Unemployment (% of total labor force)	Youth unemployment (% of total labor force ages 15-24)
-1 – 2 %	Japan	-0.3	0.8	4.7	9.0
	Hong Kong SAR, China	0.5	4.5	5.5	11.6
	Brunei Darussalam	0.7	1.5		
	Taiwan, China	1.0	4.1	4.4	11.0
	Singapore	1.9	5.9	4.8	8.4
2 – 3 %	Macao SAR, China	2.2	12.3	4.8	8.6
	Malaysia	2.2	5.0	3.4	10.0*
	China	2.3	10.2	4.0	
	Thailand	2.6	4.0	1.6	5.2
	Vanuatu	2.7	3.5	4.6*	
3 – 5 %	Korea, Rep.	3.2	4.5	3.6	9.8
	Fiji	4.0	1.1	5.9*	
	MENA. avg.	4.4	4.3	12.3*	24.9*
	Philippines	4.6	4.7	9.3	18.7
	East Asia & Pacific avg.	4.9	8.9	4.6	
5 – 6 %	Cambodia	5.1	8.0	2.0*	3.4*
	Lat. Amer. & Cari. avg.	5.3	3.5	8.3	16.4
	Samoa	5.4	3.3	5.0	12.2
7 – 19 %	Tonga	7.5	1.3	3.1*	11.9*
	Papua New Guinea	7.6	3.7		5.3
	Europe & Cen. Asia avg.	7.6	5.1	8.9	18.5
	Vietnam	7.9	7.1	2.3*	4.9*

[4] This said, higher unemployment can weaken the collective bargaining power of workers, constraining wage demands. Thus, higher unemployment weakens pressure on wages, which translates into lower inflation. The negative empirical relationship between unemployment and inflation is described by the so-called Phillips Curve (Phillips, 1958). Recent experience in East Asia and elsewhere dispute this relationship.

Indonesia	7.9	5.3	8.8	26.3
Lao PDR	9.1	7.1	1.4*	
Mongolia	9.2	7.0	3.4*	20.0*
Myanmar	18.7	12.9*		

Source: Data calculations based on data derived from WDI database. Note: Regional averages only reflect developing countries in the respective region. *Reflects the average for less than 8 observations over these 12 years.

4.10 Many countries actively target a low inflation rate, yet the evidence of the impact of inflation targeting on performance is mixed. A number of studies find that inflation targeting can help build institutional credibility and thus increase long-run growth and reduce economic volatility (IMF 2006; Gonçalves and Salles 2008). Others find that moderate rates of inflation (even up to 20 percent or more) have no detectable effect on real variables such a growth, investment, foreign direct investment or employment (Bruno and Easterly 1998; Epstein 2000). Especially in emerging economies, recent evidence suggests the effect of inflation targeting on the real economy may have been overestimated.[5]

4.11 Table 4.2 shows that there are six countries in East Asia Pacific which use inflation targeting to fix their consumer price index. Globally, there are 28 countries that set these monetary policy targets (IMFa 2012). The four developing countries in East Asia with inflation targets adopted the policy after the East Asian financial crisis in 1997. While there is evidence that inflation targeting has helped reduce inflation (Gerlach and Tillman, 2011), there is little evidence that the policy has significantly improved growth and employment, relative to that of countries that have not adopted targeting, such as China, Hong Kong, Malaysia, and Singapore (Naqvi and Rizvi 2010).

4.12 Beyond inflation targeting, arguments are growing louder that central banks need to establish more comprehensive mandates that include employment promotion (Epstein and Yeldan 2008; Epstein 2009). Whether central banks should consider adopting stronger mandates towards employment gives rise to several technical issues. One issue is how to set a target, for example, based on overall employment, full employment, or a composite measure of employment. Another issue is that such a shift in policy focus would depend on the collection of high-frequency employment data, which presents challenges for many countries. Also, an employment target may produce policy rigidities. For central banks to monitor the extent to which their objectives are being achieved, it is necessary to have in-depth analysis of the performance of the labor market. Yet in a number of countries in the region, as shown in Table 4.2, central bank reporting lacks detailed analysis of employment trends, even among high-income countries.

[5] Brito and Bystedt (2009) re-examine studies documenting a strong positive effect of inflation targeting (IT) and find that in emerging economies (i) growth tended to drop during adoption of IT and (ii) countries with IT regimes have not displayed superior economic performance in the longer run relative to countries that did not adopt IT. This finding could be in part due to emerging countries often adopting inflation targets that may be appropriate for developed countries but not for faster-growing developing countries (Anwar and Islam 2011).

Table 4. 2 : Several central banks in East Asia Pacific have adopted inflation targeting, but few include detailed labor market analysis in their annual reports

Central banks' targeting of inflation and level of reporting on employment across East Asian countries

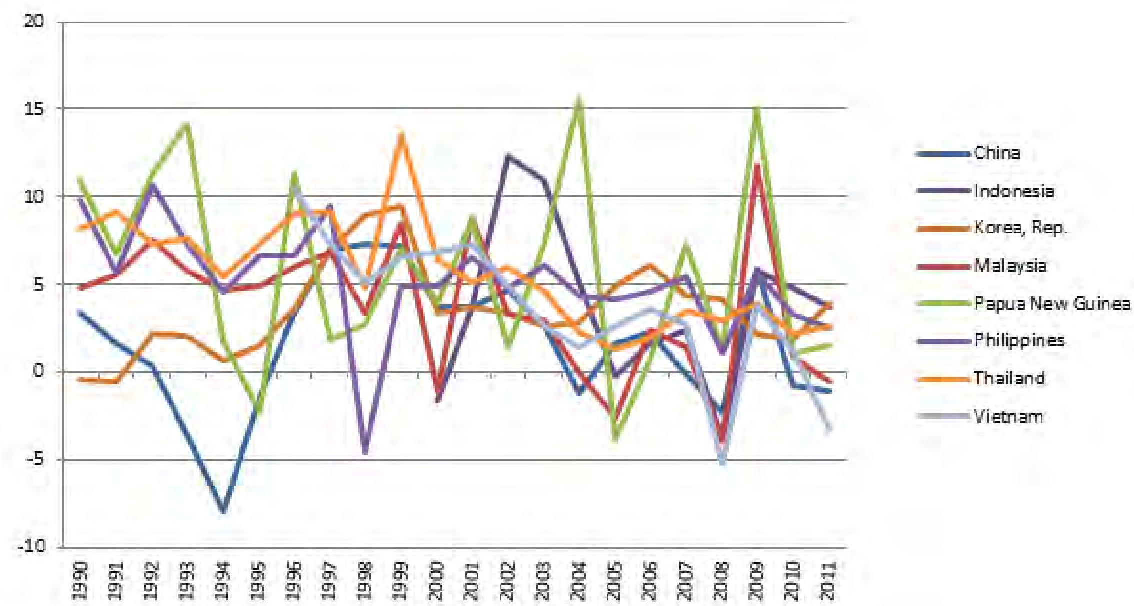
	Inflation data				Employment analysis in the latest available annual reports of central banks		
	Inflation targeting adoption date	Inflation rate at adoption date	2010 end-of-year Inflation	Target inflation rate	None	Brief analysis	Detailed analysis
Australia	1993	2.0	2.7	2 - 3	√		
Cambodia	x	x	x	x	√		
China	x	x	x	x			√
Indonesia	2005	7.4	7.0	5 (+/- 1)			√
Lao PDR	x	x	x	x	√		
Korea, Rep.	2001	2.9	3.5	3 (+/- 1)			√
Malaysia	x	x	x	x			√
New Zealand	1990	3.3	4.0	1 - 3	√		
Philippines	2002	4.5	3.0	4 (+/- 1)		√	
Thailand	2000	0.8	3.1	0.5 - 3			√
Vietnam	x	x	x	x		√	

Sources: Data for the first four columns are derived from IMF calculations, Hammond 2011, and Roger 2010, while data for the last three columns is derived from annual reports of central banks, and ILO 2012. Note: Employment analysis refers to the latest available English-language annual report of central banks accessible online. While the 2012 annual report of the central bank in Australia lacks an employment analysis, the 'maintenance of full employment' in the country is one of the three explicit functions of the Reserve Bank.

4.13 The above discussion notwithstanding, monetary policy can be used effectively to smooth business cycle fluctuations and to stabilize employment outcomes in the short-run. During an economic slowdown or contraction, increasing the money supply and lowering interest rates can help increase employment as lower financing costs can boost consumption and investment. Indeed, central banks often use monetary policy to counteract short-term business cycle fluctuations. There is broad consensus that, while often effective in the short-run, this "pump priming" is something monetary authorities should engage in with great care (Friedman and Schwartz 1963; Hossain and Chowdhury 1996). Figure 4.2 shows volatile trends in the real interest rates for a number of East Asia Pacific countries. In the years immediately following the Asian financial crisis and the global financial crisis, the real interest rates in all these countries bounced back down to pre-crisis levels.

Figure 4. 2 Although still volatile, interest rates in many East Asia Pacific countries are trending downward.

Real interest rates (%), selected East Asia Pacific countries, 1990-2011



Source: Based on data derived from World Development Indicators.

4.14 Exchange rate policy is a monetary lever that grows in importance to sustaining demand for labor and human capital, the greater a country's integration with the global economy. As pointed out in chapter 1, countries in East Asia Pacific have experienced years of sustained global and regional economic integration at higher levels than countries in other regions. Thus for this region more than others, exchange rate policies have a direct impact on the demand and supply of labor and human capital through several channels.

4.15 First, depreciation of a country's exchange rate decreases the relative price of labor, which helps to increase exports and consequently the labor demand for traded goods that are domestically produced. This can lead to an increase in output and in turn help increase employment in the "tradable" sectors. The boost can quickly spill over to the non-tradable production since the consumption of workers in these sectors helps raise demand for non-traded goods -typically, services- raising employment overall. This has been East Asia's experience through several instances of exchange rate depreciation (Kim and Yung-Hasiang 2007). Second, movements in exchange rates alter the relative price of labor and capital. When a country's currency depreciates, the relative cost of labor falls making it more attractive at the margin for businesses to raise the labor intensity of their production. Third, in the medium and longer term, exchange rate depreciation increases economic competitiveness and raises the potential profitability of businesses since input costs fall and demand rises. Through each of these channels, exchange rate policy can function as an instrument of industrial policy: similar to tariffs, exchange rate policies can raise import cost and make export-oriented sectors more competitive (Frenkel and Ros 2006, Rodrik 2003).

4.16 The value of a country's currency can also move in the other direction of exchange rate appreciation. Large increases in foreign exchange earnings can cause a currency to overvalue, leading to exports that are less competitive. Appreciation pressures are a constant concern of policy makers in resource-rich countries like Mongolia and Papua New Guinea, and in countries where foreign assistance accounts for a large share of the national budget. Surges in foreign exchange earnings can also impede labor and export diversification. A fixed exchange rate regime can—in principal—reduce this volatility and help lower inflation, when pegged to a low-inflation currency. However, maintaining price stability requires much more than exchange rate policy. And because there is not much evidence that exchange rate pegs lead to more trade or investment, what a country might gain in price stability could come at a cost of longer term imbalances (Obstfeld and Rogoff 1995).

Table 4. 3 Several East Asian countries have moved to more flexible exchange rate policies.

De Facto classification of exchange rate arrangements, 2011

	General classification	**Further detailed classification**
Brunei Darussalam	Currency board	Hard pegs
Cambodia	Stabilized	Soft pegs
China	Crawl-like	Soft pegs
Fiji	Conventional peg	Soft pegs
Hong Kong	Currency board	Hard pegs
Indonesia	Floating	Floating regimes
Japan	Free floating	Floating regimes
Kiribati	No separate legal tender	Hard pegs
Laos	Stabilized	Soft pegs
Malaysia	Other managed	Residual category
Marshall Islands	No separate legal tender	Hard pegs
Micronesia	No separate legal tender	Hard pegs
Mongolia	Floating	Floating regimes
Palau	No separate legal tender	Hard pegs
Philippines	Floating	Floating regimes
Samoa	Conventional peg	Soft pegs
Singapore	Other managed	Residual category
Solomon Islands	Other managed	Residual category
South Korea	Floating	Floating regimes
Thailand	Floating	Floating regimes
Timor-Leste	No separate legal tender	Hard pegs
Tonga	Pegged w/ horizontal bands	Soft pegs
Vanuatu	Other managed	Residual category
Vietnam	Stabilized	Soft pegs

Source: Data derived from International Monetary Fund, Financial Operations and Transactions (IMF 2012).
Note: The table distinguishes among four major categories: hard pegs (such as exchange arrangements with no separate legal tender and currency board arrangements); soft pegs (including conventional pegged arrangements, pegged exchange rates within horizontal bands, crawling pegs, stabilized arrangements, and crawl-like arrangements); floating regimes (such as floating and free floating); and a residual category, 'other managed'. Data reflect the status as of April 30, 2011.

4.17 Exchange rate policies in countries that were deeply affected by the 1997 East Asian financial crisis largely shifted towards greater flexibility after that crisis (Table 4.4). The experience of some affected East Asian countries demonstrates how costly maintaining rigidly pegged currencies can be, creating vulnerability to speculative activities. The imbalances caused by fixed exchange rates helped contribute to the crisis (Fischer 2001). The countries most affected -Indonesia, Korea and Thailand- reformed their exchange rate regimes to allow for more flexibility. Flexible exchange rates tend to be associated with better medium and long term growth performance, particularly in developing countries (Rogoff et al. 2003; Levy-Yeyati and Sturzenegger 2003; Levy-Yeyati et al. 2005; Harms and Kretschmann 2009), even if some countries in the region with managed exchange rates such as China also show solid economic and labor-market performance.

4.18 In an important departure from the trend in exchange rate policies since 1997, Malaysia moved to a pegged arrangement after the financial crisis, underpinned by capital controls (see Box 4.1). After the shock of the East Asian financial crisis, some countries re-imposed capital controls, following a sustained period of liberalization, to help manage volatility and avoid contagion from financial shocks (Fischer 2001; Kaplan and Rodrik 2002). Several countries continue pursuing some form of exchange rate management to smooth volatility (World Bank 2012a). This is particularly the case of Timor Leste and many of the small countries in the Pacific (Table 4.3).

Table 4. 4: East Asia's financial crisis motivated a move to greater exchange rate flexibility

Official exchange rate regimes pre- and post-1997 in East Asian countries affected by the 1997 financial crisis

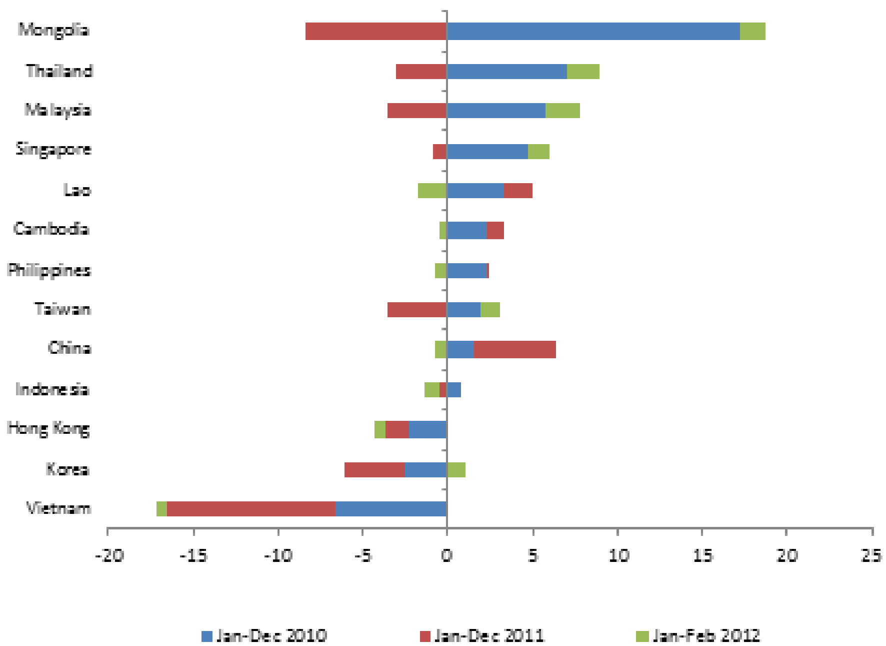
Indonesia	November 1978-June 1997	Managed Floating
	July 1997- December 2000	Independently Floating
Korea	March 1980-October 1997	Managed Floating
	November 1997- December 2000	Independently Floating
Malaysia	March 1990-November 1992	Fixed
	December 1992-September 1998	Managed Floating
	September 1998- December 2000	Pegged Arrangement
Philippines	January 1988- December 2000	Independently Floating
Thailand	January 1970-June 1997	Fixed
	July 1997- December 2000	Independently Floating

Source: IMF data derived from Exchange Arrangements and Exchange Restrictions, several issues; and based on a IMF Working Paper by Hernández and Montiel, 2001.

4.19 More recently, some of the East Asian countries that made their exchange rates more flexible appear to have been well served by this flexibility during the global financial crisis of 2008-2010. In contrast to other low- and middle income country regions, countries in East Asia were left relatively unscathed and experienced a quick recovery. Whereas rigid exchange rate regimes elsewhere forced labor markets to "quantity adjust" through widespread job-losses, East Asian economies experienced mainly a downward adjustment in earnings. One explanation for this contrasting experience is that a large portion of the 'blow' of the global financial crisis was absorbed by exchange rate movements that kept East Asia's exports competitive. This said, exchange rate management—mostly through systematically undervaluing exchange rates—has been a consistent part of the success of a number of other countries in the region such as China in promoting sustained labor-intensive growth.

Figure 4. 3 Flexible exchange rates helped absorb the blow of the Global Financial Crisis on East Asian countries.

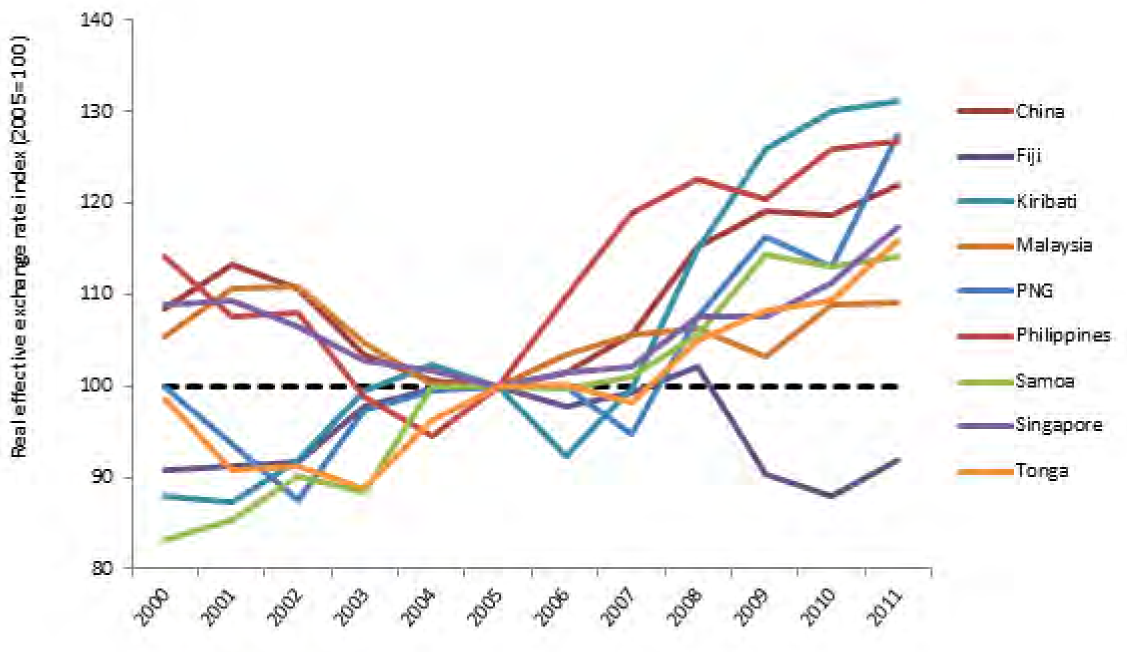
Change in nominal effective exchange rate, in percent over the period 2010-2012



Source: Data derived from Haver Analytics.

4.20 But trends in long-term, real exchange rate movements are more revealing and important than a government's official exchange rate policy. Since 2005, there has been an upward trend among East Asia Pacific countries in real effective exchange rates -measured as the value of a currency against a weighted average of several foreign currencies, and adjusted for inflation. If this trend continues, it will point to the need for alternative means of sustaining export competitiveness, as well as the growing importance of domestic consumption to fuel demand for work.

Figure 4. 4 Real effective exchange rates are on the rise across East Asia Pacific.
Trends in real effective exchange rates across East Asian and Pacific countries, 2000-2011



Source: WDI database. Note: Real effective exchange rate index uses 2005 (= 100) as reference year.

Box 4. 1 Capital controls: An alternative to sustaining demand for work?

Capital controls --the management of capital flows in and out of a country—are another monetary policy instrument. Malaysia used this tool intensively to manage the impact of the 1997 financial crisis.

Restrictions on capital flows were implemented to ensure public resource space for a counter-cyclical response and to minimize the impact of the financial crisis. The objectives of the capital controls policy included: fostering expansionary macroeconomic policy, defending the exchange rate, minimizing capital flight, safeguarding foreign exchange reserves as well as managing without an IMF stabilization program (United Nations 2010).

The measures adopted were: a prohibition policy to halt offshore speculation of the national currency, the ringgit; government approval to export foreign currencies by residents to mitigate speculative capital flows; a requirement to repatriate export profits within half a year from export; and the creation of a one-year prohibition for the export of external portfolio capital. These capital controls, while still controversial among some within the finance community, effectively constrained outflows of foreign exchange reserves and currency speculation, without observably deterring foreign direct investment, and accelerated crisis recovery (ibid.).

China's capital controls also attract substantial criticism. In particular, they may create fear among investors of being 'locked in' during a crisis (Edwards 1999). There is some empirical evidence that in East Asia, capital controls deter some foreign direct investment (Asiedu and Lien 2004). Similarly evidence from Malaysia suggests that capital controls can foster an environment more amenable to corruption and cronyism (Johnson and Mitton 2003). The effect of capital controls on growth and demand for work is thus not always clear.

4.2 Public spending and taxation

4.21 Fiscal policy can be a powerful tool in the hands of governments pursuing employment goals, often through longer-term public investments, especially in human capital, but also through shorter-term spending. Sustained investment in health and education generally support growth and productive employment. With direct influence on demand for work, public spending can stimulate aggregate demand or expand aggregate supply. These "active" policies and the overall fiscal structures with less explicit employment objectives help explain how net spending moves with the economic cycle. With respect to work, the outcome policy makers seek to achieve is predictability and counter-cyclicality of public spending. Households are engaged in a constant struggle to smooth their consumption over the ebb and pull of aggregate demand. An important goal of spending and taxation policies should be to support their efforts.

4.22 Public sector investments in human capital programs designed to directly promote employment, as well as countries' strategic investments, are taken up elsewhere in this report (chapters 5 and 6, and spotlight 2). In this chapter, we focus first on the overall "cyclicality" of spending, that is, whether a government sets the spending and revenue "levers" so that it is net-spending (if necessary, running deficits and accumulating debt) in downturns and contractions, and net-saving (running budget surpluses, paying down debt, and piling up reserves) during periods of growth. Secondly, we analyze the role of taxation policy in influencing employment.

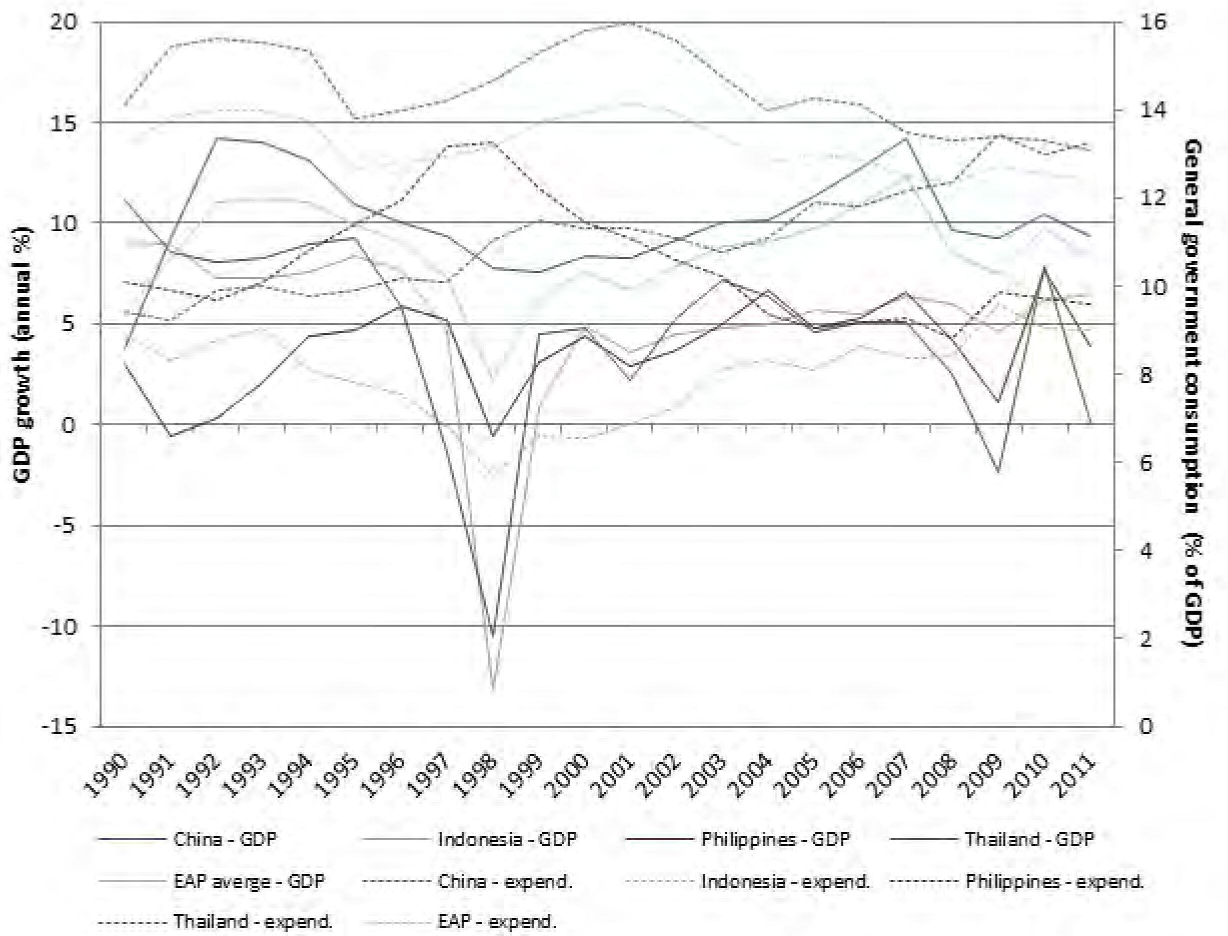
4.23 In the high income OECD countries, progressive tax systems with a broad base of contributors and unemployment insurance schemes act as passive or "automatic" stabilizers. In low and middle income countries where taxes are not levied on a similarly broad or diverse base, and where coverage of unemployment insurance plans is low (if they exist at all), governments have to be more active to achieve counter-cyclical fiscal spending. In countries with a large share of natural resource exports, counter-cyclical fiscal policy measures can help manage the impact of price volatility of minerals and commodities on aggregate demand and revenues.

4.24 Do countries in the region take these measures to ensure counter-cyclicality? Counter-cyclical policies can be very effective at compensating reductions in aggregate demand and, in doing so, containing unemployment during a downturn. This is one of the important lessons drawn from the East Asian financial crisis (IMF 2009). During the regional crisis, among countries where GDP contracted the furthest, such as Indonesia and Malaysia, government consumption actually fell. In contrast, public spending rose in Brunei Darussalam, Fiji, Hong Kong, Korea, Macao, the Philippines and Thailand.

4.25 More recently, to manage the contraction in the wake of the global financial crisis, governments in East Asia Pacific were better positioned to adopt counter-cyclical spending, including fiscal stimulus. Figure 4.5 shows trends in general government final consumption expenditure (% of GDP, a proxy for fiscal stimulus) and growth over the period 1990-2011. While GDP growth in nearly all East Asia Pacific countries with available data fell between 2007 and 2009, levels of government consumption expenditure increased especially, between 2008 and 2009.

Figure 4.5 East Asian countries were in a better position to adopt counter-cyclical spending to manage the global financial crisis.

Trends in GDP growth and general government final consumption expenditure (% of GDP) across select East Asian countries over the 1990-2011 period



Source: Illustration based on data derived from WDI database. Note: General government final consumption expenditure (formerly general government consumption) includes all government current expenditures for purchases of goods and services (including compensation of employees). It also includes most expenditure on national defense and security, but excludes government military expenditures that are part of government capital formation. It is important to note, once again, that the EAP average is strongly driven by trends in China.

4.26 In 2009, 32 countries announced economic stimulus packages, including all G20 members, accounting for 1.4 percent of global GDP. About 90 percent of the global stimulus came from G20 economies. China announced the largest stimulus package as a share of GDP worldwide (4 trillion yuan equal to 13 percent of GDP), followed by Saudi Arabia, Malaysia and then the United States (ILO 2009). The magnitude of fiscal stimulus packages varied widely across East Asian countries (Table 4.6). Infrastructure spending accounted for over 60 percent of the stimulus packages in China, Korea, the Philippines and Thailand (Table 4.5). However, even though there are many short- and medium-term instruments and measures other than infrastructure to help raise aggregate demand, there does not appear to have been a clear rationale for the composition of stimulus packages (ADB 2011).

Table 4. 5 :Stimulus packages were heavily weighted toward infrastructure investment.

Features of Fiscal Stimulus Package: Three Major Items of Expenditure

	Infrastructure	Tax Breaks	Transfers	Other
Indonesia	X	X		Waived import duties
Malaysia				Guarantee funds, equity investment
Philippines	X	X		General increase in budget
China	X			Health care reform
Korea	X	X	X	
Thailand		X	X	Education

Source: ADB 2011.

Table 4. 6 :China and Korea lead in the volume of fiscal stimulus.

Fiscal Stimulus Packages in Selected East Asian Economies

	Forecast drop in GDP*	Stimulus/GDP, 2008 (%)	Deficit 2008/GDP (%)	Deficit 2009/GDP (%)	Debt/GDP, 2008 (%)	Current Account Balance/GDP (%) 2008
Indonesia	-3.6	1.2	-0.1	-2.1	33	0.2
Malaysia	-7.3	10	-4.8	-7.6	42.5	17.6
Philippines	-4.6	4.1	-0.9	-2.3	56	2.5
China	-2.5	13	-0.4	-3.2	17.6	10.1
Korea	-6.2	12.8	0.3	-6.5	33	-0.4
Thailand***	-10	1.1	-1.1	-6	33.6	-0.1

Source: ILO 2009; International Financial Statistics (IMF). Notes: *Measures the difference in IMF's GDP forecasts between 2008 and the 2009; **Estimate as a result of implementing the stimulus as announced by country authorities; ***New package of more than 17% of GDP over three years.

4.27 With the exception of some countries in the North Pacific, Timor Leste and more recently Mongolia, countries in East Asia Pacific generally forgo the national stabilization and savings mechanisms used by governments elsewhere to achieve counter-cyclical fiscal aims. The premier examples from middle-income countries are the stabilization funds and fiscal rules employed by many governments in Latin America, albeit with varying levels of success. Chile's stabilization fund and fiscal rule have been widely acclaimed for smoothing public spending over the business cycle and effectively supporting aggregate demand. In a country where unemployment insurance was only introduced in 2002, and covers a little more than half of working people in any given year, the stabilization fund and fiscal rule are foundational to Chile's counter-cyclical outcomes, particularly its ability to sustain employment in the wake of the global financial crisis.

4.28 The countries of East Asia have a much longer track record for sustained, prudent fiscal policy that creates relatively greater credibility and instills greater confidence than countries at similar levels of development in other regions. This, and relatively fewer instances of resource windfalls of the sort often experienced by Mexico and Venezuela, may have lowered the need to institute non-discretionary, contingent rules and other policy devices. However, this still begs the question, whether in a downturn, governments in East Asia Pacific are adequately prepared, not only with savings but with plans, to step up in a timely manner.

4.29 Ultimately, it was a longer track record of relative fiscal prudence that placed several East Asia Pacific countries in a much better position than other developing countries to manage shocks with counter-cyclical policies, such as fiscal stimulus to sustain demand for labor and human capital. Part of this fiscal prudence reflects smaller budgets and high savings rates across the region. Another part reflects the structure of taxation.

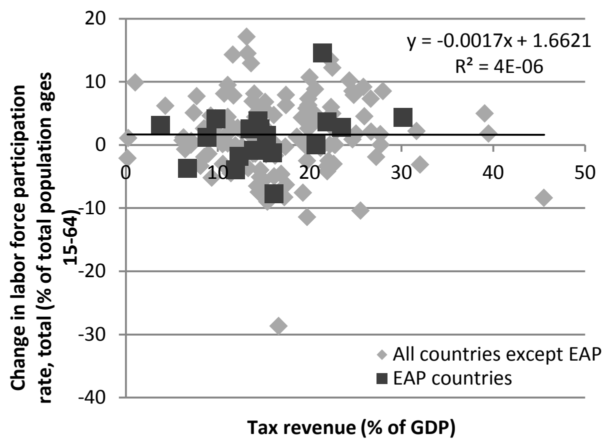
4.30 There is an important interplay between public revenue structures, incentives for investment and the demand as well as supply of labor and human capital. Governments are always looking for ways to increase their revenue and broaden their tax base. How earnings are taxed and at what rate can influence incentives especially for corporate tax rates. Similar to price uncertainty, uncertainty about taxation can affect the decisions of firms and households.

4.31 Can the structure of taxation foster higher employment? The theoretical debate tends to revolve around two basic ideas. Advocates of limited taxation claim that entrepreneurs in high tax countries have less capital for reinvestment, and by extension, to grow and increase demand for work. At the margin, higher direct taxes are in theory also expected to lower work effort and discourage supply of labor and human capital. Higher-taxation advocates, however, argue that when more revenue flows into government, greater investment can be made into better infrastructure and a more qualified workforce, which makes the broader business environment functional, can attract foreign investment and promote more inclusive, productive employment.

4.32 With no clear theoretical consensus, the question can only be answered empirically and the evidence is mixed. Scandinavian countries have both the highest labor force participation rates as well as the highest tax revenue as a share of GDP. Among 143 countries with available data, there is no clear relationship between changes in a country's labor participation rate between 1990 and 2011 and either its level of tax revenue as a share of GDP (figure 4.6, panel a) or its share of revenue from taxes on income, profits and capital gains (figure 4.6, panel b). Indeed, the top 20 countries in the world with the strongest increase in labor force participation over these two decades have an average share of tax revenue of 17.9 percent of GDP, while the bottom 20 countries with the strongest reduction in labor force participation have an average share of tax revenue of 18.1 percent of GDP. The five countries in East Asia Pacific where labor force participation fell the most between 1990 and 2011 (Thailand, Lao PDR, China, Hong Kong and Malaysia) had an average share of tax revenue at 12.6 percent of GDP over this period, while the five countries in the region with the largest increase in labor force participation (Macao, New Zealand, Japan, Singapore and Fiji) had an average share of tax revenue at 19.6 percent of GDP.[6]

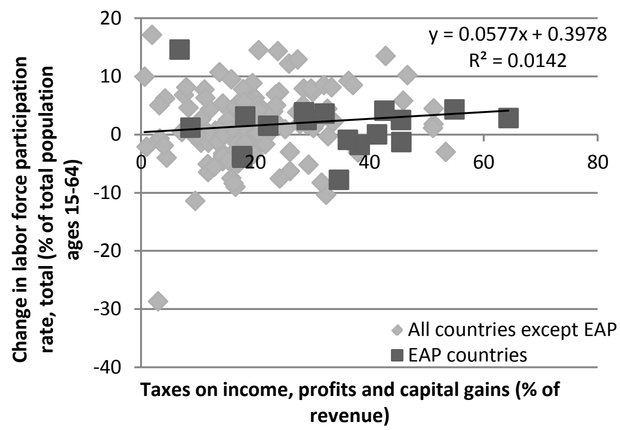
Figure 4.6 The volume of taxation does not appear to strongly affect labor force participation.

(a) Change in labor force participation rate (between 1990-2011) by tax revenue as a share of GDP (average 1990-2011)



Source: Authors' illustration based on data from World Development Indicators.

(b) Change in labor force participation rate (between 1990-2011) by share of revenue from taxes on income, profits and capital gains (average 1990-2011)



Source: Authors' illustration based on data from World Development Indicators.

4.33 Relative to other low and middle income country groupings, East Asia Pacific is a *"low tax"* region. Tax revenue as a share of GDP is lower than in any other developing country region, accounting for only 11 percent of GDP compared to, for example, 15.6 percent in Eastern Europe and Central Asia and 17.5 percent in the Middle East and North Africa. That revenue from tax is so low in part reflects the stage in the structural transformation process in which most East Asia Pacific countries find themselves. Subsistence and small-scale commercial agriculture is still a very large segment of the economy in most countries. The volume of unregistered and unregulated economic activity constrains what governments can collect in tax revenue.

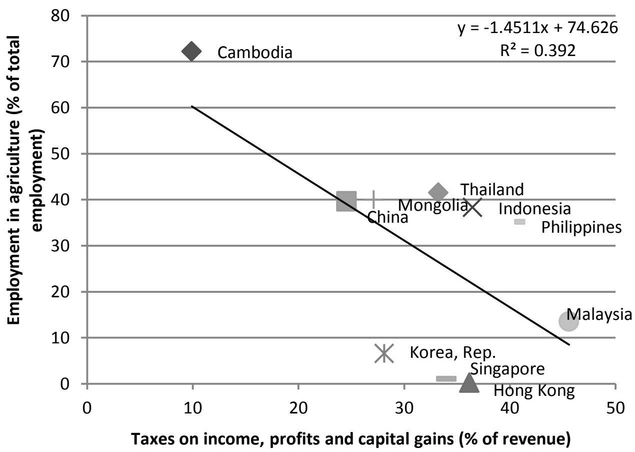
4.34 Figure 4.7 shows negative correlations between employment in agriculture and tax revenue across 10 East Asian countries with available data. In an average East Asian country with a 10 percentage points smaller share of people employed in agriculture, the government collected an average of about 6.9 percentage points more in taxes on income, profits and capital gains as a share of government revenue. Countries in the region with higher shares of "vulnerably-employed" people (own-account and unpaid family workers) tend to raise less

[6] Similarly, historical data indicate that employment creation in the US has historically been strongest under higher tax rates and weakest under low tax rates. Indeed, during the period 1940-1970 the top individual income tax rate in the US averaged 83 percent.

revenue from taxes on income, profits and capital gains[7]. In East Asia, a decline in a country's share of vulnerably-employed people by 10 percentage points is associated with an average increase in taxes on income, profits and capital gains as a share of revenue of about 5.5 percentage points.

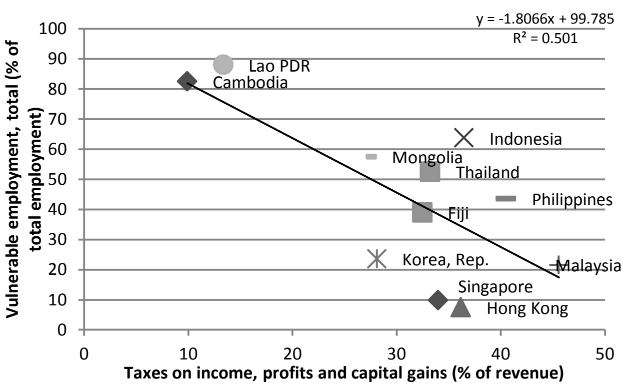
Figure 4.7 A large number of people still in agriculture and unregistered forms of work, constrains government revenue in most of East Asia Pacific.

(a) Share of employment in agriculture by share of revenue from taxes on income, profits and capital gains in East Asian countries, 2011 or latest year



Source: Data derived from IMF and ILO, see WDI and GDF databases. Note: Data reflects the latest year between 2011 and 2005 for all East Asian countries with available data.

(b) Share of vulnerable employment by share of revenue from taxes on income, profits and capital gains in East Asian countries, 2011 or latest year



Source: Data derived from IMF and ILO, see WDI and GDF databases. Note: Data reflects the latest year between 2011 and 2005, and represents all East Asian

[7] 'Taxes on income, profits, and capital gains' are levied on the actual or presumptive net income of individuals, on the profits of corporations and enterprises, and on capital gains, whether realized or not, on land, securities, and other assets (see: http://data.worldbank.org/indicator/GC.TAX.YPKG.RV.ZS)

countries with available data, with the exception of Macau, an offshore financial center and tax haven with no control regime for foreign exchange.

4.35 A dominant commodities sector contributes to more limited tax collection and a more volatile public resource pool in several East Asia Pacific countries. A very high employment share in agriculture as a share of total employment—for example, in Cambodia, Vietnam and Vanuatu at over 50 percent—can contribute to greater volatility in overall economic output (due largely to greater price fluctuations in the agriculture sector) and therefore greater volatility in tax revenue. Many workers in these countries are subsistence farmers and consume most of their output, so there is often no margin of income above subsistence to make even limited contributions to tax revenue or that can be channeled into future investments in human capital. Taxes are a burden often falling largely on the share of the population working in industry and services, as well as natural resource exports.

4.36 Even those people mostly working in the formal economy report evading taxes. Using data derived from the East Asia Barometer, table 4.7 shows the reported levels of tax evasion of respondents by their occupation. For the survey, respondents' were asked if they 'refused to pay taxes or fees to the government' at least once during the last three years. People in all types of occupations evade paying taxes. Evasion appears particularly pervasive in the Philippines, Thailand and Mongolia. Yet the likelihood that a salaried employee will report evading is similar to that of people in other forms of work. Perceptions of limited government capacity to enforce tax obligations, or dissatisfaction with public services may be contributing to tax evasion, regardless of where and how people are working.

Table 4. 7 Self reported tax evasion appears to vary little across different ways of working

Share of population who refused to pay taxes or fees to the government one or more times in the past three years within East Asian countries, by main occupation

	Total	Salaried workers (excluding unpaid family workers)	Employers and Self-employed	Presently un-employed but looking for work	Presently un-employed and not looking for work	Never worked before	Unpaid family workers	Purely property owner	No. of obs.
Indonesia, 2006	5.3	5.5	9.5	0	4.5	10.0	0		1,569
Mongolia, 2006	8.2	8.2	7.0	7.5	7.1	12.5			1,201
Philippines, 2005	9.9	9.7	10.9	8.1	10.4	5.0	0	33.6	1,166
Singapore, 2006	1.4	2.0	0	1.4	0	1.8			1,003
Taiwan, 2006	4.0	3.9	3.9	11.7	2.2	0	5.3		1,544
Thailand, 2006	7.9	8.6	7.3	11.3	7.6	3.7		21.4	1,490
Vietnam, 2005	1.6	0.9	1.5	2.9	3.9	6.7	0	0	1,172

Source: Calculations based on data derived from the East Asia Barometer surveys, see http://www.jdsurvey.net/eab/eab.jsp. Note: Due to a limited number of observations data on 'purely property owners' should be read with caution.

4.37 Turning to the structure of taxation, East Asia Pacific countries have a relatively low tax rate on commercial profits, at an average of 36.2 percent, compared with Europe and Central

Asia at 41.6 percent and Latin America and the Caribbean at 47.6 percent.[8] In several countries, individual income tax rates have declined since 2005. Corporate tax rates have also declined in nearly all East Asia Pacific countries. Indonesia in particular has taken substantial steps to reform its tax environment, and reduce individual income and corporate tax rates further than any other East Asian country.[9] Over the past 7 years, the maximum corporate tax rate fell by 8 percentage points in China and Taiwan, and by 5 percentage points in Indonesia, contributing to a more favorable environment for foreign investment.

Table 4. 8 : Direct taxes have been declining in many East Asia Pacific countries.

Changes in individual income tax, corporate tax and indirect tax rates in East Asia Countries over the period 2005 and 2012

	Maximum individual income tax rate			Maximum corporate tax rate			Indirect tax rate		
	2005	2012	Diff.	2005	2012	Diff.	2005	2012	Diff.
Cambodia	..	..	..	..	20	..	..	10	..
China	45	45	0	33	25	-8	17	17	0
Fiji	31	31	0	31	28	-3	12.5	15	3
Hong Kong	16	15	-1	17.5	16.5	-1	..	..	..
Indonesia	35	30	-5	30	25	-5	10	10	0
Korea, Rep.	35	38	3	27.5	24.2	-3	10	10	0
Macau	12	12	0	12	12	0	..	..	..
Malaysia	28	26	-2	28	25	-3	10	10	0
Papua New G.	47	42	-5	30	30	0	10	10	0
Philippines	32	32	0	32	30	-2	10	12	2
Samoa	..	..	..	29	27	-2	..	15	..
Singapore	21	20	-1	20	17	-3	5	7	2
Taiwan	40	40	0	25	17	-8	5	5	0
Thailand	37	37	0	30	30	0	7	7	0
Vanuatu	..	..	..	0	0	0	..	12.5	..
Vietnam	40	35	-5	28	25	-3	10	10	0
Africa avg	30.2	26.8	-3.4	31	28.9	-2.1	13.7	14.2	0.5
Asia avg	29.1	34.9	5.9	29.8	23.1	-6.7	12.3	12.2	0.0
EU avg	40.1	37.4	-2.8	25.3	22.8	-2.6	19.5	21	1.5
Lat Am avg	31.7	31.8	0.2	29.7	28.3	-1.4	15	12.8	-2.2
Oceania avg	41	37.8	-3.3	30.6	28.6	-2.0	11.3	12.9	1.7
OECD avg	41.8	40.6	-1.2	28.5	25.4	-3.1	17.7	18.8	1.0
Global avg	33	31.8	-1.2	27.9	24.4	-3.5	15.8	15.4	-0.4

Source: Staff calculations based on data derived from KPMG, see www.kpmg.com/global/en/whatwedo/tax Note: Data reflects all East Asian countries with available data (for detailed information on a particular country's specific tax breakdown see: www.kpmg.com/Global/en/WhatWeDo/Tax/tax-tools-and-resources).

[8] Regional data presented here refer only to the average for developing countries in the respective region, i.e. no high-income countries are included.

[9] Indonesia's parliament adopted a new income tax law in late 2008 which established a single income tax rate for corporate taxpayers and permanent establishments, and replaced the previous progressive tax rates. The measure was widely praised by the country's private sector (Asia Law 2008).

4.38 In contrast, indirect taxation although relatively low is on the rise. In East Asia Pacific countries, on average 29.4 percent of revenue is collected from taxes on the consumption of goods and services, compared to an average of 36.8 percent in Europe and Central Asia and 40.1 percent in Latin America and the Caribbean. In spite of (or likely due to) corporate and individual taxes having fallen in many countries in the region, indirect taxes have been stable, and in some cases have risen. Indirect taxes—such as value added tax (VAT), goods and services tax (GST) and sales tax—appear to be, in part, compensating for reductions in tax revenues from corporate and individual taxes. Fiji, Philippines and Singapore are actively redistributing the tax burden mainly from firms (↓ corporate tax) to consumers (↑ indirect tax).

4.39 From a public finance perspective, diversifying and broadening the tax base by using indirect taxes more intensively can help stabilize revenues. From a labor market perspective, the shifting mix of taxation instruments could improve incentives for work. The shift away from income tax to greater taxation of consumption should, all else equal, provide households with greater incentives to supply human capital. To the extent that social insurance is financed mainly from the same sort of tax (rather than with mandatory contributions paid by employers), the shift should create greater incentives for firms to hire, a discussion taken up in greater detail in chapters 6 and 9. Given that the region on a whole has the lowest indirect tax rates in the world (with consumers in Thailand, Singapore and Taiwan, China, for example, paying only 7 percent or less in indirect taxes), it is conceivable that policy makers in East Asia Pacific countries, especially in those with fiscal difficulties, consider adjusting indirect tax rates upwards before raising other types of taxes.

4.40 A shift toward more intensive use of indirect taxes, however, raises concerns about equity and the wellbeing of lower income households. There are tradeoffs between income taxes, which are generally a form of progressive taxation, and sales or value-added taxes, which tend to be regressive as lower income groups consume a higher fraction of their disposable income. It is thus important to note that raising value added or goods and services taxes could be more politically difficult if not accompanied with compensating measures to limit the impact on lower-income households.

4.41 From the standpoint of firm incentives, the current structure of taxation in the region is not burdensome. Generally, firms in East Asia Pacific find it easier to pay taxes than firms in other developing regions, although their experience varies widely from country to country. The last column of table 4.9 ranks economies on the ease of 'paying taxes' for firms among 183 countries. Singapore and Hong Kong have the most favorable tax regulation environments in the region. The worst performer is Vietnam. Firms in Vietnam spend the most time in paying their taxes: on average 941 hours per year to prepare, file and pay (or withhold) corporate income tax, value added tax and social security contributions. Vietnam is followed by the Philippines, and then Indonesia. Firms in Indonesia make on average the highest total number of tax payments per year (51 payments), compared to their neighbors.

Table 4.9 Indicators on the ease of paying taxes across East Asia and the Pacific, 2010

	Paying taxes						
	Payments (number per year)[i]	Time (hours per year)[ii]	Profit tax (%)[iii]	Labor tax and contributions (%)[iv]	Other taxes (%)[v]	Total tax rate (% profit)[vi]	Global rank for paying taxes
Brunei Darussalam	27	96	8.3	8.5	0	16.8	20
Cambodia	39	173	18.9	0.1	3.5	22.5	54
China	7	398	5.9	49.6	7.9	63.5	122
Fiji	33	163	28	10.2	0.2	38.3	80
Hong Kong	3	80	17.6	5.3	0.1	23	3
Indonesia	51	266	23.7	10.6	0.1	34.5	131
Kiribati	7	120	23.4	8.5	0	31.8	6
Korea, Rep.	12	225	15.1	13	1.5	29.7	38
Lao PDR	34	362	24.8	5.6	2.9	33.3	123
Malaysia	13	133	17	15.6	1.4	34	41
Marshall Islands	21	128	0	11.8	53	64.9	96
Micronesia	21	128	0	6.8	52	58.7	92
Mongolia	41	192	10.2	12.4	2	24.6	57
Palau	19	128	65.9	6.5	0.5	73	97
Papua New Guinea	33	194	22	11.7	8.6	42.3	106
Philippines	47	195	21	11.3	14.2	46.5	136
Samoa	37	224	11.9	7	0	18.9	66
Singapore	5	84	6.5	15.9	4.7	27.1	4
Solomon Islands	33	80	14.6	8.5	3.1	26.2	25
Taiwan	15	245	13.7	18.4	3.5	35.6	71
Thailand	23	264	28.8	5.7	3	37.5	100
Timor-Leste	6	276	0	0	0.2	0.2	31
Tonga	20	164	24.3	0	1.4	25.7	29
Vanuatu	31	120	0	4.5	3.9	8.4	32
Vietnam	32	941	17.2	22.6	0.3	40.1	151
East Asia & Pacific	25	215	16.8	10.7	6.9	34.5	..
East Europe & C. Asia	37	302	9.3	21.7	9.5	40.5	..
Lat. America & Cari.	32	382	19.9	14.6	13.2	47.7	..
Mid. East & Nor. Afr.	21	188	11.3	16.9	4	32.2	..
OECD high income	13	186	15.4	24	3.2	42.7	..
South Asia	28	281	18.6	7.7	18.2	44.4	..
Sub-Saharan Africa	37	318	18.1	13.5	25.5	57.1	..

Source: Data derived from World Bank's Doing Business, see http://www.doingbusiness.org/data Note: Data on paying taxes reflects the results from the most recent round of data collection which was in December 2010, while the rankings for all economies are benchmarked to June 2011. Names of taxes have been standardized; for instance, income tax, profit tax, and tax on company's income are all classified as corporate income tax. [i] The total number of taxes and contributions paid, the method of payment, the frequency of payment and the number of agencies involved for a standardized case during the second year of operation. [ii] The time it takes to prepare, file and pay (or withhold) the corporate income tax, the value added tax and social security contributions (in hours per year). The hours for VAT include all the VAT and sales taxes applicable. The hours for Social Security include all the hours for labor taxes and mandatory contributions in general. [iii] The amount of taxes on profits paid by the business as a percentage of commercial profits. [iv] The amount of taxes and mandatory contributions on labor paid by the business as a percentage of commercial profits. [v] The amount of taxes and mandatory contributions paid by the business as a percentage of commercial profit that are not already included in the categories of profit or labor taxes. [vi] The total tax rate measures the amount of taxes and mandatory contributions payable by the business in the second year of operation, expressed as a share of commercial profits (for further information on methodology see http://www.doingbusiness.org/methodology/paying-taxes).

4.42 Relative to countries in any other region, East Asia Pacific countries also have on average the lowest share of firms that identify tax administration and tax rates as a major constraint. While this is reassuring for the region's overall business and tax environment, there are countries such as Lao PDR and especially Thailand, in which large shares of firms report that administering taxes is a major constraint to doing business (24.7 and 34.9 percent, respectively). The countries in the region in which the senior management of firms spends the most time in a typical week dealing with the requirements of government regulation (e.g. taxes, customs, completing forms) are Micronesia (12.4 percent of their time), Mongolia (12.1 percent) and Samoa (13.9 percent). The countries where firms reported the highest average number of visits or required meetings with tax officials were Lao PDR and Mongolia.

Table 4.10: Although taxes are not frequently reported as a constraint on businesses

Firm-level data on whether taxes and regulations are constraints, and data on the informal sector in East Asian and Pacific countries

	Taxation and tax regulations			Informal economy			
	Percent of firms identifying tax rates as a major constraint	Percent of firms identifying tax administration as a major constraint	Senior management time spent dealing w/ the requirements of government regulation, %	Percent of firms identifying practices of competitors in the informal sector as a major constraint	Percent of firms competing against unregistered or informal firms	Percent of firms formally registered when they started operations in the country	Number of years firm operated without formal registration
Cambodia (2007)	16.3	14.8	5.6	32.8	..	87.5	0.7
Fiji (2009)	26.6	16.1	4.4	15.1	39.6	93.5	1.1
Indonesia (2009)	4.4	4.8	1.6	14.7	65.1	29.1	2.4
Korea, Rep. (2005)	15.1	9.1	0.1	..	..	..	..
Lao PDR (2009)	43.2	24.7	1.2	6.9	12.8	93.5	0.2
Malaysia (2007)	21.4	16.9	7.8	16.2	..	53	0
Micronesia (2009)	22.7	23.9	12.4	11.8	41.1	96.9	0.2
Mongolia (2009)	32.6	9.1	12.1	25.5	43	90.1	2.5
Philippines (2009)	19.5	15.2	9.1	23.7	37.5	97.5	0.5
Samoa (2009)	33.5	19.7	13.9	16.3	63.6	88.4	0.6
Thailand (2006)	36	34.9	0.4	..	..	..	..
Timor-Leste (2009)	3.5	2.5	3.8	18.8	66.4	91.8	0.7
Tonga (2009)	16.6	8	6.6	32.4	86.8	93.5	0.3
Vanuatu (2009)	26.6	9.8	7.5	9.7	39.9	88.1	1.3
Vietnam (2009)	6.3	5.3	4.6	14.3	55.6	87.5	1.4
East Asia & Pacific	22.1	14.7	6.5	18.3	50.1	83.9	0.9
East. Eur. & Cen. Asia	39.5	20.6	10.6	28.5	44.7	96.2	1.1
High-income OECD	29.3	19.7	4.2	22	44.1	99.3	0
Latin Amer. & Carib.	35.1	22.7	12.7	30.2	62.3	86.8	1.1
Mid. East & Nor. Afr.	47.1	34.4	10.8	42.7	50	85.2	0.4
South Asia	24.2	18.8	6.1	21	36.9	89.6	1.1
Sub-Saharan Africa	36.5	26.6	7.5	38.7	65.6	82	0.7
World	34.9	23	9.1	31.7	56.2	87.8	0.9

Source: Data derived from the World Bank's Enterprise Surveys, see http://www.enterprisesurveys.org/Data Note: Data reflects all East Asian and Pacific countries with available data. Typically 1200-1800 interviews are conducted in larger economies, 360 interviews are conducted in medium-sized economies, and for smaller economies, 150 interviews take place (for information on methodology see: http://www.enterprisesurveys.org/Methodology).

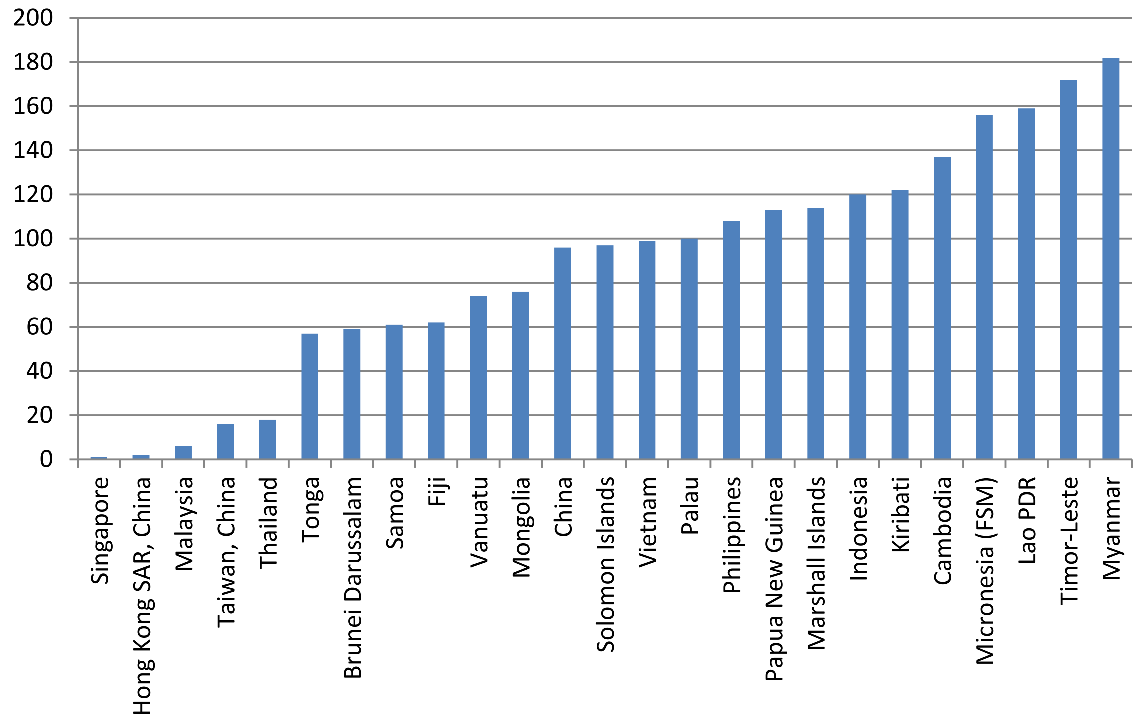
4.43 Overall, deploying a wide range of tax instruments over the broadest possible base is healthy for an economy and for employment outcomes. Countries' level of taxation but also the mix of tax instruments varies across the region, with top economic performers deploying contrasting revenue measures. Top performers in the region range from China with overall high tax rates to Singapore, Taiwan, Hong Kong, and Macau with overall low tax rates, while all five economies despite very different tax levels experienced unemployment rates below 5.5% and GDP growth rates above 4% over the period 2000-2011.

4.3 An enabling environment for enterprise?

4.44 This section assesses the degree to which countries' business environment constrain or enable the employment markets. Governments play a key role in shaping the business environment which provides the basic public goods and services necessary for the private sector to conduct operations. These public goods and services range from access to financial institutions and administering regulation and licensing to providing infrastructure including electricity and roads. The business environment makes the conditions for firms and workers functional and keeps investment costs manageable (IMF and World Bank 2012). The business environment sets the climate within which customers, producers, distributors, competitors and, among others, exporters interact with each other.[10] In East Asia Pacific, performance on business climate indicators is mixed, with some of the top performers (Singapore and Korea) but also the poorest performers (Lao PDR and Timor Leste) in the world.

Figure 4. 8 East Asia Pacific has both the leaders and the laggards in the "ease of doing business" league tables.
Ease of doing business ranking, 2013

[10] For an in-depth discussion on the importance of a solid business climate for development, see the World Bank's World Development Report 2005: A Better Investment Climate for Everyone.



Source: Data derived from World Bank's Doing Business, see http://www.doingbusiness.org/data.

4.45 The four largest constraints reported by businesses in East Asia Pacific are, in order of importance: access to finance, an inadequately educated workforce, practices of the informal sector (informal competition), and insufficient or unreliable supply of electricity. In analyzing nationally-representative, firm-level survey data of an economy's private sector, table 4.11 illustrates the key obstacles reported by businesses across all East Asia Pacific countries with available data. These top four obstacles for private sector businesses are consistent across different firms and countries at different levels of development. The subsequent discussion outlines each of these major obstacles further, with particular emphasis given to the reported top constraint, access to finance.

4.46 Access to finance is the most frequently reported obstacle facing businesses in the region. Access to financial services, including saving accounts, credit cards and loans, facilitates operations and investment, helps firms to plan for longer-terms and expand, and thus can foster economic growth and sustain demand for human capital. For households, access to financial services can also help to smooth consumption and better manage times of unemployment. In short, better-functioning financial markets facilitate the use of resources more productively: the more inclusive a financial system is, the better and the more broadly it can mobilize savings that can then be translated into investments that support overall economic growth and work. A large body of empirical evidence shows that access to finance is one of the most important drivers of economic growth (see e.g. Levine 2005; Beck 2008; Hanusch 2011).

4.47 Compared to other developing regions, people in East Asia Pacific have relatively good access to financial institutions, but with strong variation across countries. East Asia Pacific countries rank fairly well internationally in providing access to bank accounts at formal financial institutions (table 4.12). About 55 percent of adults in the region have a bank account, allowing them to save, lend, make payments and better cope with risks. The region also ranks well internationally according to the share of people who have received a loan from a financial institution in the past year (8.6 percent).

4.48 However, in some countries in the region less than a quarter of adults 15 years or older have an account at a formal financial institution, for example Vietnam (21.4 percent), Indonesia (19.6 percent) and Cambodia (3.7 percent). Only 51.5 percent of firms in Indonesia have a checking or savings account, the lowest rate in the region among countries with available data (based on World Bank's Enterprise Survey data). Moreover, despite good access to bank accounts, the region's coverage of credit cards is far lower than that in Latin America and Eastern Europe. Part of the problem of financial inclusion, is that few countries have credit registries in place that provide a history of debtors' creditworthiness (World Bank 2012).

Table 4. 11: Financial inclusion indicators across East Asia and the Pacific, 2011

Percentage of respondents age 15 + reporting…

	Credit card (% age 15+)	Account at a formal financial institution (% age 15+)	Account used to receive wages (% age 15+)	Saved at a financial institution in the past year (% age 15+)	Saved any money in the past year (% age 15+)	Loan from a financial institution in the past year (% age 15+)	Loan from a private lender in the past year (% age 15+)	Any loan in the past year (% age 15+)
Cambodia	0.1	3.7	1.1	0.8	31.0	19.5	12.8	59.5
China	8.2	63.8	18.7	32.1	38.4	7.3	1.1	29.4
Hong Kong SAR, China	58.1	88.7	48.7	42.8	59.0	7.9	2.1	27.7
Indonesia	0.5	19.6	7.7	15.3	40.5	8.5	2.0	49.1
Korea, Rep.	56.4	93.0	49.4	46.9	64.5	16.6	0.6	32.5
Lao PDR	3.1	26.8	3.0	19.4	54.5	18.1	4.9	32.5
Malaysia	11.9	66.2	26.3	35.4	51.0	11.2	2.2	32.5
Mongolia	1.9	77.7	29.4	23.2	33.5	24.8	5.0	45.8
Philippines	3.2	26.6	8.5	14.7	45.5	10.5	12.7	58.1
Singapore	37.3	98.2	52.5	58.4	60.9	10.0	1.7	32.7
Taiwan, China	45.9	87.3	41.8	45.7	58.1	9.6	1.7	24.0
Thailand	4.5	72.7	33.5	42.8	60.0	19.4	2.3	27.2
Vietnam	1.2	21.4	5.8	7.7	35.3	16.2	3.0	43.9
East Asia Pacific	6.6	54.9	16.9	28.4	39.8	8.6	1.9	33.8
Europe Central Asia	16.2	44.9	27.3	7.0	20.4	7.7	1.5	39.5
Latin America Caribbean	18.4	39.3	20.2	9.7	26.0	7.9	2.5	25.4
Middle East North Africa	2.4	17.7	6.0	4.5	20.0	5.1	4.7	41.8
Sub-Saharan Africa	2.9	24.0	9.9	14.2	40.2	4.8	5.4	46.8

Source: Data is derived from the Global Financial Inclusion Database (World Bank), based on nationally representative survey data. Note: Data for regions only reflect developing countries.

4.49 Access to finance is particularly important for small and medium-sized enterprises (SMEs) which are often constrained in their ability to raise financial resources. Globally, access to finance is not only the leading constraint reported by firms but also a challenge that particularly affects smaller firms in low- and middle-income countries. Whilst SMEs are not always the key drivers of economic growth in every country, a vibrant SME sector is a common characteristic of dynamic economies. SMEs tend to be an source of demand for human capital in East Asia Pacific (see Chapter 2).[11] When it comes to access to credit for SMEs, the region has the best performers (Malaysia) and the second worst overall performer (Palau). The Pacific island states rank especially poorly on this indicator. There remains therefore large scope for improving the rules for obtaining credit and extending financial inclusion.

4.50 Skills shortages are the second most pressing constraint to doing business. Global evidence shows that this constraint is particularly binding for large firms or firms in more developed countries. Within the region, the largest share of firms identifying an inadequately educated workforce as a major constraint are in the Pacific, particularly Tonga (58.7 percent) and Micronesia (43.6 percent), while firms in Indonesia (4.5 percent) and the Philippines (7.8 percent) report the lowest shares in the region. These "gaps" between the skills firms say they need and what they are able to find exist the world over. And they are often the sign of dynamic, growing and diversifying economies. A deeper discussion of how countries' human capital supply systems perform, where and why they fall short is taken up in Chapter 5.

4.51 The third most important obstacle reported by businesses in the region is the competition that they face from firms operating informally, beyond the reach of regulation and taxation. Just over half (50.1 percent) of firms in the region reported that they compete against unregistered enterprises, while 18.3 percent of firms in the region identified the practices of competitors in the informal economy as a major constraint; Cambodia had the highest share at 32.8 percent. High levels of informality not only deprive the public resource pool of tax revenue but can also reduce standards and regulation of the products and services these businesses provide.

4.52 Access to electricity is the next most frequently reported constraint to firms and their expansion. As many as 23.7 percent of firms in East Asia Pacific identified insufficient electricity as a major constraint to their businesses, with this share ranging from 5.4 percent in Tonga to 61.4 percent in Timor-Leste, based on calculations of enterprise survey data. Firms in the region reported an average of 2.5 electrical outages in a typical month. Ensuring a reliable and affordable flow of electricity enables businesses to produce more added-value products, helps

[11] Access to finance is also important to household supply of human capital. Households borrow partly for non-business related purposes, especially consumption; yet access to credit also allows them to improve their productivity by investing in health and education. This in turn can help them find or improve employment opportunities (FDIC 2009; Demirguc-Kunt and Klapper 2012).

to free up time from household tasks and, especially in rural areas, can thus increase the numbers of women in market employment (Dinkelman 2011).

Table 4. 12 East Asia Pacific lives up to its reputation as business friendly region, but several obstacles constrain enterprises.
Obstacles to businesses and the extent of their impediment across East Asian and Pacific countries

	Year	Access to finance	In-adequately educated workforce	Practices of the informal sector	Electr-icity	Tax rates	Political in-stability	Corrup-tion	Crime, theft and dis-order	Trans-portation	Business licensing and permits	Access to land	Tax admin-istration	Labor regul-ations	Customs and trade regul-ations	Courts	Total
		Most frequently reported			→						→			→ Least frequently reported			
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	
East Asia & Pacific avg.	...	16.4	12.2	10.4	10.2	10.0	8.6	6.3	5.3	4.5	3.8	3.7	3.7	2.6	2.1	0.2	100
Cambodia	2007	4.9	2.9	9.1	16.6	5.1	16.5	24.1	6.3	2.7	2.8	2.8	1.9	0.8	2.0	1.5	100
Fiji	2009	6.3	4.5	5.4	3.9	8.0	44.4	2.5	8.6	1.7	0.6	1.1	1.1	8.8	3.3	0.0	100
Indonesia	2009	47.9	4.3	13.7	6.5	1.3	6.9	1.6	3.0	4.3	3.3	3.9	0.4	1.3	1.4	0.2	100
Lao PDR	2009	21.2	16.5	4.0	8.9	36.8	0.0	0.2	0.1	2.8	0.5	6.8	0.6	0.0	1.5	0.3	100
Malaysia	2007	7.2	33.6	0.0	0.0	0.0	0.7	11.1	2.2	0.0	15.2	2.3	17.9	4.8	5.0	0.0	100
Micronesia,	2009	8.1	25.2	4.5	15.8	9.7	0.0	1.6	1.6	12.6	4.8	4.8	6.5	4.8	0.0	0.0	100
Mongolia	2009	30.3	10.2	7.1	3.4	16.0	7.0	4.4	1.1	2.6	6.5	4.5	3.3	0.3	3.1	0.1	100
Philippines	2009	14.8	2.6	26.4	11.3	13.0	6.2	4.9	4.4	2.3	5.8	0.8	1.6	1.9	3.8	0.2	100
Samoa	2009	13.3	11.6	13.8	8.6	16.9	0.9	1.9	13.8	4.7	1.0	3.9	6.9	1.9	1.0	0.0	100
Timor-Leste	2009	12.1	7.8	2.0	36.3	0.0	10.2	6.7	12.7	4.5	3.5	3.6	0.0	0.0	0.7	0.0	100
Tonga	2009	7.4	15.5	20.1	1.3	15.6	14.3	17.0	0.3	1.6	0.1	5.4	1.3	0.0	0.0	0.0	100
Vanuatu	2009	14.8	13.9	9.5	15.7	4.4	4.2	2.6	14.3	4.9	3.5	1.6	0.9	8.0	1.5	0.0	100
Vietnam	2009	24.7	10.2	19.3	4.3	3.5	0.4	3.3	1.0	13.3	1.4	6.9	6.3	0.9	4.2	0.3	100
World avg.	...	16.4	7.8	11.0	14.0	10.6	8.4	6.7	5.3	3.2	3.0	3.3	3.2	2.6	3.4	1.0	100

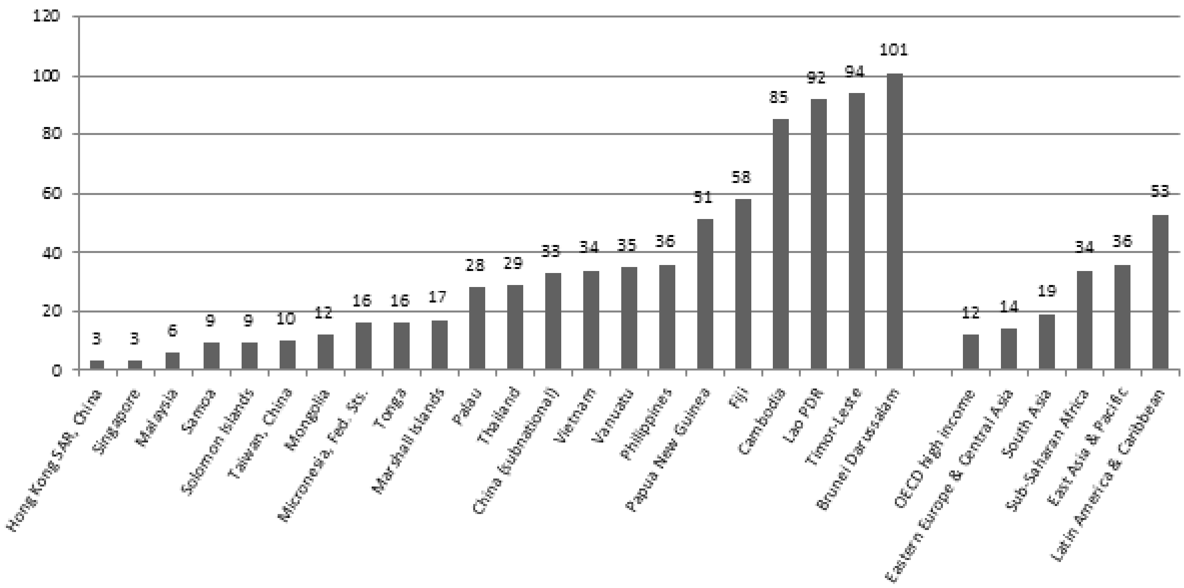
Source: Data derived from the World Bank's Enterprise Surveys.
Note: Data in this table reflect the shares of firms that report each of the 15 obstacles as the major constraint (these shares add up to 100%). Year reflects latest survey year. The Enterprise Survey is answered by business owners and top managers. Sometimes the survey respondent calls company accountants and human resource managers into the interview to answer questions in the sales and labor sections of the survey. Typically 1200-1800 interviews are conducted in larger economies, 360 interviews are conducted in medium-sized economies and for smaller economies, 150 interviews take place (for more information on methodology see: http://www.enterprisesurveys.org/Methodology).

4.53 Although not among the top reported obstacles to enterprise, transportation constraints caused by critical infrastructure gaps pose problems, particularly in countries with adverse geographic conditions. Anybody who has experienced traffic in Jakarta or Manila is likely to agree. One in five firms or more in Mongolia, Thailand, Timor-Leste, Vanuatu and Samoa report transportation as a major constraint. Infrastructure gaps in these countries constrain access to markets. Within areas of poor public provision of basic infrastructure, large firms at times construct roads for their own needs, acquire generators and build water wells. These are examples of firms making up for the failures of government, rather than coordinated partnership between public and private sector. This type of private effort is not the most cost-effective means to provide basic infrastructure services, nor the most equitable as small firms often do not have the minimum level of investment needed for such provision (IMF and World Bank 2012).

4.54 Much like the rate of taxation and costs of compliance, regulation does not appear to discourage business activity in the region. Small shares of firms report that business licensing and permits (3.8 percent), labor regulations (2.6 percent), and customs and trade regulations (2.1 percent) present obstacles. Nonetheless, since different firms within the same country report different experiences with the time needed to receive their license or to comply with certain regulations, this could provide an explanation for why corruption is reported as the seventh most important obstacle to enterprise in the region (Hallward-Driemeier, Khun-Jush, and Pritchett 2010). Corruption is reported to be very high in Papua New Guinea and Cambodia, while Singapore and Hong Kong have some of the lowest reported levels, according to the World Governance Indicators.

4.55 The time required for businesses to acquire licenses and permits is another obstacle that, although not in the top ranked problems reported by firms, presents unnecessary constraints to business in several South East Asian countries**.** On a whole, East Asia Pacific lags behind the global average in the 'number of days required to register a firm', measured as the median duration that incorporation lawyers report is needed to finalize the process with minimum follow-up and no extra payments. Some countries are particularly lagging, with an average waiting time of two and a half months or more to register a firm in Cambodia, Lao PDR, Timor-Leste and Brunei Darussalam. Such extended periods of time may discourage business activity, and stand in stark contrast to many of the higher performing countries in the region (figure 4.9).

Figure 4. 9 The time required for business registration varies widely across East Asia Pacific
Number of days required to register a firm, 2012

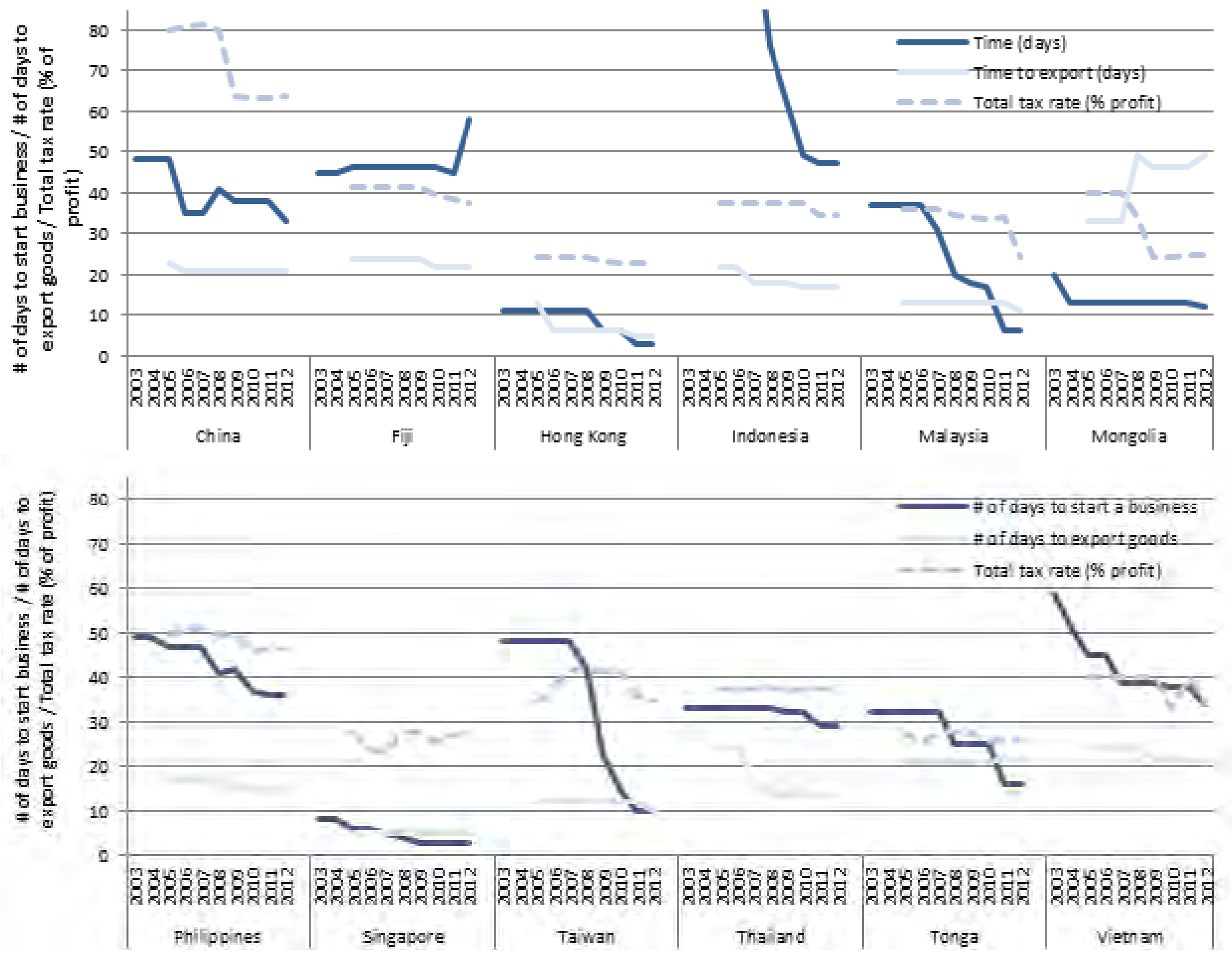


Source: Data derived from World Bank's Doing Business, see http://www.doingbusiness.org/data Note: Data collection for this survey round was completed in June 2012.

4.56 There have been substantial improvements in key business environment indicators over the past decade. Figure 4.10 illustrates these trends in the region. Without attributing any form of causality, countries in which unemployment rates have fallen by more than 2 percent since 2003—Indonesia, Hong Kong and the Philippines—all improved their business climate over this period by reducing the total number of days required to start a business, the number of days needed to comply with all procedures to export goods, and the total tax rate as a share of commercial profits.

Figure 4.10 Several business environment indicators have improved substantially across East Asia Pacific

Trends in selected business environment indicators across East Asia and the Pacific, 2003-2012



Source: Illustration based on data derived from the World Bank's Doing Business database, http://www.doingbusiness.org/custom-query Note: In Indonesia, the number of days to start a business dropped from 168 to 105 days between 2003 and 2007. As a significant outlier, this data for Indonesia has been omitted from the figure to allow for a consistent display of data. Data was not included on other important investment climate indicators such as the number of days to get electricity (given that the # of days in most countries did not change over this period) and access to credit rankings (given the lack of data for many years across all countries).

4.4 Are the "Fundamentals" in East Asia Pacific pro-work?

4.57 The state plays a critical role in enabling employment. It shapes the overall environment within which firms operate and can adopt policies to mitigate macro shocks and address market imperfections. It can also adopt more proactive policies to improve the environment for enterprise. Macroeconomic policy administrators—including Ministries of Finance, Central Bankers and the respective regulatory agencies—can, therefore, not only be guardians of macro stability but also facilitators of employment. Public policies affecting a country's inflation, exchange rates and the cyclicality of public spending can influence employment and business cycle fluctuations, as the private sector demands a certain degree of stability concerning their returns and decisions about savings and investments.

4.58 While monetary policy can be a useful tool to smooth business cycle fluctuations and stabilize labor market outcomes in the short-run, it does not directly offer long-term policy prescriptions. In terms of inflation targeting, some evidence of the effect of existing regimes on reduced inflation exists while the evidence of its effect on employment and growth is limited. Whereas many East Asian governments might have succeeded in promoting export-led growth and employment by fixing their currencies at low exchange rates, this strategy was ultimately shown to come at too high a price for some countries, resulting in imbalances and vulnerability to speculation which they could not withstand. Exchange rate policies largely shifted towards greater flexibility after the 1997 financial crisis among the most affected countries, while several countries also adopted inflation targets to gain the confidence of markets. China, of course, is an important exception to this trend with respect to its exchange rate policies, with a non-convertible currency which many argue is undervalued. Some countries, especially many Pacific island states, maintain hard pegged regimes. The question is not whether or not to peg or float, but rather what combination of monetary and exchange rate policies are going to help governments achieve flexibility with credibility.

4.59 When it comes to the demand and supply of human capital, the fiscal outcomes that count are predictability and counter-cyclicality of spending to help households in their day-to-day efforts at smoothing consumption. Yet fiscal policies linked to employment goals can be designed not only to expand aggregate supply but also to stimulate aggregate demand. Counter-cyclical policies and large-scale stimulus packages can have critical effects on compensating reductions in aggregate demand and sustaining work in the short term. Countries in East Asia Pacific exhibited better performance in containing the costs to household of the global financial crisis. Arguably, there is room for precautionary preparation and mitigation policies to reduce the extent of discretion, and to speed the flow of public resources to where they will most effectively sustain demand and employment.

4.60 Greater stability and counter-cyclicality could be achieved through a broader and more diversified tax base. In terms of tax policy reforms, some governments in the region have begun to redistribute the tax burden mainly by reducing tax rates on firm profits (but also, to a lesser extent, individual incomes) and by increasing indirect tax rates. There is likely space for policy makers to continue this trend in most countries in the region, as indirect tax rates are currently some of the lowest in the world. Tax reforms aimed at increasing value added or goods and services taxes will, however, be most difficult particularly in countries without re-distributional social protection policies.

4.61 Firm-level survey data reveal that the environment for enterprise and the demand for labor and human capital is encouraging. In the region, performance on overall business climate indicators is mixed, with some of the top performers (Singapore and Korea) but also the poorest performers (Lao PDR and Timor-Leste) in the world. Yet, in the region, fewer firms complain about taxation, restrictive labor regulation, hassle costs of dealing with government, or corruption. This sets countries in East Asia Pacific quite apart from other low and middle-income countries. But the favorable environment for enterprise is both precious and fragile, requiring the close care of policy makers to maintain.

4.62 The four most frequently reported constraints on businesses in East Asia Pacific are limited access to finance, an inadequately educated workforce, unfair competition from firms in the informal economy, and insufficient and unreliable electricity. Governments can play a critical role in removing these constraints and therefore in promoting an enabling business environment which makes the conditions for firms and workers functional and allows firms to invest, expand and increase their demand for labor and human capital.

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Table A4.1 Tax Revenue by type of tax and various employment indicators in East Asian and Pacific countries, 2011 or latest year

	Tax structure											
		% of tax revenue			% of revenue				% of commercial profits			
	Tax revenue (% of GDP)	Customs and other import duties (% of tax revenue)	Taxes on exports (% of tax revenue)	Taxes on income, profits and capital gains (% of total taxes)	Taxes on goods and services	Taxes on income, profits and capital gains	Taxes on international trade	Other taxes	Labor tax and contributions	Profit tax	Other taxes payable by businesses	Total tax rate
Cambodia	10.1	21.8	2.5	16.8	34.5	9.9	14.3	0.1	0.1	18.9	3.5	22.5
China	10.5	4.2	-25.2	27.8	58.9	24.6	3.7	1.2	49.6	5.9	7.9	63.5
Fiji	23.2	16.9	0.7	35.8	40.9	32.5	15.9	1.4	10.2	28.0	0.2	38.3
Hong Kong SAR	12.8	0.6		58.6	8.6	36.2	0.4	16.6	5.3	17.6	0.1	23.0
Indonesia	10.9	3.5	2.8	50.6	29.4	36.5	2.0	4.1	10.6	23.7	0.1	34.5
Kiribati									8.5	23.4	0.0	31.8
Korea, Rep.	15.2	6.0		42.0	26.7	28.1	4.0	8.0	13.0	15.1	1.5	29.7
Lao PDR	12.7	10.8	0.8	21.1	41.9	13.4	7.3	0.6	5.6	24.8	2.9	33.3
Macao SAR, China	34.7			4.1	88.6	3.9		1.6				
Malaysia	14.3	1.8	1.7	66.5	16.7	45.6	2.4	3.9	15.6	17.0	1.4	34.0
Marshall Islands									11.8	0.0	53.0	64.9
Micronesia, Fed.									6.8	0.0	52.0	58.7
Mongolia	22.7	10.1	0.0	42.6	28.5	27.1	6.4	1.6	12.4	10.2	2.0	24.6
Myanmar	3.9	3.9		43.3	30.7	25.2	2.3					
Palau									6.5	65.9	0.5	73.0
Papua New Guinea									11.7	22.0	8.6	42.3
Philippines	12.1	23.7		44.7	28.6	40.5	21.5	5.9	11.3	21.0	14.2	46.5
Samoa									7.0	11.9	0.0	18.9
Singapore	13.8	0.1		44.6	26.2	34.0	0.0	16.0	15.9	6.5	4.7	27.1
Solomon Islands									8.5	14.6	3.1	26.2
Taiwan, China									18.4	13.7	3.5	35.6
Thailand	16.0	5.7	0.0	42.3	40.2	33.2	4.5	0.6	5.7	28.8	3.0	37.5
Tonga									0.0	24.3	1.4	25.7
Vanuatu									4.5	0.0	3.9	8.4
Vietnam									22.6	17.2	0.3	40.1
East Asia & Pacific (all income levels)	11.5				28.6		4.0	1.6	11.1	17.9	6.3	35.3
East Asia & Pacific	11.0				29.4		6.4	0.8	10.5	17.9	7.9	36.2
Europe & Cen. Asia	15.6	..			36.8		2.5	0.1	22.2	9.2	10.2	41.6
Latin Ame. & Cari.					40.1		4.0	1.8	15.4	19.8	12.5	47.6
Mid. Ea. & No. Afr.	17.5				31.4		6.0	2.8	19.1	15.5	6.0	40.6
Sub-Saharan Africa	15.7								13.2	18.5	25.6	57.3
World (all income)	14.2				32.4		3.9	1.7	16.2	16.0	12.6	44.8

Source: Data from IMF, Government Finance Statistics Yearbook and data files, ILO; see WDI and GDF databases. Note: Data reflects the latest year between 2011 and 2005 for all East Asian countries with available data. ‘Taxes on income, profits, and capital gains’ are levied on the actual or presumptive net income of individuals, on the profits of corporations and enterprises, and on capital gains, whether realized or not, on land, securities, and other assets; intragovernmental payments are eliminated in consolidation. For detailed definitions of other indicators employed see: http://data.worldbank.org/. Regional data refers only to the average for developing countries in the respective region, i.e. not all countries, unless otherwise indicated.

Chapter 5: Building Human Capital

Despite some progress in East Asia Pacific, governments' current investments in human capital are skewed away from the foundational health and education services that build the most valuable skills in dynamic economies

5.1 Human capital, in the form of individuals' health, talent, knowledge and other productive attributes, contributes to economic growth and employment creation. Economies with more human capital are more likely to grow faster through higher productivity, greater innovation, and successful adaptation of new knowledge (Warsh, 2006). One of the most robust predictors of GDP growth across countries is the quality of education, as indicated, for example, by scores on international standardized tests taken by secondary school students (Hanushek and Woessman 2009; Jimenez et al 2012). In addition, workers' health influences their availability to work and their productivity at work. Poor health has negative impacts on GDP growth through lost labor productivity and the costs of treatment (Abegunde et al 2007).

5.2 Human capital directly enables the three development transformations that occur through work discussed in Chapter 3. At the individual level, workers with greater human capital are likely to earn more and enjoy improved living standards. Improved nutrition, particularly early in life, can directly increase earnings later in life (Behrman and Rosenzweig 2001; Hoddinott et al 2008). Private returns to every additional year of schooling are estimated at 10 percent on average around the world, with even higher rates in less developed countries (Barro and Lee 2012; Montenegro and Patrinos 2012).[1] At the aggregate level, labor productivity has risen faster in East Asia than in any other region since 1999, and investments in human capital have played an important part in fueling this growth (Chansarn 2010; Kucera and Roncolato 2012). However, as argued in Chapter 3, these trends have been uneven across and within countries, and unequal opportunities to build, maintain and protect the human capital that people need to succeed in the labor market may threaten social cohesion.

5.3 People in East Asia Pacific have enjoyed substantial improvements in health outcomes and in educational attainment, but indicators of these successes are only indirect measures of their human capital. Across the region, most people complete basic education and enjoy longer life expectancy than in previous generations. While some of the lower-income countries in the region continue to struggle with low levels of educational attainment, many countries are now turning to the challenge of expanding higher education and capabilities for the labor market. Education, health, and work experience can all contribute to skills—the specific competencies that individuals can productively apply to their work. However, just because more kids are

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[1] Private returns are measured as increases in individuals' earnings. On average, returns are larger for women than for men, and in recent years the returns to tertiary schooling have been higher than the returns to primary or secondary schooling (Montenegro and Patrinos 2012).

going to school does not necessarily mean that they are learning and building skills, which are much harder to observe directly.

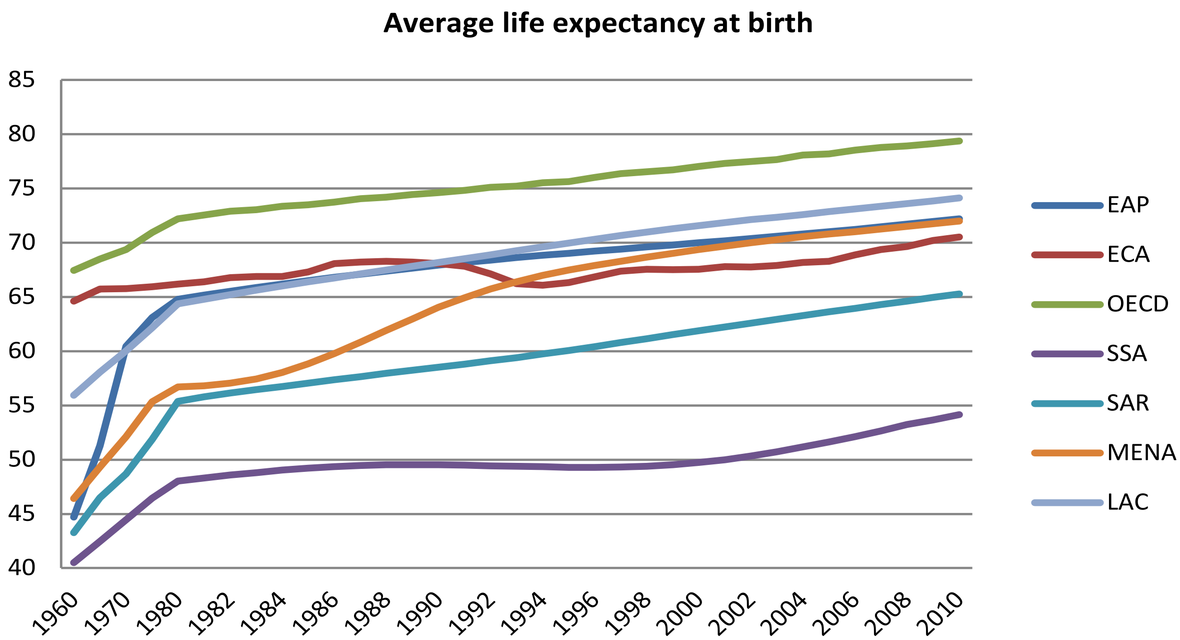
5.4 This chapter examines the supply and demand for skills in the region and provides a conceptual framework for understanding 'skills gaps', their causes, and broad implications for policy. When should skills gaps motivate policy intervention? A time lag or gap between the skills employers seek and which workers have to offer, is to be expected in any dynamic economy, as new workers with different skills enter the labor market and existing workers adjust their skills. Only in an economy in perpetual equilibrium, producing the same goods and services, and cut off from technological advances in the rest of the world would the skills sought by employers always be readily available. This explains why in today's globalized economy, skills shortages are reported by employers in almost every country to be a constraint to the growth of their businesses. Thus it is not the existence of skills gaps that should be a worry, but rather which gaps are found and how persistently they remain. Gaps in foundational skills are particularly inefficient, and gaps in all types of skills can hamper growth when they are too wide and too persistent. Governments have an important role to play in filling skills gaps when the health and education systems and the existing labor force are slow to adjust to changing demand, or when market failures distort people's choices of skills investments and firms' choices of production technology.

5.5 The demand for skills is evolving rapidly in East Asia Pacific countries, creating wide and persistent skills gaps—shortfalls in cognitive, behavioral, as well as employment-specific skills—that may constrain economic growth and the wellbeing that households can derive from work. Skills development in the region needs to go beyond the focus on technical and vocational education, a set of education services that provide only a fraction of the skills demanded in these fast-changing economies. Moreover, we argue that there are multiple causes of skills gaps, rooted in both the education systems and the labor markets of East Asia Pacific countries. This multiplicity of causes creates an imperative for policymakers to first identify the nature of the skills problems they face before designing solutions.

5.1 Countries in East Asia Pacific have made substantial progress in health and education

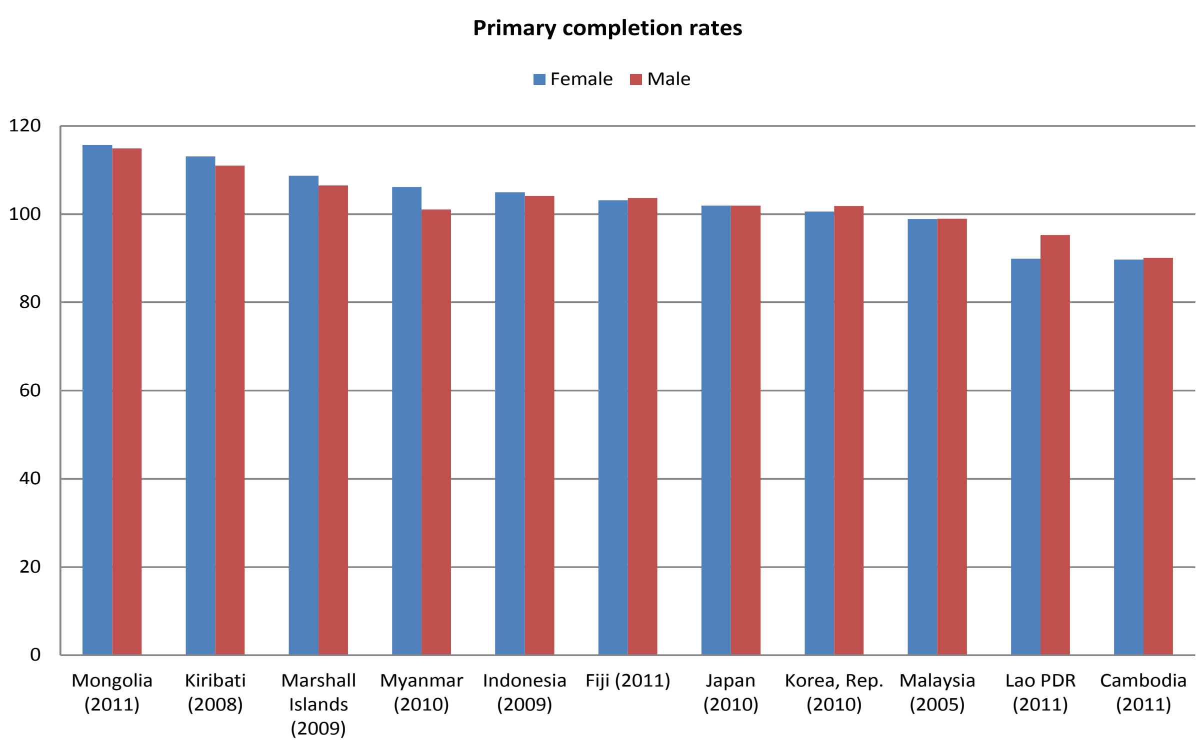
5.6 Countries in the East Asia Pacific region are well ranked according to many standard health and education outcome indicators commonly used as measures of human capital. For example, figure 5.1 shows that the region as a whole now has the third highest level of life expectancy globally. Schooling attainment has grown substantially across East Asia Pacific over the past several decades: for example, in Indonesia the population had on average 34 percent more schooling in 2010 than in 1995. This improvement has also narrowed gender disparities: the majority of both girls and boys, over 90 percent in many countries, now attain a basic education (Figure 5.2). While East Asia Pacific has experienced the largest gains in secondary school enrollment, the region still trails behind many other regions in tertiary level schooling (Figure 5.3).

Figure 5.1 East Asia Pacific has the third highest average regional life expectancy



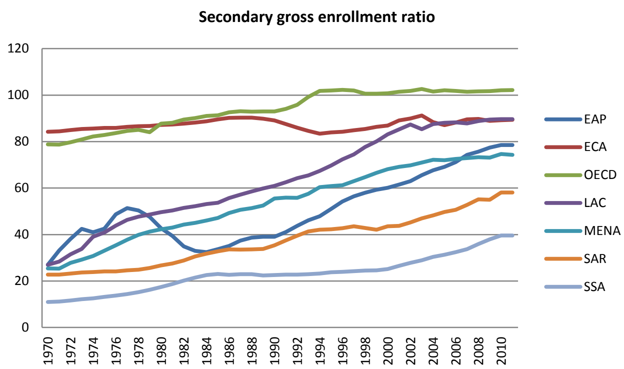
Source: World Development Indicators.

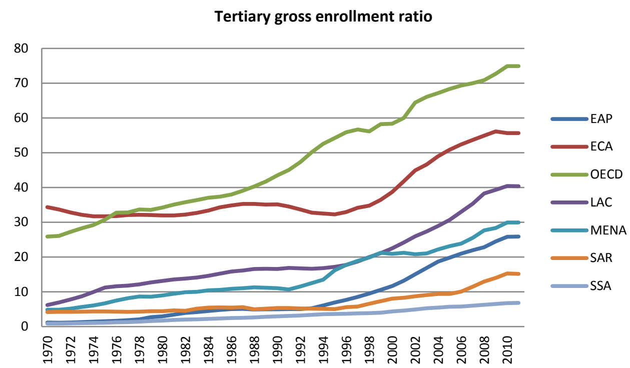
Figure 5. 2 Most girls and boys complete primary schools



Source: World Bank Education Statistics.

Figure 5.3 East Asia Pacific has made the largest gains in secondary enrollment, but lags behind in tertiary schooling

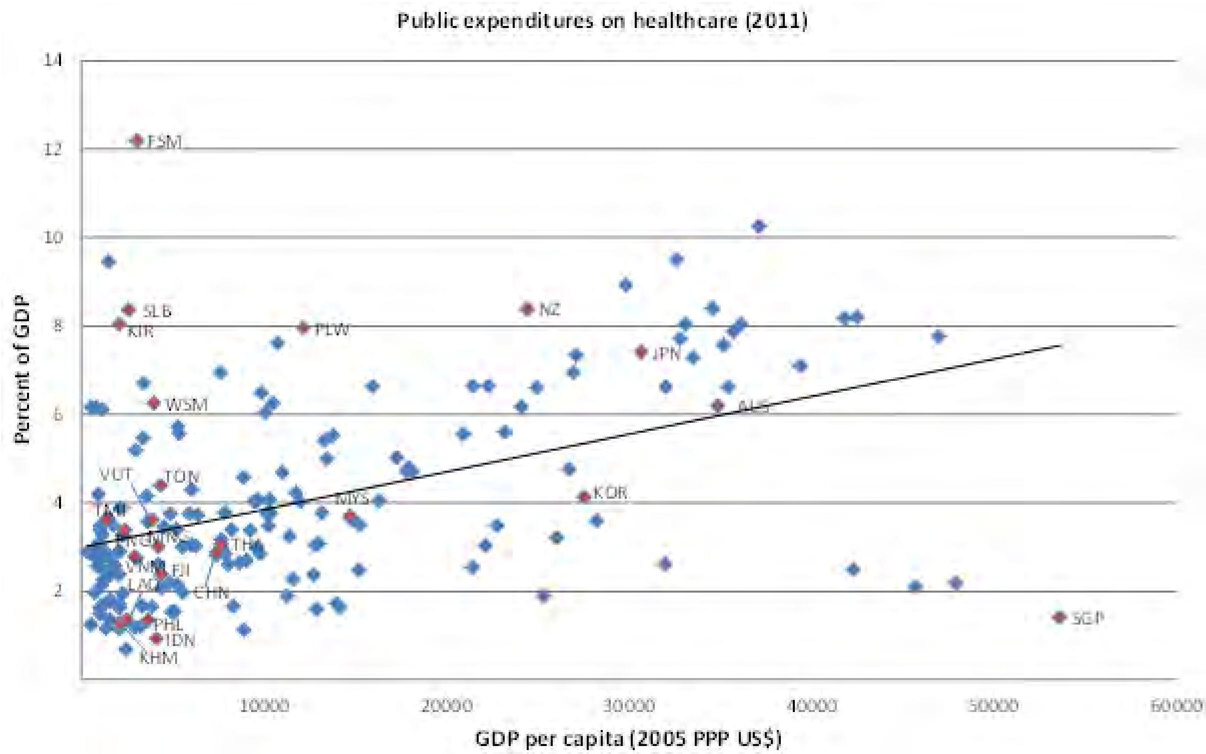




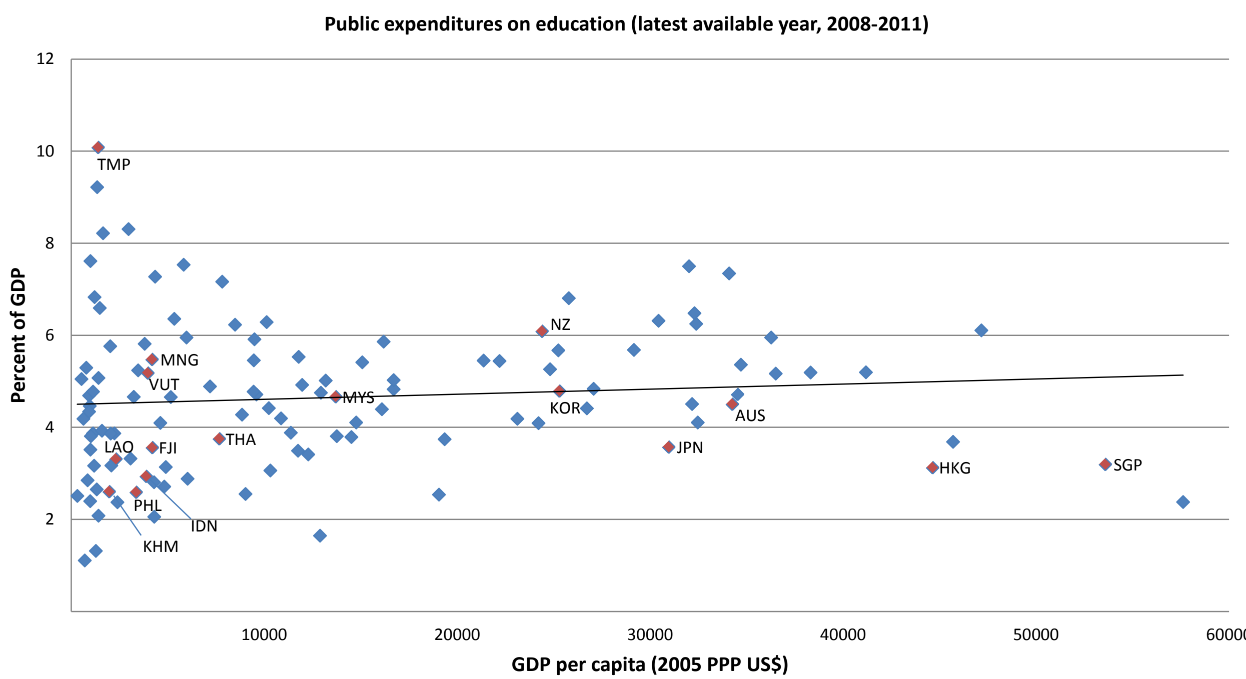
Source: World Bank Education Statistics

5.7 Countries in the East Asia Pacific region have achieved these levels of performance without a notably high level of spending on health and education, although the public sector's role differs substantially across countries. Figure 5.4 shows spending in health and education as a share of GDP for countries at different income levels. In general, low and middle income countries spend relatively less on education and health as a share of GDP than richer economies. Governments in East Asia, including Lao PDR, Cambodia, the Philippines and Indonesia tend to spend less on both health and education than other countries at similar levels of income. Several Pacific island countries, including the Federated States of Micronesia, the Solomon Islands, Kiribati, and Samoa, devote relatively large amounts of public spending to healthcare, often funding costly curative care as well as basic services. In higher education, the private sector plays a significant role in some countries, including Cambodia, the Philippines and Indonesia, where over 50 percent of students attend private institutions, whereas fewer than 20 percent of students do in Thailand and Vietnam (Figure 5.5). In China, where about 50 percent of the region's tertiary students reside, over 80 percent attended public institutions in 2008 (Liu and Wang 2010).

Figure 5.4 East Asian countries spend less on education and healthcare than countries at similar income levels, while Pacific countries spend relatively more on healthcare

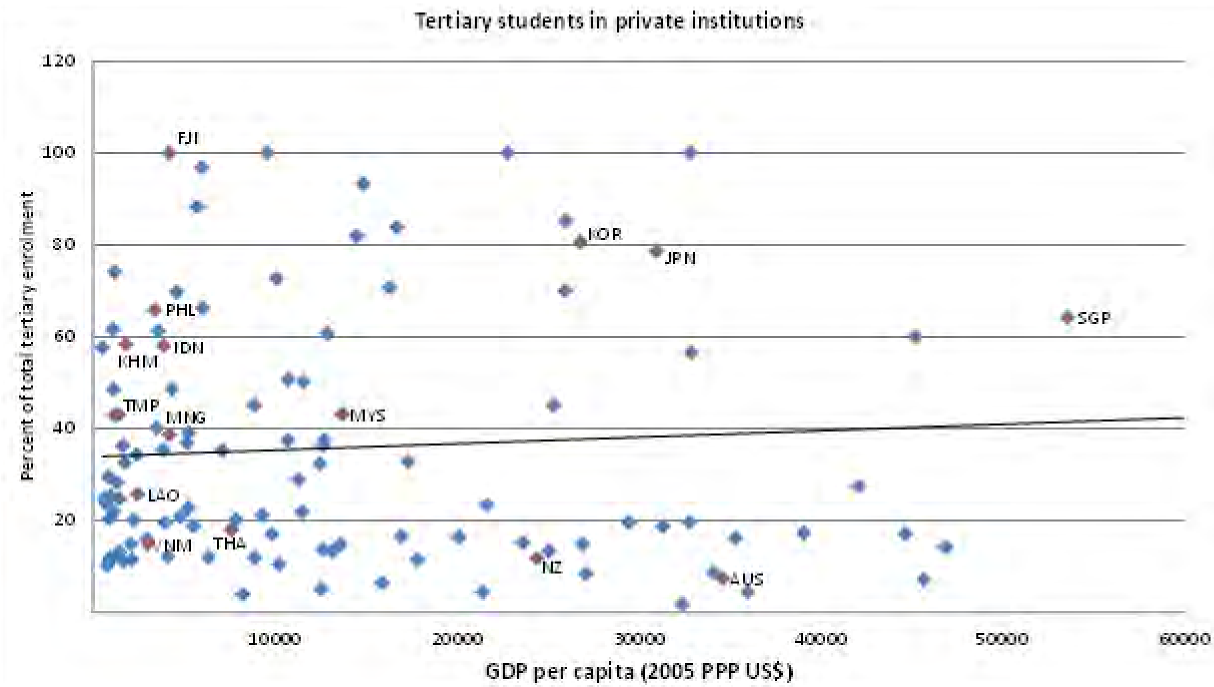


Source: World Bank Health, Nutrition and Population Statistics



Source: World Bank Education Statistics

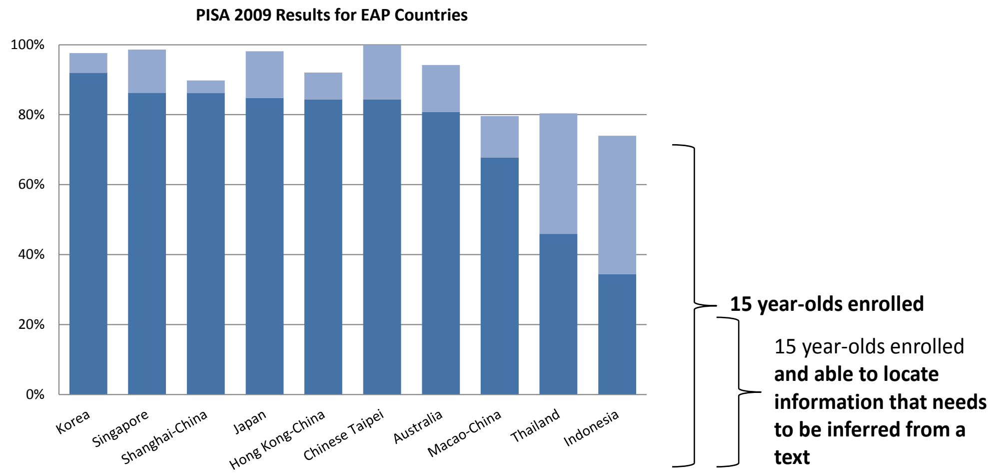
Figure 5.5 Private tertiary institutions play an important role in some countries



Source: World Bank Education Statistics.

5.8 Although health and education indicators are readily available, the skills derived from human capital directly affect productivity. Even high levels of education may be inadequate due to poor quality or poor alignment of skills taught with skills demanded in the labor market. School systems vary in their ability to produce skills. As an imperfect illustration of this, Figure 5.6 shows that the fraction of 15-year olds who master an expected competency level, as measured in the PISA international standardized test, is always lower than the fraction enrolled in school across East Asia. The gap is particularly stark in Indonesia and Thailand. In addition, the alignment of education with what employers need is increasingly an area of concern, as traditional schooling systems face challenges in meeting rapidly evolving demand for different skills. The remainder of this chapter examines skills directly in order to identify the constraining factors that limit the production of skills demanded in the labor market.

Figure 5.6 Enrollment does not guarantee learning



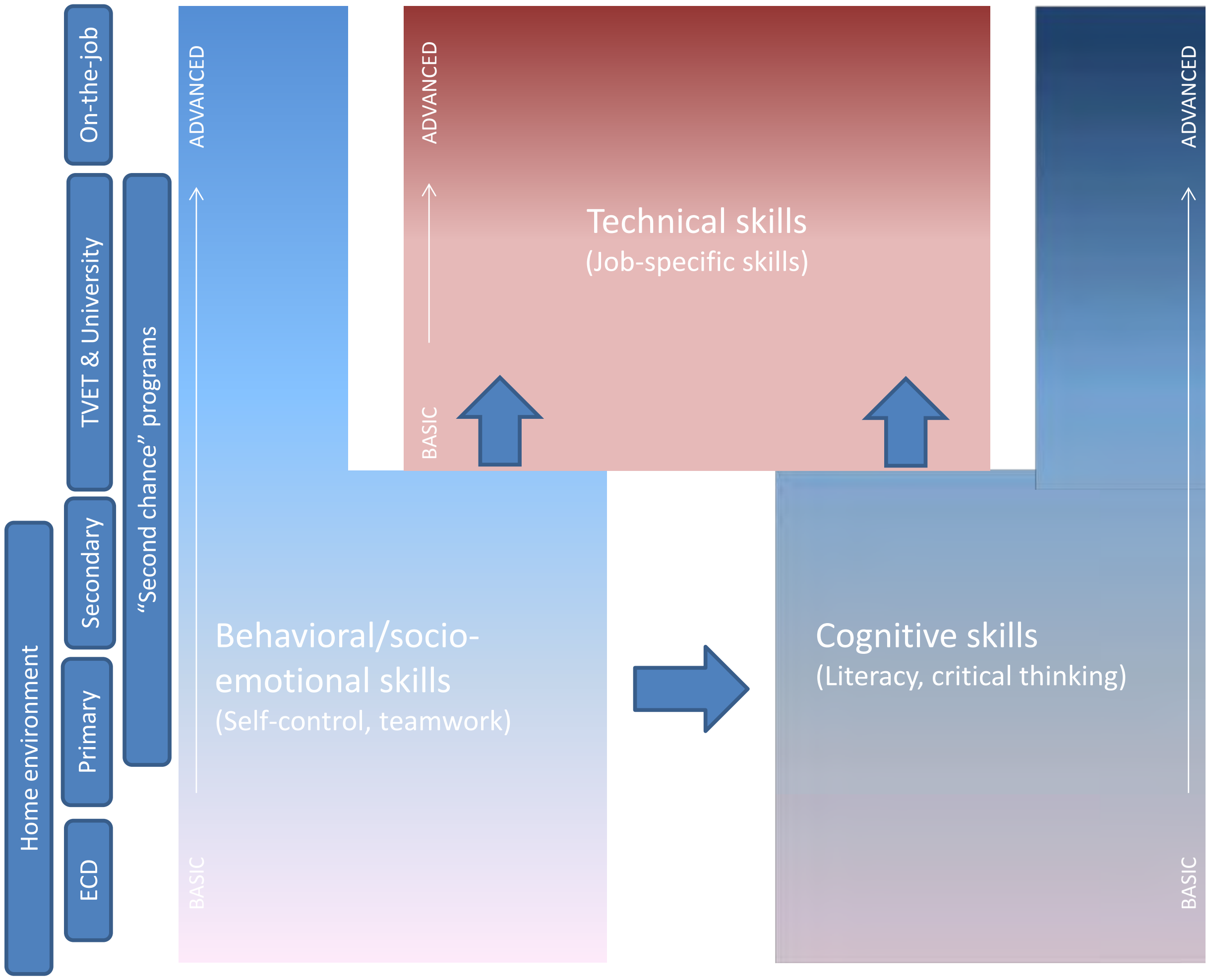
Source: OECD 2010.
Notes: PISA (Program for International Student Assessment) tests the skills and knowledge of 15-year-old students in three key areas: reading, math, and science. The result graphed here corresponds to attaining level 2 in overall reading proficiency (out of 7 levels: 1a, 1b, 2, 3, 4, 5, 6). Across the OECD, 81.2% of students participating in the 2009 round of PISA attained this level or higher.

5.2 Skills stocktaking: Supply, demand, and skills gaps

5.9 What are skills? This chapter builds on the rubric created by the World Bank's STEP (Skills Towards Employment and Productivity) Skills Measurement Project to define skills. In STEP, skills are broadly grouped into three different categories: (i) cognitive, (ii) behavioral/socio-emotional, and (iii) technical. Cognitive skills include numeracy, problem solving skills, verbal communication, and memory. Behavioral/socio-emotional skills include teamwork, work effort, reliability and discipline. Technical skills are skills required in specific work or for specific tasks.

5.10 How are skills formed? Building skills is a progressive, life-long activity that involves many critical inputs, with the highest returns to investments made at early ages. Figure 5.7 provides a schema to summarize the formation of different types of skills through different stages in life. Basic cognitive and behavioral skills, also called 'foundational' skills, begin building early on, and are influenced by nutrition, the home environment, and the quality of schooling. Further schooling and training, as well as on-the-job learning, build technical skills and advanced cognitive and behavioral skills. Evidence from a wide range of countries shows that basic cognitive and behavioral skills acquired early on form the critical foundations for future skill acquisition. The malleability of different types of skills varies: for example, socio-emotional skills are malleable at least through adolescence (Borghans et al 2008). However, across all skill categories, the earlier in life investments are made, the more effective they will be in forming enduring skills (Heckman 2008). This occurs in part because future investments, built on solid foundations, will have higher returns (Cunha and Heckman 2007). Therefore, the capacity to learn must be supported from the very earliest ages.

Figure 5.7 Skill building starts early, involves many inputs, and continues throughout life



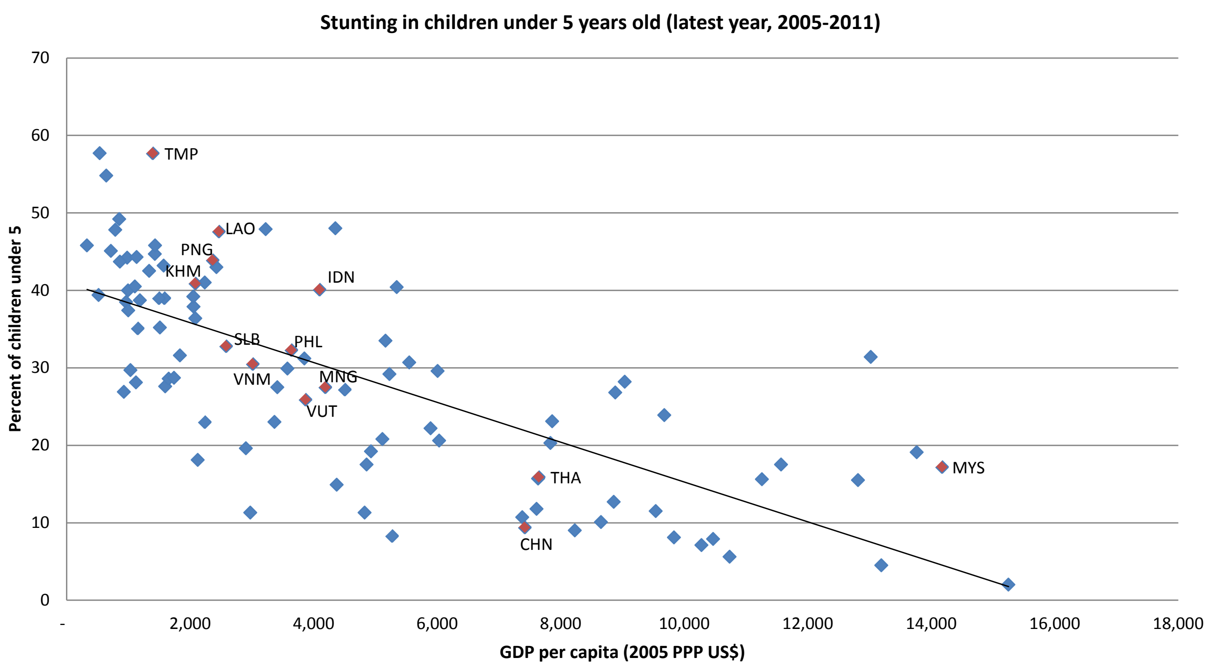
Source: World Bank 2013a; East Asia Pacific Jobs Report team.
Notes: Color gradation represents progress from basic to advanced level of each skill type. Examples of skill types are provided in parentheses. Basic cognitive and basic behavioral skills are frequently referred to as foundational skills throughout the chapter.

The supply of skills

5.11 While the educational attainment of successive generations has been rising in East Asia Pacific countries, the ability of health, education, and training systems to produce skills varies substantially across the region. Direct measures of skills supply, both for the "flow" of new entrants into the labor market and for the "stock" of existing workers, are scarce. However, several indicators, as well as recent surveys of households and employers across the region, suggest that behavioral, cognitive, and technical skills are inadequate, even among educated workers.

5.12 Nutrition and early life circumstances are critical inputs to foundational skills, but many children in East Asia Pacific countries are not getting off to a good start. Stunting, a manifestation of chronic malnutrition, afflicts large numbers of children in the region and is likely to affect the accumulation of skills throughout their lives. More than 40 percent of children under 5 in Cambodia, Lao PDR, Timor Leste and Papua New Guinea are stunted, as shown in figure 5.8. The lack of particular nutrients also plays a direct role in inhibiting skill formation. In Thailand, iodine deficiency is a major cause of relatively low IQ scores among children, found to be 91 on average in 2009, compared to 104 in developed countries (World Bank 2012b). Recent legislation in Thailand aims at tackling this problem by mandating the iodization of all salt destined for consumption in the country.

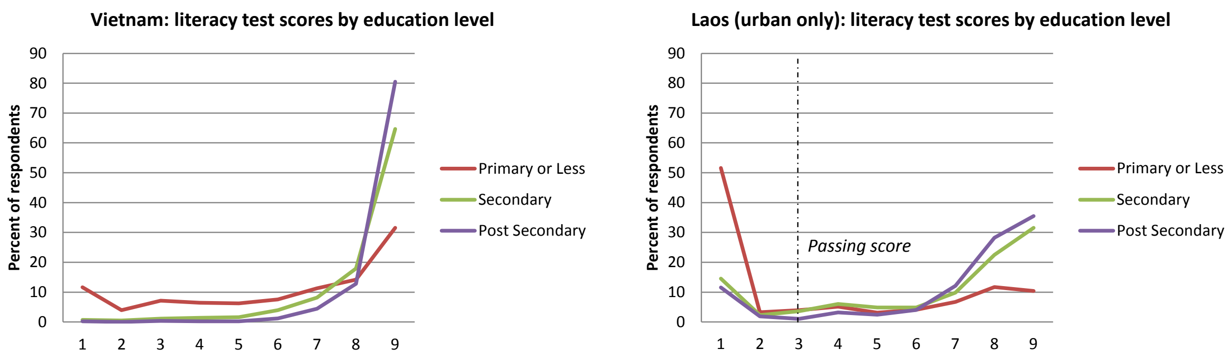
Figure 5.8 Stunting threatens 20-60 percent of children's foundational skills in many East Asia Pacific countries



Sources: Global Health Observatory and World Development Indicators.
Note: GDP data for North Korea is unavailable, but stunting in children under 5 years old was estimated to be 32.4% in 2009 (Global Health Observatory).

5.13 Some countries have a strong and growing stock of foundational skills, while others continue to struggle with the quality of basic education. The World Bank's STEP Skills Measurement Project provides new data on both the supply and demand for cognitive, behavioral, and technical skills in labor markets around the world. In 2011, household and employer surveys were carried out in six countries, including Vietnam, Lao PDR, and Yunnan Province in China. Figure 5.9 shows the fraction of individuals achieving each score, on a scale of 1-9, on the basic literacy test conducted as part of the STEP household survey. On average, a graduate of primary school in Vietnam scored better on the test than a secondary graduate in Lao PDR. Overall, only 67 percent of participants in Lao PDR passed the literacy test, while 95 percent and 99 percent in Vietnam and Yunnan, China passed (World Bank 2013a, 2013b; Liang and Chen 2013). These results suggest that Lao PDR, where school enrollment rates are lower, faces ongoing challenges with both increasing access and the quality of education. Many Pacific island countries have even more serious deficits in their stocks of foundational skills and ongoing challenges to producing skills in their education systems. For example, in the Solomon Islands, recent surveys have found that the functional literacy rate in the population is only about 17%, and, although the net primary enrolment rate is 91%, only 22% of primary students are functionally literate (World Bank 2012c).

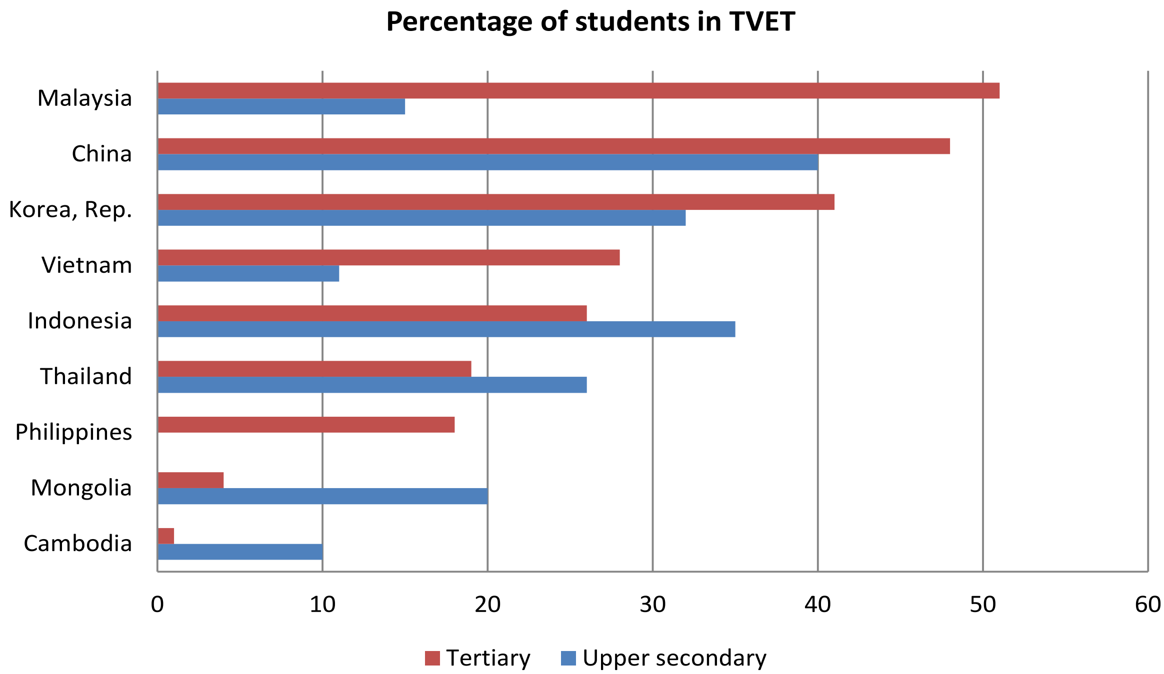
Figure 5.9 Both the amount and quality of education are inadequate in Lao PDR



Source: World Bank 2013a and 2013b.
Note: The literacy test designed to assess foundational reading skills was administered to survey respondents as part of the household survey component of STEP.

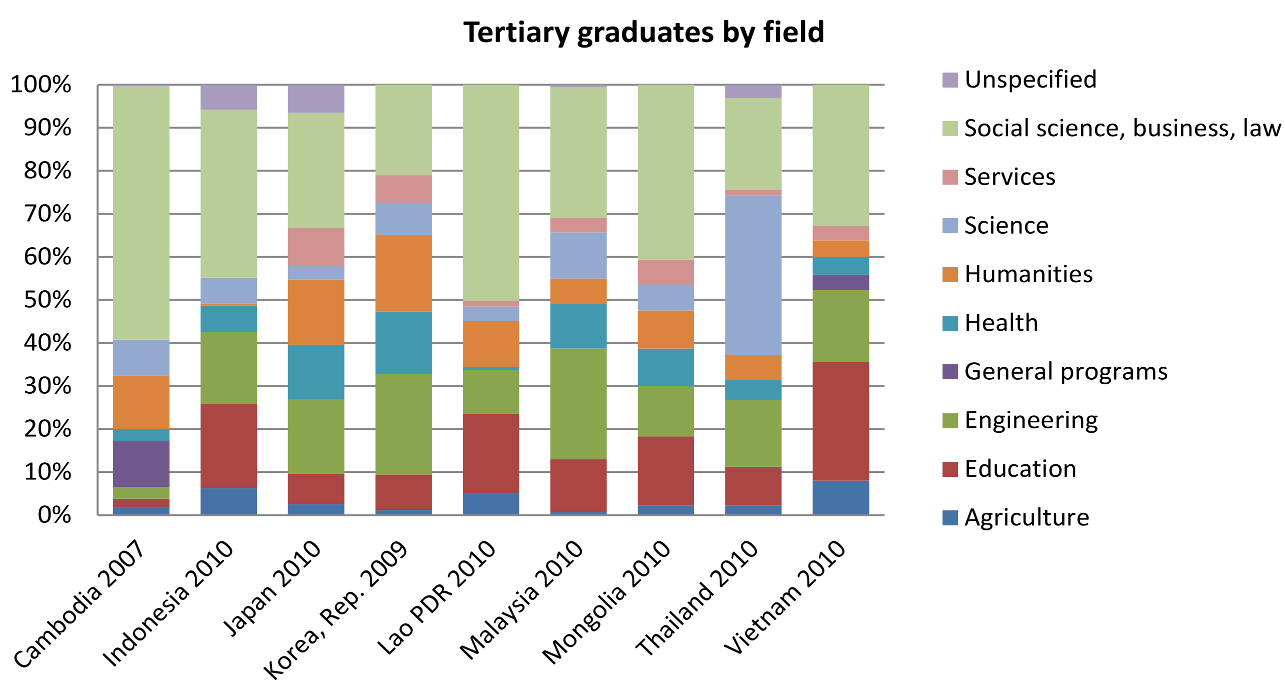
5.14 The supply of technical and advanced cognitive and behavioral skills in East Asia Pacific countries depends on the quality of their higher education and training programs as well as their alignment, i.e. how well-matched programs are to current and future demand of firms. Across most countries, the stock of advanced skills is small, as small shares of the population have tertiary degrees. While the flow is increasing quickly, it is still limited:: the regional tertiary gross enrollment ratio is less than 30 percent. In addition, the flow of technical and advanced cognitive and behavioral skills may not be well-aligned with current and future demand. Among those enrolled in upper secondary and tertiary, several countries in developing East Asia, notably Malaysia, China and Indonesia, have a large number of students in specialized technical and vocational education and training (TVET) (figure 5.10). These students may possess formidable technical skills but insufficient advanced cognitive and behavioral skills required for work due to the sometimes limited focus of TVET programs. Even the supply of technical skills, produced by both general education and TVET programs, may not align with the needs of employers. As Figure 5.11 illustrates, the fraction of students enrolled in engineering and natural sciences is often much smaller than the fraction in social sciences in most countries, except in Thailand and Malaysia. In Cambodia, for example, the high share of social science graduates is creating concern that the skills needed to fuel Cambodia's economic growth, namely natural sciences, are not being created (World Bank 2012d). The most popular fields of study also differ between men and women, contributing to possible gender differences in skills attainment (Box 5.1).

Figure 5.10 TVET programs are a large part of education systems in several East Asian countries



Source: World Bank 2012a.

Figure 5.11 Social sciences may be oversupplied in Cambodia, Lao PDR and other countries



Source: World Bank Education Statistics.

Box 5. 1 Gender differences in education and skills attainment

Gender gaps in education in East Asia Pacific countries have narrowed substantially since the 1990s, and in some cases even have been reversed. At primary and secondary, girls and boys enrollments are roughly on par across countries. This is even true of women and men at the tertiary level. In many countries, including China, Malaysia, Mongolia, the Philippines and Thailand, girls and women have higher enrollment rates than boys and men at both the secondary and tertiary levels. Girls in Indonesia, Malaysia, Thailand and the Philippines also tend to outperform boys on international standardized tests of reading, math and sciences.

However, women may still have very different marketable skills than men for several reasons. On technical skills, women's completion rates in vocational training are lower than men's in Thailand, Indonesia, Vietnam and Mongolia even though the reverse tends to be true for completion of general secondary education (Cambodia experiences the opposite patterns). In tertiary education, women tend to sort into very different fields of study from men. For example, many young women in Vietnam, Indonesia and Thailand choose to train in education over law and engineering even though the returns in terms of higher earnings are not as high. The choice reflects social norms, curriculum, expectations about the labor market and other factors. In terms of behavioral skills, research in the United States has found that girls display better behavior and socio-emotional abilities than boys from an early age, impacting grades and school progression (Jacob 2002; Cornwell, Mustard and Van Parys 2013).

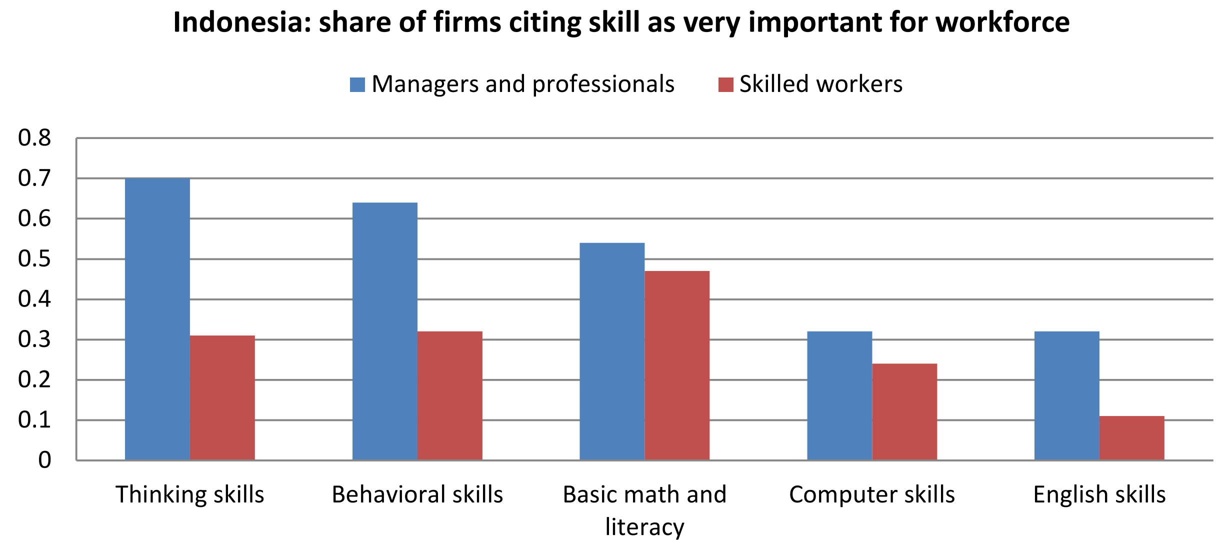
Source: World Bank 2012e

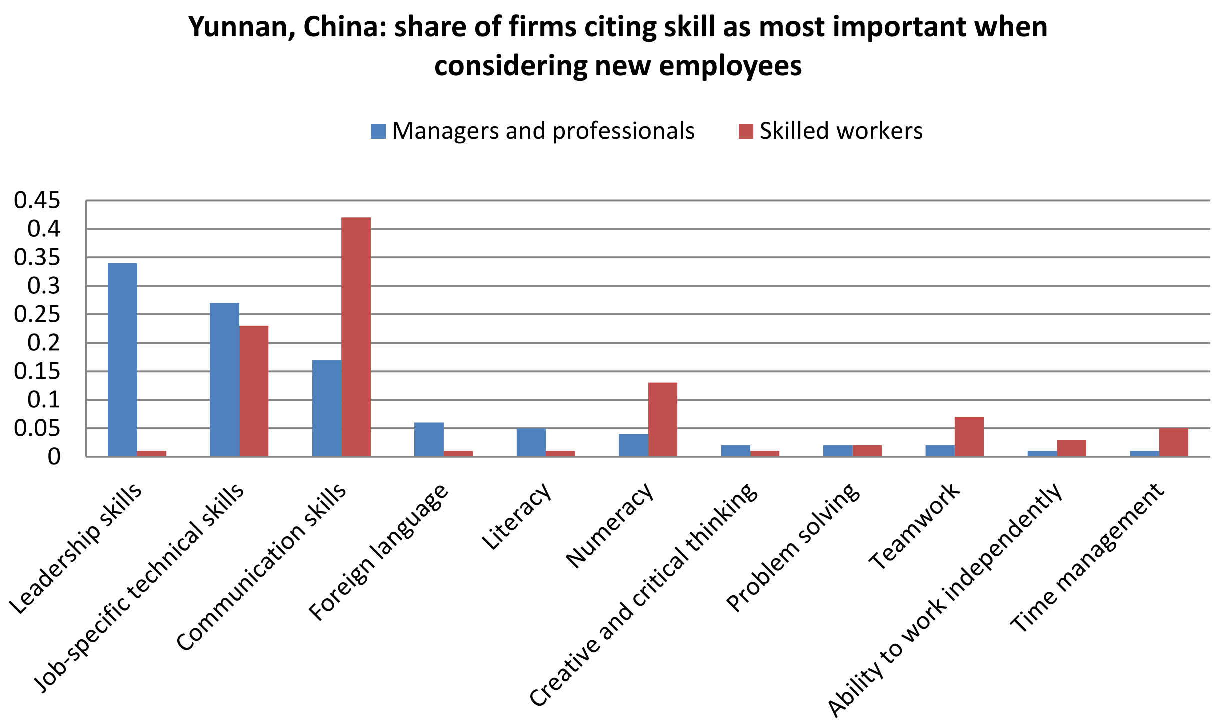
The demand for skills

5.15 The demand for skills from employers in East Asia Pacific economies goes well beyond technical skills. In most surveys, employers report that cognitive, behavioral, and technical skills are *all* important for their workforce. Evidence of this demand for a broad set of skills is clear from survey results in China and Indonesia (Figure 5.12).[2] In Indonesia, thinking and behavioral skills are considered very important, alongside math. In Yunnan, China, many firms cite that leadership and communication skills are as important as employment-specific skills. Similarly, among professional workers in Malaysia, a range of skills appear to be valued: computer, presentation, problem-solving, and writing skills are all associated with a higher wage premium (World Bank 2013c).

Figure 5.12 Cognitive, behavioral, and technical skills are all important to employers.

[2] Surveys differ substantially across countries, making comparisons difficult. In addition, surveys often focus on a subset of all employers, such as formal employers with a minimum number of employees, or only employers in urban areas. These restrictions mean that survey results are not fully representative of labor skills demand, but often represent the fastest-growing sectors in countries.

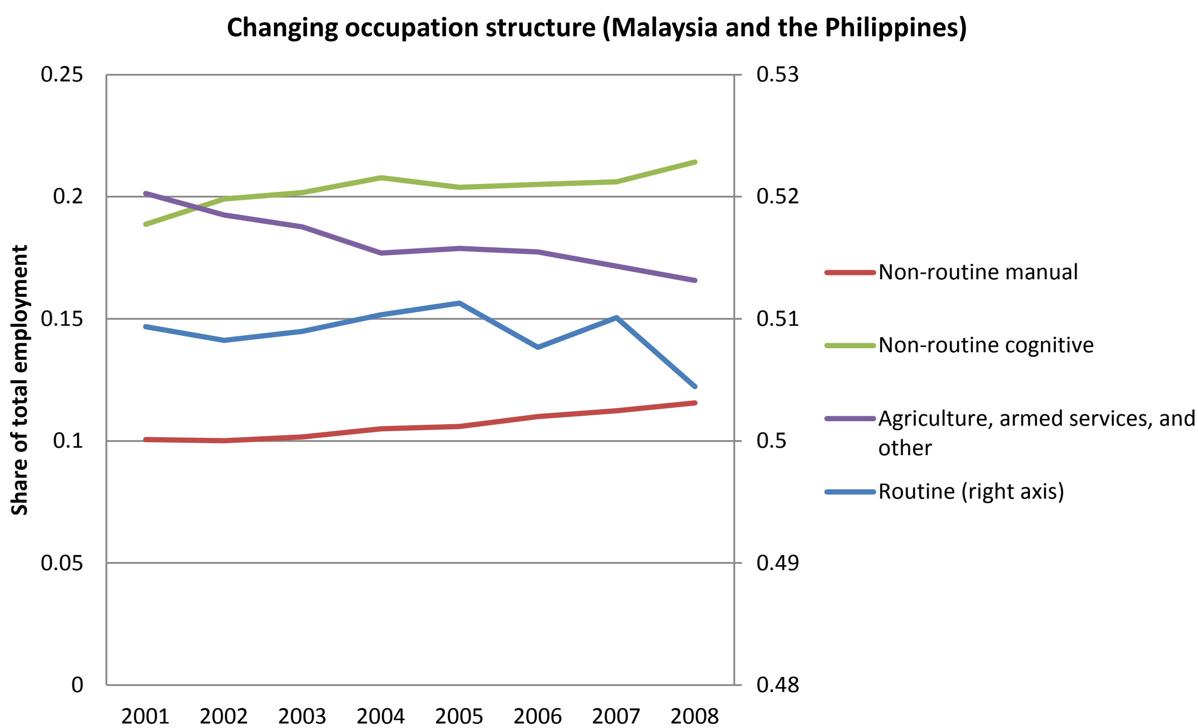




Sources: di Gropello 2010 and Liang and Chen 2013.

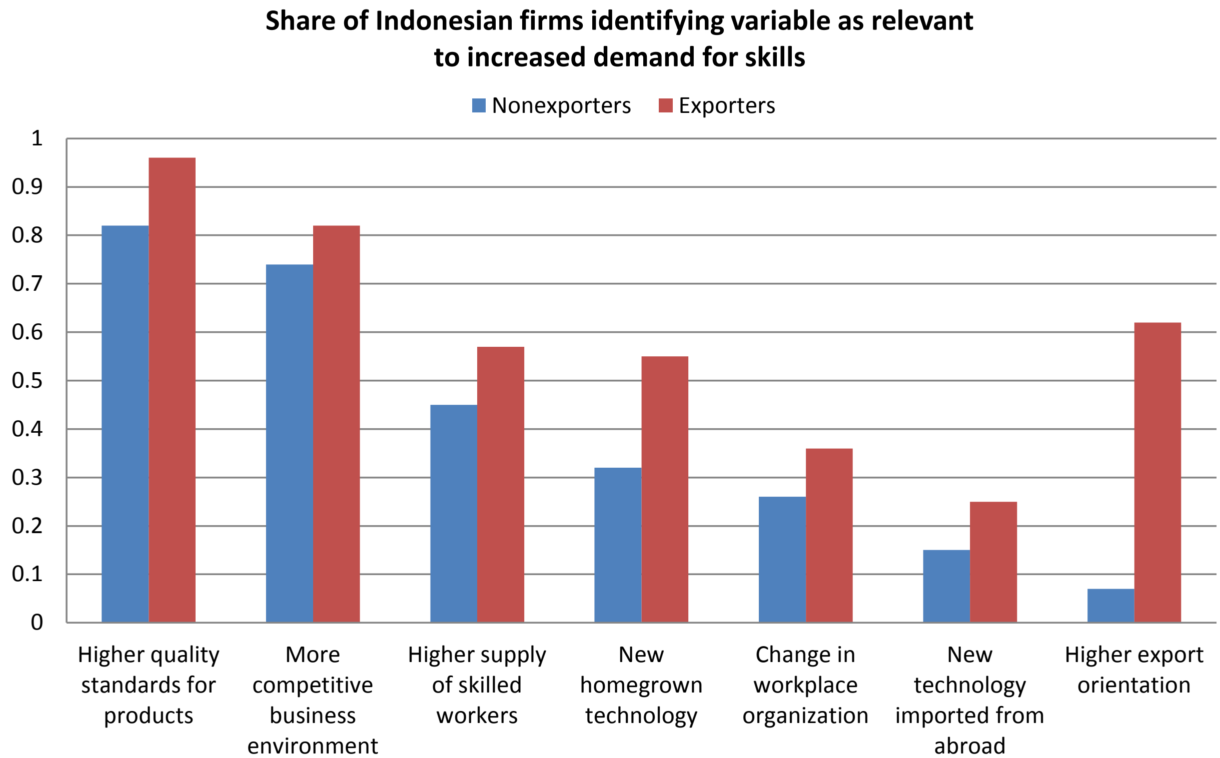
5.16 Technological advances are rapidly changing the mix of skills demanded in the labor markets of both developing and advanced economies. Globally, steeply declining costs for computer processing capacity are driving skill-intensive technological change, whereby the returns to work requiring skills that are complementary with computers have increased, while work requiring skills similar to what computers are good at doing are disappearing (Autor, Levy, and Murnane 2003). Computers substitute for workers in tasks that can be carried out by following an explicit set of rules (labeled "routine" tasks by Autor, Levy, and Murnane), while computers complement workers in problem-solving, communications, and complex cognitive activities, as well as in manual activities that cannot be easily characterized by a set of rules (or "non-routine" tasks). Figure 5.13 shows that in Malaysia and the Philippines, the share of employment in non-routine skill-intensive occupations has been rising, while the share in routine skill-intensive occupations, substitutable by computers and computer-operated machinery, has been in decline.

Figure 5.13 Routine work is in decline in Malaysia and the Philippines



Source: Key Indicators of the Labor Market (ILO).
Note: Occupations are categorized according to Jaimovich and Siu 2012, and ILO 2013.

Figure 5.14 Employers in Indonesia report increasing quality standards and competition as key drivers of skill demand



Source: di Gropello 2010.

5.17 In East Asia, economic transformation and global integration are increasing the demand for an educated workforce and for relevant skills. These trends are evident from recent skills survey data from Indonesia and the Philippines. In both countries, the surveys were carried out in 2008 and included representative samples of several hundred manufacturing and service firms in high-growth geographical regions, 473 firms in Indonesia and 300 firms in the Philippines (di Gropello, et al. 2010, 2011). Firm managers, as well as employees, were asked about the nature of the business, current and future skill needs, and local and national skills supply. Survey results show that recent hires in manufacturing and services firms have been mostly workers with secondary or tertiary education, and even more so for exporting firms. Across most East Asian firms, higher worker education levels are strongly linked to foreign direct investment, exporting status, and innovative activity (Almeida 2009).[3] Over 95 percent of manufacturing and services firms in Indonesia report expecting their demand for skills to increase in the next ten years (di Gropello, et al. 2010). Figure 5.14 shows that higher quality standards and increased competition are the top reasons given for these expected increases in worker skills. Similar forces appear to be at work around the world: GDP per capita and the intensity of non-routine cognitive skills used in the labor force are positively correlated, both in a cross-section of countries and within countries over time (Aedo, et al. 2013).

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[3] China is an exception to this finding, where exporting status is correlated with *lower* worker education, likely due to specialization in low-skilled manufacturing (Almeida 2009).

Skills gaps

5.18 What are skills gaps? The definition of a skills gap differs for foundational skills versus technical and advanced skills. Because foundational skills (basic cognitive and basic behavioral skills) such as literacy improve people's wellbeing, they have intrinsic value and are therefore development goals in their own right. Gaps can therefore be defined relative to universal possession of these foundational skills. Even when they are not pure public goods (in the classical sense), the externalities from these foundational skills for societies are so large that they merit public financing to minimize gaps as far as possible. For technical and advanced cognitive and behavioral skills, gaps can be defined by the relative difference between supply and demand. Specifically, a gap exists when the supply of skills is not enough to meet demand. Such high demand would drive up wages and employment for workers with the right skills or particular sets of skills.[4] Workers without the demanded skills would experience higher rates of unemployment, while some jobs went unfilled because of a lack of appropriately skilled workers.

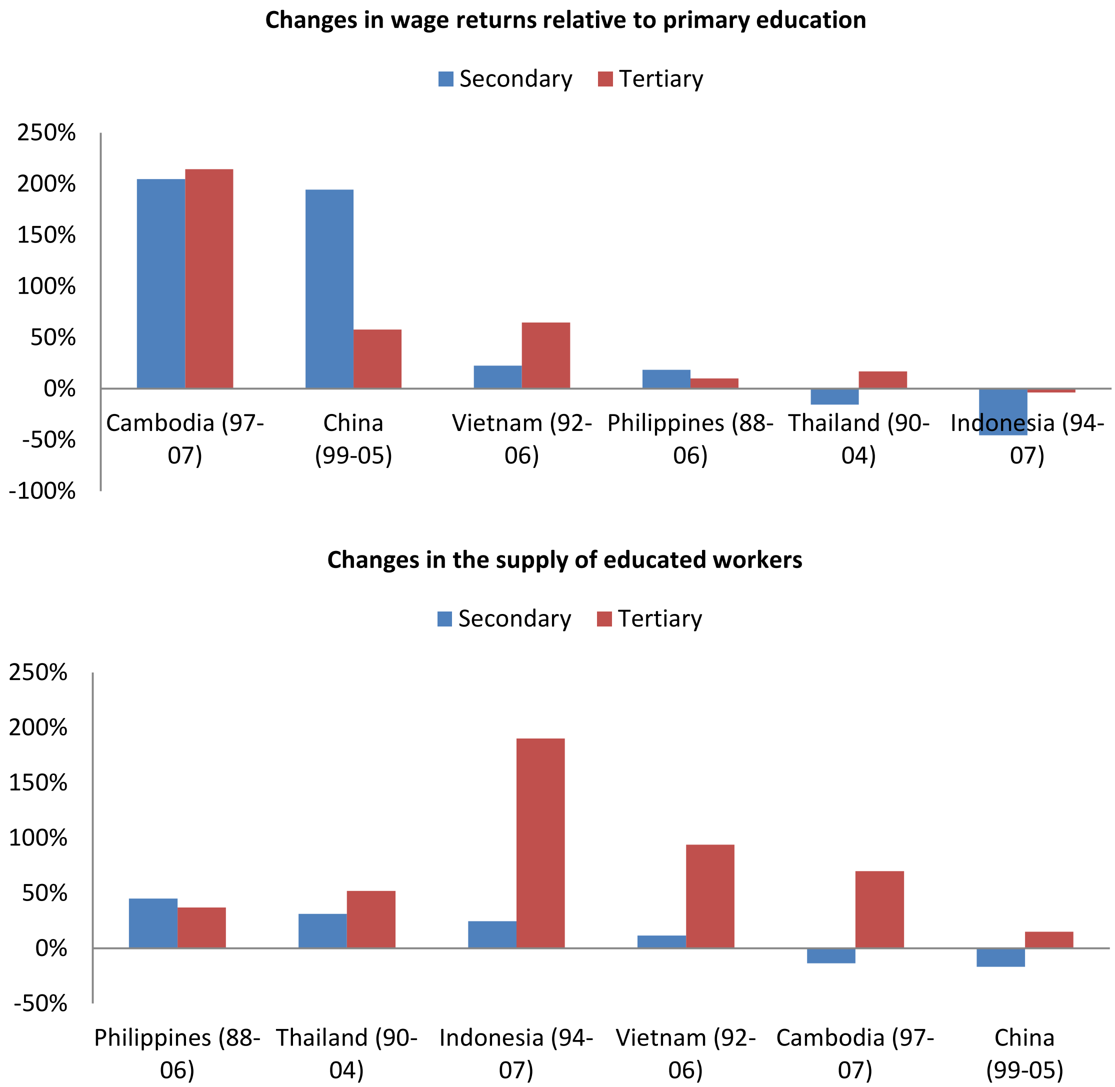
5.19 The type of detailed data on worker characteristics and experiences in the labor force that is needed to directly identify skills gaps is limited in East Asia Pacific and many other regions. In addition, many skills are inherently difficult to measure precisely, such as behavioral skills. Therefore, in this chapter we rely on evidence of education shortfalls and employer opinions to infer the existence and nature of skills gaps.

5.20 The supply of skilled workers may be inadequate to meet the demand for skills for three reasons: inadequate quantity, poor quality, or misalignment. In some countries, the quantity of educated workers may be scarce relative to employer needs, as evidenced by quickly rising returns to education. While demand for educated workers cannot be observed directly, it can be inferred by observing the evolution of labor market returns to education with simultaneous changes in supply (Katz and Murphy 1992).[5] Figure 5.15 shows that in the handful of East Asian countries where data are available -for example Cambodia, Vietnam and the Philippines- wage premiums have increased or held steady in the face of rising supply. These simultaneous increases in supply and returns suggest that demand for educated workers has grown in pace with or even faster than supply.

[4] A specific set of skills can be thought of as defining an occupation.

[5] The Katz and Murphy approach is formulated as a relative one, e.g. the supply of highly educated workers relative to less educated workers, and the relative wage premium between the two groups.

Figure 5.15 Education wage premiums have increased or held steady in the face of rising supply



Source: di Gropello and Sakellariou 2010.

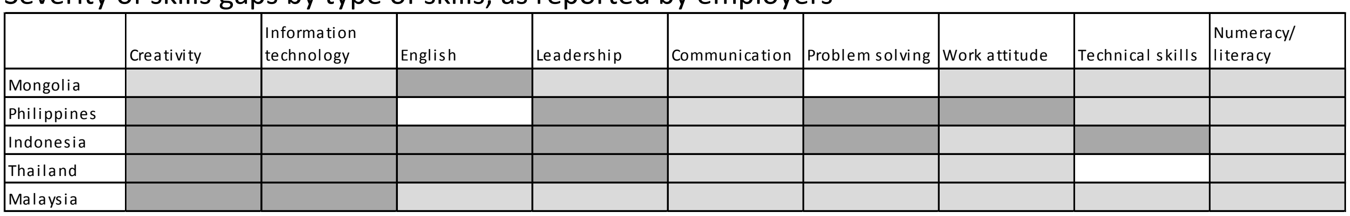
5.21 Across countries, employers take issue with the skills of the existing workforce, and, perhaps more concerning, with the skills of new graduates. In Malaysia (and many other countries) export-oriented and innovating firms are more likely to complain about an inadequate stock of skills in the workforce, consistent with the earlier discussion on the impacts of globalization on the demand for skills (World Bank 2013d). Employers also complain about the flow of new skills. For example, 76 percent of Cambodian employers in a recent survey—an employer survey on the education and skills of their own staff and the workforce overall—claimed that new graduates were not equipped with the right set of skills (World Bank 2012d). In Vietnam, nearly 50 percent of employers assert that the education system does not produce the skills required to meet the needs of their workplaces (World Bank 2013a). Employer perceptions are often similarly negative for TVET and general higher education graduates. In

Lao PDR, 40-60 percent of employers said that both systems did not produce the right levels and types of skills they need (World Bank 2013b).

5.22 Cognitive and behavioral skills are just as much of an issue as technical skills for many employers. While policymakers often focus on expanding TVET to address skills gaps, the challenges are much broader, and relate to both general and technical vocational education. When queried, employers complain that their staff lack a range of skills including many cognitive and behavioral skills. Figure 5.16 shows, for example, that employers complain about severe skills gaps in creativity and leadership, but not as severe in technical skills. In addition, the performance of TVET graduates compared to general graduates varies by occupation and country, and is likely linked to the quality of training and breadth of skills taught (World Bank 2012a). In Indonesia, secondary TVET students score significantly less well on national standardized tests than general secondary students, suggesting that some cognitive skills may be lower (Chen 2009). However, in many countries, TVET is considered an inferior option for students, making it difficult to accurately compare the quality of the systems.

Figure 5.16 Gaps in creativity, IT and leadership skills are the most common across East Asia

Severity of skills gaps by type of skills, as reported by employers



Source: World Bank 2012a.

Note: Data comes from various employer surveys and is not perfectly comparable. Darker shades indicate more severe skills gaps.

5.23

5.3 Why do skills gaps exist and persist?

5.24 Several types of failures in both education and training systems as well as labor markets lead to the skills gaps observed in East Asia Pacific countries. Skills gaps are "a symptom of many diseases." Gaps in foundational skills are largely due to government failures to provide all citizens with nutrition, quality basic health and basic education. Gaps in technical and advanced cognitive and behavioral skills can be a result of government and a range of market failures. This section discusses a conceptual framework for skills production and utilization, and within this framework highlights available evidence of failures leading to skills gaps in the region. Understanding these different failures can enable East Asia Pacific countries to effectively address skills gaps.

Failures in producing foundational cognitive and behavioral skills

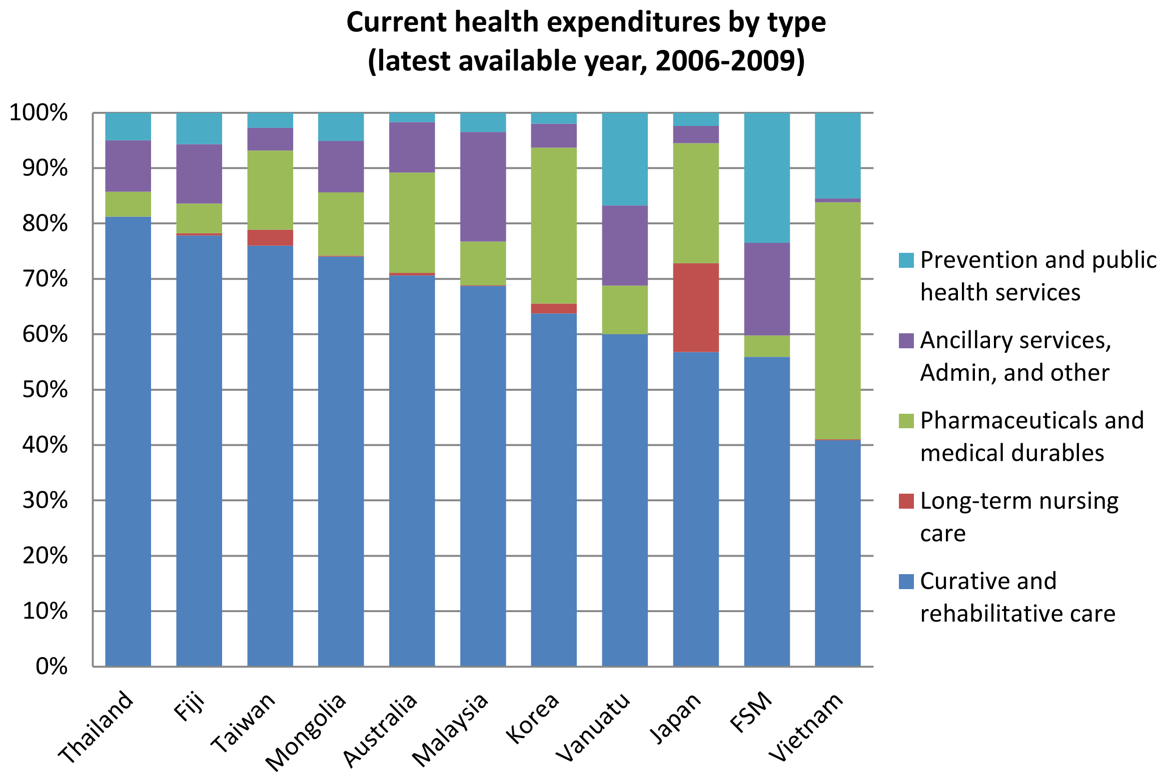
5.25 Without government interventions, investments in foundational skills are unlikely to be optimal.. With perfect incentives, individuals and their families would invest in skills up to the point where their marginal costs of investment equaled their marginal return from the labor market, and this level of investment would be socially optimal if the individual's private return and cost were identical to the return and cost for society. In the real world, this does not happen for several reasons. First, incentives are imperfect. Parents may be unaware of the importance of early investments in the development of their children or, even if aware, be unable to finance these investments. Second, individual acquisition of foundational skills benefits society by making individuals more engaged and responsible citizens and better parents, as well as by potentially increasing the overall level of productivity and growth in the economy (Moretti 2006; Oreopoulos and Salvanes 2011). To the extent that individuals do not take these benefits into account when making investment decisions, government funding can increase the efficiency of investment in foundational skills.[6] In addition, basic cognitive and basic behavioral skills are the foundation upon which advanced and technical skills are built. These factors provide the rationale for government involvement in building foundational skills through public funding of early childhood development, and primary and secondary education.

5.26 However, across East Asia Pacific, many governments do not put sufficient emphasis or make adequate investments to produce foundational skills. Spending on child nutrition and primary health care is often insufficient to provide the foundation for good health and learning for all children, and then for sustained health and productivity in their adult lives. Figure 5.17 shows that the share of total health expenditures spent on preventive health is low across low, middle and high income countries in the region. This pattern in spending does not in itself reveal a skewed policy stance, and to a degree, simply reflects the higher relative cost of secondary and tertiary health care (hospitalization and specialist treatment, particularly the Pacific island countries that spend a lot sending patients abroad for treatment). However, the point remains, most countries in the region under-invest in nutrition, preventative and primary

[6] Investments have social returns at all levels of skills, and the size of social returns relative to private returns of education is an area of ongoing research (Topel 2004).

care. Many of the negative effects of malnutrition and lack of primary health care early in life are irreversible, with few second chances to correct these deficits (Naudeau et al 2011). People who incur these deficits early in life struggle throughout their lives to maintain good health during their learning and working years.

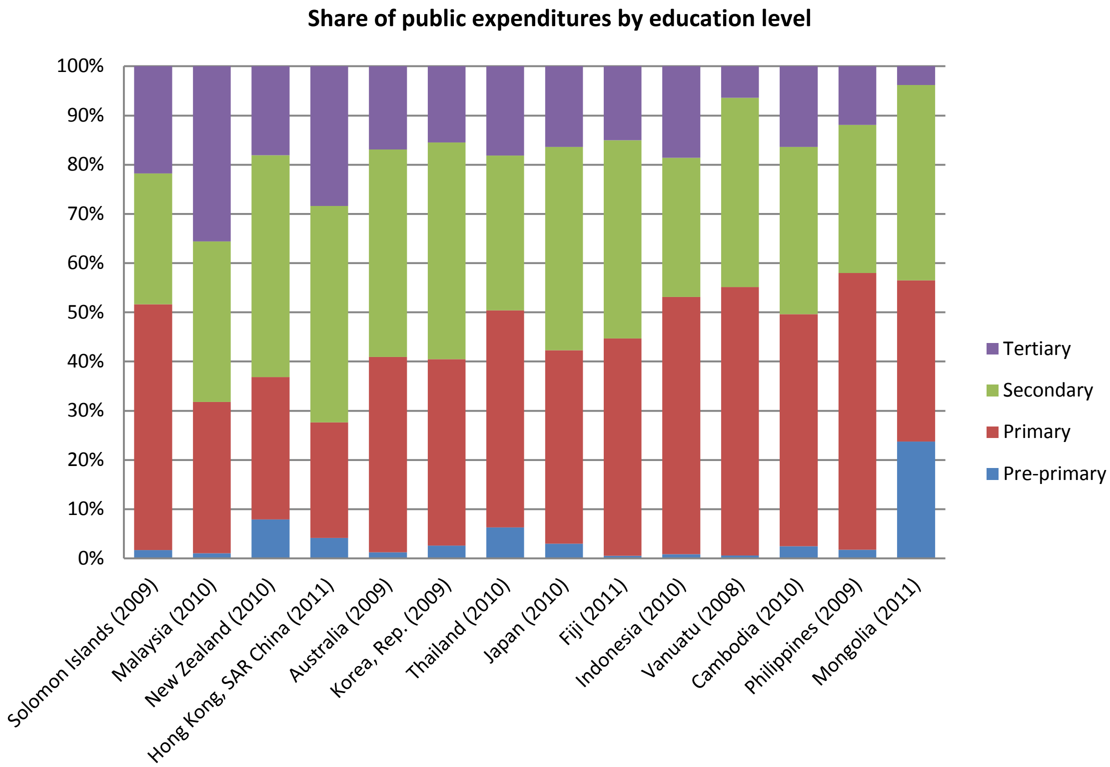
Figure 5.17 Spending on preventive and public health is relatively low



Sources: Department of Health and Social Affairs FSM 2010; Hyoung-sun and Rannan-Eliya 2010.
Notes: Data comes from national health accounts and includes public and private spending.

5.27 Similarly, in education, public spending on early childhood programs is relatively low, and existing investments are sometimes ineffective. Most countries use less than 5 percent of overall public spending in education for pre-primary schooling, except Mongolia, New Zealand (a globally recognized leader in early child development and education), and Thailand (Figure 5.18). Even at the primary level, where governments spend large shares of their education budgets, inappropriate organizational arrangements, weak systems, and low capacity can limit the effectiveness of spending. For example, the Solomon Islands spends about 25 percent of its government budget on education, and about half of this goes towards primary education. Yet high absenteeism and low teacher quality, poor management, and other challenges limit the production of skills from this spending (World Bank 2012c). In Cambodia, where only 3.8 percent of adults completed secondary education in 2007, a shortage of teachers and limited facilities contribute to both low quality and low attainment (World Bank 2010). Similar challenges exist in Lao PDR, where a recent study found that only about 49 percent of the country's villages have a "complete" primary school offering instruction in all five primary grades (McLaughlin 2011).

Figure 5.18 Spending on early childhood education is relatively low



Source: World Bank Education Statistics.

5.28 Effective "second-chance" programs to complement the formal school system can help fill gaps in foundational skills. Those who leave the schooling system before gaining foundational skills, including literacy and numeracy, face difficulty in acquiring technical skills and more advanced cognitive and behavioral skills. This issue is significant in many countries of East Asia Pacific, where large numbers of youth drop out of school before completing full courses of secondary, and sometimes even before completing primary education. For example, in Indonesia, about 1 million dropouts from the formal education system enter the government's equivalency system every year (di Gropello, et al. 2010). However, evaluating the effectiveness of these second-chance systems is difficult due to the limited information collected on their performance or the outcomes of their participants.

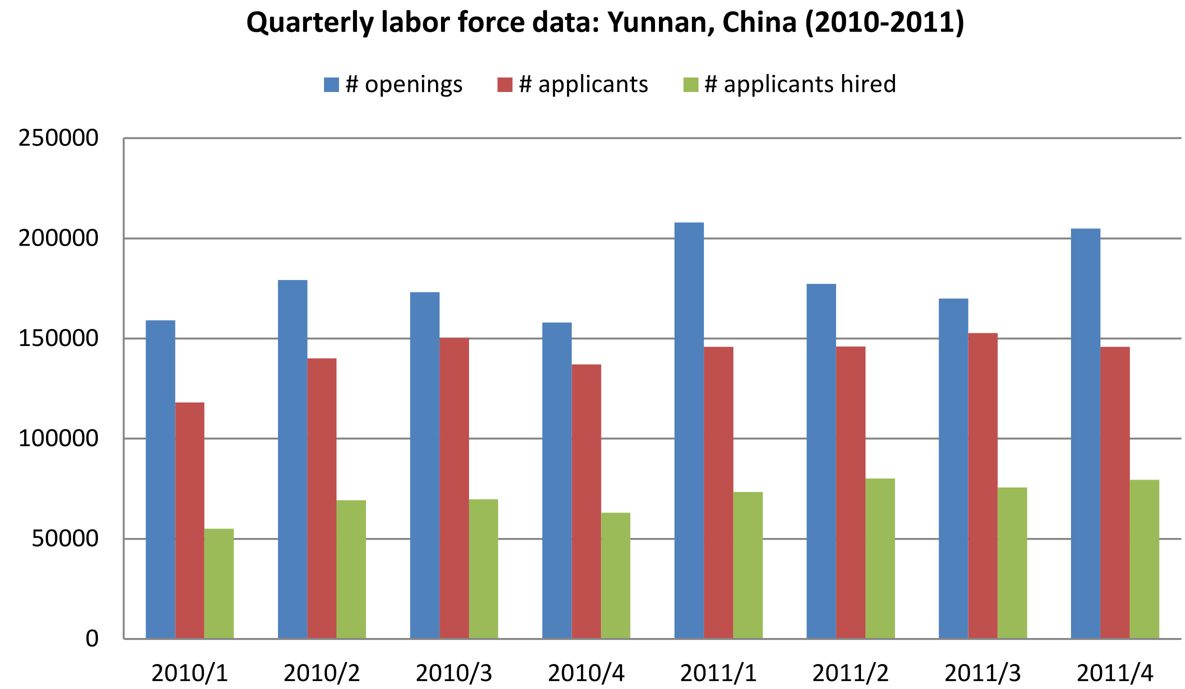
5.29 Even when basic education systems are strong and of good quality, the changing demand for skills in the labor market is creating new challenges to pedagogical emphasis and curriculum content. For example, creative problem-solving is a cognitive skill increasingly required in workplaces undergoing rapid technological change (Levy 2010). Yet education systems in East Asia Pacific countries often emphasize memorization. For example, Vietnam, a country with nearly universal primary school enrollment and very high secondary school enrollment, faces this challenge in the kind of cognitive skills its education system produces. Fifth graders do well on math problems requiring the application of known rules, but falter when required to apply the same mathematical principles to new contexts (World Bank 2013a).

Failures in producing technical skills and advanced cognitive and behavioral skills

5.30 When do gaps in technical and advanced skills merit policy intervention? While gaps in foundational skills should ideally be addressed wherever they are found, gaps in technical and advanced cognitive and behavioral skills are to be expected in any dynamic economy as demand evolves quickly. But these gaps are inefficient when they are too wide and persistent, and can hamper employment growth when the skills of new workers flowing into the labor market and the adjustment of the stock of skills of existing workers are inadequate.

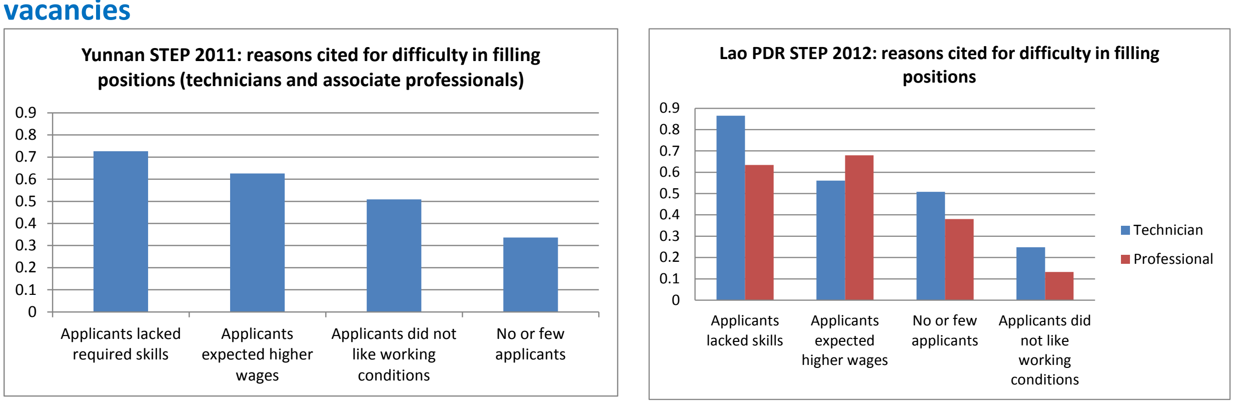
5.31 Skills gaps may be a constraint to employment in East Asia Pacific. In Indonesia, the Philippines, and several Pacific island countries, youth unemployment and inactivity rates are high relative to the rest of the region (see Chapter 3). Firms across the region cite an inadequately educated workforce as the second most important obstacle to their operations (see Chapter 4). In Yunnan province, China, recent labor force data show that the majority of employment vacancies are going unfilled (Figure 5.19). Several factors play a role in unemployment and unfilled vacancies. Employers in China and Lao PDR cite applicant dissatisfaction with the wages they are offered and with working conditions, suggesting that workers have high reservation wages and/or expect higher returns to their investments and wait for better-paying employment. But the data also indicate that a lack of skills is clearly an important reason for difficulties in filling vacancies (Figure 5.20). Employer perceptions may be due to both a true lack of skills in the labor market or to difficulties in matching with the right job seekers. A conceptual framework to understand the underlying causes of skills gaps is necessary in order to identify effective policies to narrow them.

Figure 5. 19 Over one third of recent employment vacancies in Yunnan, China went unfilled



Source: Liang and Chen 2013

Figure 5.20 Employers cite lack of skills among applicants as a top reason for persistent vacancies



Source: Liang and Chen 2013; World Bank 2013b.
Notes: Data comes from the Skills Toward Employability and Productivity (STEP) employer survey.

Gaps in advanced and technical skills arise and persist from a range of market failures, which justify the need for government involvement, as well as failures of government itself.[7] The

[7] In addition to the market and government failures discussed, another factor for consideration in the under-supply of advanced skills is the role of institutions of higher education in producing research and innovation public goods. For example, universities and research institutes often produce basic research that increases fundamental knowledge in a field and research that is highly valuable but too expensive for individual firms to undertake. Such research and innovation can ultimately contribute to productivity and competitiveness, and to economic growth (World Bank 2012a).

market failures can be grouped into four broad categories: failures in labor markets, credit markets, coordination, and our own decision making limitations.[8] Table 5.1 provides some detail on the nature of these different failures, as well as the government failures that they can compound. In reality, countries are often faced with several of these failures simultaneously and to varying degrees. But considering each separately clarifies both the underlying challenges and, as elaborated in the subsequent section, the implications for public policy.

Table 5. 1 A range of failures explains gaps in technical and advanced cognitive and behavioral skills

Failures	Description
Labor markets	• Imperfect competition for worker skills • Costly search and limited information for both workers and firms
Credit markets	• Individuals can't access adequate credit to fund skill acquisition • Firms can't access adequate credit to fund training
Decision-making	• Missing information on market returns or education/training provider quality • High discounting of the future
Coordination	• Employers use low-skill technologies because high-skill workers are not available / workers don't invest in skills because jobs not available
Government	• Weak policymaking process • Inappropriate institutional arrangements • Limited information

Source: Adapted from Almeida, Behrman and Robalino (2012).

[8] The conceptual aspects of the discussion that follows draw heavily from Almeida, Behrman, and Robalino (2012).

Labor Market Failures

5.32 Two important labor market externalities can lead to underinvestment in skills. In a perfectly competitive labor market, firms compete for workers, who are able to capture their full marginal product and thus have the incentive to invest in skills to their privately optimal level.[9] This level of investment may still be below the social optimum if technical and advanced cognitive and behavioral skills have substantial positive externalities, as discussed earlier. However, actual labor markets are far from perfect, due to many factors including the costs of searching for vacancies and for workers, and labor market regulations. Two important externalities for skills investment are created by these deviations: the "poaching" and "matching" externalities.

Box 5. 2 Skills poaching and matching in imperfect labor markets

Poaching externalities arise because most of the skills that individuals acquire are valuable to more than one prospective employer. With limited competition between firms for workers with particular skills, neither workers nor firms can fully capture the returns to investments in skills because a future employer could benefit from these investments by "poaching" the worker.

Matching externalities arise from the time, effort, and limited information that characterizes many workers' search for employment, and firms' search for workers. When workers and firms find each other, some bargaining over wages occurs, because only limited information is usually available on the market rates for a worker's particular set of skills. The negotiated wage will depend in part on the relative bargaining power of firms and workers. Specifically, the more bargaining power a firm has, the lower the wage will be for any given skill, and the less a worker will invest in that skill. Several factors can influence firms' bargaining power, including the number of competing job seekers and the firms' alternatives, such as using a lower-skill technology.

More broadly than these two specific externalities, any characteristics of the labor market that reduce the expected value of skill investments for workers or firms may contribute to skills gaps.

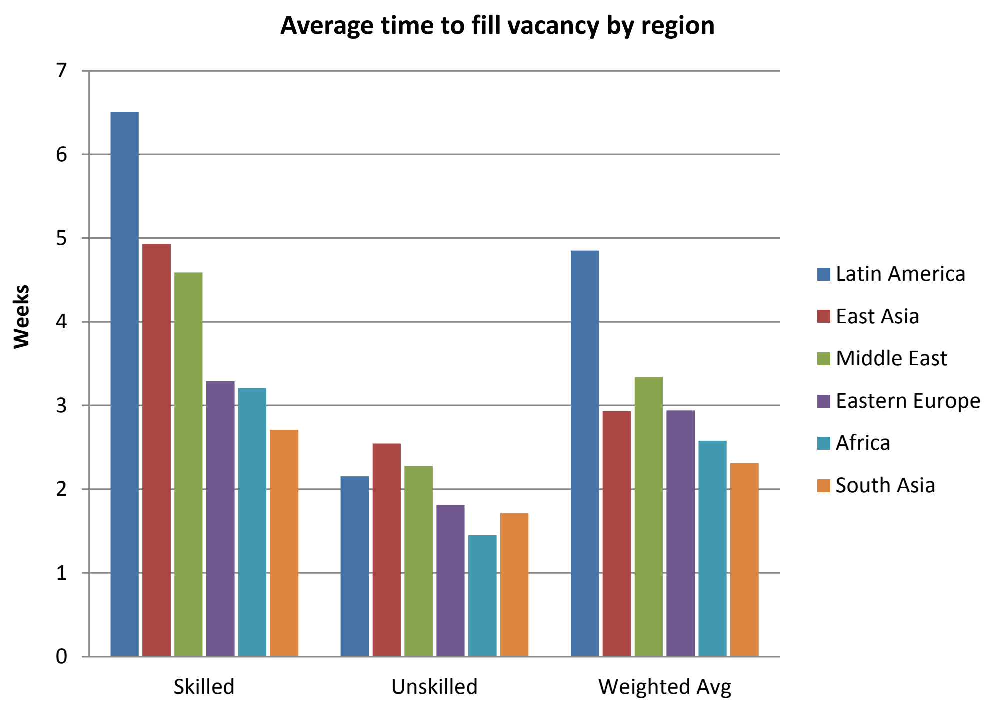
Source: Burdett and Smith (1996); Stevens (1996)

5.33 Labor market imperfections in East Asia Pacific countries play a role in creating skills gaps. Vacancies for skilled workers in East Asia Pacific countries are open longer than in any other region except for Latin America (Almeida and Jesus Filho, 2011). It takes close to 5 weeks on average to fill a position of a skilled employee (Figure 5.21). These long durations may exist

[9] Conversely, in a monopoly, a firm could capture all the returns to workers' skills and would therefore be incentivized to invest.

in part because employment seekers and firms with openings have difficulties finding each other. In Indonesia, for example, only 10 percent of firms use a private employment service or a recruiter, and only 30 percent use newspaper ads. Similarly, 16-17 percent of workers use newspaper ads and vacancy notices to find work, and only 4 percent use employment services. The majority of firms and workers rely on private networks and recommendations when searching for candidates and vacancies, respectively (Tables 5.2 and 5.3). These recruitment and employment search practices likely limit the pool of qualified candidates identified by firms, increasing their perceptions of skills gaps. In addition, they may reduce workers' expectations of finding a good job, and therefore their incentive to invest in skills.

Figure 5.17 Vacancies for skilled workers in East Asian countries remain unfilled longer than in most other regions



Source: Almeida and Jesus Filho 2011.
Notes: Data is from Enterprise Surveys 2002-2005. East Asia includes Cambodia, China, Indonesia, Thailand, and Vietnam.

Table 5. 2 Few Indonesian firms recruit widely for vacancies

Share of firms using this method to fill vacancies	
Private network	80%
Employee recommendation	50%
Newspaper ad	30%
Notice posted outside of firm	20%
Internal promotion	20%
Internet	10%
Private employment service	10%
Recruiter	10%
Contact with schools	10%
Job fair or contact with schools	1%
Public employment service	1%

Source: di Gropello 2010.

Table 5. 3 : Most Indonesians rely on private networks to find employment

Share of workers using this method to find employment	
Private network	47%
Employer recommendation	36%
Newspaper ad	17%
Vacancy notice	16%
Job fair or school	9%
Internet	8%
Internal promotion	8%
Employment service	4%

Source: di Gropello 2010.

Credit market failures

5.34 In many developing countries, individuals and firms are often unable to borrow enough money to finance investments in technical and advanced cognitive and behavioral skills. Lenders may lack information on the creditworthiness of potential borrowers, and on the expected returns of their skills investments. For relatively expensive education or training that pays off slowly over time, loans are too risky for traditional private lenders unless potential borrowers have collateral, which individuals and small firms often lack in low and middle income countries.

5.35 Across East Asia Pacific, where student fees represent an increasingly large share of education financing, governments have created loan and scholarship programs in response to this market failure. However, the costs of higher education remain particularly burdensome for many families (World Bank, 2012a). In China, for example, average university payments (including tuition and living costs) net of grants, loans, and work study, still amount to 30 percent of average household income (Ma, 2010). Government student loan programs exist in several countries, including China, Malaysia, Mongolia, Thailand, and Vietnam. However, they have a limited effect on increasing access for lower income students, as allocation and eligibility for these programs is not granted on a needs-basis, the programs cover a small proportion of students, and have relatively short payback periods of six or ten years (World Bank 2012a).

5.36 A lack of access to finance may also limit some firms' investment in worker skills, particularly for small or informal firms. Training programs can be costly to purchase or set up in-house, potentially limiting the ability of small firms to invest in skills, even when it may be profitable to do so. For example, 58 percent of Filipino firms and 34 percent of Indonesian firms cited poor access to finance as a reason for not providing formal training (di Gropello et al 2010; di Gropello et al 2011).

Information and decision making failures

5.37 Individuals face a scarcity of information when making decisions about investments in skills. Prospective students most often have little information on the relative labor market returns to different types of technical skills when deciding on courses of study. In addition, the quality of education and training institutions, particularly in the private sector, can be difficult to determine without reliable accreditation systems. In East Asia Pacific, very few countries have national qualification frameworks in place and even among those that do, many challenges remain. For example, independent accreditation bodies exist in the Philippines, where about 70 percent of all higher education institutions are private. However, as of 2007, more than 80 percent of higher education institutions had no accredited programs (di Gropello 2011). Challenges to full implementation of qualification systems include resistance from universities and other institutions that fear losing autonomy and complications in coordinating effectively across government departments, independent bodies, education and training providers, and employers (APEC 2009).

5.38 Even when information is adequate, individuals can still make poor skill investment decisions. Impatience or an under-valuing of the lifetime returns to skills can lead some to drop out of school or training too early. Financial pressures and the low quality of instruction are also common causes for early school leaving. While most countries have some form of second-chance system, investing later in life is more difficult, as some skills become less malleable while personal responsibilities in terms of family and work increase.

5.39 Social norms and family pressures can also exert strong influence on what types of skills individuals choose to acquire, particularly where labor market and training quality information is limited. A 2008 survey in Cambodia found that only one in five graduating secondary students based their decisions of what to study on the labor market, while seven in 10 followed their parents' advice (World Bank, 2012a). Without systematic data collection on labor market demand, students' ability to make good investment decisions will be limited. For example, while returns to post-secondary TVET are nearly equal to the returns of university education, only 17 percent of Cambodian students express an interest in enrolling in TVET (World Bank 2012d).

Coordination failures

5.40 Coordination failures occur when firms benefit from workers investing in skills, and workers benefit from firms demanding more skills in ways that cannot be compensated through the market mechanism due to externalities. Two types of externalities can cause coordination failures, based on the level of skills involved: innovation and vacancy externalities. Innovation externalities occur when workers' advanced technical skills facilitate the adoption or generation of new technologies, which in turn increase firms' success. However, firms requiring such high-level skills are less likely to enter markets where few workers possess such skills, and workers are less likely to invest in these skills because they see few employment opportunities (Almeida, Behrman, and Robalino 2012). Vacancy externalities occur when workers' medium-level technical skills make firms more productive, but firms do not hire workers with these skills because they are scarce and can demand relatively high wages. Due to a lack of employment opportunities, workers do not invest in such skills.

5.41 Some countries in East Asia may be facing skills gaps due in part to coordination failures. In Malaysia and the Philippines, where large shares of skilled workers migrate internationally, individuals may choose to invest in skills that meet the needs of the external labor market, rather than skills that are demanded domestically (World Bank 2012f). Because the skills they would need are therefore relatively scarce, firms in these countries may find it more profitable to utilize lower-skill technologies. The Cambodian tourism industry provides an example of vacancy externalities. Tourism employers complain that low-level workers lack behavioral and foreign language skills that would make the firms more productive. Only about 12 percent of the labor force is able to speak a language other than Khmer. However, employers likely find it more profitable to utilize workers without these skills, which are scarce and thus expensive to hire (World Bank 2010).

Government failures

5.42 The many market failures contributing to gaps in technical and advanced cognitive and behavioral skills provide strong motivation for government action. However, as with basic education, governments often fall short of achieving the outcomes they want. The most difficult challenge faced by governments is the difficulty of building higher-order skills on weak foundations. In a number of East Asia Pacific countries, foundational skills are not strong. As a consequence, only a limited number of people in the workforce can attain advanced skills, regardless of the volume of public spending directed towards higher education. There are inequitable consequences to the current challenge as well: in countries like Solomon Islands, where only a small share of the student population is able to read to the standard required to complete secondary school –more likely to be students from better off households- public spending on tertiary education is likely to be very regressive. This challenge underscores the importance of high-quality government-financed foundational skills formation at early ages for both economic growth and equity.

5.43 In addition, policymaking processes and institutional arrangements within government often limit policymakers' ability to set an integrated strategy for skills development. Responsibility for the various steps in the process of skills development is usually divided across multiple ministries, creating obstacles to effective communication and cooperation. For example, in Malaysia, ten different federal ministries and agencies play a role in the ownership, funding, operation, or regulation of TVET institutes (Bin Omar, 2013). Such complex institutional arrangements create numerous challenges to building skills, and Malaysia is implementing a comprehensive human capital framework to address these challenges.

5.44 Inappropriate institutional arrangements between public administration and service providers, combined with excessive regulation and with limited information, also constrain governments' ability to correct market failures. Governments frequently fail to give service providers, public or private, sufficient autonomy or accountability, limiting the service providers' ability and incentives to improve performance (World Bank 2012a). Accountability requires information on the outcomes of individual schools, universities, and training centers—such as graduation rates, certification exam pass rates, and employment rates of recent graduates. This type of information is often neither collected nor reported. To give indicative evidence of government failures, a standardized assessment of the public policy environment for skills development is available for a handful of East Asia Pacific countries. The Systems Approach for Better Education Results – Workforce Development (SABER-WfD) scores countries' policies and institutions for workforce development, including institutional arrangements and accountability, on a scale from "latent", "emerging", "established", to "advanced" (Box 5.3). Vietnam's policy environment is on the "emerging" end of the scale, trailing behind Malaysia's "emerging/established" ranking, and Singapore's "established/advanced" performance.

5.45 Lastly, governments often need to collect more information about the labor market to play an effective role in higher education, and in TVET in particular. As providers, funders, or regulators of institutions that produce technical skills, governments often have insufficient knowledge of the current state of the labor market and of expected changes. This challenge is especially stark in East Asia, where economies grow and change fast, resulting in constantly evolving demand for skills. Without updated information on employment trends, effective oversight of programs and institutions focused on producing technical work-specific skills is limited.

Box 5. 3 The Systems Approach for Better Education Results – Workforce Development

SABER-WfD is a new diagnostic tool to assess government's policies and institutions for workforce development relative to international good practice. Countries are assessed on three dimensions:

1) Strategic Framework which pertains to policies that set the direction for workforce development and define its authorizing environment
2) System Oversight which relates to the "rules of the game" (including funding regimes) that guide the functioning of the system
3) Service Delivery which concerns the provision of training services to equip individuals with market and job relevant skills

Each dimension is underpinned by nine policy goals, which are in turn defined by three tangible policy actions per goal. Data to assess each policy action is gathered from interviews with credible informants as well as documentary sources, and scores for each dimension are calculated on a scale from one to four (corresponding to latent, emerging, established, and advanced).

Countries that achieve advanced scores have largely overcome the government failures in building skills discussed in this chapter. SABER-WfD is currently being carried out around the world, in countries at different levels of development. To date, the results of five countries are available:

	Strategic Framework	**System Oversight**	**Service Delivery**
Ireland 2000	*Advanced*	*Established*	*Advanced*
Korea 2010	*Advanced*	*Advanced*	*Established*
Malaysia 2010	*Established*	*Established*	*Established*
Singapore 2010	*Advanced*	*Established*	*Advanced*
Uganda 2011	*Emerging*	*Latent*	*Latent*
Vietnam 2012	*Emerging*	*Emerging*	*Emerging*

Sources: World Bank 2012g; World Bank 2013d.

5.4 Policy priorities and examples of success in skills development

5.46 The preceding sections provided evidence of skills gaps in East Asia Pacific countries, and the clear need for governments to both mitigate market failures and improve their own performance in order to fill those gaps. Gaps in foundational skills persist in a number of countries in the region, despite greater access to health and education services. In these countries, governments' policy priority should be to ensure adequate financing and high-quality provision of nutrition, basic health and basic education services. Whether governments directly provide these services, oversee private provision, or utilize a combination of public and private provision is of less importance than ensuring that households have information and access to good quality services to ensure the right investment as the earliest possible age. The foundation of basic cognitive and behavioral skills has important social benefits, and without it, efforts to build more advanced skills and increase the productive capacity of the labor force are limited in their effectiveness. However, the effects of investments in foundational skills take many years to be realized, as they affect the flow of new skills into the labor market with a long lag. Governments must assess the tradeoffs between these long-term efforts and investments with more immediate returns to grow the stock of skills in the current labor force.

5.47 To address gaps in technical and advanced cognitive and behavioral skills, the policy focus needs to go beyond the expansion of technical vocational education, to ensuring the efficient production of in-demand skills throughout the secondary and post-secondary education and training system. The evidence presented in this chapter suggests that the rapidly evolving demand for skills in East Asia Pacific countries creates gaps in *all* types of skills—cognitive, behavioral, as well as technical skills. TVET programs tend to focus too narrowly on employment-specific skills at the expense of broader cognitive and behavioral skills, and sometimes do not provide the level of technical skills demanded. General programs can often have the opposite shortcoming, by not focusing enough on producing strong technical skills. The focus in all types of education and training programs therefore needs to shift to providing the full set of skills demanded by employers.

5.48 The chapter also showed that the policy focus needs to go beyond the supply side, to improving the functioning of the markets for skills production and the signals they receive from the labor market. A number of market failures, including in education systems and in labor markets, cause skills gaps and provide a strong motivation for government action. However, governments often lack information about market demand, particularly in technical skills, and this problem becomes more severe the faster an economy grows and changes. Therefore, rather than focusing on direct public provision of technical and advanced cognitive and behavioral skills, governments could focus instead on collecting and disseminating labor market information, acting as effective regulators of education and training institutions, and subsidizing demand with financing that enables individuals to make more nimble choices as returns from the labor market for certain skills shifts.[10]

5.49 Because skills gaps arise and persist for many reasons, the particular set of challenges a country faces warrant different policy actions. Figure 5.22 lays out a framework of the broad priority actions required: generate and disseminate information, align incentives, and increase capacity. These three areas address the problems of information, incentives and capacity that the World Bank's regional report on Higher Education in East Asia Pacific (World Bank 2012a) identified as causes of the disconnects in higher education that in turn fail to produce the skills demanded. Figure 5.22 also gives examples of specific policy actions to address the market and government failures discussed in the chapter, but there are likely many more potential

[10] Several European countries, including the Netherlands, Norway, and more recently Hungary and Romania, have successfully generated and disseminated information through tracer studies of university graduates. Tracer studies track graduates and interview them at one or multiple points after graduation on a range of subjects, primarily to gauge their labor market experiences (Sondergaard and Murthi 2012). Ideally, such studies would track all graduates, as they do in the Netherlands, or a representative sample of graduates. Then this data can serve to address multiple failures by providing both potential students and governments with information on education and training provider performance and labor market trends.

solutions available, depending on the nature of the failure faced and the broader country context.

Figure 5. 18 Alternative policy actions respond to different skills challenges

	Generate & Disseminate Information	Align Incentives	Increase Capacity
Labor markets	• Create and manage appropriate labor market information systems	• Enforce apprenticeship contracts between firms and workers	• Facilitate recruiting links between schools/training centers and firms
Credit markets	• Collect earnings data in labor market information systems	• Provide guarantees or other incentives to private banks	• Expand public student loan programs
Decision-making	• Collect data on school and training provider performance and disseminate to students and families	• Subsidize opportunity and other costs of education and training to make staying in school easier	• Provide counseling and support services to youth at risk of dropping out
Coordination	• Facilitate information flows between firms and schools/training centers on current and expected demand	• Subsidize worker training and firm upgrading/technology adoption in specific sectors	• Facilitate firm opportunities to support schools/training centers with instructors, materials or facilities
Government	• Collect and utilize data to evaluate school and training provider performance	• Hold providers accountable for performance through funding mechanisms or other incentives • Make providers accountable to students through voucher systems	• Improve institutional arrangements to provide sufficient autonomy at all levels • Deliver needed support to teachers and administrators at school level

Source: *At Work in East Asia Pacific* report team.

5.50 Several countries in East Asia Pacific have become global leaders in producing the skills required to fuel economic growth, and their experiences provide valuable examples of success. Korea, Singapore, and Taiwan China are well-known for having overcome the coordination failures common to low and middle income countries by effectively aligning the incentives of households, employers and training providers. In all three places, governments pursued strategic plans that created demand for high-skilled labor and subsidized the technical training to meet this demand through the 1960s and 1970s. A ready supply of high skilled labor subsequently spurred the growth of the technology-intensive sectors that are the engine of these economies today (Ashton et al 2002; Almeida, Behrman and Robalino 2012).

5.51 Recent experiences with generating and disseminating information and increasing capacity in Korea provide examples of promising approaches to addressing multiple failures. Since 2008, Korea has built up a Quality Assurance System for tertiary education, combining compulsory information disclosure about operations and performance with a public-private accreditation system (Young 2013). Information generated from this system, including graduation and employment rates, is disseminated to the public through a well-utilized public website, and high-performing education institutions are rewarded with grants. In addition, recognizing the burden of tertiary education costs on families, Korea is expanding its needs-based student loan program to increase the capacity of individuals to build technical and advanced cognitive and behavioral skills. These initiatives promote accountability and competition among education and training providers on important outcomes, and enable students and their families to make better choices.

5.52 However, critical to the success of policies for skills production in Korea and other high income East Asian countries, was developing a foundation of good nutrition and strong basic health and education. In each of these countries, governments went to great lengths to ensure the broadest possible access to foundational human capital investments, and high quality standards. Without this foundation, attempts to build higher order skills in a significant share of the workforce could not have succeeded.

5.53 Many other countries in the region, and around the world, are taking this lesson seriously, and successfully closing skills gaps. In the Philippines, for example, a large elementary school reform program, the Third Elementary Education Project, targeted government failures in the provision of foundational skills through measures to increase capacity and align incentives. From 2000 to 2006, the program provided teachers with training, devolved management to schools, increased the distribution of school supplies, along with several other measures deployed to increase quality. These measures were effectively implemented, and not only raised test scores, but also increased the educational attainment girls' and their eventual labor market earnings (Yamauchi and Liu).[11]

[11] In the Philippines, the returns to education for women are higher than for men, and the program results are in line with these existing gender differences.

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Chapter 6: Labor market regulations, interventions and institutions

Although relative newcomers to labor market regulation and social protection, many East Asia Pacific governments are becoming more activist, but moving in the wrong direction.

6.1 In this chapter we turn to labor market policies, including social protection from risks to earnings from work. If there is such a thing as an East Asia Pacific stereotype of this area of policy, it is characterized by high flexibility and scant protection. The analysis in this chapter shows how weak that stereotype has become. We distinguish between labor *regulations*, *interventions* and *institutions*. The distinctions are important to understand how each influence the demand and supply of labor and human capital. *Regulations* set the legal parameters of employment, in the form of minimum wages or restrictions on dismissal, and imply costs to employers and workers. *Interventions* are deployed by the State to make up for market short-comings, such as the inability of private financial markets to viably insure the risk of unemployment. The costs of interventions are borne by all tax-payers whether they participate in the labor market or not. *Institutions* are the condoned structures and agreed procedures by which interested parties exert their influence, make and carry out decisions that shape regulations and interventions. In the labor market, the best example of an institution is the space afforded in the legal code of many countries for collective bargaining. But institutions can also refer more expansively to the conventions and procedures of pluralist, representative democracy that influence the demand and supply of labor and human capital.

6.2 Labor market regulations and interventions are formulated according to each country's institutions in an attempt to address market imperfections, such as uneven power between those who seek and those who sell labor and human capital, information failures on all sides, and limited or weak insurance to mitigate risks to household wellbeing from loss of work. The 2013 WDR argues that in most countries -as well as in the academic literature- the debate about these structures absorbs more time and is far more heated than their actual impact on efficiency outcomes (these are, market participation, employment, unemployment and earnings) would seem to merit.

6.3 In this chapter we examine whether this broad conclusion also applies to the countries of East Asia Pacific. We devote much of the chapter to take stock of regulations, interventions and institutions in the region, as well as to measuring how they compare with similar structures in other countries. Important for readers to note, we have applied measurement tools from the OECD's Jobs Study (OECD, 1994)[1] to low and middle income countries in East Asia. While plenty of alternative measures are available,[2] this application provides helpful insights. For in

[1] The resulting indicators and measures have been used to track trends in labor market policy in subsequent *Employment Outlook* reports, referenced OECD 1997, 2004, 2006 and 2007.

[2] A rich set of labor market policy indicators is available from the World Bank's Doing Business, "Employing Workers" database.

choosing their labor market policies, most countries in the region have elected models crafted for labor markets in Europe, codified late in that continent's Industrial Revolution or in the inter-war period.

6.4 The discussion in this chapter focusses mainly on the labor regulation, interventions, and institutions in the ASEAN group of countries, as well as Mongolia and China. Where available, evidence from additional countries in East Asia Pacific is also brought to bear. Comparable measures of regulation drawn from the labor codes of these countries show that the average level of employment protection in East Asia is actually higher than the OECD average, and that there are notable outliers like Indonesia, where workers whose employment is regulated enjoy more de jure protection than workers in France, Greece, or Portugal and only a little less protection than workers in Spain. In China, workers in regulated employment are de jure more difficult to dismiss than workers in Belgium and Italy. Similarly, reflecting only what is codified in labor laws, the Philippines has the highest average statutory minimum wage in the region, followed by Cambodia and Indonesia. When ranked by the ratio of the minimum wage to value added per worker, the average statutory minimum wage in the Philippines is among the highest in the world. Indeed, by this measure, it is much higher than in Belgium and France and more generous than in high-income countries in East Asia Pacific with statutory minimum wages, such as Australia and New Zealand.

6.5 While restrictions on dismissal and wage regulation are being loosened in most middle income and high income countries in other regions, the observed movement of regulation in East Asia Pacific is in the opposite direction. The regulatory framework in East Asia Pacific countries is becoming more restrictive. And as more people seek work in the manufacturing and services sectors, the ability of governments to enforce regulations grow, and firms find it harder to evade, these extreme levels of regulation in the labor code will become more binding constraints. Indeed, for a segment of firms in many East Asia Pacific countries that are already too large to evade –many of them international companies- onerous levels of regulation are a problem, and for many a source of unfair competition from smaller rivals who can still ignore the rules and hire informally.

6.6 But do the laws on the books matter? After taking stock of de jure structures, we review the evidence of de-facto outcomes gathered for this and companion regional reports recently published by the World Bank Group and elsewhere. The evidence gathered for this report shows that while labor policies may indeed still have a limited impact on employment, unemployment and wages they have distributional consequences that favor prime-aged men at the expense of women, young people, those who work part time and in self-employment. For example, rising minimum wages in Indonesia disproportionally lower the employment opportunities of women with fewer skills, young workers, and recent entrants to the labor market. In Thailand, increases in the minimum wage have had an adverse impact on employment prospects of women, low-skilled workers, and elderly working people. In Vietnam, women are more likely than men to be earning at levels close to the minimum wage. This makes working women in Vietnam more vulnerable than men to changes in the minimum wage. We argue that this uneven impact should not come as a surprise, since the prevailing models of labor market regulation and interventions were conceived in parts of the world and during periods in history when prime-aged men in full-time, dependent employment made up the largest group of working people.

6.7 The evidence we have gathered from countries in East Asia Pacific and elsewhere, indicates that particularly for women, younger workers, as well as for self-employed people and those who work part-time, overly constricting policies can create more damaging distortions than the market failures they were designed to correct. The biased impact of prevailing models of labor regulations and social protection on forms of work that are prevalent in most East Asia Pacific countries, is a growing problem that creates both segmentation and exclusion from the labor force altogether. Evidence gathered for this and companion World Bank Group reports shows a positive association between the levels of de jure employment protection, social insurance contributions and other taxes on labor, and the extent of informal economic activity. In China, the attempt with the 2008 Labor Contract Law to expand coverage of social insurance financed from payroll taxes was associated with a lower probability that certain workers were protected (Giles, Wang, and Park 2013).

6.8 These unintended consequences can be even more damaging in places where due to limited government capacity, regulations are applied only to certain sectors of the economy or are poorly enforced. Similarly, even when reasonably designed, poorly administered and narrowly applied regulations and interventions can aggravate rather than correct inequitable outcomes, all at a cost to tax-payers.

6.9 In addition, a section of this chapter looks at why organized labor is less powerful in East Asian countries than in countries at a similar level of development in Latin America and Central and Eastern Europe. For a few countries where the power of unions is already high or rapidly increasing (such as Indonesia and Philippines), unions may be exercising a monopoly in representing working people in dialogue with the government and employers, and failing to enable the voices and views of the majority who do not work in dependent wage relationships to be heard. Labor market institutions that only allow the participation of a narrow group of stakeholders – whether labor unions on the supply side, or industry associations on the side of demand - can become fiefdoms where selected interests become entrenched, and where decisions are taken that make labor and human capital markets less rather than more contestable, threatening productivity and sustained wellbeing from work.

6.1 Regulation

Minimum wages

6.10 Minimum wages have become a nearly universal instrument of labor market regulation, and are applied in more than 90 percent of ILO member countries (ILO, 2012). Most countries in East Asia Pacific have adopted a statutory wage policy. However, East Asia's low and middle-income countries are "late comers" to labor market regulation when compared to countries in other regions. The governments in Latin American countries adopted European models of labor market regulation, including minimum wages in the 1920s and 1930s.[3] As they became independent, many of the former colonies in South Asia, the Middle East and Africa retained regulations that were applied mainly to public sector employment and in urban, industrialized sectors of production. The details of the minimum wage policies in the countries reviewed in this chapter are presented in annex Table 1. The Philippines was the first country in East Asia Pacific to implement a national minimum wage in 1951. After the Second World War, Burma, Malaysia and other colonies established wage legislation similar to Britain but coverage was minimal (Starr, 1993). Almost a quarter century would pass after these early instances of labor market regulation before another government in East Asia Pacific chose to regulate wages.

6.11 Indonesia instituted a minimum wage in the early 1970s for people working in the urban manufacturing sector. Thailand introduced a minimum wage in 1972 for Bangkok and the metropolitan area. In 1974, nationwide enforcement began, and minimum wage rates were established for Bangkok and the metropolitan area, 38 large provinces, and the remaining provinces. Vietnam set a minimum wage for foreign companies in 1992; however, over time it established a minimum wage for domestic firms. In 2011, the government eliminated discrepancies in the rates and set one common rate for foreign companies and national private companies. More recently, the level was made uniform for all of the private sector. China passed the first legislation allowing states to enact the wage policy in 1993. Regulation was further strengthened in 2004. Mongolia introduced a procedure for determining minimum wages for employees in state owned and joint stock enterprises in 1995. In 1998, coverage was extended to the private sector. Cambodia adopted a minimum wage policy in 1997 after the promulgation of the first Labor Law. In Lao PDR, a minimum wage was introduced for the private sector in 2006. Although Malaysia did not have an active minimum wage in 2010, a minimum wage act was passed in 2011 and the policy came into effect in January 2013. Although Singapore is the only country in ASEAN to not have a statutory minimum wage, the Ministry of Manpower makes recommendations for wage adjustments.

6.12 Typically wage regulation is outlined in legislation that gives legal force to the terms of agreements negotiated among employers, trade unions, and employees (Deakin and Wilkinson, 2009). A companion World Bank report on minimum wage policies (World Bank, 2013b) shows that countries in East Asia Pacific differ greatly in the goals they want to achieve when establishing and making modifications to their minimum wage regulation. Countries can be sorted by these objectives into three groups: the first group seeks to reduce poverty and

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[3] Latin American countries were among the first developing countries to adopt labor codes and to institute minimum wages. Beginning the mid-1930s and especially during the 1940's minimum wage legislation was adopted in most of Latin America. This process was associated with the promulgation of comprehensive labor codes, which became common in Latin America in the 1930s. In some cases, the introduction of the labor codes was preceded by constitutional provisions that laid the basis for the regulation of workers' rights. Labor legislation in Latin America first appeared in Chile and Mexico in the early 1930s. The first country to establish a minimum wage policy was Mexico in 1931, and was soon followed by Brazil (1938), Costa Rica (1943), Uruguay (1943) and Colombia (1945).

inequality by increasing the earnings of low-income workers (Devereaux, 2005); the second group seeks to promote productivity growth; and the third group seeks to address efficiency issues in the labor market to improve outcomes for employers and workers.

6.13 A notable feature of minimum wage regulation in East Asia Pacific countries is that the level of de-jure minimum wages typically varies widely across provinces and districts, and often can also vary between economic sectors. Only Mongolia and Lao PDR set a single national minimum wage level. All of the other countries reviewed set different minimum wages at a sub-national and sector level. Cambodia has three national minimum wage rates for workers in the garment sector based on the occupational level (apprentice, probationary, and regular levels). Although the Cambodian Labor Law includes some provisions for the establishment of minimum wages in all sectors, minimum wages are only set for the garment sector.

6.14 Myanmar has national sector-specific minimum wage rates for employees in public service and the rice milling, cheroot and cigar rolling industries. In Indonesia, minimum wage levels are set for each province and may be further set for districts and economic sectors[4]. In China, minimum wage rates exist for each of the 33 provinces. In the Philippines, there are multiple regulated minimum wage levels as well, varying per region, per province and sector. Within regions, rates may also be set for different provinces or localities and/or for different sectors, non-agricultural, agricultural and retail and service. In Vietnam, rates vary according to location and the employer. Prior to 2011, basic rates in Vietnam were set for four broad regions. Within each region, rates were set separately for private domestic firms and for foreign companies. Currently, there are four regional rates that apply to workers employed in the private sector and one national rate that applies to public sector workers. In Thailand, about 32 minimum wage levels existed, varying by provinces and sector. However, in 2011 the government proposed a unified rate of 300 Bhat across the country.

6.15 In most cases, minimum wage levels are set by the national government after consultations with a *tripartite* body, with the required representation of employers, workers and government. In Cambodia, Thailand, Vietnam, Myanmar, Malaysia and Mongolia, the national government and a tripartite body has a critical role in the setting of the minimum wage level.[5] However, in practice it is unclear how balanced the tripartite body really is, making it difficult to ascertain the level of consultation that takes place in the adjustment process. In Indonesia, China and Philippines, minimum wages are set by regional governments in consultation with tripartite committees. Only in Lao PDR is the minimum wage set unilaterally by the national government. In Indonesia, the 2003 Manpower Law established that minimum wage levels were the responsibility of regional governments following recommendations from the Provincial councils[6]. In China, the administrative department of labor and social security of provinces, autonomous regions or municipality set the rates in consultation with the regional

[4] Several provinces have set sector minimum wages for agriculture, mining, manufacturing, utilities, forestry and rubber industries.

[5] In the case of Thailand and Vietnam, regional rates are set at the central level by the Ministry of Labor after consultations with representatives each of employers and employees

[6] The wage council consists of government, entrepreneurs, labor organization representatives.

trade unions and federations of enterprises. In the Philippines, minimum wages are set by regional tripartite wages and productivity boards.[7] We take up this discussion again in the section of this chapter on institutions.

6.16 Across much of the region, the average level of minimum wage relative to average and median wages and as a proportion of value added per worker varies significantly. Few countries in the region have maintained the level of minimum wages consistent with their codified wage adjustment formulas. Some countries (or regions within these countries) have made minimal adjustments, allowing the value of the minimum wage to fall with respect to productivity, or to deteriorate with inflation. Other countries have enacted dramatic increases, with little observable relationship to changes in workers' productivity (World Bank, 2013b).

6.17 Among the countries reviewed in this chapter, Thailand had the lowest level of monthly minimum wage in 2011 relative to the country's GDP per capita. This has changed since an increase with enactment of the single national minimum wage level in 2012. Most Indonesian provinces had similarly low minimum wage levels, until changes made recently. In 2008, the real value of the minimum wage for most ASEAN countries fell in the wake of a sharp rise in inflation. In response to growing pressure from certain groups of workers and the increasing frequency of strikes since 2011, the governments of Cambodia, Lao PDR, Indonesia, and Thailand enacted substantial increases in minimum wage levels.

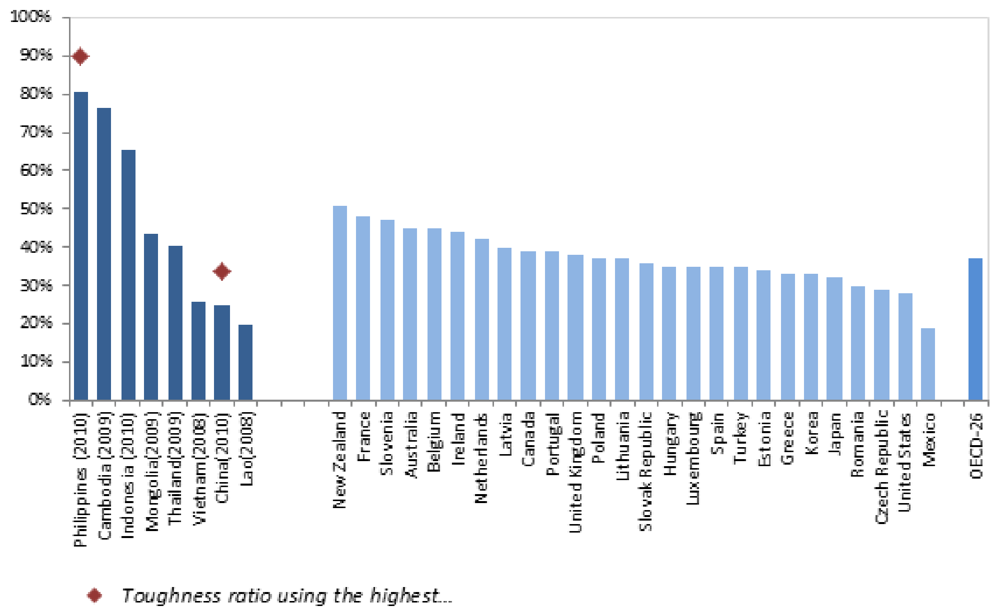
6.18 The Philippines has the highest minimum wage level, especially relative to the average wage. In 2012, the Philippines had an average national minimum wage set above the 90th percentile of countries in the world, ranked by the ratio of the minimum wage to value added per worker.[8] In Figure 6.1 the red diamond indicates that the level in some regions of the country is even higher (or tougher) but the blue bar shows the average for all regions. Readers are reminded that the measure in Figure 6.1 is de-jure, or a synthetic index reflecting what is in the labor codes of the countries included, rather than what people are actually being paid on average.

[7] Each of the 16 regions in the Philippines has its own Regional Board. Before 1989 minimum wages in the Philippines were set nationally by Congress. However since 1989, with the enacting of the Wage Rationalization Act/the Republic Act # 6727, minimum wages are established at the regional level.

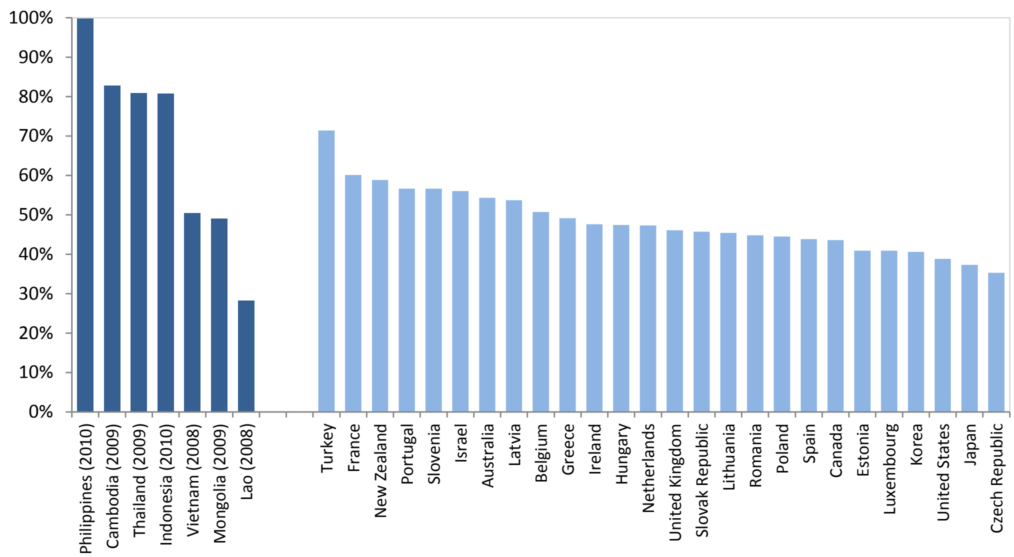
[8] In the East Asia and Pacific region, only the Solomon Islands, the Federated States of Micronesia, Fiji, and Vanuatu have higher relative minimum wages, and all these ratios are within five percentage points of each other. See the 2013 Doing Business "Employing Workers" data: http://www.doingbusiness.org/~/media/GIAWB/Doing percent 20Business/Documents/Miscellaneous/EWI-DB2013-data.ashx.

Figure 6. 1 De jure minimum wages are highest in Philippines, Cambodia and Indonesia.

(a) Ratio of the minimum wage to average wage



(b) Ratio of the minimum wage to median wage



Source: ILO/ Travail; OECD

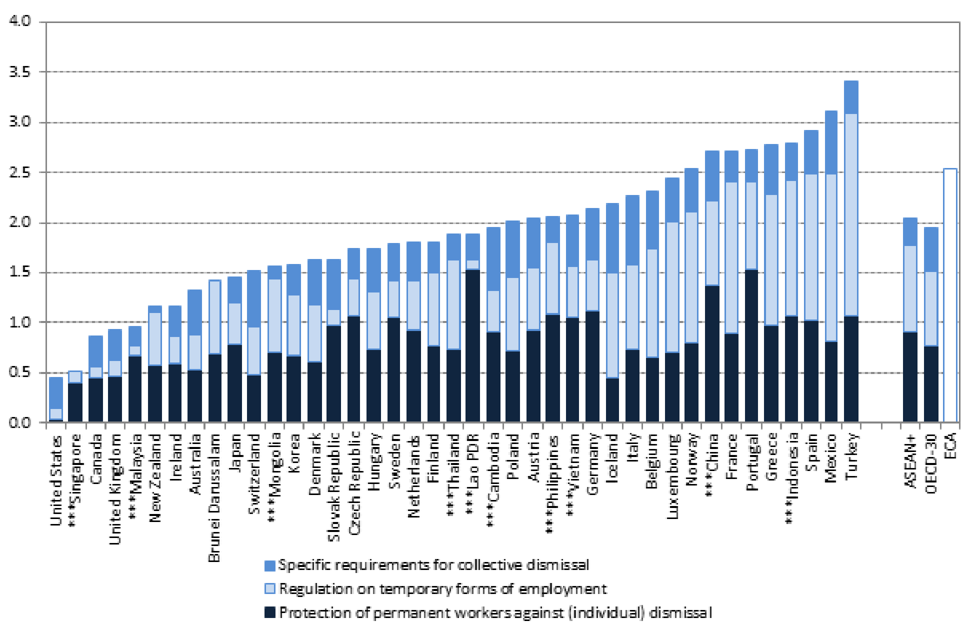
Note: OECD figures are for 2010. Average wage correspond to the average wage of employees working in sectors where covered by the minimum wage laws.

Employment protection legislation

6.19 A second widespread form of labor market regulation, employment protection (legislation) or EPL, restricts employers' ability to dismiss workers. An index for employment protection legislation (EPL) for ASEAN countries, China and Mongolia compares some of the most critical employment costs employers face in these countries. The index ranges from 0 to 6: 0 being the least restrictive and 6 the most restrictive EPL on employers' decisions. Figure 6.2 shows how countries in East Asia Pacific compare with OECD countries and the average for Europe and Central Asia. The average level of restriction from EPL in the ASEAN countries is slightly lower (1.8 for the period 2009-2010) than the average for OECD countries (1.9). There is however, significant variation in how restrictive job protection is, ranging from as low as 0.59 for employers in Singapore to 2.79 for employers in Indonesia.

6.20 On the whole, countries in East Asia Pacific do not stand out for tight restrictions on dismissal. This observation of de jure levels of employment protection are consistent with the low frequency with which firms report labor market regulation to be an obstacle to their growth (presented in Chapter 4). However, Indonesia, China, Vietnam and the Philippines stand out for having the most restrictive employment protection regulation. In Vietnam and the Philippines, much of the stringency reflected in the index stems from the regulation on the dismissal of permanent workers and discouragements of the use of workers on fixed-term contracts. On the other side of the spectrum, employers in Malaysia and Singapore are the least restricted by employment protection regulation.

Figure 6. 2 Some countries in East Asia Pacific have similar restrictions to Southern Europe.
Employment Protection Legislation (EPL) index (2008-2010)



Source: Staff estimates using various sources.
Notes: Score ranges from 0 (least stringent) to 6 (most restrictive). OECD average includes a sample of 30 countries and figures are for 2010. ECA figures are for 2007. * **ASEAN+ countries

6.21 Many high and middle income countries have relaxed their employment protection regulation over the past 20 years.[9] Reforms have generally entailed extending the maximum length of fixed-term contracts, allowing renewals of fixed-term contracts, and encouraging firms to contract from temporary work agencies. Restrictions in high-income countries have been eased further by modifying severance payment, shortening notice periods, and by reducing requirements for collective dismissals (ILO, 2012). Similarly, countries in Eastern Europe and Central Asia and Sub-Saharan Africa have increased flexibility in employment regulation with the hope that more flexibility will lead to increased investment and employment.

6.22 In East Asia Pacific, however, changes to employment protection have generally increased restrictions on firms, and where governments were not already actively regulating the labor market, they have stepped in with regulation on the more restrictive end of the scale. Indonesia for instance, reformed labor regulation with the passage of the Manpower Law (Act no. 13) in 2003, which tightened labor regulation by increasing the amount of mandated severance payments and adding some restrictions on the use of temporary employment (i.e., fixed-term contracts and subcontracting). China adopted a Labor Contract Law (LCL) in January 2008, which made significant changes to the 1994 Labor Law, and increased workers' protection. The new law was passed in response to recurrent problems of labor abuse and worker rights violations[10].

6.23 Employment protection regulation typically includes dismissal costs for regular workers, rules about use of temporary workers and fixed term contracts. Tables 2 and 3 in the annex to this chapter provide details drawn from the labor codes of each country reviewed. Dismissal costs mainly take the form of severance pay.[11] In East Asia, Indonesia and Lao PDR have the highest dismissal costs. In Indonesia, the 2003 Manpower Law increased severance pay for workers with three or more years of service and established an additional 15 percent of severance pay as a gratuity payment in compensation for the loss of housing and health care benefits. Employers in Lao PDR and Indonesia must pay the equivalent of seven months of full wages to dismiss a worker with 4 years of tenure. The dismissal costs for workers with longer tenure rises steeply; for instance, a worker with 20 years of service receives an average severance payment equal to 36 months of wages in Lao PDR, and 25 months of wages in Indonesia. This is six times more in severance than what the labor code in the average OECD country requires for a dismissed worker with 20 years of service.

Figure 6. 3 Firms face the highest de jure severance costs in Lao PDR, Indonesia and China.

(a) Severance pay for tenure of 4 years, in

(b) Severance pay for tenure of 20 years, in

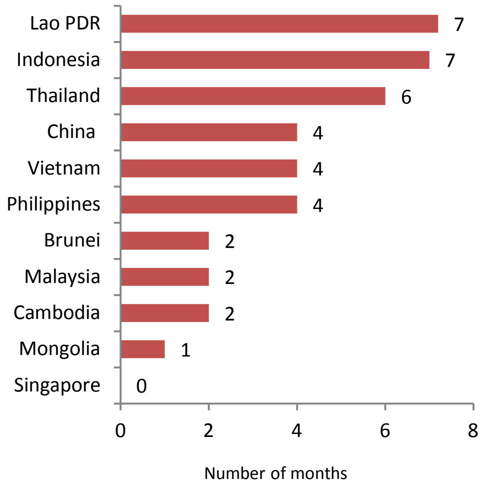
[9] Most high-income OECD countries experienced a relaxation of their employment protection regulations in the last two decades, driven mainly by easing restrictions on temporary employment (OECD; 2004, World Bank, 2012).

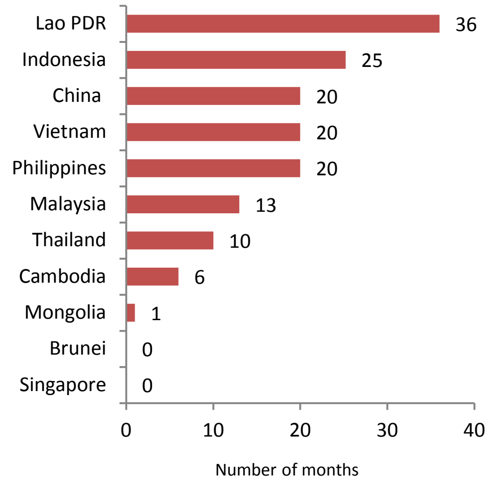
[10] The law passed after the slave labor scandal in the coal mines of Shanxi and Henan provinces. The government realized that violations of workers' rights, not to mention the resulting strikes, negatively affected social stability and economic development.

[11] This is due, in part to the administrative difficulty of administering national income protection plans (Vodopivec 2006).

monthly wages

monthly wage





Source: Staff calculations using various sources

6.24 The statutory notice periods in the East Asia Pacific countries reviewed are typically between 1 to 1.5 months for a worker with 4 years of tenure, which is about the same length as in OECD countries. Although most countries do not have onerous procedures and requirements for dismissing workers, there are some exceptions. In Brunei, Cambodia, Indonesia, Lao PDR, China and the Philippines, employers are obligated to notify a third party, typically workers' representatives, before making a worker redundant. Further, in Lao PDR, Indonesia and Brunei, employers are not allowed to lay-off workers without permission from the appointed government agency. All of the countries reviewed, except Malaysia, allow reinstatement after unfair dismissal.

6.25 Legal allowances for the use of temporary contracts and contracting additional workers from temporary agencies are commonplace. The use of temporary or "fixed term" contracts provides flexibility to employers by allowing them to hire without incurring some of the costs for permanent workers. With this type of contract, in theory, employers can adjust their labor input with market demand fluctuations. They can also be used as a screening device: employers can use the extended trial time period to gauge the workers' productivity level and subsequently hire the worker permanently. However, there are also disadvantages. Employers will have less incentive to invest in the human capital of workers on shorter, fixed term contracts (Nielen and Schiersch, 2012).

6.26 Many European countries introduced fixed-term contracts to reduce high levels of unemployment in the mid 1980's. Previously, the labor code of most European countries restricted the use of fixed term contracts, but they have become far more common. Powerful unions have, however, constrained the extent of liberalization, leading to "two tier" labor markets particularly in Southern Europe (see Box 6.1).[12] Among the East Asia Pacific countries reviewed, about half have put restrictions on the use of temporary work in place: Brunei, Indonesia, Mongolia, Philippines and Thailand all restrict the use of fixed term contracts. Cambodia, China, Lao PDR, Malaysia, Singapore and Vietnam have legislation enabling employers to use fixed-term contracts for permanent tasks, though the levels of flexibility vary. Few countries in East Asia Pacific impose a limit on the duration of these contracts or restrict the number of times they can be renewed. Lao PDR, Malaysia and Singapore are the most flexible. Indonesia on the other hand, has the most restrictive regulation on the use of temporary contracts: it prohibits people on fixed-term contracts to fill roles deemed permanent, and for roles deemed temporary, the duration of a fixed contract is not allowed to exceed three years (two years and a single year renewal). This period was recently shortened from five years.

6.27 Turning to the final element of employment protection measured in Figure 6.2, few East Asia Pacific countries regulate additional protective measures for collective dismissals, or large volume lay-offs as part of retrenchment, downsizing and redundancies. The most restrictive additional regulations on mass redundancies are found in Cambodia, Vietnam and China. In Cambodia, employers must notify the labor authorities and workers' representatives of the circumstances for lay-offs in writing, and receive guidance on how to minimize the effects of the reduction. Dismissed workers have priority to be re-hired for the same position within two years.

6.28 In China, the LCL defines collective dismissals as lay-offs involving more than 20 employees or at least 10 percent of the total number of the employees in a firm. Collective dismissals are only permitted when an employer is going through an adjustment of business operations or runs into serious operational difficulties. Employers are required to notify and consult with labor unions and employees about the dismissal 30 days in advance, consider their opinions and submit a workforce layoff plan to the labor administrative department. If an employer that has gone through this process is able to hire again within six months, their former employees have to be given preferential consideration. In Vietnam, the law does not specify the number or percentage of laid-off employees that constitute a 'collective' dismissal. The provision applies to any lay-offs resulting from technological change or organizational restructuring. Employers must engage in consultations with labor unions and an executive committee to formulate specific criteria (business requirements, seniority, skill, family conditions) for dismissals.

Regulation on the movement of people[13]

6.29 Although movement of people across borders is more likely to capture news headlines, the largest movements of people seeking work happen within countries. As has been shown in

[12] In Germany, the share of workers with fixed term contracts rose from 30 percent in 2000 to 45 percent in 2010 (Nielen and Schiersch, 2012).

[13] In this section, we give greater relative room to discussion of regulations on internal migration. Labor migration across borders is discussed in much greater detail in a companion regional report, World Bank (2013a).

earlier chapters, this has been especially true in East Asia Pacific, and as will be shown in chapters that follow, is still underway. Voluntary internal migration from rural areas to cities has been gaining importance since the mid-1970s. This shift is especially notable in the urbanizing economies of South and East Asia, with the rapid rise of manufacturing and services. In China, with the easing of residency restrictions, migration from rural areas to cities in the past 30 years is the largest movement of people in the world.

6.30 Indeed, attempts by China to channel the flow and settlement of its people provide a useful synopsis of the regulation of labor migration. In the second half of the 20th century, China undertook some of the most active internal migration policies ever observed, initially to great economic benefit. Following the communist accession to power in 1949, the Chinese government sought to stimulate industrialization through policies that encouraged rapid urbanization. Households were given incentives to move to cities, and rural workers responded en masse. As a result, the urban population of China had by 1953 grown by a third, to 78 million people.

6.31 Seemingly in response to a larger than expected flow from rural areas, the government quickly attempted to stem the tide, establishing departments that centralized hiring in 1953, and soon thereafter instituting restrictions on travel and grain rationing in cities. But these measures failed to slow the outflow of Chinese rural workers significantly, and by the late 1950s, the population pressure on cities grew to such an extent that the government mobilized millions to move back to the countryside. But with the Great Leap Forward (1958-60), the government abandoned all attempts to control the flow of labor, and again sought to accelerate industrial development, motivating another surge of workers to China's cities. By 1960, China's urban population had doubled from that in 1949.

6.32 In the early 1980s the government became particularly preoccupied with the speed of urbanization. Although rural-to-urban migration was responsible for only 20 percent of the growth of China's cities from 1949 to 1980, mounting evidence of burdened infrastructure and services in the "megacities" of Shanghai and Beijing, concentrated the attention of policymakers on movement from rural areas.

6.33 The main tool employed by the government to regulate the flow of workers is the household registration system of "hukou", which is based on four tenets: that migration, especially to urban areas, should be allowed only if compatible with economic development, that rural-to-urban migration must be strictly controlled, that movement between settlements of similar population size need not be controlled, and that flows from larger to smaller settlements or between rural areas should be encouraged. Under the hukou, each individual has an official place of residence. People are allowed to work legally, receive social security benefits including health coverage, and to access food rations only in their place of residence. A change can be granted only by permission, similar to a local authority granting a visa. But some forms of legal temporary migration are allowed to meet shifts in labor demand. As the government's preoccupation with the size of China's cities and the pace of urban growth changed, the hukou was tightened or loosened. Despite the controls, lax enforcement has allowed large flows of migrant workers cities to settle in cities under “temporary” status. Indeed, in the last 30 years the labor force requirements to fuel China’s spectacular growth performance has relied on de jure temporary migrants, who are permanent de facto.

6.34 Today the surge of people from rural areas is ebbing. Yet one in five rural workers migrates, and migrant labor accounts for a third of urban employment. China’s industries are in constant demand of low-cost labor, which has become very difficult to find. Recognizing the growth dividend from allowing labor to flow, the government has been loosening the hukou in recent years and is even facilitating migration. Migration restrictions have declined, the labor market has become more efficient, and mobility decisions are much more responsive to economic factors. Beginning with pilots in selected municipalities, migrants from rural areas will be given access to health and social protection services; training, labor market information and job search assistance; and recourse to protection in case of employer abuse and exploitation.

6.35 International migration, defined as the movement of people across national borders, has important economic, social, and political implications that influence regulation of the labor market (Ozden et. al, 2011). The number of people moving across borders, both legally and illegally has been steadily increasing in the last five decades, especially from countries in East Asia Pacific. Recent estimates of cross border migration show that emigrants from East Asia Pacific countries total 21.7 million people (World Bank, 2013a). These flows out of East Asia Pacific countries in recent years include more women, although the majority of people crossing borders are still men.

6.36 Cross border migration in East Asia Pacific is mostly economically motivated, and still commonly observed flowing to high-income OECD countries. However, the wide disparities in wealth and earnings across low and middle income countries in East Asia Pacific attract migration from within the region. As emerging economies in East Asia Pacific continue to grow rapidly, the movements of people across the region’s borders is likely to increase. A conservative estimate of the number of cross-border migrant workers from East Asia Pacific countries still working within the region is 7 million people (World Bank, 2013a).

6.37 High income countries like Singapore and Korea depend on foreign workers to fill labor shortages gaps. As these countries and the region’s upper middle income countries age, labor shortages will grow. Labor and skills gaps discussed in the previous chapter, will also be a persisting product of rapid growth, and act as a further incentive for people from lower-income countries to emigrate for work. In Thailand and Malaysia the local labor force is largely skilled but the economy still requires low-skilled workers to work in the growing labor-intensive segments of the manufacturing sector (namely electronics, textiles, non-metallic and mineral industries). Conversely, in Indonesia and Laos, gaps at the higher skill level compel domestic and foreign companies to recruit professional and managers from Thailand and Vietnam.

6.38 Economic opportunities and large prospective earnings differentials are a product of East Asia Pacific’s particular mix of economic integration, consequent high growth and aging populations. The inflow of foreign workers to middle-income countries in the region is no longer considered a temporary phenomenon. The ASEAN regional block provides a case in point, where economic integration has led to increased interest in the movement of human capital across borders. To that end, the ASEAN Economic Community has set the mobility of skilled workers in ASEAN as a goal for 2015. The rising volume of movement across borders has compelled many East Asia Pacific countries to establish well defined regulations on immigration. Recent liberalization of the movement of labor across borders takes the form of bilateral labor agreements (BLAs).

6.39 Destination countries like Singapore, Malaysia, and to an extent Thailand, have had to design comprehensive labor migration management systems aligned with their long-term economic goals. In Malaysia, unemployment affects mainly youth and especially unskilled youth. For this reason, Malaysia currently limits (or makes more costly) the inflow of low-skilled immigrants. But like many other countries around the world, Malaysia faces shortages of skilled workers so it also has initiatives to attract well-educated foreigners. Several features of immigration policy from high-income countries in East Asia Pacific are influencing the new policies of middle-income destination countries like Thailand and Malaysia. For instance, Australia uses a quota system that is publically announced every year as part of the federal budget process. The objective is to limit the number of visas issued for permanent residency while keeping the system highly responsive to economic conditions and the needs of employers.

6.2 Interventions

6.40 Labor market interventions –"active" labor market programs like training and job search assistance, and "passive" unemployment benefits and other forms of social insurance- are relatively rare in East Asia Pacific countries. Spending on social protection programs tends to be concentrated on social insurance, and then mainly on retirement pensions (ADB, 2013). The mandate to contribute to finance these interventions can be perceived as a tax on any employer or workers who would save less, or who does not think the promise of benefits is credible. The expected impact of this tax on the incentives to hire or informalize labor is relatively straightforward: all else equal, a higher tax wedge should increase the extent of informal employment. But the expected impact of active and passive labor market programs is less so.

Table 6.1 Employment interventions are still rate in East Asia Pacific countries

Average annual expenditure in US$PPP, not including administration costs

	Unemployment benefits and active labor programs	Public works	All social insurance	All social protection	Employment interventions / SI (%)	Employment interventions / all SP (%)
East Asia Pacific*	**0.7**	**16.6**	**16862.3**	**21390.7**	**0.1**	**0.1**
Europe Central Asia	4211.4	n.a.	145732.0	173506.0	2.9	2.4
Latin America Caribbean	n.a.	24.7	241520.0	270627.0	0.0	0.0
Middle East North Africa	n.a.	29.1	448.7	622.7	6.5	4.7

South Asia	n.a.	n.a.	3117.6	5003.5	0.0	0.0
Sub-Saharan Africa	n.a.	7.1	1799.2	3216.4	0.4	0.2

Source: ASPIRE, World Development Indicators
Notes: *Numbers are not likely to capture recent increases in spending as part of stimulus programs

6.41 By their intended purpose active programs that improve workers' human capital or eliminate some of the information asymmetries that delay and frustrate *"matching"* in the labor market should lower the extent of unemployment. Active programs might also lower the search and training costs of firms, and so indirectly subsidize employment creation. Passive programs like unemployment benefits, can remove the urgency of finding new work, and thus also improve the quality of matches. However, the record of effectiveness of active programs is checkered at best, and if unemployment benefits are overly generous or poorly designed, they can perversely lower peoples' motivation to look for and accept employment.

"Passive" programs

6.42 Social insurance plans to cover labor market risks are relatively rare in East Asia Pacific countries. In middle and upper middle income countries of Europe and Central Asia and Latin America, they are a prominent tool in the State's social protection arsenal. Unemployment benefits protect individuals against the risks to their consumption from job-loss, and for a period of job search. Only three of the countries reviewed for this report -Thailand, China and Vietnam- have introduced unemployment insurance schemes. China, for instance, introduced the UBs program in 1986 following the start of economic reform, while Thailand and Vietnam introduced their unemployment programs in 2004 and 2009, respectively.

6.43 Table 6.2 describes the unemployment benefit level for China, Thailand and Vietnam, the duration and conditions required to qualify for benefits. Unemployment insurance benefits in Thailand and Vietnam are as generous as in many high-income countries. The benefit levels or replacement rates, (the portion of previous income replaced by insurance benefits) are similar (40–75 percent) to OECD countries. In Vietnam, the monthly benefit is equivalent to 60 percent of the average earnings in the 6 months before unemployment. In Thailand, the benefit level depends of the reason for becoming unemployed. If unemployment is involuntary, the laid-off worker receives 50 percent of her previous daily wage (average daily wage in the highest paid 3 months during the 9 months before unemployment). In China, unlike other countries, the program has a flat benefit level set by the local authorities, which should be higher than the local public assistance benefit but lower than the local minimum wage.

Table 6.2 Unemployment insurance is still rare in East Asia Pacific countries.
Main features of unemployment insurance in Thailand, China and Vietnam

Country	Average unemployment benefit	Unemployment insurance benefit duration (months)	Qualifying conditions
Thailand	50 percent of the average daily wage in the highest paid 3 months during the 9 months	6 months (in any 1 year)	6 month contribution within 15 months before unemployment

	before unemployment. The maximum daily benefit is 250 baht		
China	Flat benefit level set by the local authorities. Higher than the local public assistance benefit but lower than the local minimum wage	12-24 months (depending on applicant's years of contribution)	The benefit is payable for a maximum of 1 year with less than 5 years of coverage, for a maximum of 1.5 years with 5 or more but less than 10 years of for a maximum of 2 years with 10 or more years of coverage
Vietnam	60 percent of the average monthly earnings in the 6 months before unemployment	3-12 months varying per contribution.	▪ 3 months; 12 to 35 months of contributions ▪ 6 months; 36 to 71 months of contributions ▪ 9 months with 72 to 143 months of contributions ▪ 12 months with 144 months of contributions or more

6.44 In China and Vietnam, the duration of benefits varies according to workers' years of contributions. In China workers who contributed for less than five years receive benefits for up to 12 months, those who contributed for five to ten years may receive benefits for up to 18 months, and a person who has contributed for over ten years may receive benefits for up to 24 months. In Vietnam, the duration of the benefits ranges from 3 months for worker that contributed from 12 to 36 months to 12 months for worker with 144 months of contributions.

"Active" programs

6.45 Labor intensive public works and other "active" labor market programs –targeted training programs (covered in the previous chapter), wage subsidies, and employment search assistance – are also rare in low and middle income East Asia Pacific countries, when compared to their prevalence Latin America and especially in Europe and Central Asia where they are mainstay of formal social protection policy.

6.46 Prior to the East Asian crisis of 1997-1998, labor market programs only existed in the high-income countries of the region. In the wake of that crisis, governments rapidly deployed a broad arsenal of programs, with varying degrees of effectiveness. Low levels of registered and verifiable job-losses, generally incomplete and poor quality administrative data, and the rush to mobilize, limited the ability of governments to target active programs effectively. Benefits set at high levels relative to average wages and the lost earnings of the neediest households, hindered the self-targeting features of public works (Betcherman and Islam, 2001). Nevertheless, the experience of responding to extensive unemployment in the wake of the East Asian crisis left governments in the region a lot wiser.

6.47 Building on their experience in the late 1990s, some countries in East Asia Pacific are using ALMPs as a part of their permanent arsenal of interventions to help households mitigate employment risks. This stood governments in good stead during the global financial crisis of 2009-2010. In response to the crisis, Malaysia was able to quickly provide subsidized training and monetary incentives for employers to encourage worker retention and rehiring of retrenched workers. Thailand devoted significant stimulus funds to an intensive vocational training program that aims to train 500,000 unemployed, soon to be unemployed, and new graduates during 2009-2010, providing one month of training and three-month cash allowances to help them find employment or start businesses. To address the problem of unemployed urban workers, Cambodia implemented a cash-for-training program that provides vocational training in agriculture, industry, and mechanics. Lao PDR experimented with food-for-training, with a particular focus on women. Again, as in the case of unemployment insurance, the overall effectiveness of ALMPs in reaching poor and otherwise vulnerable people has been limited, since many of these programs are only able to reach people who have lost registered forms of work (World Bank, 2012).

6.48 Labor intensive public works programs, however, do not have the same design limitations. Public works programs can be effective at reaching people who have lost work or whose small businesses have gone under even if work was unregistered, informal work. Public works programs are a preferred instrument in countries where most employment cannot be verified legally, or where employment information systems are poor or have only partial coverage of the workforce. This is mainly because of their self-targeting features, specifically a cash (or in-kind) "stipend" amount set at low levels with respect to the market wages for low-skilled labor; a full time work requirement; and relatively difficult work (see Box 6.2).

6.49 In general, public works programs have played a smaller role in the nascent social protection systems in East Asia Pacific countries, compared to their prevalence in other developing country regions. In East Asia Pacific, public works programs have taken the form of cash- and food-for-work schemes, as in Cambodia and Lao PDR. In other countries, they are offered in the more traditional manner similar to India's National Rural Employment Gurantee (NREGA) or Argentina's Jefes y Jefas de Hogar. In China, the government has encouraged use of public works and public works community systems as a means of providing retrenched workers with employment opportunities. According to the All-China Women's Federation, around 40 percent of laid-off women, who accounted for over half of the country's unemployed in 2002, found employment in community positions in their neighborhoods (World Bank, 2008c).

6.50 In several countries in East Asia Pacific that have experienced violence and remain fragile ostensibly due to high rates of youth unemployment and inactivity, labor intensive public works are deployed by government to restore stability and put young people on a path to employability through training and apprenticeships. Such is the case in Papua New Guinea, Timor Leste and Solomon Islands. In the Solomon Islands, the Rapid Employment Program has been credited with helping to bring stability to Honiara after troubles that threatened to pull the country apart. As Solomon Islands moves from stabilization back to the path of development, the program is expected to keep helping young people gain skills and find work.

Box 6. 1 Can Public Works act as Social Insurance for Informal Workers?

The risk of losses from unemployment is generally not considered "insurable" by markets since it can be highly systemic—that is, when unemployment strikes, say in a crisis or recession, a large number of individuals in the risk pool are affected. Since there are typically not enough "winners" to compensate "losers" from the employment shock, it becomes too expensive for insurers to cover losses. However, household earnings protection is important, both for social as well as efficiency reasons: earnings protection can help households avoid bad coping in the wake of a shock to income, but also help improve matching of employment with those seeking work by removing an element of urgency from their search. For this reason governments help correct this market failure to provide or mandate earnings insurance instruments: from risk pooling at the firm level in the form of severance programs, to pooling across the working population in pay-as-you-go systems of unemployment insurance, and even systems based on individual savings accounts underpinned with minimum benefit guarantees.

However, in economies where large segments of the labor force are self employed or work informally, providing earnings insurance through any of these traditional devices is institutionally difficult and can even lead to regressive subsidies to relatively well off "formal" workers. What is more, financing social insurance structures from pay-roll contributions draws a sharp distinction between the protection enjoyed by workers with a legal contract, and those without, including the self-employed. This distinction can create segmentation and obstacles to labor mobility.

To surmount these problems, and extend earnings protection, governments in many middle and lower income countries offer labor-intensive public works or "*cash-for-work*" programs (Subbarao, 1997). These programs even featured prominently in the government responses to the sharp rise in unemployment in upper middle income Central European Countries in 2009 and 2010 (Azam, Ferre and Ajwad, 2012). Since public works programs are financed directly from general revenues and typically do not discriminate according to the type of employment individuals have lost (i.e. whether registered employment, informal or self-employment), these structures can effectively function as a social insurance instrument (i.e. a public risk-pooling intervention). Indeed, if correctly structured, these programs can be a form of social insurance that is most likely to reach workers who lose employment in the informal sector or the self employed whose businesses fail in a downturn (Ravallion and Galasso, 2004).

The critical parameter of public works programs which directly determines whether they succeed as earnings insurance for the informal workers is the program wage. Correctly setting the program wage is critical to ensure protection reaches those who need it most; is readily available in an economic down-turn; and does not introduce damaging distortions when labor markets recover.

The most effective way to ensure public works programs succeed in providing reliable and sustainable earnings protection to households that are at greatest risk, is to pay program wages below the statutory minimum wage, and ensure that the work is relatively undesirable to the individual. However, many governments make the mistake of setting program wages at the minimum wage, well above the market clearing wage for unskilled manual labor. Offering above-market wages imposes three separate economic costs. They attract more workers to public programs than really need assistance; pays each more than they would otherwise accept; and crowd out private employment. As many governments have discovered, if public employment programs offer (or subsidize) above-market wages, the fiscal costs of these programs can increase unless protection is rationed. But this places government in the uncomfortable position of working through quantities rather than through prices, and hinders the program's effectiveness to protect households. Where governments pay statutory minimum wages, they are forced to ration the number of hours and work days offered to contain costs. In effect, this forgoes self-targeting forms of earnings protection, for relatively expensive (in terms of above-market wage costs) forms of income assistance with limited coverage, and vulnerable to rent-seeking (Subbarao, del Ninno, Andres and Rodriguez-Alas, 2013).

Labor tax wedges

6.51 Interventions are, by design, mainly financed by mandatory contributions from employers and workers. We have discussed the relative scarcity of unemployment insurance and active labor market programs in East Asia Pacific countries (World Bank 2012, ADB 2013). Yet the mandatory contributions paid by formal workers and employers are substantial. This may appear incongruent, but for the provisions made by many governments in the region that allow contributing workers to access their mandatory retirement savings in the event of a household shock, such as loss of work. Indeed, these provisions have acted as financial self-insurance for many people –albeit still only the minority of people in registered, formal work- in East Asia Pacific, in lieu of explicit arrangements to mitigate the risk of unemployment (Betcherman and Islam, 2001).

6.52 If workers and employers assign little value to these interventions, the mandate to contribute creates a “tax wedge” between the cost of labor to a firm and take-home pay of employees. The size of this wedge can influence both labor demand and labor supply. The impact on incentives is greater where government has a poor track record of performance and, whether because of inflation or corruption, few workers believe they will actually ever benefit from these interventions. If the tax wedge is large and net wages are too low, workers may be discouraged from participating in the regulated part of the labor market, finding outside options –unemployment or unregistered, informal work- more attractive. Similarly, because taxes increase the costs of employing someone, they can discourage employers from hiring.

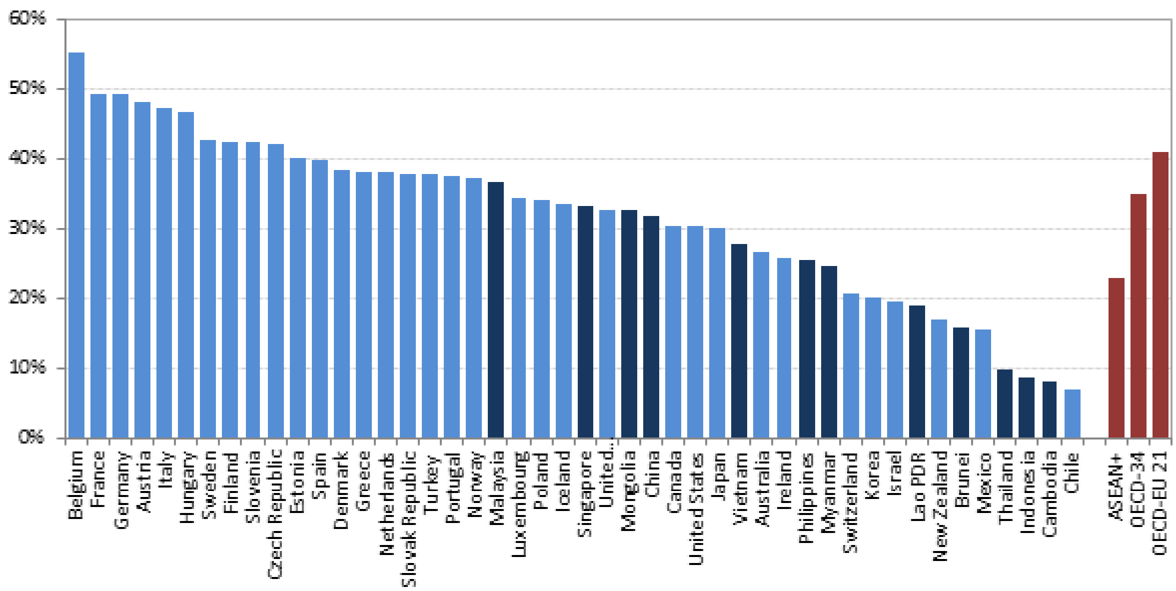
6.53 The tax wedge on labor provides a de jure measure of the extent to which the social protection and tax systems could discourage employment. It is calculated as the difference between salary costs of a worker to their employer and the amount of net income that workers receive ("take-home-pay"), expressed as a percentage of the total labor cost. Readers should note that these estimates will differ considerably from the statutory tax rates on income discussed in Chapter 4. This is because the tax wedge is calculated taking into account the circumstances of a representative worker, including what the labor code requires them to pay in mandatory contributions for employment programs and social insurance.[14]

6.54 Figure 6.4 presents the de-jure tax wedges for selected East Asia Pacific countries and OECD countries. The tax wedge in the East Asian countries is significantly lower (averaging 23 percent) than the OECD average of 37 percent and 41 percent for EU countries. Countries differ

[14] The tax wedge constructed for the ASEAN countries, Mongolia and China reflect the wages for single individuals, without children, living in urban areas and earning the average wage in service and manufacturing industries (OECD, 2012). The tax rates and social security contributions are prescribed by laws and country’s regulations and therefore differ for each country.

greatly in the overall labor taxes, ranging from a low of 8.2 percent in Cambodia to a high of 36.8 percent in Malaysia. Between 2002 and 2010, the average tax wedge for the region[15], increased 4 percentage points, increasing in all countries except China where the tax wedge was reduced 1.2 percentage points.

Figure 6.4 The highest de-jure labor tax wedge is in Malaysia and the lowest in Cambodia.
Tax wedge on labor for OECD and ASEAN+ countries, 2010, as percent of labor costs.



Source: Countries' tax regulations; KPMG's Individual Income Tax and Social Security; Taxing wages report 2011 (OECD). Un-weighted average for ASEAN+ and OECD.

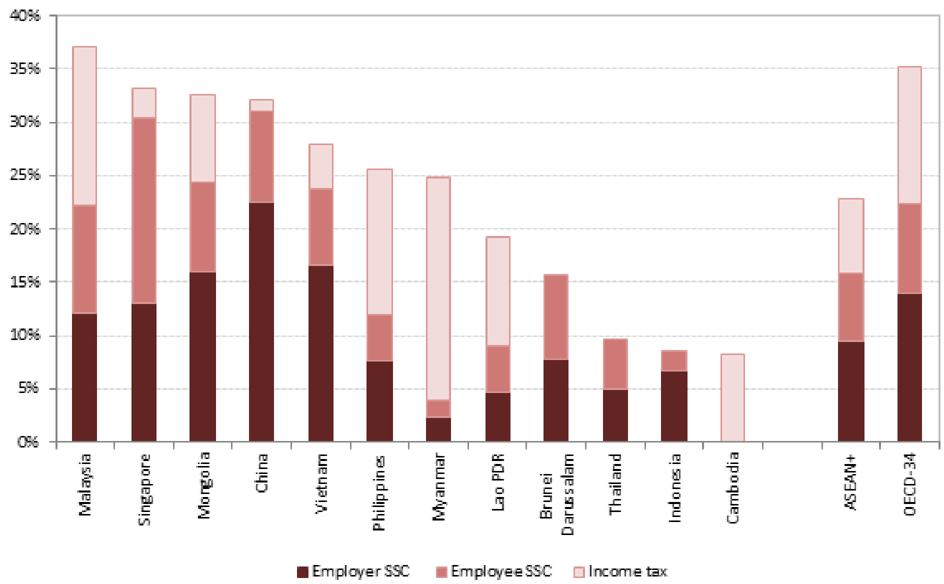
6.55 Cambodia, Indonesia and Thailand have the lowest tax wedges among the East Asia Pacific countries reviewed. The smaller tax wedge in Cambodia reflects the absence of statutory social security tax altogether, something that will soon change.[16] In Indonesia and Thailand, the smaller tax wedges reflect that workers earning average wages are exempted from paying taxes[17]. Malaysia stands out for having the highest tax wedge above 35 percent, similar to the levels observed for Norway and Luxembourg, and basically explained by the relatively higher level of taxation on personal income for workers earning the average wage (16 percent of the average gross salary) and the high mandatory contributions to social security (22 percent of the average gross salary).

6.56 Social insurance contributions account for the largest portion of the tax-wedge in East Asia Pacific countries. In most countries, employers pay the majority of these contributions (with notable exceptions). China imposes the highest social insurance contributions among the

[15] Excluding Lao and Singapore for whom data on taxes is not available for 2002
[16] In Cambodia a new Prakas has already been prepared, stipulating that social security contributions for civil servants will be shared between the government (18 percent) and workers (6 percent).
[17] In these countries, generous allowances are provided by law, which reduce substantially the taxable income of average wage workers.

countries reviewed; it represents 22 percent of the total labor cost for a worker (or 29 percent of the gross salary). Singapore on the other hand, imposes most of the tax burden for social security on workers: they contribute 17 percent of the total labor cost for social security, while employers only pay 13 percent of total labor costs in social security contributions. At the margin, and all else equal, a larger share of contributions paid by workers should more closely link eventual benefits and contributions, lowering the pure tax element of the wedge between labor taxes and take-home pay. The extent to which the statutory allocation of mandatory contributions between employers or workers actually matters, will vary greatly, but depends primarily on how workers value the benefits that these contributions finance.

Figure 6. 5 The largest portion of the tax wedge is employer contribution to social insurance
Composition of the tax wedge on labor for OECD and ASEAN+ countries, 2010, as a percent of labor costs.



Source: Countries' tax regulations; KPMG's Individual Income Tax and Social Security; Taxing wages report 2011 (OECD).

6.3 Institutions: Organized labor in East Asia Pacific

6.57 Turning to institutions, although it is impossible to really isolate institutions that have an impact on the labor market from those that shape other social and economic interactions, one in particular is directly relevant to the discussion in this chapter: organized labor. As with labor policies generally and regulation specifically, the advent of organized labor and collective bargaining came later to countries in East Asia Pacific than to countries in other regions. A large body of historical, sociological and political science literature has been written where various hypotheses for this late advent are debated.

6.58 Some writers contend that the relatively greater importance of hierarchy and fealty in East Asian societies has acted as a cultural obstacle to the adversarial model of organized labor and collective bargaining taking hold. But this explanation is disputed with examples of labor unions gaining membership and influence in similarly hierarchical and familial cultures in Latin America and Central Europe (Minns and Tierney, 2003).[18] Some historians and political scientists claim that longer periods of authoritarian government and political repression in East Asia Pacific are a more plausible explanation for weaker labor unions. And while countries in Latin America and Central Europe also experienced periods of authoritarian rule, these often followed significant periods of pluralist democracy in which organized labor gained a secure footing, from which it often played a key part in overthrowing dictatorships. In contrast, pluralist democracy is relatively new phenomenon in East Asia Pacific.

6.59 In the East Asia Pacific countries with longer histories of democracy, the politicization of labor movements is often blamed for their weakness. Links between trade unions and political parties, which formed from their emergence out of a liberation struggle and fight against a dictatorship in several East Asia Pacific countries, detracted from their mandates of representing the rights of workers. This can lead to trade union leadership which is Government-selected, conservative, and dynastic (Traub-Merz, 2002). Indeed, the politicization and co-option of unions by authorities in several East Asia Pacific countries is often offered as an explanation for their weakness. Some argue that Chinese labor unions are carrying out the conflicting functions of protecting worker's rights on the one hand, and acting as "a transmission belt" between the Party and the working masses on the other (Cooney, 2011).

6.60 Alternative explanations tie the later rise and relative weakness of organized labor, to a substantially later urbanization and industrialization in most of East Asia Pacific compared to Latin America and Central Europe. In mainly rural agrarian economies, the labor force is still living in relatively disbursed settlements, engaged in subsistence or small-scale commercial agriculture. In these settings it is more difficult to clearly separate who is a worker or a tenant, from an employer or land-owner. But even where these lines are clearly drawn, the transactions costs of organizing and coordinating in rural areas are much greater than for working people concentrated in the factories of towns and cities.

Table 6.3 Unions came late to countries in East Asia Pacific.

Ratification year of the ILO 'Freedom of Association and Protection of the Right to Organise Convention' (C 87) and 'Right to Organise and Collective Bargaining Convention' (C 98)[19]

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[18] Deyo (1989) argues that the Confuscian cultural explanation holding that "… values of hierarchy, cooperation, industriousness, paternalism, and the subordination of individual to state" (p. 5) does not account for other regions where labor unions are strong, which also hold strong cultural values of "authoritarian acquiescence", such as Iberian corporatism in Latin America.

[19] Historically, it can be very difficult at a national level to identify specific years in which labor unions were first established and gained momentum. From a legal perspective, it is easier to find the year in which countries ratified the ILO 'Freedom of Association and Protection of the Right to Organize Convention' from 1948 (C 87) and the ILO 'Right to Organize and Collective Bargaining Convention' from 1949 (C 98). In theory, ratifying these conventions allows labor unions the *de jure* right to form, bargain and exercise voice. A number of East Asia Pacific countries have not yet adopted either of these conventions, including China and Vietnam, where "wild cat" labor union strikes are a growing phenomenon. Generally, countries in East Asia adopted these conventions during the 1990s and 2000s, while countries in Latin America adopted the conventions the 1950s and 1960s. Thus, the legal space

East Asia and the Pacific			Latin America			Europe and Central Asia		
	C 87	C 98		C 87	C 98		C 87	C 98
Australia	1973	1973	Argentina	1960	1956	Albania	1957	1957
Brunei Darussalam	not sign.	not sign.	Belize	1983	1983	Armenia	2006	2003
Cambodia	1999	1999	Brazil	not sign.	1952	Azerbaijan	1992	1992
China	not sign.	not sign.	Chile	1999	1999	Belarus	1956	1956
Fiji	2002	1974	Colombia	1976	1976	Bosnia & Herz.	1993	1993
Indonesia	1998	1957	Costa Rica	1960	1960	Bulgaria	1959	1959
Japan	1965	1953	Dominican Rep.	1956	1953	Croatia	1991	1991
Kiribati	2000	2000	Ecuador	1967	1959	Czech Republic	1993	1993
Korea	not sign.	not sign.	El Salvador	2006	2006	Estonia	1994	1994
Lao	not sign.	not sign.	Guatemala	1952	1952	Georgia	1999	1993
Malaysia	not sign.	1961	Guyana	1967	1966	Hungary	1957	1957
Marshall Islands	not sign.	not sign.	Honduras	1956	1956	Kazakhstan	2000	2001
Mongolia	1969	1969	Mexico	1950	not sign.	Kyrgyzstan	1992	1992
Myanmar	1955	not sign.	Nicaragua	1967	1967	Latvia	1992	1992
New Zealand	not sign.	2003	Panama	1958	1966	Lithuania	1994	1994
Palau	not sign.	not sign.	Paraguay	1962	1966	Moldova	1996	1996
Papua New Guinea	2000	1976	Peru	1960	1964	Montenegro	2006	2006
Philippines	1953	1953	Suriname	1976	1996	Poland	1957	1957
Samoa	2008	2008	Uruguay	1954	1954	Romania	1957	1958
Singapore	not sign.	1965	Venezuela	1982	1968	Russia	1956	1956
Solomon Islands	2012	2012				Serbia	2000	2000
Thailand	not sign.	not sign.				Slovakia	1993	1993
Timor-Leste	2009	2009				Slovenia	1992	1992
Tuvalu	not sign.	not sign.				Tajikistan	1993	1993
Vanuatu	2006	2006				Macedonia	1991	1991
Vietnam	not sign.	not sign.				Turkey	1993	1952
						Ukraine	1956	1956
						Uzbekistan	not sign.	1992

Source: Data derived from ILO *'ratifications of fundamental Conventions by country'*, see: http://www.ilo.org/dyn/normlex/en/f?p=1000:10011:0::NO:10011:P10011_DISPLAY_BY,P10011_CONVENTION_TYPE_CODE:3,F Note: 'Not sign.' stands for not being a signatory.

6.61 The more compelling explanations for relatively weaker labor unions in East Asia Pacific countries, take account of the form in which industrialization has taken place, while acknowledging all of the explanations summarized above. The structural transformation process in most East Asia Pacific countries shifted employment out of agriculture and into light industry employment for export led-growth (Deyo, 1989). Growing light industry factories attracted low-skilled, low-wage workers with few advancement opportunities, little employment security, high turnover, and hence low commitment to firms, place of work and unions. This is supported by drawing contrast to the Latin American countries where import substituting industrialization encouraged heavier industries requiring a relatively skilled workforce. A relatively higher skilled workforce had higher incentives to organize and negotiate protection and higher returns on their relatively greater investments in human capital. This theory also helps to explain the contrasting experience of Korea, where the growth of heavy industry was accompanied by much stronger labor unions than in other East Asia Pacific countries.

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for labor to organize was granted significantly later in East Asia Pacific countries than in countries in Latin America. The restrictions of Soviet Communism confound further extrapolation to Eastern Europe and Central Asia.

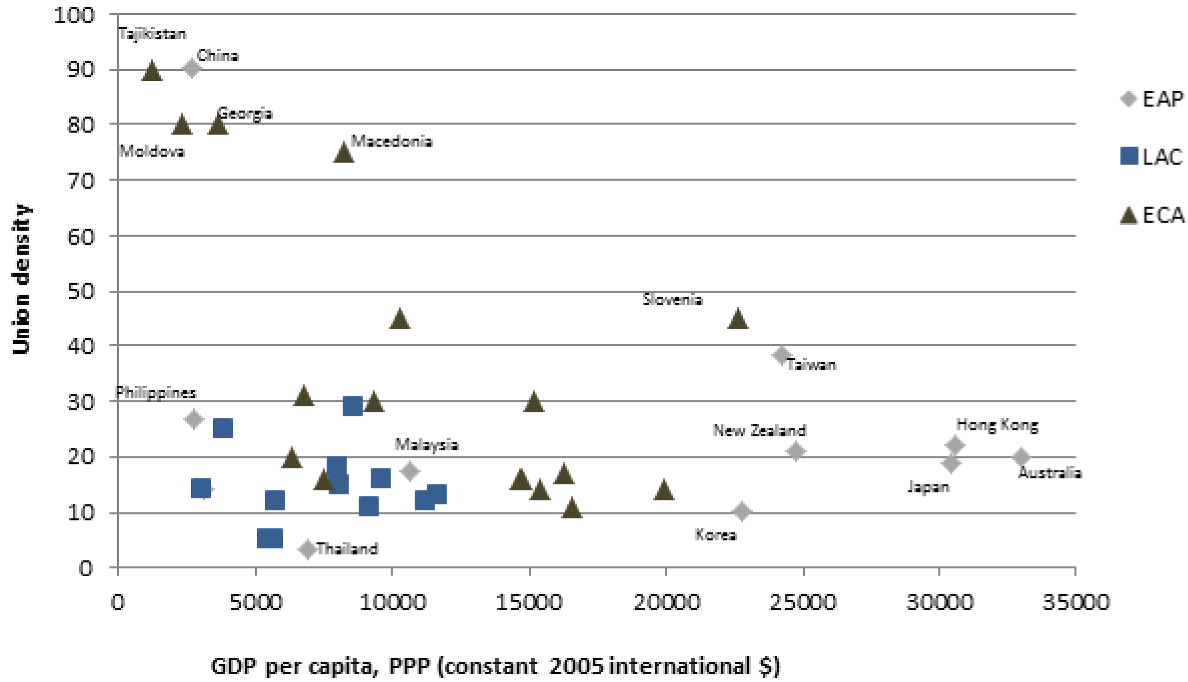
6.62 The extent of unionization (union density) in the countries of East Asia Pacific today is lower than in other parts of the world. But it is difficult to draw a general profile. The Philippines, both culturally and institutionally similar to Latin America, has rates of unionization similar to Argentina. However, more workers in Taiwan, China, are members of unions than are in any countries in the Southern Cone of Latin America. As in other regions, membership of trade unions has been declining. A notable exception to this trend is in China.

Table 6.4 Unionization is lower in most East Asia Pacific countries than in other regions.
Union density (union members as a share of the labor force) in selected countries of East Asia, Latin America and European Central Asia

Country	Union density, %	Year of union density, %	Country	Union density, %	Year of union density, %	Country	Union density, %	Year of union density, %
East Asia and the Pacific			*Latin America*			*Europe and Central Asia*		
Australia	20	2006	Argentina	28.9	2002	Albania	20	2006
China	90.3	2000	Bolivia	25	2006	Bulgaria	16	2001
Hong Kong	22.1	2002	Brazil	18.1	2002	Czech Rep.	14	2004
Indonesia	14	2005	Chile	12	2001	Estonia	11	2005
Japan	18.7	2005	Costa Rica	15	2002	Georgia	80	2005
Korea, Rep.	10.3	2005	Ecuador	12	2002	Hungary	17	2004
Malaysia	17.5	2000	El Salvador	5.3	2003	Kazakhstan	31	2002
New Zealand	21.1	2004	Honduras	14	2003	Latvia	16	2006
Philippines	26.8	2002	Mexico	13	2001	Lithuania	14	2006
Singapore	18.5	2006	Panama	11	2005	Macedonia	75	2006
Taiwan	38.3	2003	Peru	5	2002	Moldova	80	2005
Thailand	3.3	2006	Uruguay	15.9	2000	Poland	16	2006
						Romania	30	2005
						Russian Fed.	45	2003
						Slovak Rep.	30	2004
						Slovenia	45	2004
						Tajikistan	90	2006

Source: Data derived from OECD stats 2010; Hall-Jones 2010, and Johnson 2004.

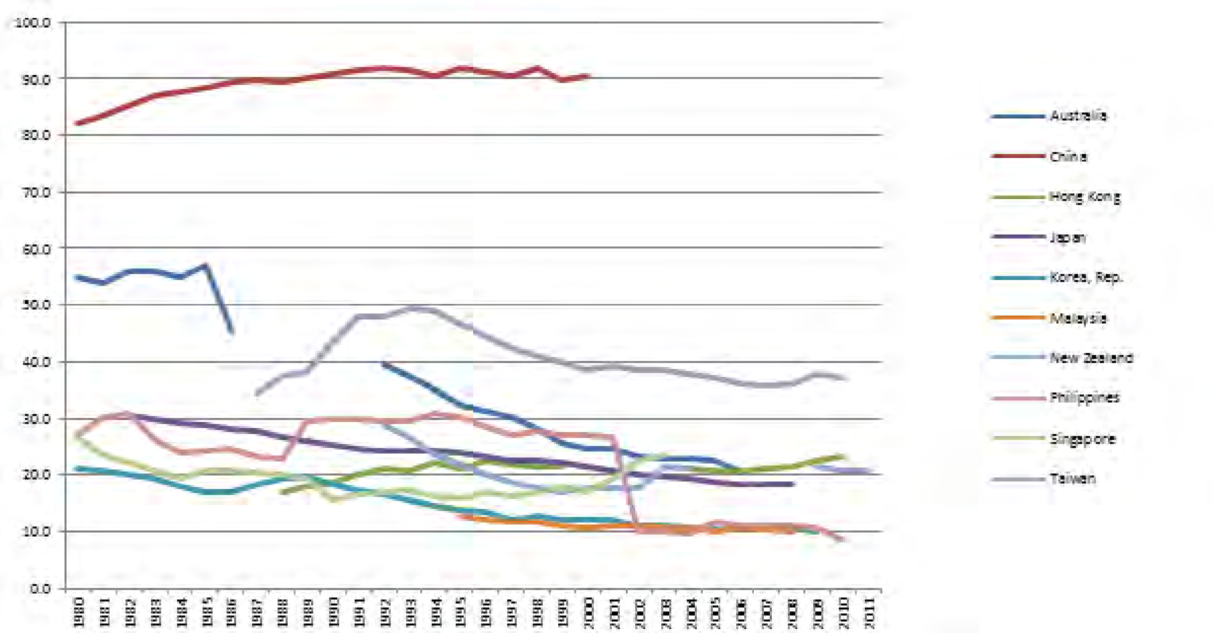
Figure 6.6 Unionization in East Asia Pacific is low, taking account for level of development.
Union density (% of union members among paid dependent employment) by GDP per capita across East Asian Pacific countries, compared to Latin America and Europe and Central Asia.



Source: Staff estimates based on GDP per capita data derived from World Development Indicators, combined with union density data derived from OECD stats 2010; Hall-Jones 2010, and Johnson 2004. Note: Data on union density are provided for the most recent year between 2000 and 2010, matching GDP per capita data for the same year. Singapore is the only EAP country that has been omitted as it is an outlier with GDP per capita at about $48,000 in 2006.

Figure 6.7 Other than in China, across East Asia Pacific union membership has been declining.

Union density (share of total paid dependent employment) in East Asia Pacific countries



Source: Data derived from ILO: http://laborsta.ilo.org/xls_data_E.html Note: The figure includes all years and all countries in EAP for which data on trade union membership is available. In terms of the drop in union membership in the Philippines in 2001, this was due to multiple-counting of membership (i.e. company workers being captured in the statistics of several competing unions), and due to the inclusion of inactive unions (i.e. inactive union names remaining on the registry list), which together inflate the country's statistics on unionism. After 2000, efforts were taken to capture the real number of unions and union membership, one of which was to distinguish between active and inactive unions (Ofreneo and Hernandez 2011).

Table 6. 5 Outside of China, the number of labor unions has also been declining

Trends in the number of trade unions in East Asia Pacific countries

	Earliest and latest year of data			% change over time
		Earliest year	Latest year	
Australia	1980-1995	325	142	-56%
China	1980-2010	376,000	1,976,000	426%
Hong Kong	1989-2011	439	788	80%
Japan	1980-2009	72,693	56,347	-23%
Korea, Rep.	1980-2008	2,618	4,886	87%
Malaysia	1980-2010	391	690	77%
New Zealand	1992-2011	58	145	150%
Singapore	1980-2010	83	65	-22%
Taiwan	1987-2010	2,510	4,924	96%

Source: Calculations based on data derived from ILO: http://laborsta.ilo.org/xls_data_E.html
Note: The Philippines has been omitted due to lack of comparability as a result of the new calculation methodology applied in the early 2000s

6.63 A key factor that has sapped the strength of organized labor in many countries, and particularly in East Asia Pacific countries, is the tendency of labor unions to be narrowly aligned with sectors where dependent, full time work is the dominant form of engagement. The inclusion of groups that mobilize people in other forms of work –like India's Self Employed Women's Association (SEWA), and globally, the Service Employees International Union - is still uncommon in the organized labor movements of most countries in East Asia Pacific.

6.64 The growth of organized labor in many East Asia Pacific nations is also significantly hindered by the reluctance of unions to recognize migrant workers and workers employed in services, and in the "private" (domestic) sphere (Ford, 2004). Labor unions around the world are facing a similar existential threat. People in self-employment, irregular employment, and migrant workers, particularly working women, are often overlooked by organized labor as a significant source of grassroots mobilization. The bargains labor unions strike for members can come at the cost of unrepresented workers. However, labor unions in high income countries with large, fast-changing service sectors have begun to reach out enthusiastically to working people with more heterogeneous profiles. In East Asia Pacific, NGO-sponsored migrant labor organizations and associations in Indonesia and Hong Kong are a part of this trend, and providing a wider segment of working people with opportunities to engage in labor institutions (Ford, 2004).

Box 6.2: Do trade unions have a hand in monetary stability?

Central banks are not the sole administrators of inflation. Trade unions also influence price developments in the macro-economy as their bargaining on wages is reflected in product prices and thus inflation in the goods market. While it is often assumed that labor unions are only concerned with benefits, and employment levels, they may also favor low inflation, as high levels can undermine real wages. Even though central banks are largely concerned with reducing inflation, some monetary authorities have mandates to reduce inflation and promote employment, while others are not free to always target inflation at the cost of other policy priorities. The competing interests and preferences over inflation and unemployment, among both trade unions and central banks, and their interplay can have important effects on employment levels.

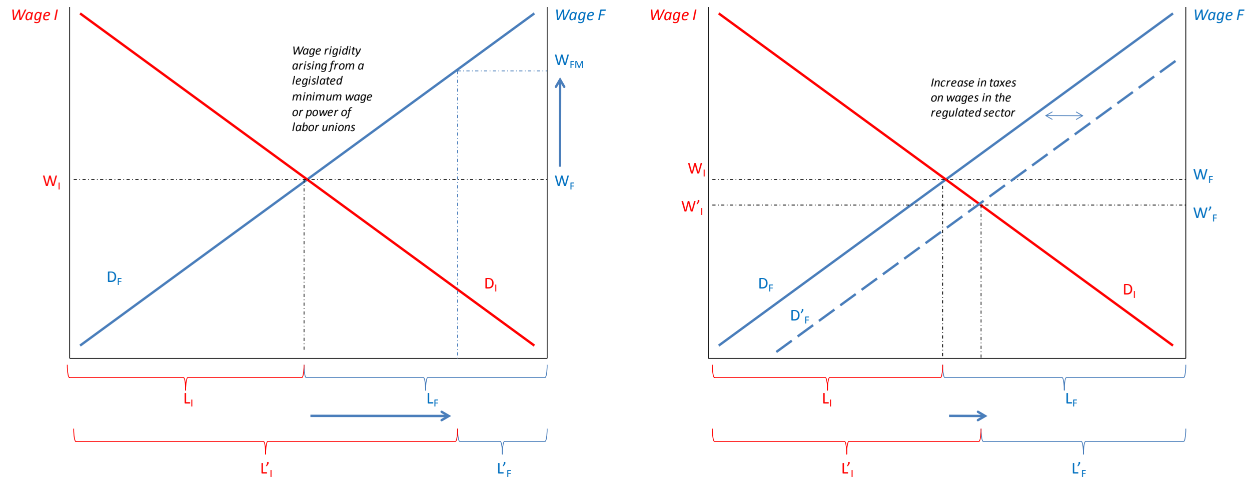
Coricelli *et al.* (2006) distinguish between two potential effects that wage bargaining can have on prices and employment. For one, the *relative price effect* works through goods substitution. Employers pass higher negotiated nominal wages on to consumers through product prices. This reduces demand for the product and in turn the demand for labor in the sector. Second, the *real balance effect* erodes the real money supply, thus helping to impede credit and economic growth. A central bank can avert an economic downturn through an accommodative monetary policy at the cost of higher inflation. On the other hand, it can also aggravate a downturn by tightening the money supply further to tackle inflation.

In conditions when unions are more concerned about unemployment than with inflation, a conservative, independent central bank is welfare-improving. The credible threat to tighten the money supply to keep inflation in check can discipline unions in their wage demands and thus stabilize inflation and employment. However, when unions care about inflation or internalize the cost of their wage demands on the economy (as is often the case in centralized bargaining systems), the central bank can be more accommodative. Yet most studies on these interconnected relationships are largely based on developed economies. While the degree of central bank independence differs largely across East Asia, unionization is generally low in the region. It is thus unclear to which extent central bank independence and unionization matter more for employment in East Asia.

6.4 The impact of labor policy on work and earnings

6.65 The text-book predictions of how regulations like a minimum wage and restrictions on dismissals, or interventions that create a wedge between the cost of labor and what people take home, are well known and actively debated. A large literature has been produced applying the text-book models in countries where most people work beyond the reach of regulation and taxes (Figure 6.8) in the informal economy (Perry, Maloney, Arias, Fajnzylberm Masonand Saavedra-Chanduvi, 2007, Packard, Koettl and Montenegro, 2012). The last three tables of the annex to this chapter, present simple conditional correlations between aggregate (country level) measures of informal work and labor policies. These are interacted with measures of governance and administrative capacity. In East Asia Pacific, as in other regions, the picture that emerges from these simple correlations using aggregate data is mixed.

Figure 6.8 The predicted impact of labor market policies from text book models is well known.



Note: In a two sector model, the size of the formal labor force is shown by L_F and the informal labor force by L_I. Imposition of a minimum wage (or the power of unions representing formal workers) pushes the formal wage from W_F to W_{FM}, causing L_F to contract to L'_F and L_I to expand to L'_I. All else equal, similarly qualified workers would prefer employment in L'_F.

Note: Restrictions on dismissal or increasing taxes on labor shift the demand curve for formal labor, causing L_F to contract to L'_F, and LI to expand to L'_I.

Source: Adapted from Perry, et al (2007)

6.66 "Segmentation" of the labor market can happen when a floor is imposed on wages - either from an actual legislated minimum wage or from the strength of labor institutions, such as a collective bargaining process and the power of labor unions in this process – which forces a wedge between the earnings of workers not covered by these arrangements and those that are. The traditional models predict that a minimum wage increases labor costs for firms and prevents them from offering formal employment to workers whose marginal productivity does not exceed the minimum. The effect will be stronger for workers with the lowest marginal productivity, especially younger, less experienced workers. "Priced out" of formal employment, they can join those genuinely unemployed, take informal employment, or seek formal work while working informally. Workers who remain employed – those with higher marginal labor productivity – benefit from higher earnings.

6.67 Elaborations in the literature, however, reveal more ambiguity about the effect regulations and interventions can have. A minimum wage might motivate workers to increase productivity in the "efficient wages" framework (Rebitzer and Taylor, 1995; Manning, 1995), or persuade job seekers and some waiting outside the labor market to hold out for a formal job even if plenty of informal employment is on offer. To the extent that employers have to report to the tax authorities at least the portion of their wage bill equivalent to some multiple of the minimum wage, raising the minimum might in some circumstances force "formalization" at the margin of transactions and inputs to their production process.

6.68 There is even less agreement on the effects of employment protection legislation on outcomes. EPL can reduce flows into, but also out of unemployment. EPL reduces turnover and increases average tenure. But it can slow new employment if restrictions on dismissing workers make employers wary before taking on someone new. These restrictions increase the attraction of using fixed-term contracts and past a certain threshold can cause employers to hire informally. For instance, in the face of waning demand, EPL will reduce lay-offs, but if firms' ability to adjust has been too constrained, even when demand rises again, employers might pause knowing they could face high dismissal costs should demand drop. While EPL can encourage employers to invest in training to make their workers more productive, it can also slow productivity growth if it acts as an obstacle to creative destruction that forces firms to keep unproductive workers. Employers that are unable to easily change their workforce to keep up with new technology or otherwise align it with changing company needs can soon find themselves at a competitive disadvantage.[20]

6.69 The impact of interventions like unemployment benefits is also ambiguous. On one hand, unemployment benefits increase the quality of matches between employers and workers. As job-loss does not leave a covered protected worker desperate, they are able to search with greater care, facilitating a more efficient job-matching process (Boeri and van Ours; 2008). If the quality of matching between firms and workers improves, structural unemployment can fall. On the other hand, insurance benefits may give unemployed workers a reason to search with less effort and intent than they otherwise would have, and to turn down available work. If the level of unemployment benefits is high, or the maximum duration of benefits is long, the urgency of finding new work is diminished. This moral hazard can lower the intensity of job search and lengthen spells of unemployment (Mortensen, 1977).

6.70 Most reviews of empirical evidence reflect these ambiguities in economic theory. Trying to identify the impact of any these measures is made more difficult by obvious differences in what a country mandates de jure, and what firms and households practice de facto. Despite what the labor code and social protection laws say, these are partially and poorly enforced in many low and middle income countries. Actual restrictions on the choices of firms and individuals are in most cases far less binding than what the laws intend. This may be one of the best explanations as to why employers in East Asia Pacific countries do not identify labor regulation, interventions and institutions as binding constraints to their growth. As mentioned in Chapter 4, countries in East Asia Pacific stand out for having the lowest share of firms that report that regulations like minimum wages and other labor laws are a "major" or "severe" obstacle to the operation and growth of their businesses. Revealingly, employers in countries with very rigid regulation such as Indonesia, Vietnam and Lao PDR are far less likely to identify labor regulation as a major or severe constraint in doing business (Figure 6.9).[21]

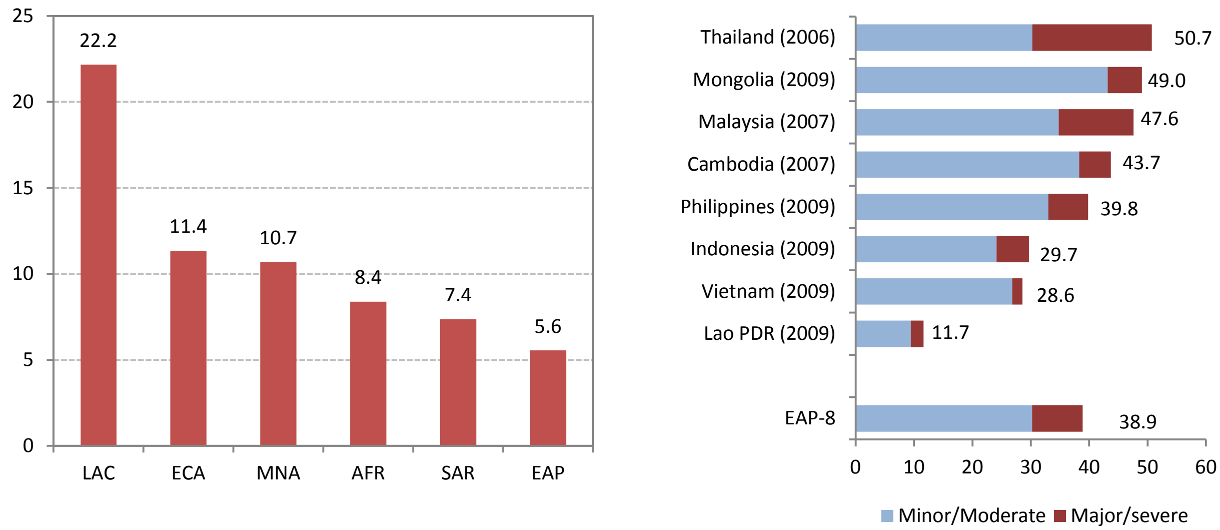
[20] This constraint can be offset if firms become more selective with the new hires and by encouraging them to invest more in workers' training (Boeri, 2003).

[21] This said the impact of stringent labor regulation may be showing up in other responses to firm surveys. Firms in several East Asia Pacific countries rank "practices of the informal sector" as a pressing problem, which could reflect the competition from firms able to evade regulation and thus gain market advantage.

Figure 6.9 Firms in East Asia Pacific countries are less likely to report labor regulations are a constraint on their growth, even where the labor code is de-jure restrictive.

(a) Percent of firms identifying labor regulations as a constraint by region

(b) Percent of firms identifying labor regulations as a constraint by countries

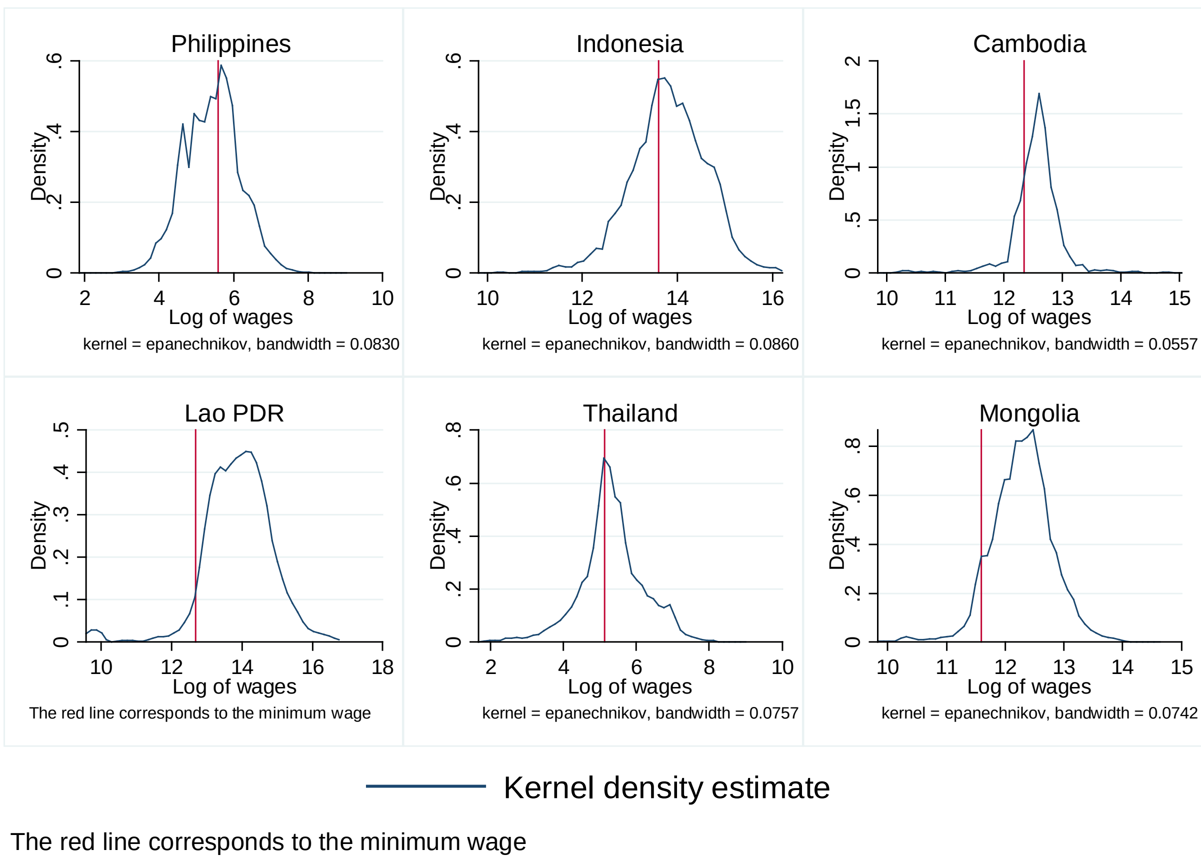


Source: World Bank, Investment Climate Surveys

6.71 High levels of unregulated work in East Asia Pacific –variously referred to as "informal" or "vulnerable", including self-employment, as discussed in Spotlight 1–are likely to be both a result of regulations and interventions, as well as a reason why restrictions in the labor code are not broadly observed in practice. In most low and middle income countries, including those of East Asia Pacific, limited compliance combines with low levels of administrative capacity in government to enforce the law (Caraway, 2008). And while economic theory may be ambiguous about the impact of regulation and interventions when they are perfectly applied, there is greater consensus that the effects of partial or poor enforcement will be negative (Betcherman, 2012). In Cambodia for instance, the law mandates that all workers in the garment sector must be paid at or above the minimum wage; however, the mean level of wage compliance at the firm level in the sector is around 80 percent. Nearly 20 percent of workers in the apparel sector earn less than the minimum wage. Noncompliance rates in Thailand and Indonesia are estimated to be as high as 30 percent. Noncompliance in Vietnam is estimated at about 10 percent (World Bank, 2013a)

6.72 So what does the available empirical evidence show? Figure 6.10 shows the distribution of earnings in six East Asian countries. There is a clear clustering around the national minimum wage line (taken as the average statutory minimum wage level) in three of the six countries. In the Philippines, Indonesia, and Thailand, a large share of working people are earnings wages below the statutory minimum levels. About 51 percent of workers in the Philippines report making less than the minimum wage. In Thailand and Indonesia around 37 percent and 36 percent of workers are earning less than the minimum wage, respectively. However, the steep slopes as the curves approach the minimum wage line (in the case of the Philippines, a sharp, horizontal rise) indicate that for a significant portion of workers, the minimum wage is binding. The steeper the approach of the distribution curve to the minimum wage line, the more likely that increases in the minimum wage will lead to dismissals or the informalisation of employment contracts for those at wage levels close to the minimum.

Figure 6.10 A large share of workers are earning less than the minimum wage
Distribution of wages, Kernel density plots



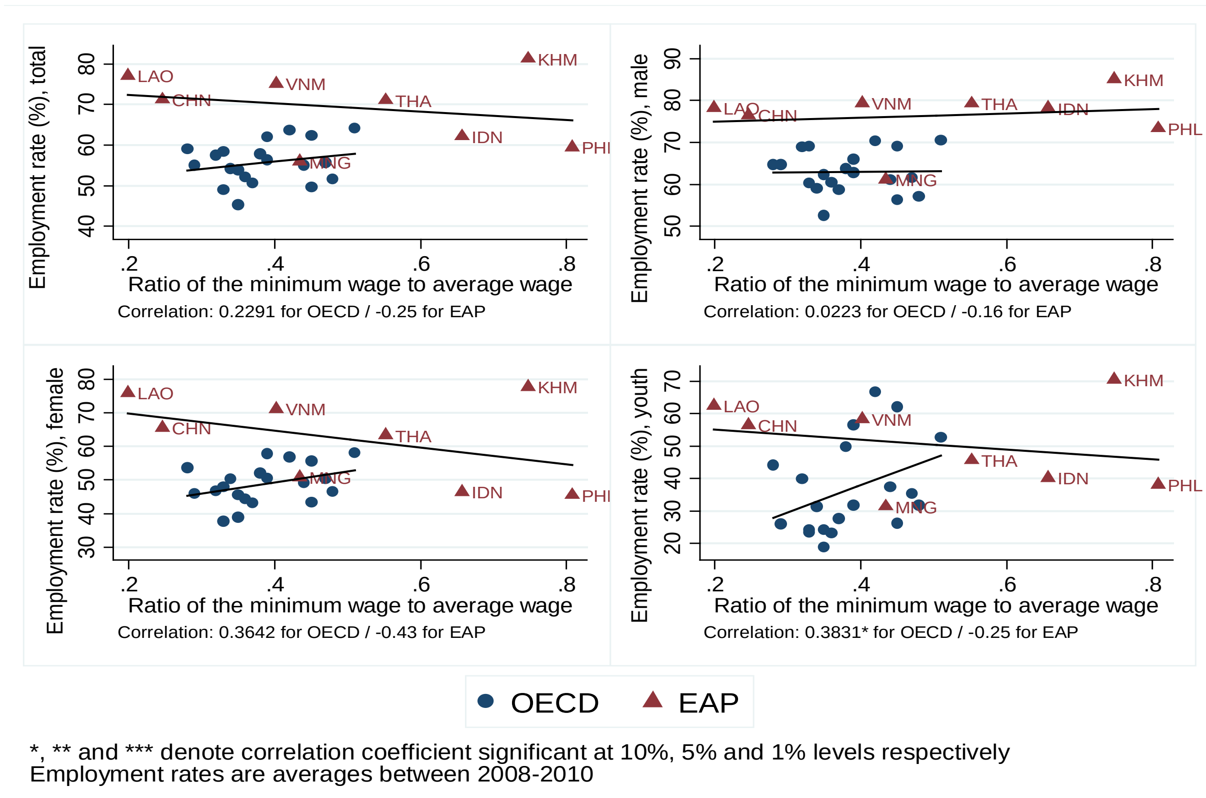
Source: World Bank (2013b)

6.73 Whether the introduction or an increase of the statutory minimum wage has a positive effect on earnings and productivity or a negative impact, largely rests on whether workers with lower marginal labor productivity remain employed. If after the introduction or increase of minimum wages, these people can find or remain in work that pays the minimum, the impact is likely to be positive.[22] Figure 6.11 suggests only a weak relationship between higher minimum wages and employment. The reported correlations are not statistically significant, and there are too few observations and high dispersion in the data for proper inferences to be made. Yet the ambiguous picture is consistent with findings of more rigorous empirical studies from

[22] In terms of productivity, if a mandatory floor on wages can create incentives for firms to increase the output of their workers by investing in training or new technology, the aggregate impact can be positive.

middle income and high income countries around the world, indicating that when statistically significant, the effects of minimum wages on aggregate employment are negative but only very modest (Betcherman, 2012, World Bank, 2013a). Where a positive impact on employment is found, it can usually be explained by stronger enforcement capacity, or fewer options for employers to offer unregulated employment to workers with low marginal labor productivity.[23]

Figure 6.11 The relationship between the level of minimum wages and employment is weak.
Minimum wage ratio of level to average wage and employment rates



Source: Staff estimates

6.74 The evidence from research in East Asia Pacific where a large informal economy in most countries introduces greater discretion for firms and workers shows more significant negative effects, particularly on workers in smaller firms. Much of the rigorous empirical work is from Indonesia, where good data and relatively frequent changes and variation in how minimum wages are applied across the country offer opportunities to study the impact of this policy in detail. Alatas and Cameron (2008) study the effects of minimum wage changes in Indonesia between 1990 and 1996, prior to the East Asian crisis, on the employment of production workers in clothing, textiles, footwear, and leather firms in greater Jakarta. They find a negative employment impact on people in small firms, but not on people working in large firms.

[23] Although theory predicts that minimum wages are likely to hurt the chances of young people, the slightly positive relationship between the minimum wage and youth employment for OECD countries (bottom, right-hand quadrant of Figure 6.11) is also consistent with a few studies, attributing this positive outcome to well enforced minimum wages attracting younger people with low labor productivity into work.

Similarly, Harrison and Scorse (2010) find that a 10 percent increase in real minimum wages in Indonesia reduces employment of production workers by an average of 1.2 percent in foreign-owned, exporting firms in the textiles, footwear, and apparel sectors.[24] They also find evidence of reduced investment, falling profits, and a greater likelihood that smaller registered (formal) firms will go out of business. More recent analysis of the Indonesian manufacturing sector covering the period 1993 to 2006, also finds that minimum wage increases have a clear and consistently negative employment impact on small firms, but a limited impact on employment in large firms. However, since there are many more small firms, the aggregate effect of rising minimum wages in Indonesia's manufacturing sector is to lower formal employment (Del Carpio, Nguyen and Wang, 2012).[25]

6.75 In the Philippines, Del Carpio, Margolis and Okamura (2013) find that real minimum wage increases had negligible effects on overall employment, owing to limited coverage of the regulation and high rates of non-compliance. However, in sectors of the Philippine economy with high coverage and compliance, Lanzona (2012) finds negative effects on employment. A 10 percent increase in the minimum wage in manufacturing reduces formal employment in the sector by up to 8 percent (World Bank 2013b). In Vietnam where minimum wages are high relative to average wages, Nguyen (2011) finds that increases in the minimum wage results in a reduction of formal employment. Again in Indonesia, Comola (2011) finds that an increase in the relative minimum wage (minimum-to-mean wage ratio) is associated with an increase in informal employment, which in turn offsets the corresponding destruction of formal jobs, and yields a net increase in total employment. Lower overall employment in the wake of a minimum wage increase is largely concentrated among labor-intensive firms with unskilled or less-skilled workers (Del Carpio, Nguyen and Wang, 2012).

6.76 Where administrative and enforcement capacity is stronger and compliance is more widespread, the introduction of a minimum wage could have positive effects on both formal employment and output. More workers would be willing to work at the higher wage, and employers would still make profits and be willing to hire. This was the case in Malaysia and Hong Kong, prior to the introduction of their minimum wage policies in 2010 and 2011/12 (World Bank, 2010). Thus the extent of coverage and compliance with minimum wage policies is a critical determinant of their overall impact on employment and earnings. As discussed earlier, if a large proportion of workers are not subject to minimum wage—whether due to legal exemptions or low compliance—minimum wage adjustments will likely have limited impact on overall employment.

6.77 An additional complication in predicting the outcomes of a minimum wage policy arises where there is a greater degree of integration and higher mobility of factors between the formal and the informal economy. In countries with very competitive factor markets, where

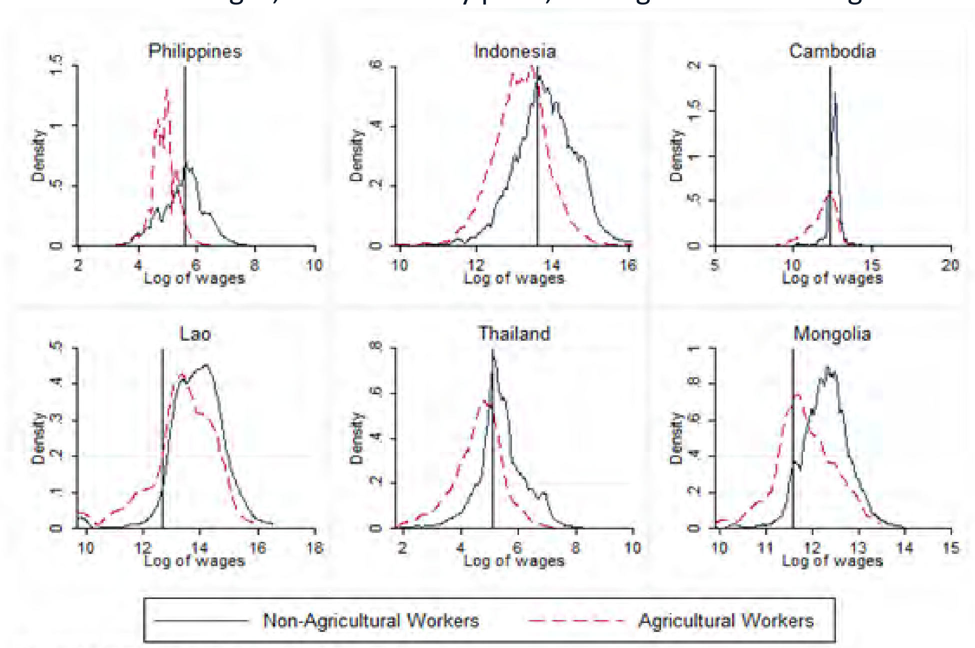
[24] Islam and Nazara (2000), Suryahadi et al (2003), and Pratomo (2011) also find negative effects of minimum wages on overall employment and earnings in Indonesia.

[25] Also in Indonesia, Rama (2001) finds a negative employment effect among firms with 20 or fewer workers, but a positive effect for medium-sized and large firms. Magruder (2011) shows that rising minimum wages in the early 1990s, increased employment for some sectors, although not in the manufacturing sector.

the distinction between formal and informal is defined mainly by compliance with taxes and entitlements to social benefits but little else, and where employers are competing to attract workers, a statutory minimum wage can inform the negotiation of informal labor contracts. A statutory minimum wage in these contexts can have a signaling or "light house" effect (Neri, Gonzaga and Camargo, 2000). Set at levels reasonably related to workers' productivity, the minimum wage has an impact on the earnings distribution of all workers in dependent employment.[26] Looking again at the distribution of earnings around the statutory minimum wage, in Figure 6.12 the reported earnings of agriculture workers are added separately, as a proxy for informal dependent labor. Unfortunately, no better variable to identify informal wage employees is available in these labor market surveys. Interestingly enough, the earnings of agriculture workers appear to be affected by statutory minimum wage, as indicated by the clustering of reported earnings around the vertical line. This is true even in countries where statutory minimum wages are de jure limited to contracts in certain sectors, like Cambodia where the minimum wage policy should inform only contracts in the garment sector.

Figure 6. 12 De jure minimum wages have an impact on de facto earnings, even for informal workers

Distribution of wages, Kernel density plots, non-agricultural and agricultural workers



The black line corresponds to the minimum wage

[26] There are examples from several countries in which the statutory minimum wage helped narrow the gap between formal and informal wages, by providing a clear signal of what the market wage rate for similar skill sets should be, and changing the equilibrium efficiency wage in (at least parts of) the informal sector (Dinkelman and Ranchhod, 2010). Recent studies have shown this lighthouse effect in Brazil and Ghana (Boeri et. al. 2010). Gindling and Terrell (2004) also find that in Costa Rica, increases to the minimum wages narrow the wage gap between formal and informal sectors. They argue that an increase in the minimum wage raises wages not only in the urban formal sector (large urban enterprises) but also across all workers covered and uncovered by minimum wage legislation (likely in small urban enterprises, large rural enterprises and small rural enterprises). In other words, the minimum wage functions as a signal to the entire labor market.

6.78 Although the impact of minimum wages on overall employment can vary widely, the negative impact on employment and in the form of higher unemployment among women and younger workers is a more consistent finding across countries. Rising minimum wages in Indonesia disproportionally lower the employment opportunities of women with low skills, younger workers, and recent entrants to the labor market (Del Carpio, Nguyen and Wang, 2012). In several countries in East Asia Pacific, research has found that women generally bear a higher burden of employment losses compared to men. In Thailand, increases to the minimum wage level had an adverse impact on employment of women, low-skilled workers, and elderly workers (Del Carpio, Messina and Saenz de-Galdeano, 2013). In Vietnam, men are more likely to earn higher wages than women and are less likely to be working for less than the minimum wage. Women are more likely to be earning at levels close to (below and above) the minimum wage level. This makes working women in Vietnam more vulnerable than men to changes in the minimum wage level (Nguyen, Nguyen and Wang, 2013).[27]

6.79 The gender impacts of minimum wages can also differ by type of worker, as illustrated again by research from Indonesia. An analysis of production and non-production workers found that for people in non-production employment – that is, those not directly involved in the firms production, such as cleaners, guards and caterers- a rise in the minimum wage disproportionately hurts women. A 10 percent increase in the minimum wage lead to a 0.6 to 0.7 percent decline in employment of women non-production workers in small firms (Del Carpio, Nguyen and Wang, 2013).

6.80 Turning to other labor regulations, a review of evidence from around the world indicates employment protection has only a modest effect, lowering employment and raising unemployment, and motivating people to work informally (Betcherman, 2012).[28] However, like the impact of minimum wage regulation in East Asia Pacific countries, the prejudicial impact of employment protection measures on young people and women is more consistently found. Indeed, in the countries of East Asia Pacific for which empirical work has been cited in this chapter, it is difficult to un-package the impact of employment protection from that of the minimum wage. But whereas the prejudicial impact of minimum wages may be determined more by poor or partial enforcement, even where perfectly enforced, employment protection measures are biased against younger people and those who might prefer or require part time employment (Heckman and Pages, 2004). Poor or partial enforcement of EPL is likely to aggravate these biases.

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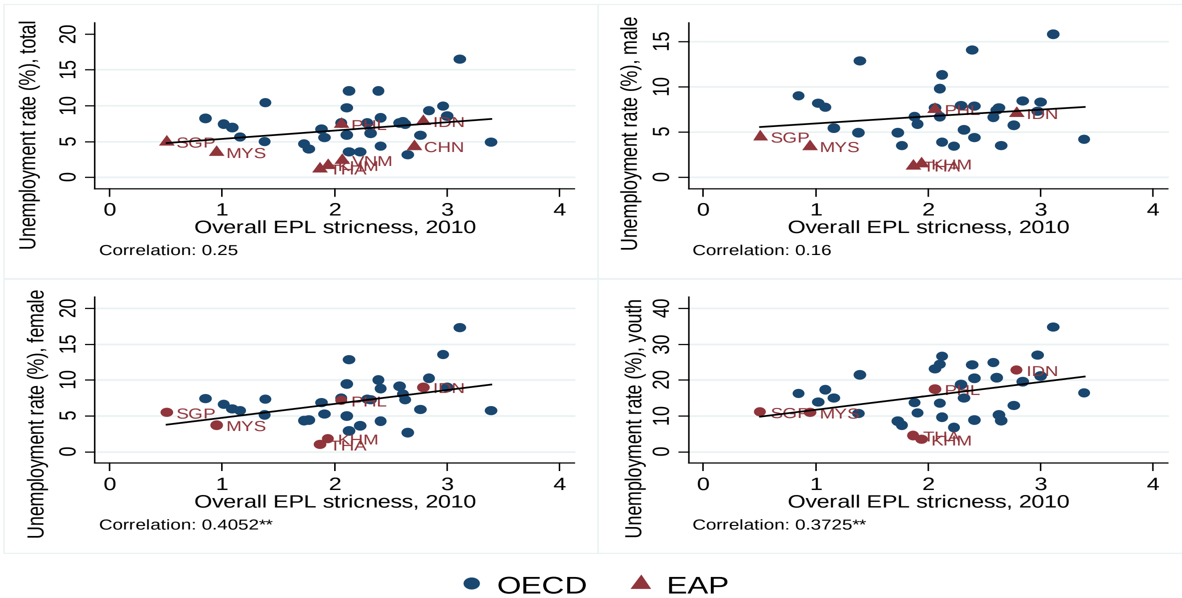
[27] Similar findings are observed in studies from the OECD and Latin America where researchers observe that despite having aggregate gains in employment and wages, when the data are disaggregated by demographic groups, the gains are often concentrated among prime-aged, skilled workers and men who keep their jobs (Cunningham, 2007).

[28] Nickell, (1997), Boeri and Van Ours, (2008); and Sanchez, (2010).

Figure 6.13 In East Asia Pacific countries, restrictive employment protection is associated with higher unemployment among women and youth.

EPL and labor market outcomes in OECD and East Asia Pacific countries



*, ** and *** denote correlation coefficient significant at 10%, 5% and 1% levels respectively
Unemployment rates are averages between 2008-2010

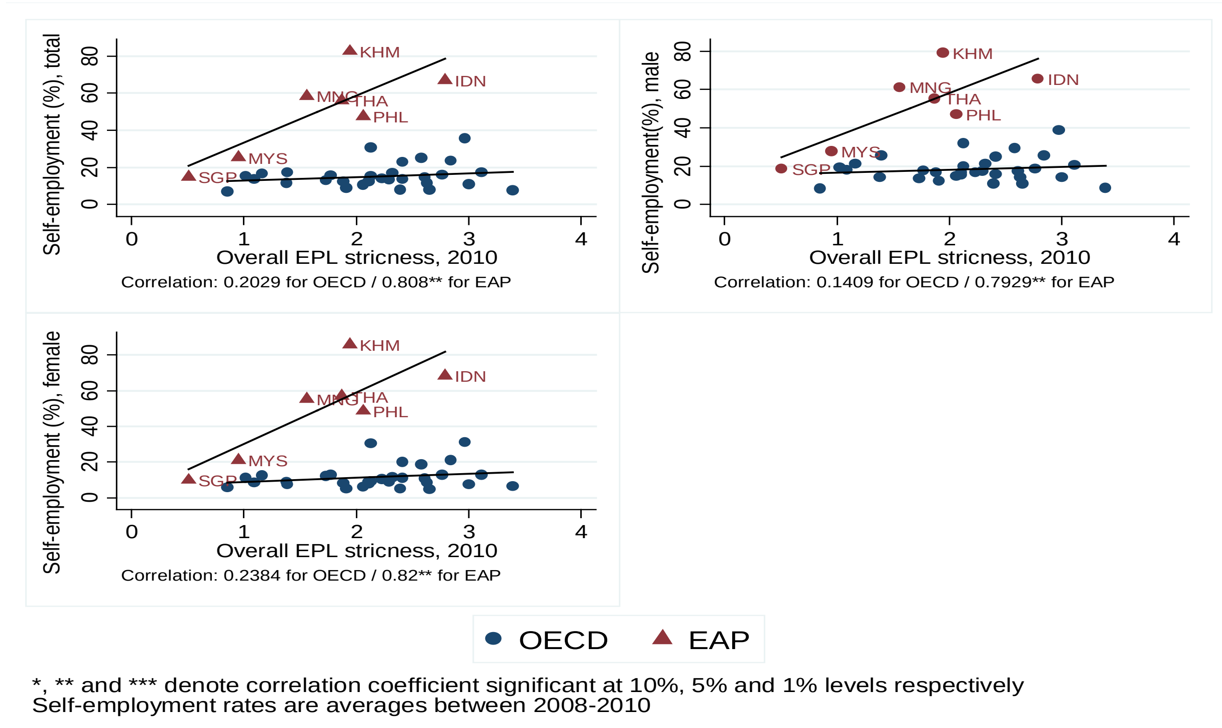
Source: Staff estimates

6.81 Restrictive employment protection regulations are often associated with lower employment of young workers, women, new entrants to the labor market, and unskilled workers (OECD, 2004 and Heckman and Pages 2004, Perry et al, 2007, Packard, et al, 2012). These groups tend to be among the first to be laid off when labor costs increase, or to be blocked from entry altogether (Lustig and McLeod, 1996). In Figure 6.13, the correlations between EPL and unemployment become much stronger and statistically significant for women and young people. And there is clearer evidence of EPL creating segmentation, possibly forcing men and women into self-employment in East Asia Pacific countries. If self-employment is used as a proxy for informal work this finding could indicate that when employers are faced with higher potential costs, they hire fewer workers formally and as a result, many workers, typically those lower skilled, are forced to work informally. In other words, employment protection regulation potentially encourages firms to shift workers from formal to informal contracts when de jure labor costs are too high and enforcement of regulations is weak. More rigorous evidence from countries around the world is consistent: more restrictive EPL raises the share of self-employment and decreasing dependent employment low and middle income countries.[29]

[29] Addison and Teixeira, 2001; Betcherman et al, 2001, Donohue, Schwab, (2006); Besley and Burgess, (2004); Kugler, (2004) for Colombia; and Haltiwanger et al. (2003) for Emerging Europe, Russia, and Ukraine

Figure 6.14 In East Asia Pacific countries, restrictive employment protection is associated with higher self-employment particularly among working women.

EPL and self-employment in OECD and East Asia Pacific countries



Source: Staff estimates

Box 6.3: Temporary contracts and labor flexibility: A cautionary note on partial reforms

Despite a slow liberalization over the last thirty years, restrictions on dismissal in many parts of Europe are still the most constricting in the world, and continue to hamper recovery efforts in the wake of the global financial crisis and Europe's own sovereign debt crisis. Reform to employment protection legislation (EPL) in Europe has been mostly piecemeal and partial. Struggling with high unemployment, in the mid-1980s, several European countries with very restrictive EPL, introduced temporary contracts to increase labor market flexibility. Since then, most gains in employment have been through fixed-term contracts. However, constrained by labor unions with political power disproportionate to their representation among working people -particularly in the public sector- many governments deregulated the use of temporary contracts, but were forced to maintain strict protection for people with open ended contracts. Because temporary contracts involve much lower firing costs, both in severance payments and legal costs, private firms in particular welcomed deregulation. However, after several years of experience, many observers blame these partial reforms for creating dualism, segmentation of the labor market and strong incentives for work to be pushed into informal markets.

Spain is a good example of labor market dualism, with the highest incidence of temporary contracts prior to the global financial crisis, and little possibility of workers moving from temporary to regular employment. In 1984, a two-tier EPL reform liberalized the use of temporary contracts. Spain registered the most rapid growth in temporary jobs, rising from 11 percent of total employment in 1983 to about 35 percent in 1995 (Guell and Petrongolo 2007). But Spain is far from unique: EU member states that introduced partial EPL reforms have seen an increase in temporary employment since the mid-1980s. Countries that long had less stringent regulations for permanent contracts—like Denmark, Ireland, and the United Kingdom—did not experience the same trend increase in temporary employment.

Younger people are more likely to be employed with a temporary contract. In most EU member states, 40 percent of young people (ages 15–39) are on temporary contracts, especially among those under 25 years of age. The share of temporary employment among workers in the 15-to-24 age group ranges from more than 50 percent in countries like France, Germany, Poland, Slovenia, and Spain to less than 20 percent in Bulgaria, Czech Republic, Latvia, Lithuania, Romania, the Slovak Republic, and the United Kingdom.

Temporary contracts are not, in of themselves, bad. They have both positive and adverse effects on labor markets. They can help make labor markets more dynamic. Bover and Gomez (2004) found that in Spain, exit rates from unemployment into temporary contracts were 10 times larger than exit rates into permanent ones between 1987 and 1994. Bentolila, Dolado, and Jimeno (2008) found that they helped decrease long-term unemployment, especially in periods of high growth. Temporary contracts can help firms to evaluate workers' suitability, and in that sense, can act as a stepping stone to more permanent employment. Temporary contracts can also act as a shock absorber, protecting firms from temporary demand fluctuations by avoiding costly adjustments to their core labor force.

However, the segmentation arises when there is little possibility of movement from temporary to open-ended contracts. Where employment protection for workers on open-ended contracts remains particularly restrictive and the employment benefits protected are relatively generous, temporary contracts can be an easy way for firms to reduce labor costs by substituting permanent with temporary workers. These incentives can eventually lead to exclusion and adversely affect productivity and investment in skills. Boeri and Garibaldi (2007) found that the share of temporary workers in Italy had a large negative impact on firm-level productivity growth. Rising employment in the aftermath of two-tier EPL reforms, led to falling labor productivity through decreasing marginal returns to labor. Although the Spanish and Italian experiences with partial liberalization of EPL led to an increase in turnover, a reduction in long-term unemployment, and greater employment, they were also associated with a fall in investment in firm-specific skills and a decrease in labor productivity.

Germany's experience has been much better, as deregulation of EPL was accompanied by incentive-compatible reforms to social protection benefits. Prior to the Hartz reforms in 2004, Germany had average annual unemployment rates of almost 10 percent. In contrast, U.S. unemployment was about 5 percent. By 2004, almost 4.5 million Germans were unemployed. Less skilled and older workers had higher unemployment rates; vocational school graduates and high school dropouts had unemployment rates of about 18 percent. The reforms were implemented between 2003 and 2005. They modernized public employment services and social welfare centers, modified existing active labor programs, and introduced new ones. They changed the institutional and legal framework for the rights and responsibilities of the unemployed and beneficiaries of social assistance. But as with other parts of Europe, employment protection was reduced for only certain segments of the labor market.

Germany's Hartz reforms have helped reduce unemployment dramatically. Despite the crisis, Germany's unemployment rate today is lower than the U.S.. Many of the newly introduced part-time and temporary jobs have served as a bridge to regular jobs. But the reforms might also have reduced the income of low-wage earners, which has declined between 16 to 22 percent over the last decade. Net real monthly income of workers in mini-jobs declined from €270 in 2000 to €211 in 2010, while income of workers in midi-jobs declined from €835 to €705.

Europe's experience has been shared by high income countries in East Asia Pacific with strict employment protection. Duality or segmentation has emerged in Korea and Japan, where the share of "non-regular" workers accounts for about a third of the workforce. Because non-regular workers are typically unable to convert their contracts to more permanent forms of employment, there is now a clear division between "insiders" and "outsiders", similar that found labor markets in Southern European countries. Deregulation in Japan and Korea was motivated by the need to increase labor market flexibility. But in both countries strong interests conspired to limit the extent of deregulation. "Non-regular" workers typically earn much less than similarly qualified regular workers; their earnings tend to stagnate while regular workers at similar levels advance; and non-regular workers typically do not have access to the same protection plans as the regular employees with whom they work.

These experiences with liberalization of EPL raise several questions. First, given the difficulty of comprehensive labor reforms, does a partial liberalization targeted at some groups or sectors work? Second, do allowances in the labor code for more flexible forms of employment lead to a "two-tier" market and a legally sanctioned underclass? Third, do flexible and temporary forms of employment serve as a step towards advancement, or are people who enter through a fixed term or part time job scarred in ways that limit their future options?

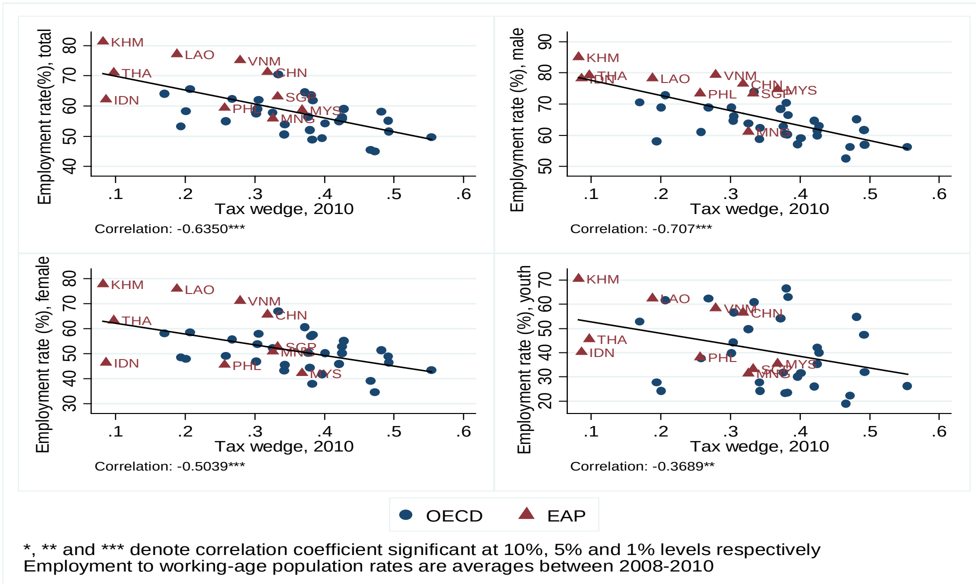
Source: Gill and Raiser (2012), Gill, Koettl and Packard (2013), Balakrisnan, et al, (2013)

6.82 Finally, turning to interventions, most empirical work focusses on the impact of the labor tax wedge on outcomes, since this is a composite (though incomplete) measure of the costs of interventions to employers and workers. Interventions are financed by governments either through ear-marked revenues from mandatory contributions, or from general taxation. In most countries, firms and workers are expected to bear some if not all of the costs of interventions. The labor code can be explicit about what share of mandatory contributions is borne by employers and what share by workers, but in practice which party bears the actual costs is determined mostly by the value workers attach to benefit promises. This is a critical dimension to consider, and one that is even more contingent on the State's credibility and track record of performance. If workers value the benefits of interventions like unemployment insurance, disability protection and pensions, and believe benefits will be available when they are needed, they are more likely to consider mandatory contributions as part of their compensation package. The opposite also holds. This reconciles the apparent paradox of high labor tax wedges and enviable labor market outcomes in Northern Europe, with those in Southern and Central Europe where labor taxes are often lower, but employment outcomes are particularly poor (Packard, et al, 2012, World Bank, 2012).

6.83 In East Asia Pacific countries, a higher labor tax wedge is associated with higher unemployment rates, as well as lower employment rates. The negative and significant correlation between the size of the labor tax wedge and employment remains when considering only women and youth, but in contrast to labor regulations, it appears weaker. With respect to unemployment, however, there is a stronger association between the size of the labor tax wedge and higher unemployment among women and youth. In China, with by far the largest labor market in the region, an attempt with the 2008 Labor Contract Law to expand coverage of social insurance financed from payroll taxes, led to a lower probability that certain workers were covered (Giles, Wang, and Park 2013).

Figure 6. 15 A larger tax wedge is associated with lower levels of employment

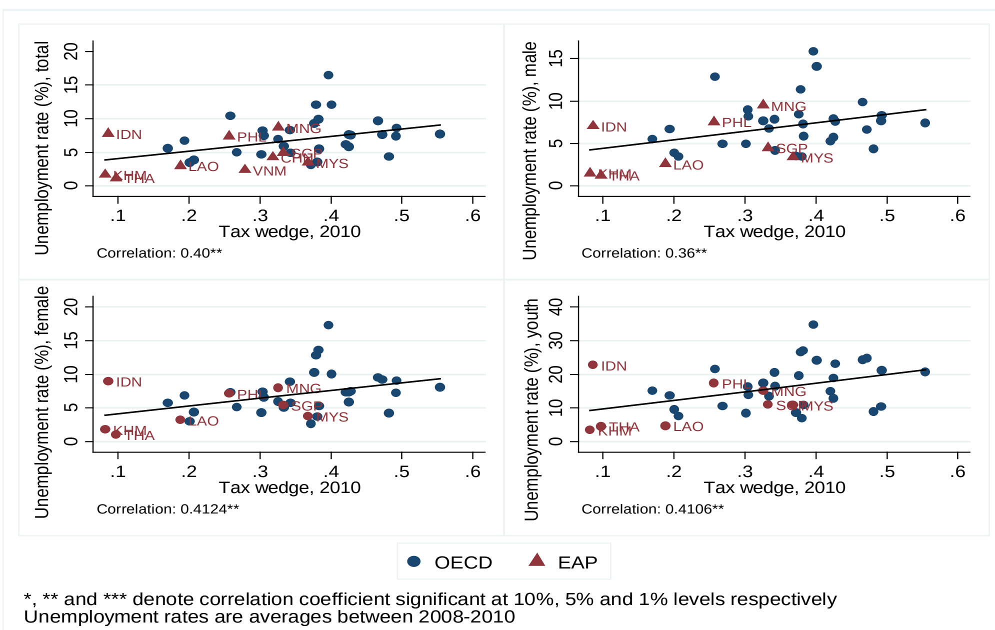
Labor tax wedge and employment rate OECD and East Asia Pacific countries



Source: Staff estimates

Figure 6. 16 A larger tax wedge is associated with higher levels of unemployment.

Labor tax wedge and unemployment rate, OECD and East Asia Pacific countries



Source: Staff estimates

6.5 Conclusions

6.84 Labor regulations, interventions and the institutions from which they emerge, are intended to address the imperfections that exist in labor markets in the form of inadequate information, uneven bargaining power, and insufficient insurance against work-related risks. The effects of these policies on the creation and destruction of employment –and ultimately on people's wellbeing- have long been debated in Europe, the Americas and elsewhere. There is consensus that at very restrictive levels, regulations on earnings and dismissal create damaging distortions of their own, rather than correcting market imperfections.

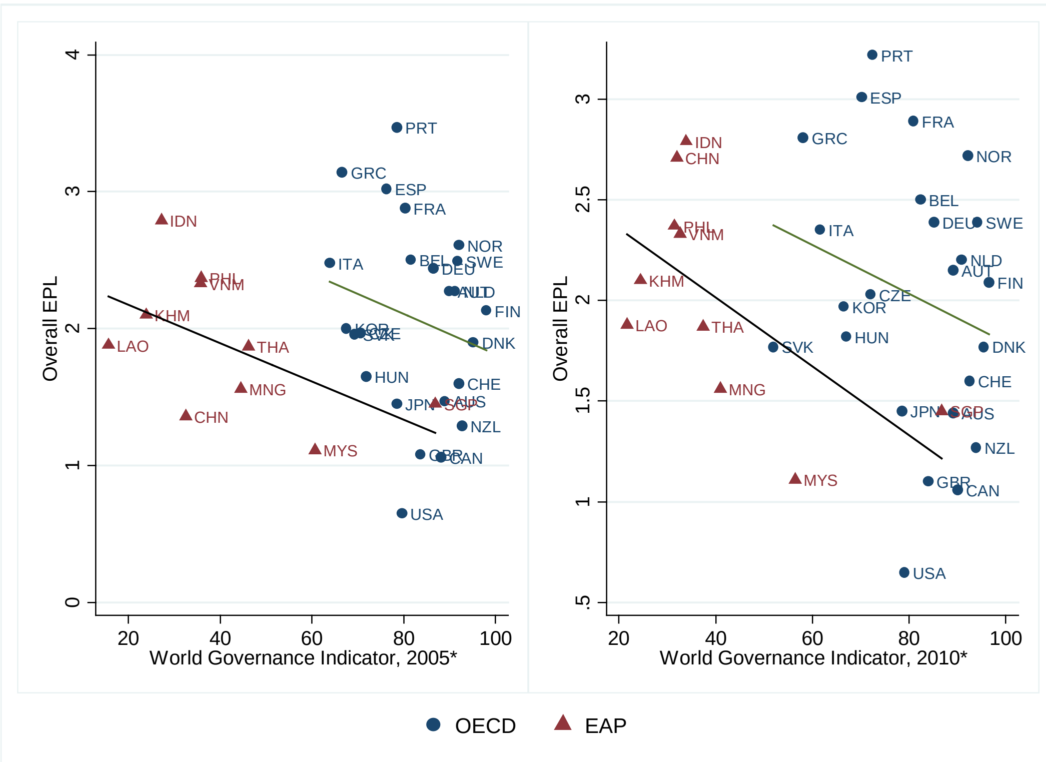
6.85 The WDR 2013: Jobs argues that the relatively modest impact of labor regulations and interventions on the level of employment and wages does not seem to merit the heated tones of the debate surrounding these measures. The report points out that most countries are avoiding extremes of too little and too much regulation, and have placed themselves on a "*plateau*" between these two extreme "*cliffs*". On this plateau, the impact of labor policies on efficiency outcomes (employment, unemployment and earnings) is modest. However, even on the plateau, labor policies tend to redistribute gains toward prime-aged men, at the expense of women, young people, those who need or prefer to work part time, and self-employed people. We argue that this finding comes as little surprise, since the prevailing models of labor regulation and interventions that are most often deployed today were first conceived in countries and during periods in history when men working in full time, dependent employment were the largest group in the labor force.

6.86 The experience of countries in East Asia Pacific with labor market and social protection policies is short relative to that of countries in other regions. The higher income East Asian countries (Japan, Korea and Singapore) exhibit the more modest levels of regulation and protection similar to North American countries, Britain, New Zealand and Australia. However, governments in many low and middle income countries in the region that have started to step into this area of policy making much later than their peers in Latin America and Central Europe, with an orientation similar to that taken in several Southern European countries. A simple reading of the labor codes in several East Asia Pacific countries reveals that in several cases employment regulation is more restrictive than in OECD countries. And in contrast to middle and high income countries elsewhere, recent changes in regulation in East Asia have been toward greater restrictions.

6.87 In East Asia, employment protection legislation (EPL) is most restrictive in Indonesia, where workers whose employment is regulated by the labor code enjoy more protection than workers in France, Portugal or Greece, and only a little less protection than workers in Spain. Regulation on dismissal is also relatively restrictive in China and Lao PDR. With high levels of structural informality and widespread avoidance of labor regulation in the manufacturing and service sectors, restrictive regulations on paper may have little impact on outcomes. Indeed, the relatively restrictive orientation of the labor code in emerging East Asian economies has probably had only minor impact thus far, relative to the impact on employment of of structural change. However, this should not be reason for complacency. These countries also tend to have relatively low levels of institutional development (Figure 6.17). When combined with poor implementation and enforcement capacity, even reasonable labor policies can aggravate the market failures that they were designed to overcome, creating segmentation and social exclusion.

Figure 6.17 Countries in East Asia Pacific combine highly restrictive levels of labor regulation, with low institutional capacity.

EPL and World Governance Indicators, 2005 and 2010, OECD and East Asia Pacific



Note: the World Governance Indicators includes various institutions such as voice, accountability, governance, corruption, regulatory quality, violence, rule of law.

6.88 For firms that are too large to evade –many of them international companies- onerous levels of regulation are a problem, and for many a source of unfair competition from smaller rivals who can still ignore the rules and hire informally. As more people in East Asia Pacific countries seek work in the manufacturing and services sectors, the ability of governments to enforce regulations grows, and firms find it harder to evade, extreme regulations in the labor code could become more binding constraints on wellbeing from work.

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Table A6.1: Summary of minimum wage systems in selected EAP countries

Country and year of introduction	Governmental entity responsible for setting minimum wages	Levels at which Minimum Wages are Determined	Coverage	Frequency of Adjustments
Indonesia (Early 1970s)	Regional governments, following recommendations from the Provincial and/or District Wage Council	Province. Province may set separate rates for district and for economic sectors.	Applies only to workers employed by firms and it is intended to be applied solely to workers with less than a year's service.	There is no specific provision in the law, but in practice minimum wage is adjusted once a year.
Thailand (1972)	Ministry of Labor based on recommendations from the National Wage Commission (NWC), the Provincial Minimum Wage Subcommittees (PSMWCs), and the Subcommittee on Technical Affairs and Review (STAR).	Regional and for sector and occupation. However, in practice rates are only set for provinces. There are today 31 geographically differentiated minimum wages set at decentralized committees in the 76 provinces and Bangkok	All full time workers on a daily base, regardless of nationality.	Annual adjustment. In practice, this rule is not followed.
Cambodia (1997)	Ministry of Labor, after receipt of recommendations made by the Labor Advisory Committee.	Rates are set only for the garment sector. There are only three levels of minimum wages that depend on the experience of workers (apprentice, probationary, and regular levels).	Minimum wage rates have in fact only been set for workers in the textile, garment and shoe-sewing sector.	No scheduled frequency of adjustment identified. The wage is adjusted from time to time in accordance with the evolution of economic conditions and the cost of living.
Lao (2006)	National government	National.	The minimum wage applies to all employees and employers who carry out activities in labor units. It also applies to persons working under written contracts for employment of three months or more. Excludes civil servants.	No scheduled frequency of adjustment identified. The last update was in 2009
Philippines (1951)	Minimum wage rates are to be set at a regional level by Regional Tripartite Wages and Productivity Boards. But the National Wages and Productivity Commission is in charge of reviewing each of the regional minimum wage rates.	Region as well as by industry (agriculture and non-agriculture)	All workers and employees in the private sector	There is no provision in the law for the frequency of minimum wage rates adjustments and changes occur every year or even every 17 months

Table A6.1: Summary of minimum wage systems in selected EAP countries

Country and year of introduction	Governmental entity responsible for setting minimum wages	Levels at which Minimum Wages are Determined	Coverage	Frequency of Adjustments
Vietnam (1992)	The government (i.e. the Ministry of Labor, War Invalids and Social Affairs) determine the minimum wage rate in consultation with the Vietnam General Confederation of Labor and representatives of the employers.	Minimum wage is set for four regions. Vietnam has different minimum wages for different types of enterprises - domestic and foreign owned.	All employees and employers in all sectors of the economy and in all forms of ownership.	The legislation does not set specific time periods for adjustment of minimum wage rate, instead giving the ministry the discretion to vary rates from time to time.
Myanmar (1948)	The President following recommendations from the Minimum Wage Council's.	Minimum wages are set at a sectorial level (public sector workers and workers in rice-milling and the cigar- and cheroot-rolling industries).	To all workers except those who are employed on a casual basis.	There is no provision in the law for the frequency of minimum wage rates adjustments
Malaysia* (2012)	National Government after consultations with the National Wage Consultative Council	Regional. (for Peninsular Malaysia and for Sabah, Sarawak and Labuan)	Private sector workers	N.A.
Singapore				
Mongolia (1995)	Government after taking account of proposals of national organizations representing employers' and workers' interests	National	To domestic business entities or organizations and citizens of Mongolia, foreign citizens or stateless persons;	Minimum wage rate shall be adjusted at least once a year
China (1993)	Local government Each province, municipality, or region sets its own minimum wage in accordance with its own local conditions.	Minimum wage rates exist for each province/region. There are also rates for autonomous regions and municipalities. There are also sectorial rates.	To enterprises, private non-enterprise entities, individual industrial and commercial households with employees (the employing entities), and the laborers who have formed a labor relationship with them.	At least once every two years.

**Malaysia will introduce a minimum wage for the first time. It will come into effect in January 2013*

Table A6.2. Summary of regulation for dismissal of permanent workers					
Country	**Notification procedures**	**Notice period** (4 years tenure) *(In months)*	**Length of the trial period** *(Maximum-in months)*	**Compensation following unfair dismissal** *(Worker with 20 years tenure)* *(In months)*	**Possibility of reinstatement**
Brunei	Consent of the Commissioner is necessary for termination	0.5	<60	0	Yes
Cambodia	Notification to the Labor Inspector is necessary	1	<3	0	Yes
Indonesia	Approval from the institution for the settlement of industrial relations disputes	1	<3	0	Yes
Lao PDR	Approval from the labor authority	1-1.5 depending on workers' skills	1-2	48	Yes
Malaysia	Written statement is enough	1.5	<24	0	No specified in the law
Philippines	Notification to a … (What party we must notify?)	1	6	0	Yes
Singapore	Written statement is enough	0.5	Not specified in the law	0	Yes
Thailand	Written statement is enough	1.0	Not specified in the law	0	Yes
Vietnam	Written statement is enough	1.5	1-2	20	Yes
China	Notice must be given in writing and the labor union notified of the reason in advance	1	6	40	Yes
Mongolia	Written statement is enough	1	6	0	Yes

Source: Countries' labor regulation; ILO-EPLEX

Table A6.3. Fixed term Contract Regulations in East Asian Countries

Country	Valid Reason for FTC use	Maximum number of successive FTC	Maximum cumulated duration of successive FTC	Temporary Working Agencies (TWAs)
Brunei Darussalam	For specific time and type of work	No limitation	no limit	TWAs need a license but there are no limitations on the type of employment
Cambodia	No limitation	No limitation	24 months	No limitation
China	No limitation	2	10 years	Placement of TWAs workers apply to temporary, ancillary and substitute positions.
Indonesia	FTC prohibited for permanent work. Allowed for : temporary, time- bound (i.e work that can be completed within three years), seasonal or experimental	2	36 months	TWAs need a license Are allowed to contract workers for auxiliary service activities or activities that are only indirectly related to production
Lao PDR	No limitations	no limitation	no limit	TWAs are not regulated
Malaysia	No limitation	no limitation	no limit	No restrictions
Mongolia	For a specified term For temporary replacement of worker, seasonal or temporary work and probationary or training period for apprentices	no limitation	no limit	TWAs are not regulated
Philippines	FTC prohibited for permanent work Allowed for specific projects	no limitation	no limit	TWAs do not need registration. No limitations on the work that can be performed, but the Secretary of Labor and Employment, may, by appropriate regulations, restrict or prohibit the contracting out of labor to protect the workers.
Singapore	No limitation	no limitation	no limit	TWAs need a license
Thailand	FTC prohibited for permanent work Allowed for specific projects or for occasional work or for seasonal jobs	no limitation	24 months	No limit.
Vietnam	No limitation	2	72 months	TWAs are not regulated but FTC regulation applies

Source: Countries' labor regulation; ILO-EPLEX

Table A6.4. Informal work, conditional correlations using basic specification

	(1)	(2)	(3)	(1)	(2)	(3)
	"Vulnerable Employment"			Self-employment		
	OLS	FE	RE	OLS	FE	RE
VARIABLES						
Tax wedge	-0.444***	-0.449***	-0.444***	-0.627***	-0.632***	-0.627***
	(0.154)	(0.134)	(0.134)	(0.136)	(0.136)	(0.136)
EPL	2.042	2.107	2.042	4.307*	4.358**	4.307**
	(2.434)	(1.811)	(1.820)	(2.394)	(1.783)	(1.785)
Union density	0.0947	0.0874	0.0947*	0.0139	0.00827	0.0139
	(0.0782)	(0.0542)	(0.0543)	(0.0849)	(0.0546)	(0.0545)
Min. Wage : Av. Wage	0.0426	0.0332	0.0426	0.00830	0.00121	0.00830
	(0.0688)	(0.0618)	(0.0618)	(0.0765)	(0.0628)	(0.0625)
Log of GDP per capita	-12.06***	-12.14***	-12.06***	-12.72***	-12.80***	-12.72***
	(1.777)	(1.324)	(1.330)	(1.817)	(1.345)	(1.345)
Inflation	0.0334	0.0498	0.0334	-0.00462	0.0111	-0.00462
	(0.244)	(0.244)	(0.245)	(0.238)	(0.248)	(0.248)
Constant	142.9***	144.0***	142.9***	154.4***	155.5***	154.4***
	(20.18)	(14.60)	(14.66)	(20.73)	(14.92)	(14.91)
Observations	96	96	96	97	97	97
R-squared	0.630	0.637	.	0.648	0.653	.
Number of period		2	2		2	2

OLS (ordinary least squares), FE (fixed effects), RE (random effects)

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Notes: OLS with cluster robust standard errors (clustering on countries)

Table A6.5. Vulnerable employment, conditional correlations using fixed effect estimation (over two pages)							
VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Tax wedge (tw)	-0.450***	-0.578***	-0.570***	-0.590***	-0.553***	1.426	-1.455
	(0.132)	(0.140)	(0.142)	(0.189)	(0.132)	(1.401)	(2.668)
EPL (epl)	1.958	1.020	37.90***	-2.196	0.472	1.790	-6.312
	(1.765)	(2.224)	(13.38)	(3.065)	(2.190)	(2.302)	(30.68)
Union density (ud)	0.0891*	0.0289	-0.0124	0.0487	-1.325***	0.00721	-1.363*
	(0.0527)	(0.0583)	(0.0590)	(0.0911)	(0.449)	(0.0591)	(0.764)
Min. Wage: Av. Wage (mw)	0.0348	-0.00520	-0.0447	-0.0308	-0.0476	-0.0317	-0.875
	(0.0610)	(0.0647)	(0.0653)	(1.520)	(0.0625)	(0.0630)	(1.591)
Log of GDP per capita	-12.23***	-7.911***	-8.782***	-9.452**	-7.152***	-6.374***	-13.57**
	(1.155)	(2.129)	(2.093)	(3.848)	(2.193)	(2.256)	(5.044)
Government Effectiveness		-6.846**	-21.36**	-3.429	-12.91***	-15.28	-37.23
		(3.057)	(8.257)	(15.97)	(4.623)	(9.496)	(29.35)
Investment Freedom		-0.135	0.113	-0.0401	-0.503***	-0.360	-0.517
		(0.0967)	(0.275)	(0.590)	(0.173)	(0.328)	(0.877)
Trade Freedom		0.187	0.215	0.0370	0.435*	0.237	0.462
		(0.251)	(0.243)	(0.394)	(0.244)	(0.242)	(0.379)
Business Freedom		0.154	0.866	0.750	0.240	0.632	1.256
		(0.150)	(0.526)	(0.730)	(0.250)	(0.514)	(1.260)
Fiscal Freedom		-0.118	0.227	-0.793	-0.384*	0.850	-1.888
		(0.120)	(0.321)	(0.810)	(0.213)	(0.525)	(1.378)
epl*Government Effective			6.828*				4.455
			(3.798)				(7.080)
epl*Trade Freedom			-0.131				-0.333
			(0.127)				(0.244)
epl*Business Freedom			-0.309				0.406
			(0.231)				(0.374)
epl*Fiscal Freedom			-0.152				-0.0952
			(0.146)				(0.365)
mw*Government Effective				-0.193			-0.0698
				(0.396)			(0.427)
mw*Trade Freedom				-0.00205			
				(0.0149)			
mw*Business Freedom				-0.0105			-0.0218
				(0.0177)			(0.0169)
mw*Fiscal Freedom				0.00942			0.0195
				(0.0213)			(0.0222)
mw*Investment Freedom							0.00845
							(0.0157)
ud*Government Effective					0.0927		0.239
					(0.102)		(0.234)
ud*Trade Freedom					0.0124***		
					(0.00443)		
ud*Business Freedom					-0.00163		-0.00638
					(0.00587)		(0.0109)
ud*Fiscal Freedom					0.00967**		0.00837

Table A6.5. Vulnerable employment, conditional correlations using fixed effect estimation (over two pages)							
VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
					(0.00450)		(0.0110)
ud*Investment Freedom							0.0222***
							(0.00807)
tw*Government Effective						0.246	0.674
						(0.267)	(0.534)
tw*Trade Freedom						0.00570	
						(0.00928)	
tw*Business Freedom						-0.0125	-0.0201
						(0.0141)	(0.0202)
tw*Fiscal Freedom						-0.0232	0.0297
						(0.0139)	(0.0300)
tw*Investment Freedom							-0.00307
							(0.0148)
Constant	145.4***	109.5***	35.40	154.1*	123.5***	6.951	254.3*
	(12.82)	(28.03)	(37.96)	(80.57)	(30.69)	(56.03)	(129.8)
Observations	97	92	92	60	92	92	60
R-squared	0.636	0.685	0.726	0.749	0.738	0.725	0.876
Number of period	2	2	2	2	2	2	2

*** p<0.01, ** p<0.05, * p<0.1

Table A6.6. Self-employment, conditional correlations using fixed effect estimation (over two pages)

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Tax wedge (tw)	-0.585***	-0.619***	-0.651***	-0.570***	-0.590***	2.341*	-3.639
	(0.128)	(0.139)	(0.138)	(0.183)	(0.127)	(1.374)	(2.655)
EPL (epl)	3.387**	1.327	44.13***	1.367	0.625	2.413	18.94
	(1.654)	(2.107)	(12.87)	(2.803)	(2.022)	(2.165)	(30.21)
Union density (ud)	0.0266	-0.0283	-0.0498	0.0475	-1.746***	-0.0641	-1.674**
	(0.0505)	(0.0566)	(0.0558)	(0.0892)	(0.432)	(0.0572)	(0.727)
Min. Wage : Av. Wage (mw)	0.0163	-0.0246	-0.0424	-1.196	-0.0823	-0.0560	-1.008
	(0.0587)	(0.0637)	(0.0630)	(1.469)	(0.0599)	(0.0616)	(1.504)
Log of GDP per capita	-11.56***	-9.856***	-10.19***	-11.11***	-8.878***	-8.787***	-11.97**
	(1.109)	(2.089)	(2.010)	(3.859)	(2.108)	(2.201)	(5.053)
Government Effectiveness		-7.501**	-12.94	-10.44	-12.60***	-14.45	-48.27*
		(2.948)	(7.796)	(15.97)	(4.395)	(9.284)	(27.60)
Investment Freedom		-0.0250	0.134	-0.0171	-0.431**	-0.173	-0.270
		(0.0959)	(0.266)	(0.594)	(0.166)	(0.322)	(0.874)
Trade Freedom		0.177	0.182	0.0196	0.441*	0.235	0.450
		(0.248)	(0.235)	(0.394)	(0.235)	(0.237)	(0.381)
Business Freedom		0.149	0.567	0.321	0.156	0.725	0.900
		(0.149)	(0.494)	(0.701)	(0.240)	(0.505)	(1.188)
Fiscal Freedom		-0.262**	0.472	-1.125	-0.602***	1.002*	-2.494*
		(0.117)	(0.301)	(0.812)	(0.203)	(0.514)	(1.315)
epl*Government Effective			2.033				-0.157
			(3.621)				(6.973)
epl*Trade Freedom			-0.0745				-0.361
			(0.123)				(0.246)
epl*Business Freedom			-0.187				0.482
			(0.217)				(0.353)
epl*Fiscal Freedom			-0.355**				-0.430
			(0.139)				(0.367)
mw*Government Effective				0.0233			0.143
				(0.392)			(0.410)
mw*Trade Freedom				-0.00124			
				(0.0150)			
mw*Business Freedom				2.98e-05			-0.0174
				(0.0170)			(0.0165)
mw*Fiscal Freedom				0.0176			0.0209
				(0.0213)			(0.0218)
ud*Government Effective					0.0568		0.306
					(0.0978)		(0.228)
ud*Trade Freedom					0.0138***		
					(0.00426)		
ud*Business Freedom					0.000691		-0.000946
					(0.00563)		(0.0110)
ud*Fiscal Freedom					0.0114**		0.0112
					(0.00434)		(0.0108)
tw*Government Effective						0.201	0.875

Table A6.6. Self-employment, conditional correlations using fixed effect estimation (over two pages)							
VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
						(0.263)	(0.519)
tw*Trade Freedom						0.00317	
						(0.00912)	
tw*Business Freedom						-0.0148	-0.0256
						(0.0138)	(0.0201)
tw*Fiscal Freedom						-0.0317**	0.0579*
						(0.0137)	(0.0294)
tw*Investment Freedom							0.00274
							(0.0148)
ud*Investment Freedom							0.0168**
							(0.00805)
mw*Investment Freedom							0.00616
							(0.0158)
Constant	145.6***	138.3***	51.86	208.4**	162.6***	5.892	289.6**
	(12.37)	(27.79)	(36.70)	(80.23)	(29.63)	(55.11)	(119.3)
Observations	99	94	94	62	94	94	62
R-squared	0.642	0.674	0.728	0.739	0.743	0.719	0.868
Number of period	2	2	2	2	2	2	2

*** p<0.01, ** p<0.05, * p<0.1

Chapter 7: Priority policy challenges to wellbeing from work in East Asia Pacific

Priorities vary widely across countries in East Asia Pacific, but most people live in countries where sustaining well-being from work requires that cities are better managed and that barriers that cause segmentation in the markets for labor and human capital are removed.

7.1 Demand and supply of labor and human capital need to be not only sustained but also further stoked. The 2013 WDR (World Bank 2012a) claims that 600 million jobs will have to be created in the next 15 years simply to maintain current levels of employment. For this reason, policy makers everywhere are worried at the relatively slow pace at which the market for human capital is recovering after the sharp contraction in 2009 and 2010. While the economies of East Asia Pacific fared far better than most and enjoy much lower rates of unemployment, similar concerns dwell on the minds of policy makers in the region, increasing their appetite for policy guidance. In the previous section of this report, we discussed the importance of sound *fundamentals*; of policies that encourage formation of the right human capital; and the institutions, regulations and interventions most likely to balance the needs of enterprise with those of working people. These elements of policy are essential to sustaining demand and supply of human capital in any country, and in chapters 4, 5 and 6, we provided an assessment of the performance of governments in East Asia Pacific countries in ensuring they are in place.

7.2 But as asserted in earlier chapters, growth, although necessary, is not sufficient to sustain demand for human capital, nor is it enough to encourage adequate supply. And while the labor code can shape outcomes, even the best designed and implemented institutions, regulations and interventions will only get a country so far. More is required of policy makers, particularly to sustain the types of work that are most likely to further transform countries along the three dimensions of development discussed in the WDR 2013 and in Chapter 3, namely productivity, living standards, and social cohesion.

7.3 These additional priority challenges vary widely from country to country, and even in the same country, they can change dramatically over time. As the WDR explains, "The types of jobs that can contribute the most to development depend on the country context. Jobs that connect the economy to the world may matter the most in some situations; in others, the biggest payoff may be for jobs that reduce poverty or diffuse conflict."[1] This important assertion notwithstanding, the global report offers a typology that policy makers can apply to identify and prioritize their particular policy challenges, and the steps they can take towards overcoming them.[2]

[1] World Development Report 2013: Jobs, p.17

[2] For an in-depth discussion of the typology and its implications for policy, readers should refer to chapters 6 (pp.190 -216) of the WDR 2013.

7.4 This chapter applies the WDR "jobs challenges" typology by using observable data to categorize East Asia Pacific countries. By doing so, the chapter sheds light on the implications of these challenges for setting policy priorities in the countries facing them. The exercise is controversial, but we believe also leads to important insights. In categorizing the countries of East Asia Pacific, the chapter highlights two important features that set the region apart from other low- and middle-income country regions. The first feature is *diversity*: East Asia Pacific countries can be found in almost all eight categories of the WDR's typology, in contrast to countries in Latin America and the Caribbean, Emerging Europe, the Middle East and North Africa, and South Asia where countries tend to cluster in one or two types. This shouldn't come as a surprise. After all, the East Asia Pacific region encompasses China, the economic powerhouse of East Asia, and home to 1.3 billion people, as well as Tuvalu, a remote island country of just 10,000 people. The second feature that sets the region apart from others is *dynamism*: because of the pace of change over the last thirty years, a larger number of East Asia Pacific countries can fit into more than one category. To capture this unprecedented pace of change, the chapter takes the WDR's categorization a step further by considering the importance of countries' transitions from one category to another. Of particular importance to the conclusions of this report, this chapter emphasizes the critical economic transitions from 'agrarian' to 'urbanizing', 'urbanizing' to 'formalizing', and 'formalizing' to 'aging'.

7.5 As argued in chapter 3, the three development transformations associated with work have for the most part unfolded at a similar pace in East Asia Pacific countries. Chapter 3 also pointed out that it is important not to take the transformative nature of work for granted, given mounting evidence that some of the transformations may be starting to lag. In this chapter, we show that upon close inspection, significant imbalances in the pace of productivity gains, changes in living standards and social cohesion are apparent. In mainly agrarian economies like Cambodia, or Lao PDR labor productivity in agriculture remains too low, and living standards with it. In urbanizing economies like the Philippines and Indonesia growing congestion and poor land management are undermining the productivity gains from agglomeration. In small island nations idle youth feel frustrated and could become increasingly disengaged. In resource- rich countries Papua New Guinea and Mongolia some forms of employment are hugely productive, but there are too few of them and there is a temptation to use the natural resource bounty to subsidize employment creation for the rest. In formalizing countries like China, and Indonesia potentially rigid regulatory models tried in Europe and Latin America are being adopted at a time when productivity gains are bound to come from firm- to- firm employment transitions rather, than from ~~urban- to- rural~~rural-to-urban movement. And in societies bound to age quickly like Thailand and Vietnam mechanisms to reconcile long working lives with protection in old age are missing almost altogether.

7.6 Although we have done our best to appeal to data in categorizing East Asia Pacific countries, our application of the typology is ultimately subjective. The categorization exercise is neither intended to be a definitive diagnosis, nor to lead to a conclusive set of prescriptions about which policies should be prioritized. We expect as many readers to disagree with how countries have been categorized as to agree. This exercise is only useful if it provides clues to policy makers about where the most important challenges to boosting work may lie. If the chapter provokes debate as to which challenges are the most pressing, then it will have served its purpose. Given their particular and globally unique geographic constraints, the discussion here is followed by a chapter specifically focused on the challenges faced by Pacific island countries.

7.1 The WDR's "jobs challenges" typology

7.7 The "jobs challenges" typology presented in the 2013 WDR starts with four broad categories: a country's level of development, demography, institutions, and natural endowments. The last of these categories is substantially different from the rest, in that "natural endowments" is less likely to present a continuum along which a country can move. For example, a country can move from a lower level to a higher level of development, or from one demographic profile to another. Natural endowments – particularly a country's geography – are relatively fixed. This presents the immediate possibility of overlap (for example, a country with high levels of youth unemployment can also be resource rich, and conflict affected; a small island state can also be rapidly urbanizing, etc.). From these broad categories, eight specific "country types" are drawn (Table 7.1).

Table 7.1The Jobs WDR presents eight country types to identify priority challenges

The "jobs challenges" typology by level of development, demography, institutions and natural endowments.

Broad cattegory	Specific types	Dominant, defining feature
Level of development	**1. Agrarian**	Majority of the population lives in rural areas
	2. Urbanizing	Agricultural modernization and rural-urban migration rapidly taking place
	3. Formalizing	An urban middle class and a large share of informal employment coexist
Demography	**4. Aging**	Rapidly increasing old-age dependency ratios.
	5. High youth unemployment	Youth unemployment rates and idleness rates at unusually high levels.
Institutions	**6. Conflict affected**	Livelihoods altered by war and violence.
Natural endowments	**7. Resource rich**	Extractive industries make a substantial contribution to exports.
	8. Small island state	Islands with less than 1 million in population.

Source: WDR 2012a, chapter 6.

7.8 We use data (some presented in earlier chapters) to map the countries of East Asia Pacific into these types. We apply empirical "thresholds" to the data to sort countries into categories. The thresholds are potentially the source of most contention in this chapter in that how they are chosen determines which challenges countries could prioritize. In this chapter, we have used the same data driven formulation of the WDR's typology. Indeed, most of the data sources and thresholds are the same as those used in the WDR's analysis.[3]

7.9 Readers should keep in mind that this process is intended to be insightful and stimulating rather than definitive or conclusive. The thresholds are determined by assessing the global distribution of data, but legitimate alternatives could just as easily be found, and could yield a different distribution of countries into the eight categories.[4] We are not making this point to undermine the exercise: indeed, the outcomes of the mapping have been assessed at length with supporting data, and appear both robust to alternative thresholds and persuasive. Rather, we want to acknowledge that the process of placing countries into "types" will always be controversial, open to differences in interpretation and dispute. The chapter seeks to exploit this inevitability to achieve deeper insights.

7.10 Obviously many countries are not just facing one challenge; they are facing several challenges. As the WDR stressed "… these criteria [used to categorize] are not mutually exclusive."[5] By applying the empirical thresholds, it is clear that most countries in East Asia Pacific map to more than one category. Fast-changing Vietnam can be mapped to four. Compared to other regions, East Asia Pacific countries are more heavily represented in three categories: 'urbanizing', 'resource-rich', and 'small island states'. The last clearly reflects the large number of sovereign countries in the Pacific, which are discussed at length in the next chapter. In contrast, countriesin emerging Europe and Central Asia are more likely to cluster into the categories 'aging' and 'formalizing', respectively. Countries in South Asia and in the Middle East and North Africa aremore likely to cluster in the 'agrarian' and 'high youth unemployment' categories, respectively. In Latin America and the Caribbean, countries cluster in the categories 'formalizing'. Argentina, Brazil, Chile and Uruguay also qualify as 'aging'.

Table 7. 2 Countries in East Asia Pacific are more likely to be mapped to more than one category, and tend to cluster in four types: *Agrarian*, *urbanizing*, *formalizing* and *small island state*.

[3] Footnotes will highlight the instances where the analysis in this chapter significantly differs to that undertaken by the WDR.

[4] For example, regions in which countries crowd into one country-type may heavily influence the global distribution of data in each case. For example, the prevalence of agrarian countries in Sub-Saharan Africa, mean that a threshold based on a global distribution may not be the perfect device for identifying which countries in East Asia Pacific are primarily agrarian.

[5] WDR, p. 190

	Agrarian	Urbanizing	Formalizing	Aging	High Youth Unemployment	Resource-rich	Small Island	Conflict Affected
Cambodia	x							
China		x	x	x				
Fiji							x	
Indonesia		x		x	x	x		
Kiribati							x	
Lao PDR	x	x				x		
Malaysia		x	x					
Marshall Islands							x	
Micronesia, Fed. Sts.							x	
Mongolia		x	x		x	x		
Myanmar	x					x		
Palau							x	
Papua New Guinea	x					x		
Philippines		x			x			
Samoa							x	
Solomon Islands							x	
Thailand	x			x				
Timor-Leste	x					x		
Tonga							x	
Tuvalu							x	
Vanuatu							x	
Vietnam	x	x	x	x				

7.2 Country categorization by level of development: 'Agrarian', 'Urbanizing' and 'Formalizing' economies

7.11 ***Agrarian***. An 'agrarian' economy is one in which the majority of the population still lives in rural areas, where work consists mainly of subsistence and small-scale commercial farming, and in related industries. With reference to the global distribution, a country is considered 'agrarian' if 60 percent or more of the population is living in rural areas. Figure 7.1(a) shows there are seven countries in East Asia Pacific that qualify as 'agrarian': Cambodia, Lao PDR, Myanmar, Papua New Guinea, Thailand, Timor Leste and Vietnam. In the figure, the size of the sphere corresponds to the population of each country. This is an important dimension of analysis that is employed throughout this chapter, as it allows a quick determination not only of where countries are mapped, but also where most people in the region are mapped.Figure 7.1(b) includes countries from other regions so that readers can gain a sense of how the countries of East Asia Pacific compare. Countries in Sub-Saharan Africa and South Asia still have large shares of their population living in rural areas.

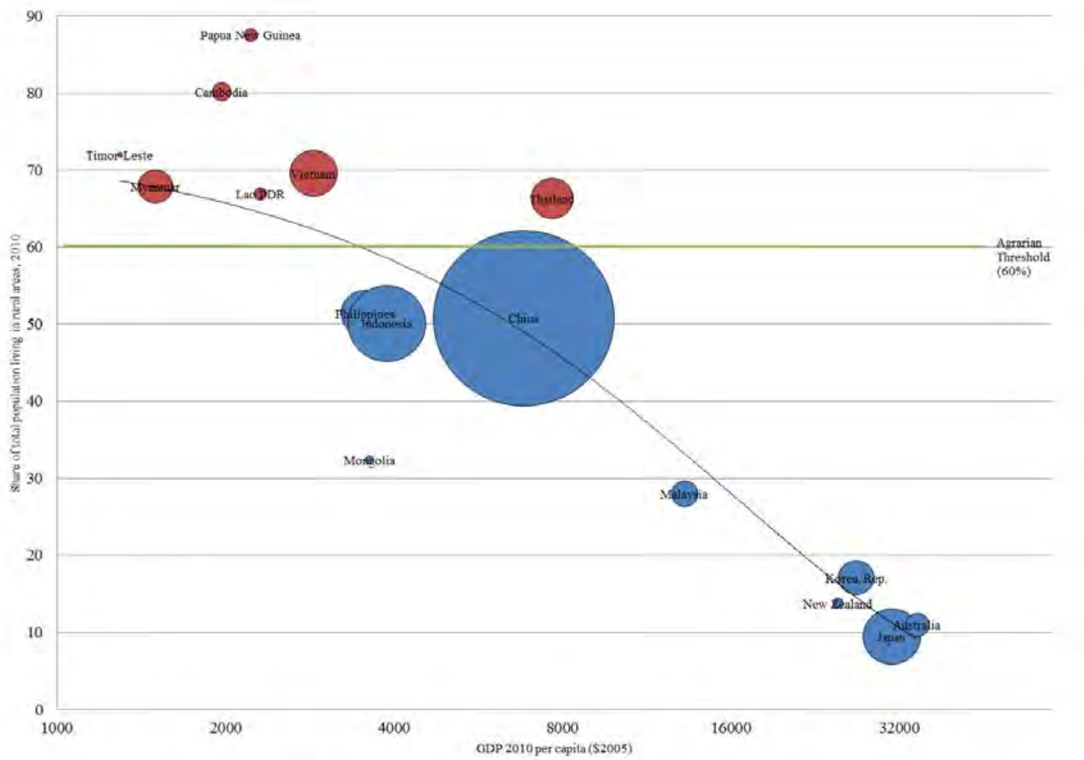
7.12 In mainly agrarian contexts, increasing the productivity of agriculture can have a significant impact on a country's development, as discussed in Chapter 3. Indeed, the International Food Policy Research Institute found that, among 42 developing countries over 1981–2003, a 1 percent GDP growth originating in agriculture was associated with an increase in the expenditures of the three poorest deciles of at least 2.5 times as much as growth originating in the rest of the economy (World Bank, 2007).[6]Yet in many countries in this category, lack of land-tenure and limited use of fertilizers and other technology mean that farming is still taking place at a relatively unproductive level, with significant resources devoted

[6] World Bank, "The World Development Report, 2008", p. 30

simply to produce goods for household consumption.[7] The priority challenge in mainly agrarian economies is to raise the productivity of agriculture. Gains made in labor productivity in agriculture~~,~~ release~~s~~ human capital to engage in off-farm rural employment. This move is eventually compounded by the pull of higher wages in towns and cities.

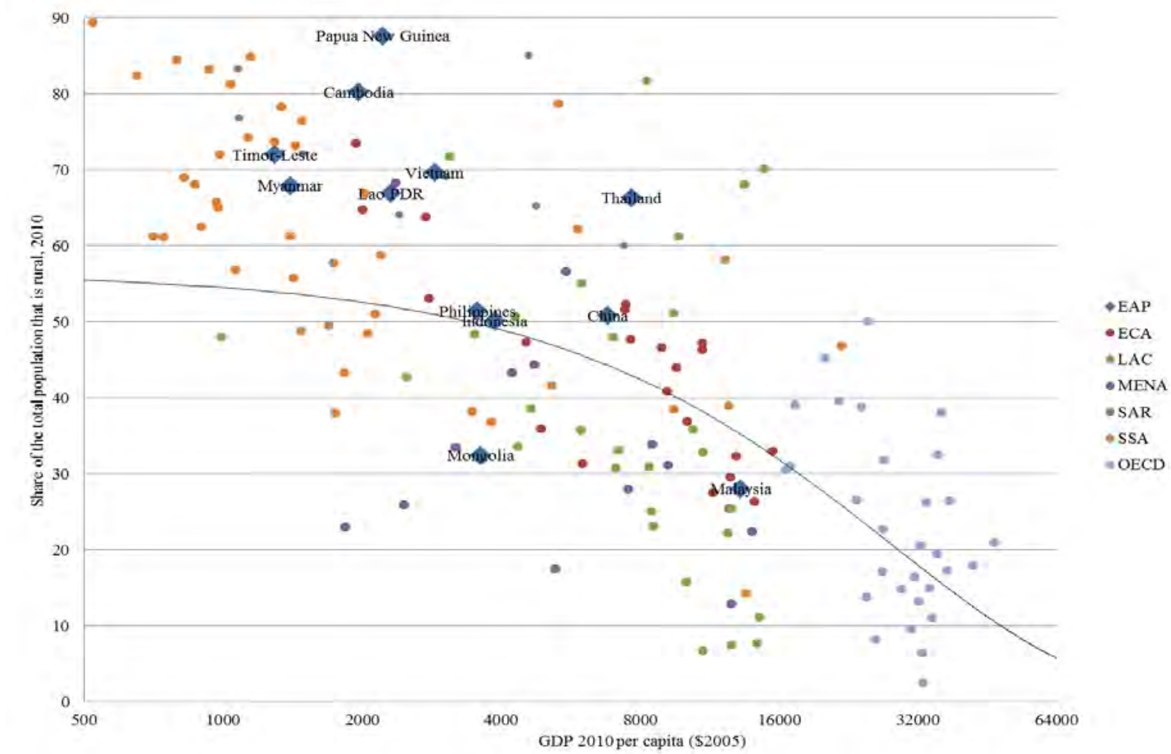
Figure 7. 1 : Seven countries in East Asia Pacific are still agrarian

(a) Agrarian, EAP. Share of the population living in rural areas, by income level and population size, 2010.



(b) Agrarian, World. Share of the population living in rural areas, by income level, 2010.

[7] D. Gollin et al, "Structural Transformation and Cross-Country Income Differences", 2002



Source: Staff estimates using World Development Indicators, Notes: Spheres=total population, 2010.

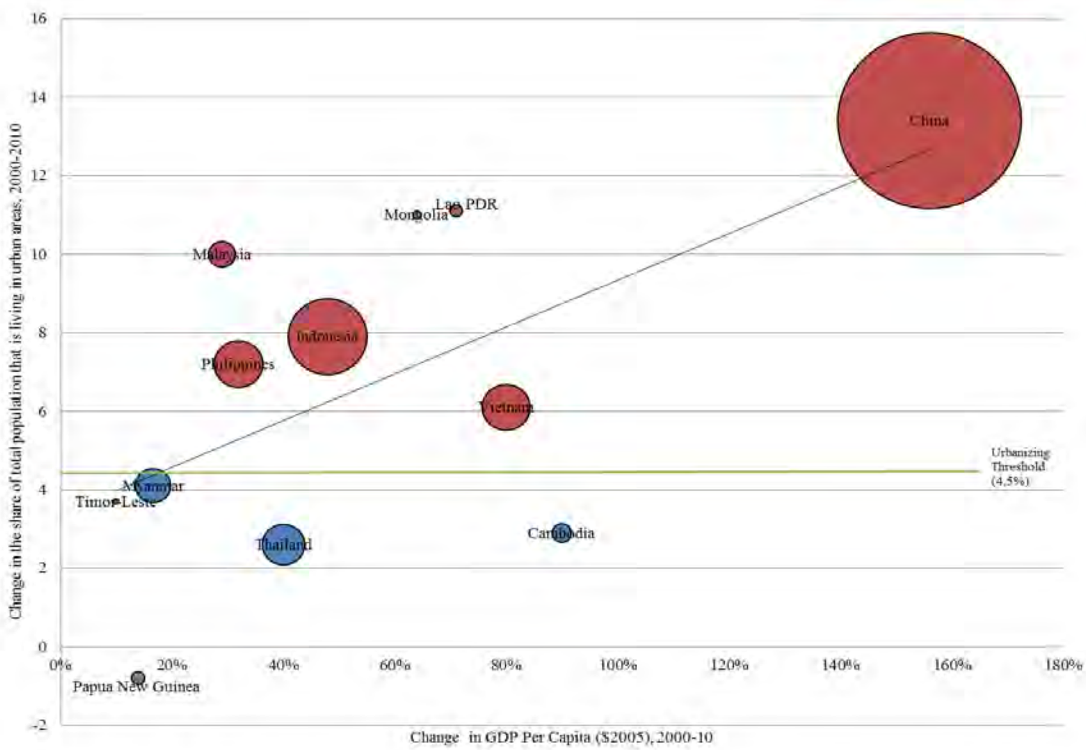
7.13 Other than in Lao PDR and Vietnam, there has been very little movement of people to towns and cities in most of the East Asia Pacific countries categorized as still mainly 'agrarian' in the past ten years. This has been clearly the case in Myanmar, Papua New Guinea and Timor Leste. This relatively static picture suggests these countries will remain mainly agrarian in the medium term.

7.14 ***Urbanizing***. As discussed in earlier chapters, a large number of countries in East Asia Pacific have been urbanizing at an unprecedented speed. Indeed, evidence in earlier chapters shows the pace of this process has been much faster in recent years than in any other region. As an abundance of unskilled labor released from farming and non-farm rural industry moves to towns and cities, governments face the challenge of quickly integrating migrants into the urban economy. In the course of urbanization, countries typically pass through an important developmental juncture at which the participation of women in work outside the home begins to rise significantly. This compounds the positive effect that urbanization has on all three development transformations. The challenge for governments is to stay ahead of the urbanization process, in order to avoid exclusion and urban poverty, and to minimize the costs of congestion so that migrants contribute to agglomeration economies. The arena for governments to prioritize action is in urban planning and management, and in particular to ensure connectivity, transportation infrastructure and linkages, and that the market for land functions well.

7.15 Figure 2(a) shows the change in the share of each country's population living in urban areas over a ten-year period. The figure distinguishes which countries are '*urbanizing*' (a flow concept) from those that are already mainly urban (a measure of stock). To be considered 'urbanizing', 60 percent or less of the country's population could be living in urban areas in 2000. Between 2000 and 2010, the population share in urban areas has to have risen by 4.5 percentage points or more. By these criteria, seven East Asia Pacific countries are categorized as urbanizing: *China, Indonesia, Laos, Malaysia, Mongolia, Philippines,* and *Vietnam.*[8] As the size of each country's sphere makes plain, most people in the East Asia Pacific region work in countries that are urbanizing. This is not to say that most people are working in urban areas, but that they are living in countries where the process of urbanization is happening fastest. This is a critical empirical point to the conclusions and recommendations made in the final chapter of this report.

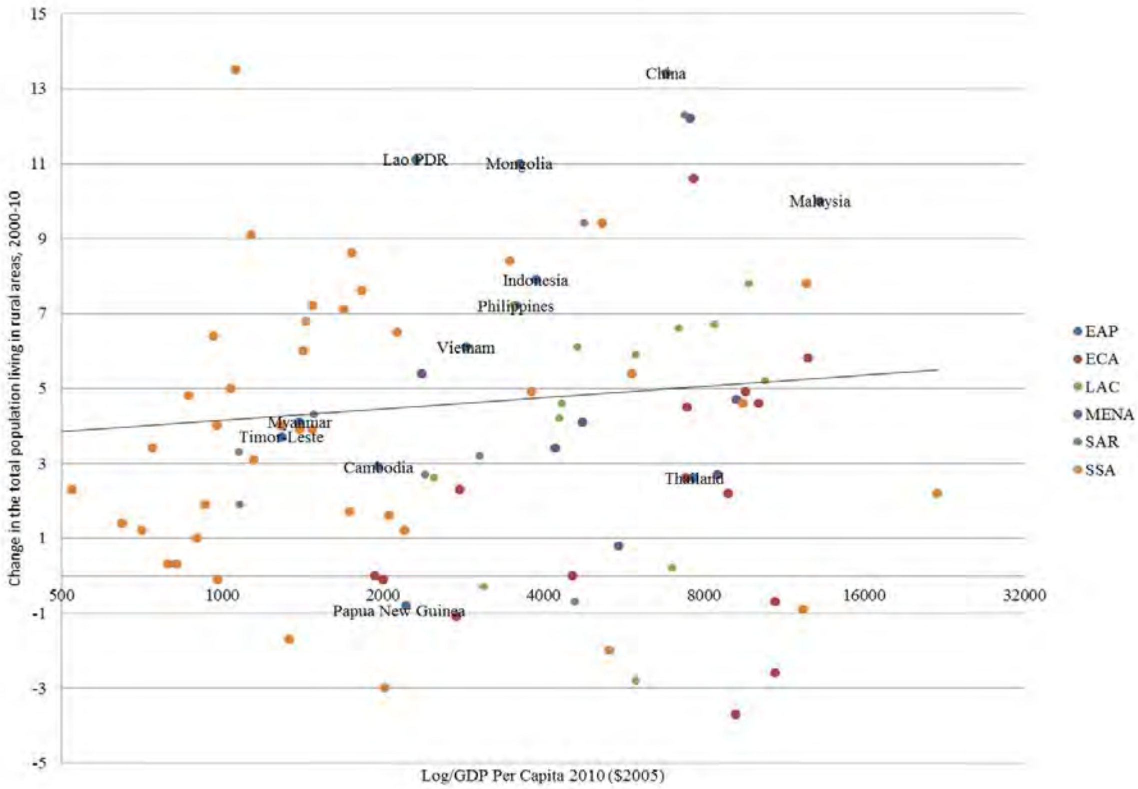
Figure 7. 2 Most people in East Asia Pacific live in countries that are rapidly urbanizing

(a): Urbanizing, EAP. Change in the share of the population living in urban areas 2000-2010, by income and population in 2010.



(b): Urbanizing, World. Change in the share of the population living in urban areas, 2000-10, by income in 2010.

[8] High income countries are excluded by virtue of the lower bound of being less than 60 percent urbanized in 2000.



Source: Staff estimates using World Development Indicators, Notes: Spheres=total population, 2010.

7.16 Within the fast growing East Asian cities, factor markets are deepening, inputs are being accessed with greater ease by producers, industry can expand in new directions thanks to innovation, and firms can find ever-narrower niches of specialization, as well as achieve valuable and powerful scale economies.[9] But none of these dynamics are inevitable. Bad policy can still get in the way to constrain the powerful forces of demand and supply of labor and human capital that urbanization should unleash. As anybody who has been stuck in Manila or Jakarta's traffic jams can attest, urban planning is too often ignored, particularly investment in connective transportation infrastructure.

7.17 Thailand is an unusual outlier in figures7.2(a) and (b). It has amongst the highest income per capita among middle income countries in East Asia Pacific, and yet the pace of urbanization is sluggish: the second slowest of all the countries in the region over the 10 year period. This is perhaps, in part, an artifact of measurement and differences in rural/urban classifications from countrytocountry, even in datasets of uniform indicators like WDI. During the same 10 year period, Thailand was shedding agriculture employment, and has seen employment in services increase by nearly that same amount as its neighbors. This observation might suggest that Thailand's urbanization is underreported, or may be evidence of policies that might be encouraging movement from farming into non-farm industry in rural areas, rather than migration to towns and cities.

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[9] Yusuf, S. & Saich, T. "China Urbanizes: Consequences, Strategies and Policies", p. 19

7.18 As may already be apparent to readers, both Lao PDR and Vietnam are categorized as being both 'agrarian' and 'urbanizing'. Figure 7.3 illustrates how the challenges of agrarian and urbanizing countries overlap. In the top left quadrant of the figure are countries that are still mainly agrarian, but that are not yet urbanizing at a significant pace. For these countries, increasing the productivity of agriculture may remain the priority for policy makers for long a while. Countries that achieve this show a definitive move to the right quadrant where, like Vietnam, they begin to urbanize in earnest. These countries will continue to face the challenge of improving agriculture productivity, even as they facilitate the integration of migrants into town and cities.

7.19 The history of agriculture development and urbanization in the Philippines provides an example of what can happen when this process is not facilitated, or when it is distorted with unclear land tenure and uneven provision of services, particularly in rural areas. This year's Philippines Development Report[10] (PDR) details that despite a head start in manufacturing compared to its neighbors, the Philippines failed to fully industrialize. Instead, the share of manufacturing to GDP stagnated at around 25 percent since the 1960. The share of manufacturing employment to total employment hardly rose by 10 percent. The PDR argues that the Philippines "missed crucial steps in the structural transformation process", namely ensuring substantive improvements in agriculture productivity, the development of rural non-farm economy, and facilitating the rise of manufacturing in towns and cities. The Philippines example shows the importance of meeting the agrarian challenges, even as the process of urbanization gets underway. Critical to facilitating urbanization is ensuring that rural areas benefit from good quality services to build the human capital of people likely to stay in farming and rural industry as well as that of aspiring migrants. The PDR argues that because rural service delivery was ignored by successive governments at critical stages of the Philippines development,~~that~~the quality of migration was compromised. When migrants have low levels of human capital upon arrival to towns and cities, they are only able to take up low-skilled employment, usually low-skilled services. "The service sector has been the largest employer since 1997. However, more than three-quarters of the service sector is composed of low-wage or low-skilled jobs… and there has been no corresponding significant increase in productivity in the service sector."[11]

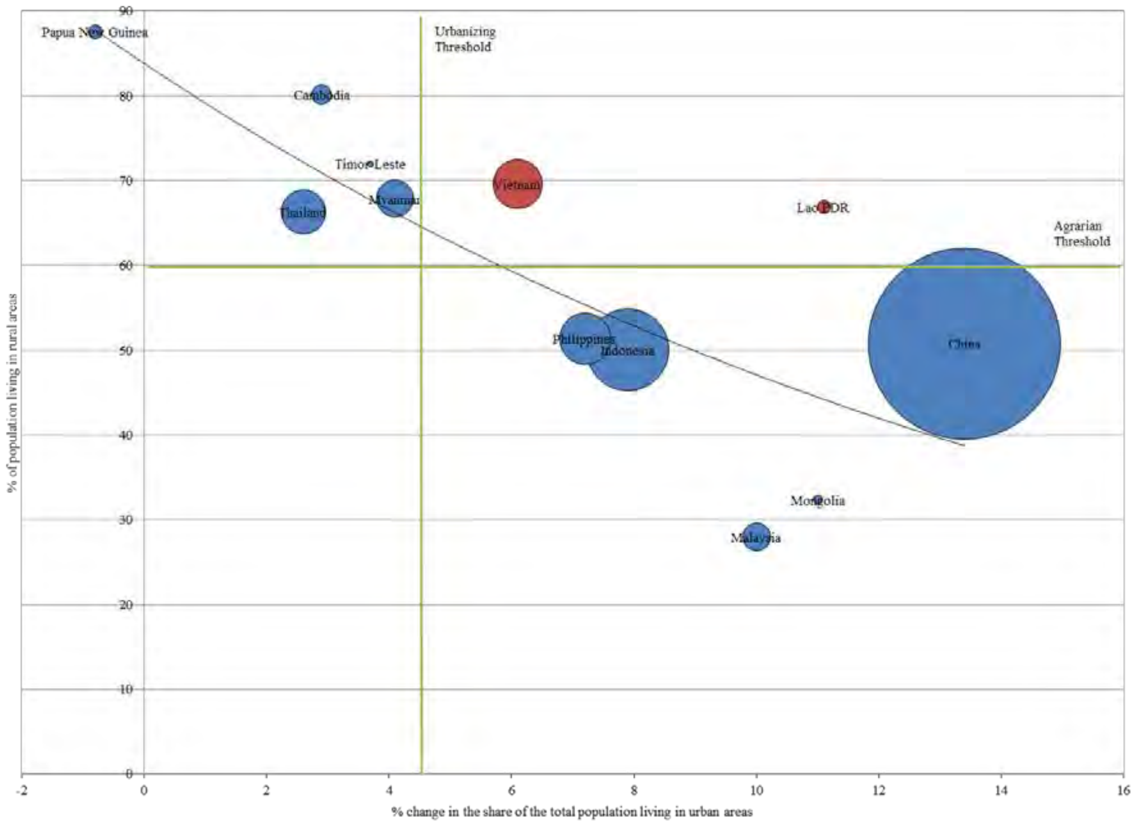
7.20 Vietnam's history provides a more positive example of how countries can manage the transition from mainly agrarian to an urbanizing economy. In 1993, 79 per cent of Vietnam's population lived in rural areas, 70 percent of working people were engaged in agriculture, and the poverty rate stood at 58 percent. Between 2000 and 2010, Vietnam's share of employment in agriculture fell by 13.6 percent, and employment in industry and services increased by 7.8 and 5.9 percent, respectively. The share of the population living in rural areas in 2010 was 9 percentage points lower than in 1993. Alongside Vietnam's move from a centralized to a more market-led economy came rapid increases in agricultural productivity. Policies were enacted to ensure more even delivery of human capital services across the country, and to foster

[10] "Philippines Development Report 2012: Creating More and Better Jobs", Exec Summary (DRAFT), p. 3
[11] Ibid.

employment outside of agriculture. Vietnam has since reduced its poverty rate at an unprecedented pace and moved from low-income, least developed status to lower middle-income status.[12]

Figure 7.3 The challenge faced by most governments in East Asia Pacific is how to manage the transition from mainly agrarian to urban economies.

Overlapping Agrarian and Urbanizing challenges: Rural population share 2010, by change in the urban population share 2000-2010, and population size.



Source: Staff estimates using World Development Indicators, Notes: Spheres=total population, 2010.

7.21 In the bottom right-hand quadrant of Figure 7.3 are the countries that are urbanizing fastest. With work being created primarily in the secondary (manufacturing) and tertiary (services) sectors, policy makers in these countries will be ~~more squarely~~ concerned with sustaining agglomeration ~~over~~and mitigating the ever-present threat of congestion, including to the environment. However, as with the blurred line between agrarian and urbanizing countries, countries where urbanization is already advanced also face overlapping challenges.

7.22 ***Formalizing.*** Countries in the 'formalizing' category like China, Indonesia and the Philippines typically already have large and mature urban centers. Yet the pace of urbanization

[12] World Bank (2012)

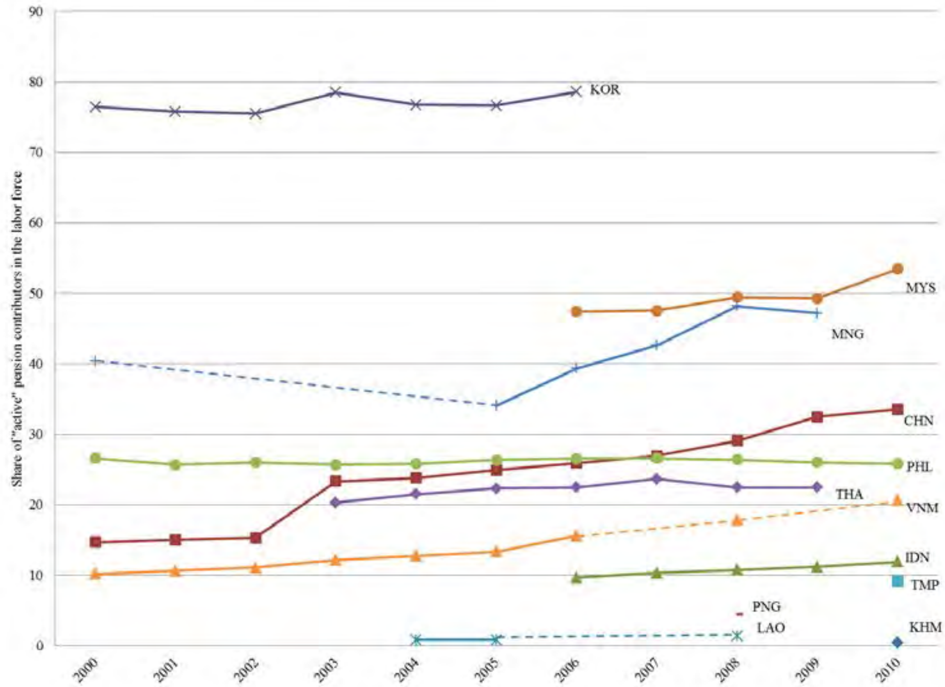
can result in a significant share of employment concentrating in the informal economy. Indeed, rather than expect urbanization to lead mechanically to greater formalization, agglomeration economies may be far more suited to and better serve the smaller, more nimble and specialized economic units commonly observed in the informal sector (Ghani and Kanbur, 2013). The challenge in such a context is to ensure access to protection and opportunities so that informality does not become a source of segmentation. Structures that create barriers between the informal and formal economy constrain the movement of capital and labor, limit productivity, can impose a ceiling on living standards for many, and in doing so corrode social cohesion.

7.23 The varying dimensions and definitions of "informal employment" and the "informal economy" have been discussed in earlier parts of the report. For the purposes of categorizing countries in this chapter, we use a single proxy indicator of the extent of formal employment: coverage of social insurance, taken as the share of the labor force contributing to a pension plan. To be defined as 'formalizing', a country has to have a significant (>=20 percent) and growing share of the labor force actively contributing to a pension plan during the last decade.[13] Figure 7.4 shows that only four countries in East Asia Pacific categorized as 'formalizing': China, Malaysia, Mongolia and Vietnam.

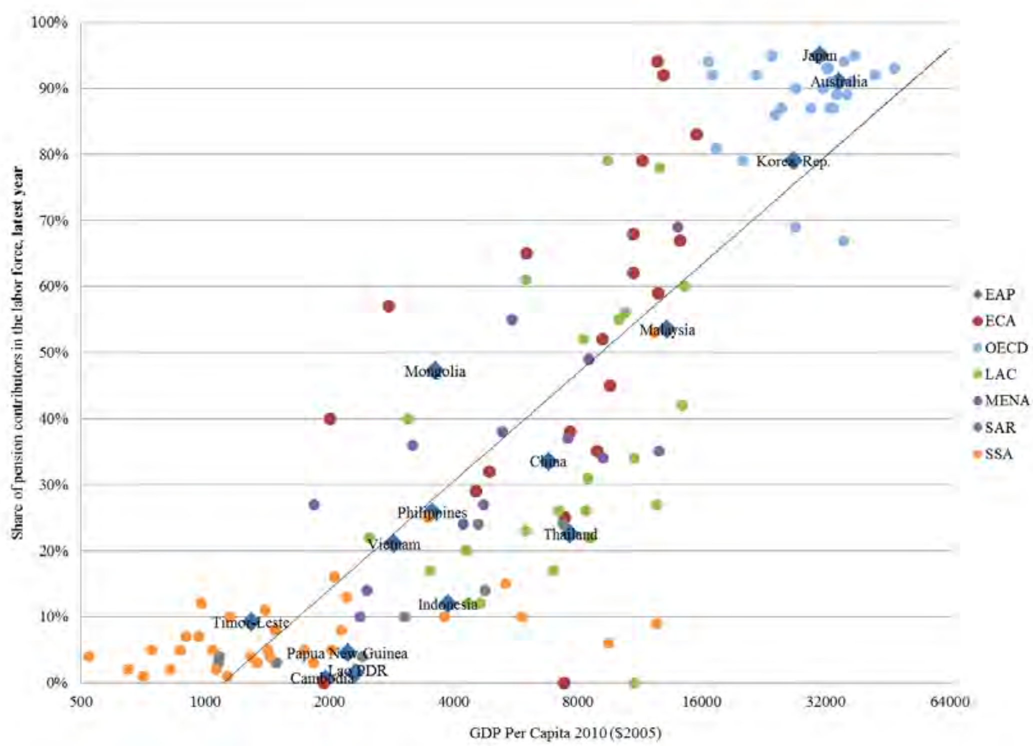
Figure 7.4 When urbanization is well advanced, a significant share of working people should be formalizing.

(a): Formalizing, EAP. Share of the labor force that is contributing to pensions.

[13] The indicator "pension contributors as a share of the labor force" is available in the World Bank's pension database. The indicator was the proxy used by the WDR typology – a one year measure of active contributors to pensions as a share of the labor force, and thresholds applied as >=25% &<=75%. Additional data collection undertaken for this report, has allowed for more data points from East Asia Pacific countries than were available in the WDR sample. This allows us to assess the increase in the share of formal employment overtime.



(b): Formalizing, World. Share of the labor force that is contributing to pensions, by income level, 2010 or latest year.



Source: World Bank Pension Database (2013) and World Development Indicators

7.24 Both Thailand and the Philippines have "significant" shares of their labor force contributing to pensions. However, the time series trends show there has been almost no growth in the share of contributors in recent years. Lack of formalization by this measure might be of particular concern in rapidly-aging Thailand; however, that country's choice to offer health coverage on a 'non-contributory' or 'universal' basis has provided wider protection and eliminated what in most countries can become an important driver of segmentation. In the case of the Philippines, however, where social protection is still mainly contribution based, stagnating levels of participation shown in Figure 7.4(a) raises greater concern for segmentation.

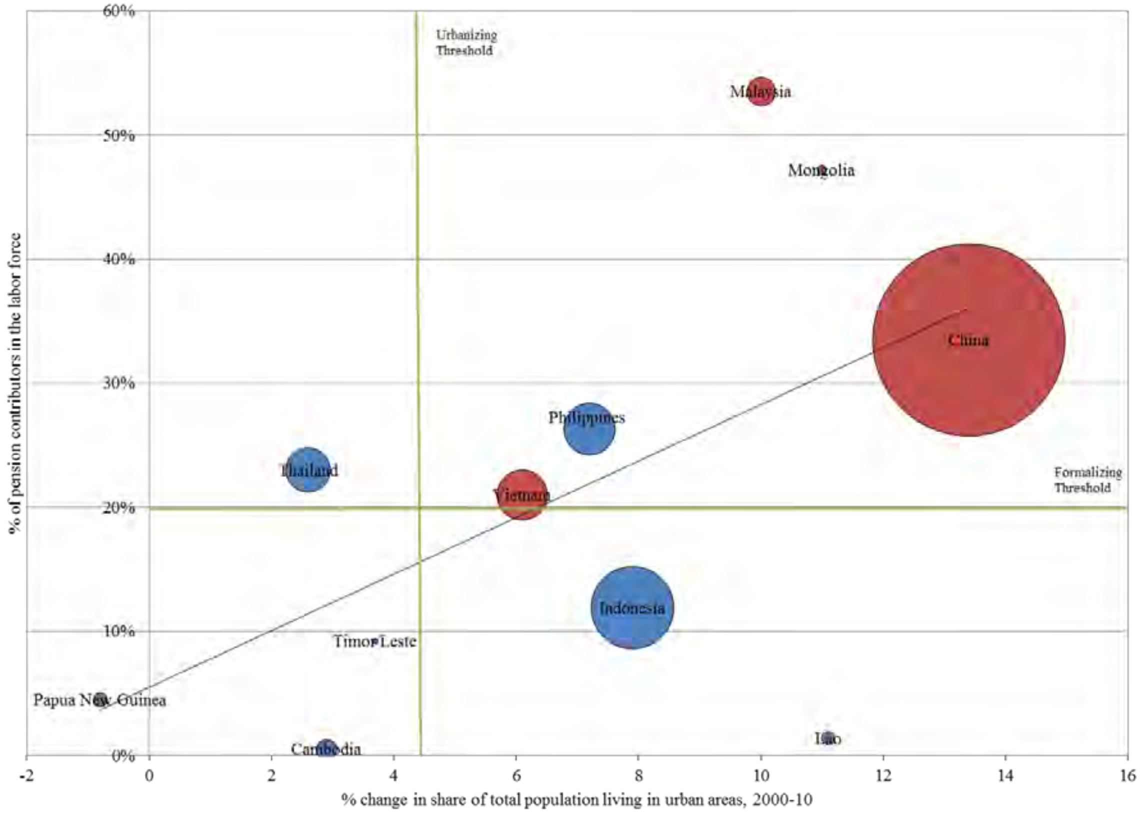
7.25 Vietnam only recently broke above our significance threshold of 20 percent. However, it has shown the strongest expansion in the share of formal employment in the region. Despite what remains a relatively low share of contributors compared to the other formalizing countries, the rapid pace of expansion is encouraging.

7.26 Cambodia, Lao PDR, Papua New Guinea, and Timor-Leste appear to be firmly 'agrarian' economies, with neither a significant nor growing share of workers in formal employment. But in most of these countries, the extent of informal employment is still structural rather than based on incentives and institutions that create segmentation and exclusion. Of much greater concern is Indonesia, a country that is among the fastest urbanizing, but that shows comparable levels of pension coverage to Timor-Leste. The extent and persistence of the informal economy in Indonesia is far less likely to be structural and more to be based on the incentives to evade as well as institutions that create segmentation and exclusion.

7.27 As with the overlapping agrarian and urbanizing challenge analysis, the dual categorization of urbanizing and formalizing countries offers helpful insights. In Figure 7.5, the red spheres indicate ~~that~~ the countries that have "growing" shares of pension contributors in the labor force, while the thresholdindicates the "significance" level. In the bottom left-hand quadrant are the agrarian economies that are neither significantly urbanizing nor formalizing. Thailand~~,~~ straddles an interesting line, depicted as being beneath the urbanizing threshold~~,~~ and above the formalizing threshold in this figure, but ~~for the~~ lacks significant ~~of~~ growth in the share of contributors to pensions ~~during~~ inthe formalizing time-series. Again, Thailand's choice to extend coverage of essential protection at least against the cost of health may alleviate some of the concern that the mapping in Figure 7.5 raises.

Figure 7.5 Formalization is not an inevitable outcome of an urbanizing economy

Overlapping Urbanizing and Formalizing challenges: Share of pension contributors in the labor force and change in the urban share of the population 2000-2010.



Source: World Bank Pension Database (2013) and World Development Indicators

7.28 Countries in the bottom right-hand quadrant, like Indonesia and Lao PDR, are urbanizing fast but do not yet have a significant level of formal employment. The Philippines, as already discussed, appears in the top right-hand quadrant above the formalizing significance threshold, but the lack of expansion in pension contributors raises concerns for the quality of its urbanization, and that the potential agglomeration economies are being constrained unnecessarily by segmentation.

7.29 The countries in the top right-hand quadrant with red spheres are both urbanizing and formalizing that is, they have a level of formal employment that is both significant and growing. However, this is not a cause of complacency. The challenges of urbanization require continuous attention, and with the exception of Malaysia, most of these formalizing countries in East Asia Pacific still have relatively low shares of contributors when compared to many of the countries in the Latin America and Emerging Europe. The challenges of an already urbanized, formalizing economy are new to countries in East Asia Pacific. This is another important point for readers to take note of that will influence the conclusions of this report. These new challenges indicate that the prevailing model that has served the region so well may need updating. But as newcomers to facing these challenges, countries in East Asia are less constrained in how they choose to respond.

7.3 Country categorization by demographics: 'Aging' and 'High youth unemployment'

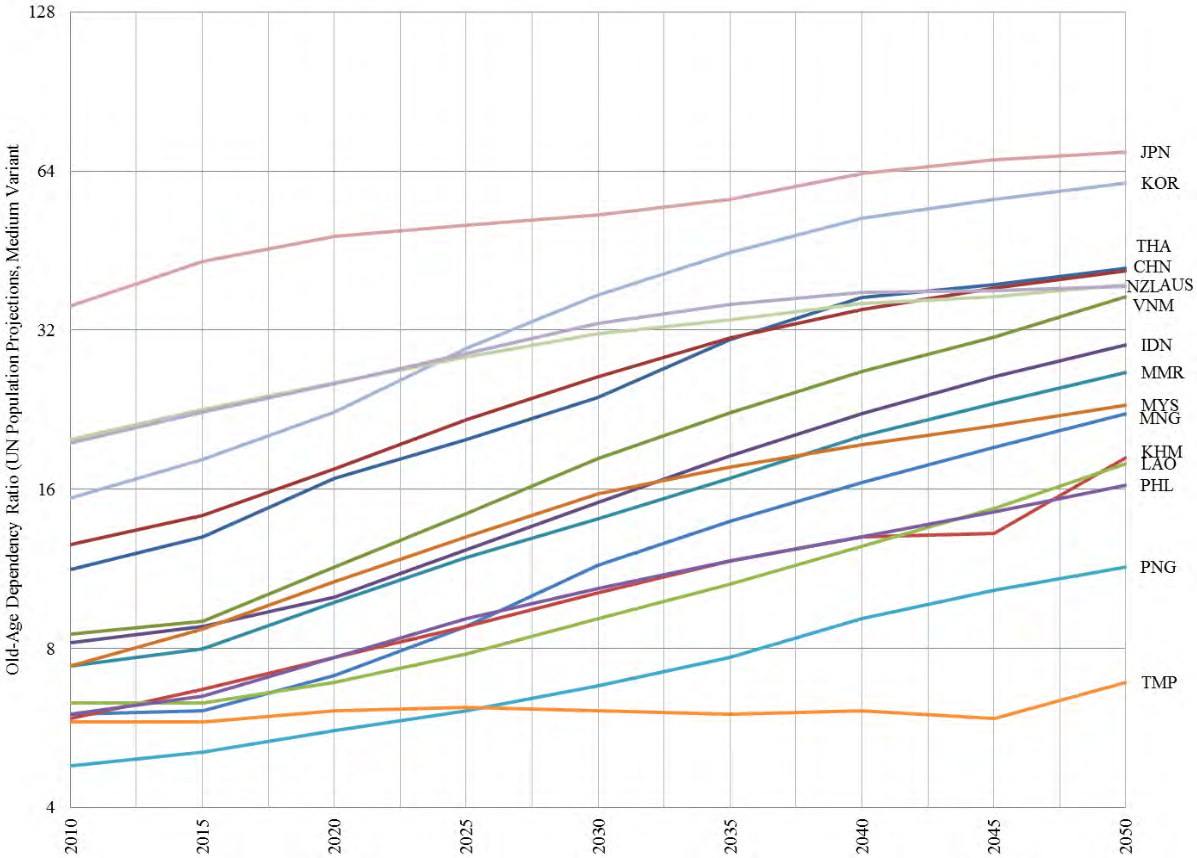
7.30 In addition to the particular challenges faced by countries according to their level of development, the WDR's typology also contends that a country's priority challenge to sustaining wellbeing from work may be primarily demographic in nature. That is, a country could be aging, or it could have very high youth unemployment.

7.31 ***Aging.*** Aging economies face the specter of a shrinking working-age population, made more foreboding by the costs of caring for the elderly. Fewer and fewer people of working-age must generate enough output and income to meet the needs of a growing elderly population. The policy challenge with respect to work is to ensure that more people are productive for as long as they can be, and that the most productive retire at later ages. Extending coverage of social security is another challenge, with fewer workers having to cover the costs of pensions and health care.

7.32 Figure 7.6 shows the old-age dependency (OAD) ratios for countries in East Asia Pacific. To be classified as aging, a country needs to have an old-age dependency ratio of 8 percent or above in 2010, based on the global distribution. Four countries are categorized as 'aging' by this measure: China, Indonesia, Thailand, and Vietnam.

Figure 7. 6 East Asia is on the verge of rapid population aging

Aging East Asia Pacific. Old-age dependency ratio (population >64/population 15-64) - UN projections (medium variant).



Source: United Nations Population Division

7.33 By 2015, UN projections suggest that most of the countries in East Asia Pacific will begin to see a significant increase in their dependency ratios, with the OAD projections showing steeper trajectory in the years that follow. Those countries categorized as 'aging' in 2010 (OAD =>8 percent) are already showing the fastest increase in OAD ratios in the world. The high-income countries of East Asia Pacific, including the Republic of Korea, Japan, New Zealand, and Australia, are also included in Figure 7.6 for illustrative purposes. Japan's level of old age dependence (35 percent) in 2010 is visually underemphasized by the logarithmic scale on the vertical-axis. Japan's OAD ratio is 16 percentage points larger than the second highest OAD ratio in the region: that of Australia, at 19 percent.

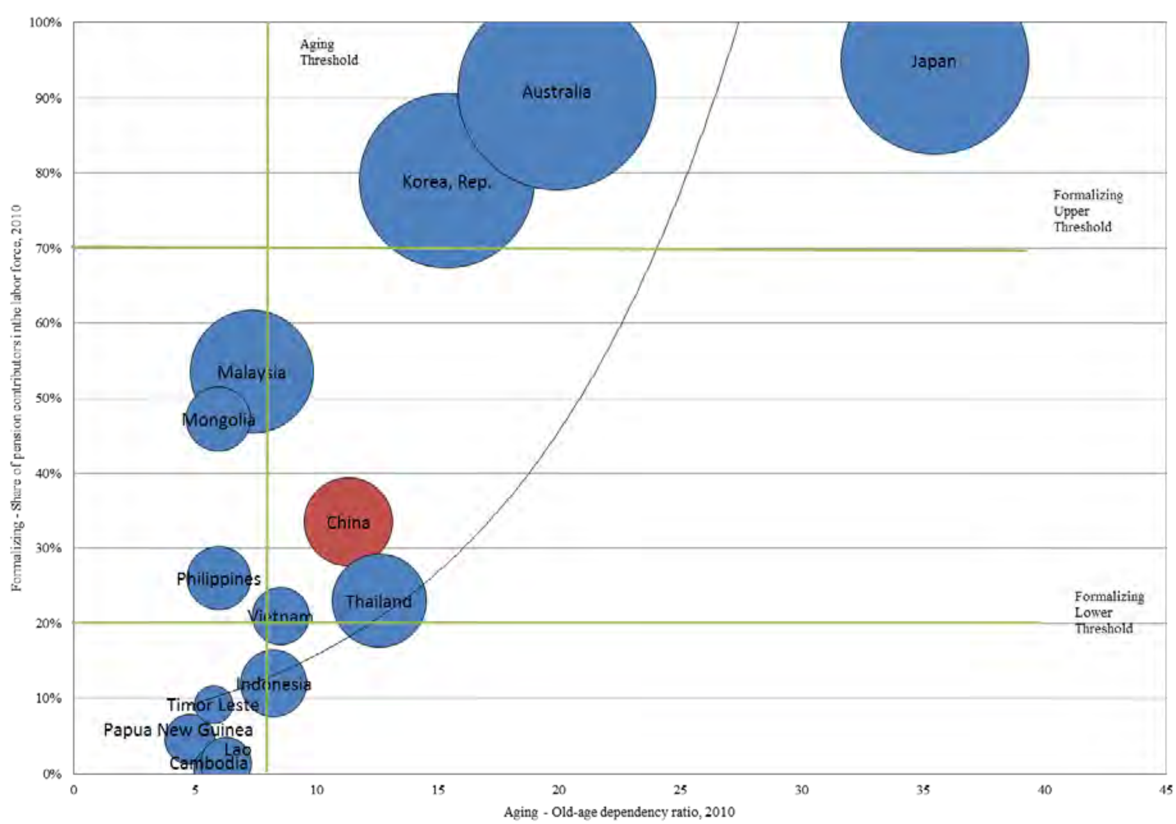
7.34 The challenge for the four aging economies in emerging East Asia ~~it~~ will be relatively acute, with Thailand and China reaching OAD ratios by 2045 equivalent to the Japanese ratio in 2010. Vietnam will reach that point in 2050 and in the same year is expected to be on par with

Australia and New Zealand. Indeed, aging in East Asia Pacific countries is occurring at a much faster pace than it did in North America, Western Europe, and Northeast Asia.[14]

7.35 In addition, the low and middle income countries of East Asia will have to meet the challenges of aging at much lower levels of wealth than Japan.This, indeed, is a key point where aging is concerned. Most countries that are grappling with the onset of aging achieved higher levels of wealth before they did so. Where faced with the challenges of aging before becoming very wealthy, for example in almost all the countries of Emerging Europe and in the Southern Cone of Latin America, the task for policy makers is made far more difficult. Middle income East Asian countries approaching their stage of rapid population aging, are in greater danger of growing old before they get rich simply because of the speed of the oncoming demographic wave. Figure 7.7 shows three dimensions of the problem of growing old before growing rich. In this figure, the spheres represent income per capita in 2010 rather than population as in earlier figures.

Figure 7.7 The constraints on growth from a large informal economy are dangerous as countries age.

Overlapping Aging and Formalizing challenges: Share of pension contributors in the labor force, by old age dependence ratio, and income level 2010.



Source: World Bank Pension Database (2013) and United Nations Population Division

[14] Asia's Aging Population: The Future of Population in Asia, p. 94

7.36 Pictured in the top right-hand quadrant of the figure are three high-income East Asia Pacific countries – South Korea, Australia, and Japan. Their income per capita spheres are large and, according to the World Bank Pension Database, they are firmly 'formalized' with over 75 per cent of their labor force contributing to pensions. While facing acute aging challenges, they are relatively wealthy and thus more able to manage the costs of caring for their elderly, albeit with some struggle.

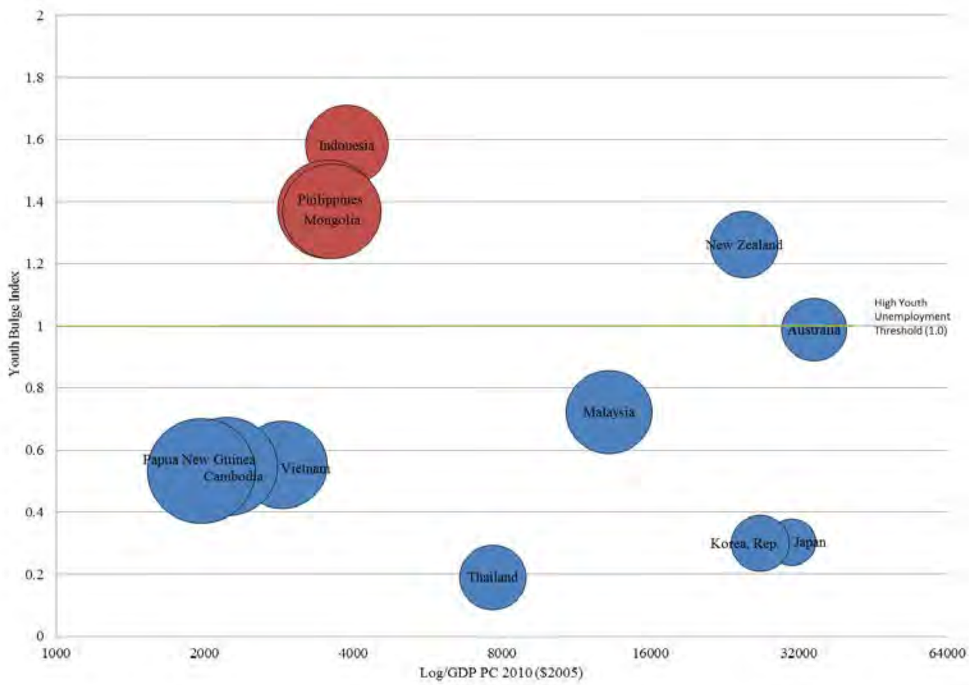
7.37 However, emerging East Asia Pacific countries are coming to experience aging with much lower levels of income and social insurance coverage. Relative to their OECD neighbors, rapidly aging China, Thailand, Indonesia and Vietnam have significantly lower levels of income per capita. Yet their OAD ratios are increasing at pace. Furthermore, Thailand, with a 'formalization' rate that has been stagnant at 23 percent of the workforce during the last decade, appears unprepared to care for its growing elderly population. And China is only just over that formalizing threshold. Conversely, it would appear from the figure that Malaysia is in a stronger position to contend with this demographic transition. At 7.3 per cent, Malaysia is not here deemed to be significantly aging yet, but as an upper-middle income country, its income per capita is significantly higher than that of China, Thailand, Vietnam and Indonesia. Critically, 54 percent of Malaysia's labor force is already actively contributing to pensions. Readers are reminded that although our proxy for formalization in this chapter is directly related to the coverage of systems to care for the elderly, the more fundamental danger of a small formal economy comes from the potential for segmentation, and getting stuck at levels of low-productivity and low-growth while the process of aging moves relentlessly onward.

7.38 ***High youth unemployment***. At the opposite end of the demographic scale, are countries with large youth cohorts and high youth unemployment and disengagement rates. As has been discussed in earlier chapters, high youth unemployment with a large youth "bulge" in the population puts downward pressure on earnings and can prejudice the outcomes that members of the youth cohort experience into later ages. A large portion of unemployed young people can also contribute to crime and political fragility.

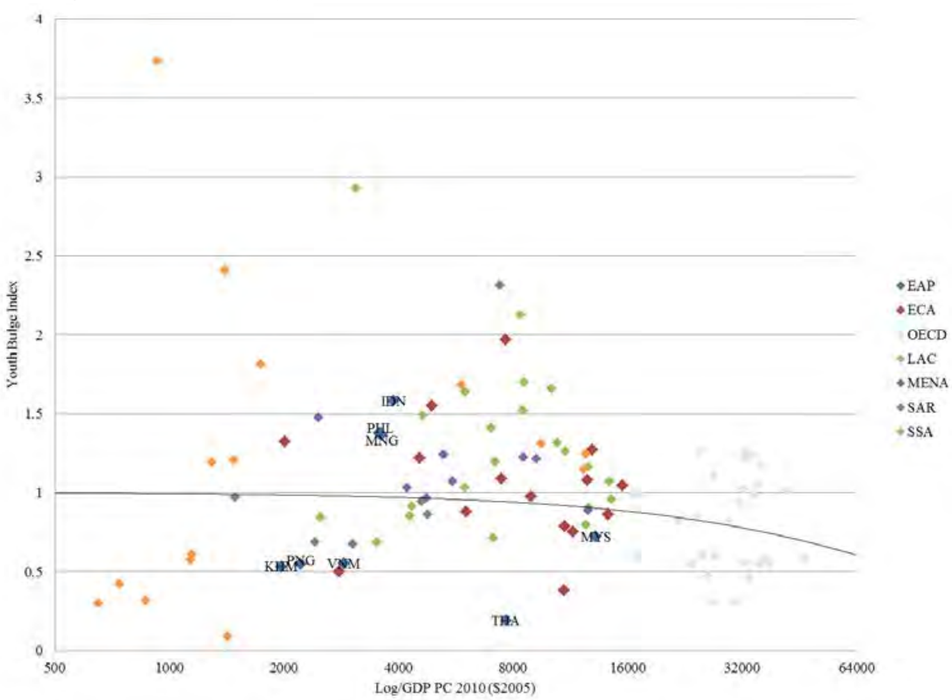
7.39 In ~~in~~ earlier chapters, youth unemployment and inactivity were shown to be a concern in Indonesia, Philippines and some of the Pacific island countries. In ~~in~~ this chapter, in order to assess whether countries have "high" youth unemployment rates, we constructed the WDR 2013's 'youth bulge index': the number of employed youth, multiplied by the youth unemployment rate (latest year) and divided by the total population in 2010.Figure 7.8 shows that, relative to the rest of the world, countries in the East Asia Pacific have relatively fewer unemployed young people. This contrasts sharply with the countries of the Middle East and North Africa. There are three notable exceptions that stand out: Indonesia, Philippines as shown before, but also Mongolia. Readers will recall that Indonesia and Philippines also stood out in the ranking of countries by measures of youth idleness (NEET) in Chapter 3.

Figure 7. 8 The problem of high youth unemployment is less acute than in other regions, but still a concern in Indonesia, Philippines and Mongolia

(a): High Youth Unemployment, EAP. "Youth Bulge Index"=number of employed youth, multiplied by the youth unemployment rate (latest year), divided by the total population in 2010. Bubble size= youth bulge (pop 15-24/pop 15-64).



(b): High Youth Unemployment, World

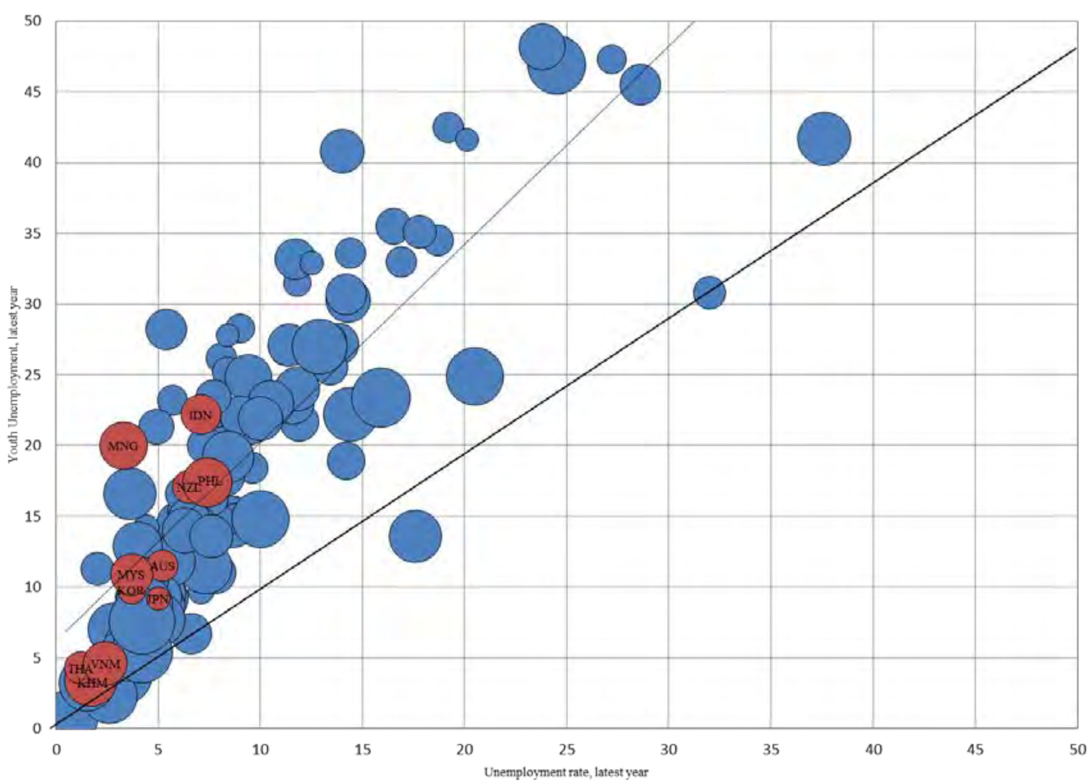


Source: World Bank staff calculations based on World Development Indicators

7.40 Youth unemployment and idleness is still a worry for many governments in East Asia Pacific, even if on a global scale the challenge appears more acute elsewhere. Alternate measures of the relative challenge faced by young people may do a better job of explaining why. Figure 7.9 shows how youth unemployment compares to overall unemployment in a large sample of countries including those in East Asia Pacific. The 45-degree line and the global regression line emphasize that typically youth unemployment is higher than unemployment in the general population, and that the two rates are strongly positively correlated. Concern rises where the youth unemployment rate deviates substantially from the overall unemployment rate. Mongolia has a relatively large youth-bulge (size of the sphere) and a youth unemployment rate of 20 percent, which far outstrips the overall unemployment rate of 3.3 percent. This is also true of Indonesia with a youth unemployment rate of 22.2 percent, compared to an overall unemployment rate of 7.1 percent. In these countries, a substantially higher youth unemployment rate is not simply a reflection of higher overall unemployment, but the product of specific barriers to employment opportunities faced by young people. Some of these arise from regulation and how social protection systems are structured and financed, as discussed in Chapter 6.

Figure 7.9 The gap between youth and overall unemployment is highest in Indonesia, the Philippines and Mongolia.

Youth unemployment rate (15-24) relative to the regular unemployment rate (15-64)



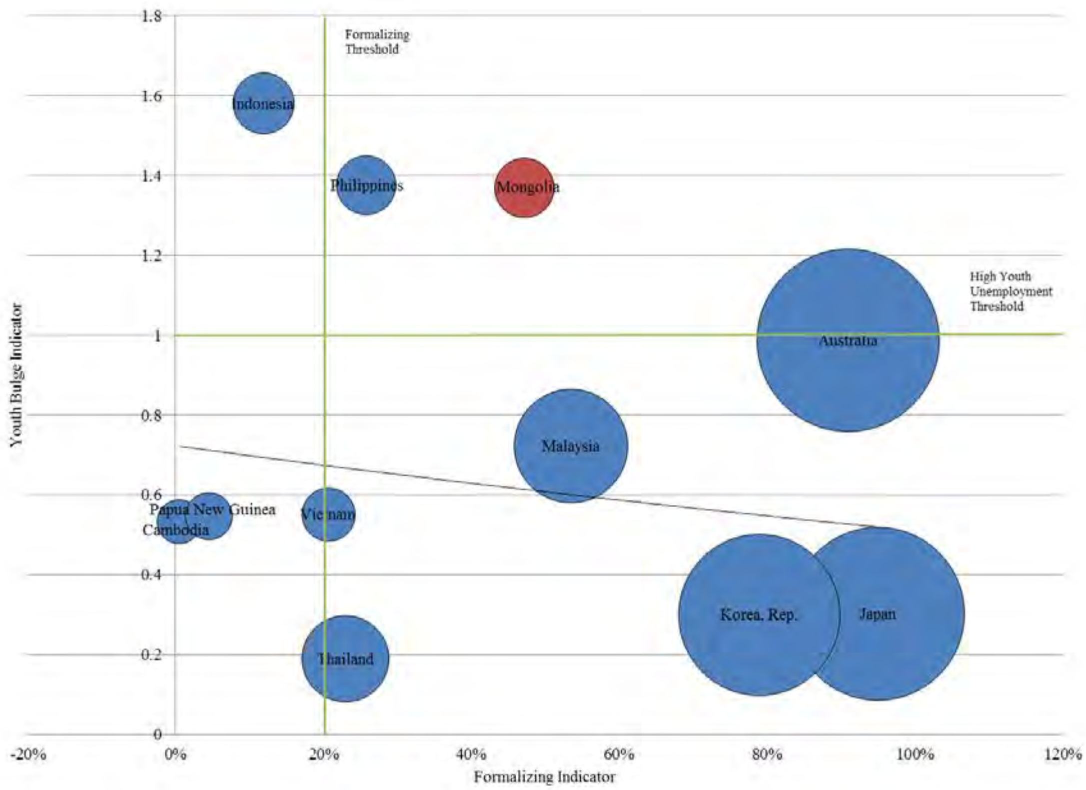
Source: World Development Indicators.

Note: size of the sphere reflects the youth bulge index.

7.41 With respect to high youth unemployment, a large informal economy introduces additional challenges. As indicated by Figure 7.10, Indonesia -in the top left quadrant- has low levels formal employment combined with high youth unemployment. When young people have few formal employment options upon entry to the labor market or early in their careers, their future work prospects can be adversely affected (Hyytinenand Rouvinen, 2008, Cruces, Ham and Viollaz, 2012). Furthermore, to the extent that a large informal economy reflects widespread use of outdated technology and a constraint on productivity, these countries may be poorly positioned to take optimal advantage of relatively large youth cohorts entering the labor market. For these reasons, although many East Asia Pacific countries lie below the 2013 WDR's global threshold of 'high youth unemployment,' this particular challenge to wellbeing from work cannot be ignored.

Figure 7. 3 Low levels of formalization combine with high youth unemployment to prejudice the longer term prospects of young people and constrain growth.

Overlapping High Youth Unemployment and Formalizing challenges: Sphere size = income per capita, 2010 ($2005).



Source: World Bank staff calculations based on World Development Indicators, World Bank Pension Database (2013).

7.4 Country categorization by endowments: 'Resource rich' and 'Small island states'

7.42 ***Resource-rich***. Sitting atop a wealth of mineral resources may seem like a blessing, but it raises pressing challenges to the supply and demand for labor and human capital. Extractive industries necessary to exploit mineral resources rarely create work beyond an initial construction phase. There are two pertinent references in the WDR 2013 that emphasize this point using countries from the East Asia Pacific region; firstly, in Papua New Guinea, the Liquid Natural Gas (LNG) project created an initial investment equivalent to 230 percent of GDP and generated some 9,300 jobs in the leading construction phase, but failed to retain more than 1000 people at work after completion. PNG's landowner companies are helping to mitigate these risks to employment and ensure more equitable distribution of welfare from resources (see Box 7.1). In Mongolia, similarly, the Oyu Tolgoi copper mine motivated an investment equivalent to 74 percent of GDP which created 14,800 jobs during the construction phase. But the mine retained less than 4,000 people working after construction was complete. Furthermore, the benefits in poverty reduction of mining sector employment are debated. Work in the mining sector in Lao PDR has had a limited impact on reducing poverty and raising living standards.[15]

7.43 Mineral resources can also account for a large share of export revenue. This can attract large foreign exchange flows that can induce inflation and "Dutch-disease" effects, causing the currency to appreciate, and harming the competitiveness of other industries that employ larger numbers of people. The best forms of work to further the development transformations in these contexts are those that grow the economy outside of the extractive industries sector, and that diversify the export base. Resource rich countries can also look to generate fiscal windfalls through increases in taxes and royalty revenues upon the extractive industries in order that fiscal spending can be spent on pro-poor, pro-employment initiatives in areas like education, health, electrification and connective transportation infrastructure.

7.44 For Figure 7.11 data on the share of minerals in total exports, 2005-2010 from the World Integrated Trade Solution (WITS) database were used to assign countries to the resource rich category.[16] A country is categorized as "resource-rich" if the portion of minerals in its exports is 20 percent or higher. By this criterion, Figure 7.11 (a) highlights five East Asia Pacific countries that are categorized as resource-rich: Myanmar, Papua New Guinea, Mongolia, Lao PDR, and Indonesia. Although not shown, Timor Leste also falls into this cattegory.[17] Among the high-income countries of East Asia Pacific, Australia alone is categorized as resource rich, and indeed, in 2012 and 2013 the country has lost employment in steel and car production, as well as in tourism and the wine industry, even as overall unemployment has remained at a low 5.5 percent.

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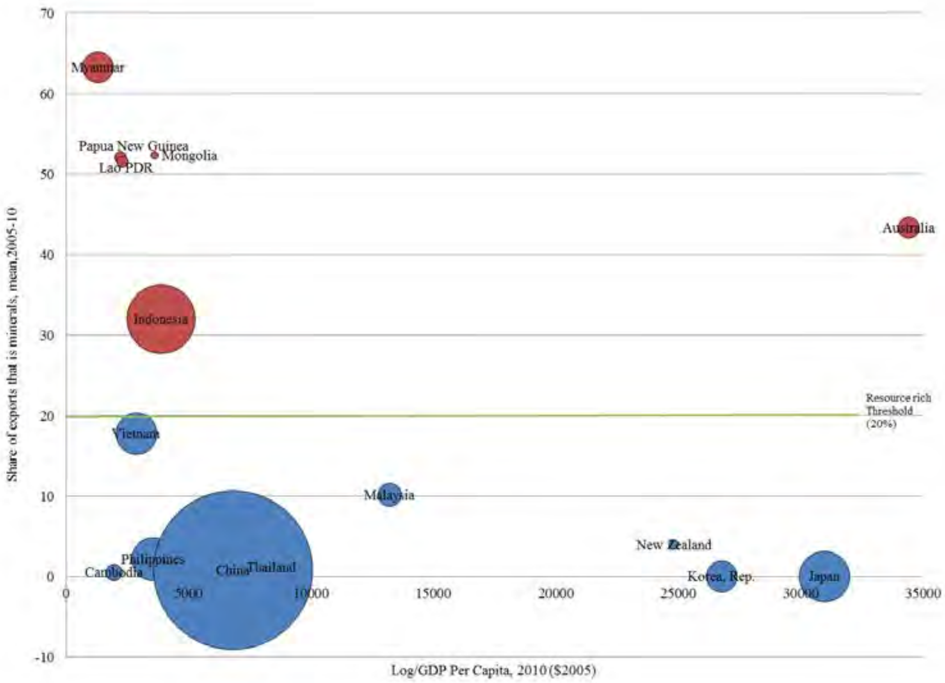
[15] "[in Lao] direct gains from employment did not significantly contribute to overall poverty reduction… even though poverty among mining sector employees fell by more than 23 percentage points between 2003 and 2008… because of its small share in overall employment, the mining sector's total contribution to poverty reduction was less than 0.1 percent out of the 6 percent nationwide reduction achieved in that same period." Lao Development Report 2010, p. 17.

[16] Data was also collected on *net*-exports of minerals in order to see if this had any significant impact on the countries that were deemed to be resource rich, and the dual jobs challenges of job creation and Dutch disease. It did not change the categorization – all were also net exporters.

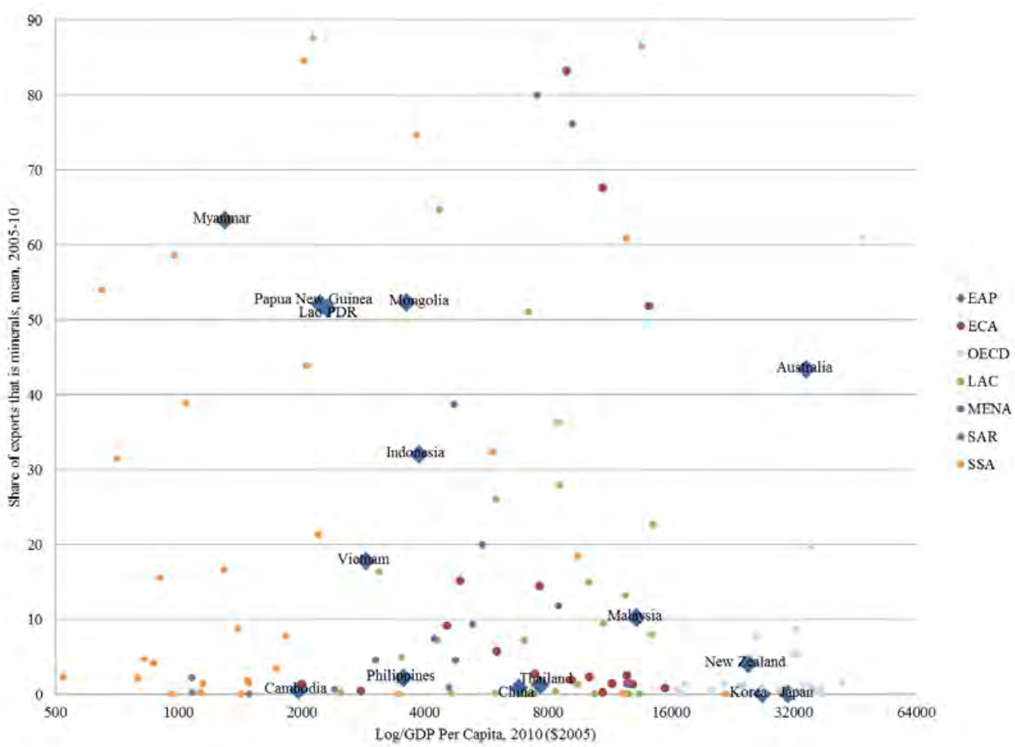
[17] For Timor Leste, alternative World Bank sources were used.

Figure 7. 4 Many economies in East Asia Pacific depend heavily on mineral exports.

(a) Resource-rich, EAP. Share of minerals in exports, mean 2005-2010, by income level 2010 and population size



(b): Resource-rich, World. Share of minerals in exports, mean 2005-2010, by income level 2010



Source: World Integrated Trade Solution (WITS) database and World Development Indicators

Box 7.1 PNG's landowner companies: Leveraging the extractive sector for non-extractive employment

As with several other countries in East Asia Pacific and in other regions, Papua New Guinea is enjoying the bounties from a natural resource boom. However, the history of low and middle income countries managing resource riches has not been good, and the pitfalls that turn a resource bounty into a resource curse, are well documented from countries in Latin America, Africa, Europe and Central Asia. But these prior experiences make Papua New Guinea doubly fortunate, as it has the opportunities to learn from past mistakes and apply good practices to manage price fluctuations and foreign exchange flow, as well as governance challenges and the threats to the labor market. The advent of PNG's landowner companies is a case in point and an example of government, international companies and stakeholders working together to spread the welfare benefits from natural resource extraction and leverage employment for the people of PNG even beyond the extraction sectors.

Family groups hold traditional ownership of the vast majority of PNG's landmass. These ownership claims tend to be hereditary, passing through the clan structure, and follow an area's tribal lines. They reflect farming and living practices that can extend back generations, although the exact boundaries of where one family group's ownership ends and another's starts may have been in dispute for similar lengths of time.

The modern Independent State of Papua New Guinea holds formal legal ownership of the nation's sub-surface resources. This legal ownership is the basis of agreements the State makes with resource companies to develop and market the country's enormous mineral and energy wealth. This mineral and energy resource extraction funds PNG's imports and much of the national and many provincial governments' budgets. But many of the richest deposits are in the country's most remote areas, where treacherous terrain makes outside access difficult. In these areas, traditional landowners' can rarely count on continuous services such as public health posts or schools or security.

The State has the legal right to purchase equity holdings in resource projects, up to limits defined in legislation. These equity holdings generate dividend streams, which add to the State's receipts from royalties and corporate taxes. The State allocates part of these dividend flows to traditional landowners, with the allocation set in legislation – for example, the State may purchase up to 22.5 percent of the equity of a petroleum project, of which 2 percentage points are allocated to traditional landowners.

In addition to this equity-based share of profits from a resource extraction project, resource developers are required to develop domestic PNG supply capacity and human skills. Resource investments are required to include national material and labor content plans, and many resource companies include such plans within their corporate social responsibility commitments. Many landowner groups seek to employ these domestic supply and capacity building requirements to negotiate contracts to supply certain services to the resource project as part of a project agreement. The State supports this process of negotiating project agreements, by establishing a national framework agreement as a starting point for negotiations, and with a specific agency established to support the negotiation process. This agency, the Minerals Resource Development Corporation (MRDC), organizes forums that bring traditional landowners, resource developers and the various government agencies together to develop benefit sharing arrangements. It also assists landowner groups to form landowner companies.

Landowner companies are entities incorporated under PNG's corporations law. An internal constitution determines various aspects of the company's operations, but for the modern resource company and the State, the landowner company presents a unified entity representing diffused traditional titles and claims. Through the landowner company the resource company can distribute payments, enter contracts which it can, at least in theory, enforce.

Landowner companies range along a continuum of business development focus. Most are at one end, focusing on distributing the revenue shares from the resource project among their members of their particular clan group. Many look to invest some of these revenues in various assets (eg, real estate) or businesses that may generate ongoing income for the landowners. Some seek to create employment opportunities for their shareholders with their local resource development by filling the service contract provisions of the benefit-sharing contracts. These are usually for low-skilled ancillary services, such as security – paying local groups to protect the mine site, equipment and workforce – or providing labor for civil works, and, in some cases, catering and camp maintenance or logistics.

From this experience of supplying services to a specific resource project, a select few landowner companies have built commercial enterprises supplying similar services to other customers in other areas. These larger businesses tend to collect into an 'umbrella' landowner company several landowner companies of landowner groups connected to the same resource project. They then manage the commercial businesses via separate but wholly owned companies. These 'entrepreneurial landowner companies' are emerging as a model for PNG to develop a diversified, job-intensive and modern domestic service sector out of PNG's traditional institutions and natural resource wealth.

A half-dozen landowner companies combine these skills. One example is Anitua, an umbrella company that unites the landowner companies of the six clan groups around Newcrest's large gold mine on the Lihir group of islands, plus the local government's business arm. Out of its catering contracts with the mine, it developed National Catering Services (NCS). In the mid-2000s, NCS started tendering for other catering contracts – some at mine construction sites (eg, Ramu Nickel) but also for other large customers outside of the resource sector (the PNG Defence Forces). Key to the successes of the entrepreneurial landowner companies has been the clear separation of their social roles from their business activities, and their solid governance of both. The umbrella landowner companies aggregate the resources and interests of smaller, clan landowner companies, creating the space for the business ventures to develop and operate protected from immediate social pressures.

The great uncertainty around the global economy, hence around commodity prices and the stream of future investment in PNG's natural resources, poses challenges especially to the entrepreneurial landowner companies. Having built growing businesses and made substantial investments in long-term capacity on the basis of a rapidly growing pool of large, cash-rich customers that prioritize production ahead of cost control, these larger landowner company businesses are more exposed to a downturn among that customer pool than the less ambitious landowner companies that looked little further their neighboring resource project. Some entrepreneurial landowner companies are clearly preparing for this. For example, Star Mountain is investing heavily in technical training colleges and developing capacity in mining services, ahead of the decline in at Ok Tedi, the key mine associated with the company.

In sum, of the many landowner companies established to share the revenues from the extraction of PNG's great natural wealth with the traditional landholders, a handful have used PNG's national input requirements to build diversified, growing enterprises. Most limited their objectives to extracting and distributing revenues from a one-off project, and some have failed to even ensure that their members receive the benefits they are due. Far-sighted business vision and skilled leadership distinguishes the most successful companies from the rest. The challenges of entry into an environment with PNG's cultural complexity, costs and limited infrastructure provide these landowner companies further advantages. They represent a means of building diversified domestic services and resource extraction upstream sectors, providing a path for thousands to transition into work and the modern cash economy. But, as the recent surge in demand passes, they will need to find means of becoming more competitive if this structure is not to become an additional cost of developing businesses in PNG.

Contributed by Timothy Bulman, World Bank Country Economist for Papua New Guinea

7.45 Figure 7.11 (a) illustrates that as many low and middle income countries in East Asia Pacific are categorized as resource-rich as those are not. Figure 7.11(b) emphasizes just how important this category and its challenges are in East Asia Pacific. Although a larger number of Sub-Saharan African countries and as many Latin American countries can also be found in the resource rich category, in both those regions there are many more countries overall. Relative to their number, the challenge of resource riches are a particularly important one to sustaining demand for work in East Asia Pacific countries.

7.46 ***Small islands states***. The challenge in raising and sustaining the demand and supply of human capital in small islands states are presented by limits to productivity and growth imposed by geography. Small island countries have a limited and fragmented landmass and –as is especially challenging for the Pacific islands- are remote from large markets. These limitations are relatively immovable restraints on growth. The priority challenge in such settings is to foster emigration. In doing so, workers access larger economic centers, cheaper inputs, and more investment, allowing them to earn higher incomes. Crucial for the development of small island economies is that these higher wages translate into remittances.

7.47 The typology sets an upper limit on what could be considered a small island state. To qualify, an island country needs to have a population of less than 1 million. Consequently, two island nations –as defined by the UN list of Small Island Developing States - Papua New Guinea and Timor-Leste do not fall into this category. Table 7.3 presents data on the populations of the small island states in the region, in 2010. The population figures are shown alongside data on land mass. Tuvalu, with a population less than 10,000, has a land mass of just 30 square kilometers. However, Fiji, with some 18,000 square kilometers more in landmass than Tuvalu, sees that land mass divided across 332 separate islands. Kiribati, one of the most remote and geographically dispersed countries in the world, has a landmass of 810 square kilometers, consisting of 33 islands, but this is spread over 3.5 million square kilometers of ocean – an area larger than India.

Table 7. 3Small populations and limited land, constrainsgrowth and the demand for work

	Land area (sp. km)	Population, total (2011)
Papua New Guinea	452,860	7,013,829
Timor-Leste	14,870	1,175,880
Fiji	18,270	868,406
Solomon Islands	27,990	552,267
Vanuatu	12,190	245,619
Samoa	2,830	183,874
Micronesia, Fed. Sts.	700	111,542
Tonga	720	104,509
Kiribati	810	101,093
Marshall Islands	180	54,816
Palau	460	20,609
Tuvalu	30	9,847
Total	64,180	2,252,282

Small Islands

Source: United Nations list of small island states

7.48 The challenges of East Asia Pacific's small island states are particularly acute and pressing, even if they are experienced by less than 2.5 million people. These are taken up in much greater detail the next chapter of this report.

7.5Country categorization by institutional factors: 'Conflict affected countries'

7.49 ***Conflict affected countries.*** Lastly, the WDR's typology contends that a country's priority challenge may be based on the weakness of its institutions, with specific reference to conflict-affected countries. The challenge for these countries is severe, and focuses on the promised gains in social cohesion through the demobilization of former combatants and reintegrating their displaced populations through productive work. East Asia Pacific is not a region with many conflict-affected countries, in the way that this category shapes thinking about employment in the Middle East and Africa. However, as touched on in chapter 3, Timor Leste, Solomon Islands, and parts of Philippines provide the exceptions.

7.50 To define this category, the WDR drew on two sources of information. Firstly, any country in the Uppsala Conflict Data Program database that had at least 1000 battle deaths in an "internal or internationalized internal conflict" in 2010 (their latest year), is categorized conflict-affected. Secondly, any country included in the 2012 World Bank fragility list that had UN peacekeeping and peace-building missions were also categorized as conflict-affected. By at least one of these criteria, Timor-Leste could be categorized as a conflict-affected country, and is the only such country in the region. That said, the UN peacekeeping force has since left Timor Leste, indicating that the country's primary challenges to increase wellbeing from work in the coming years lie in increasing the productivity of agriculture and rural non-agriculture industry, as well as in managing the potential volatility of its enormous petroleum wealth.

7.6 Implications for policy makers concerned about work

7.51 Setting aside for the time being the challenges faced by small – and more importantly, *distant* – Pacific Island countries which we return to in chapter 8, and those of the 'resource rich' category of countries (Myanmar, Indonesia, Mongolia, Timor Leste and Papua New Guinea), most countries in the East Asia Pacific region are 'agrarian' or 'urbanizing'. Indeed, as shown by the size of the spheres in Figures 1(a) and 2(a), most *people* in the East Asia Pacific region are living and working in mainly agrarian and rapidly urbanizing contexts. This is an important insight for readers to take from this chapter, because according to the WDR 2013, when countries are (or are close to) urbanizing, all three development transformations tend to happen in tandem: productivity and wages are increasing, living standards are rising and as more people move out of poverty and into the urban middle class, there is greater social cohesion. Chapter 3 presented a large body of evidence showing how all three development transformations have unfolded in East Asia Pacific countries.

7.52 As shown in the previous section, most people in East Asia Pacific are now or soon will be living and working in countries that are nearing the end of the structural transition from 'agrarian' to 'urbanizing' economies. During the transition from agrarian to urbanizing –which in East Asia has generally coincided with lower fertility and the emergence of the demographic dividend- the economic forces released from the large-scale movement of people from rural farms to urban firms, are so powerful that they propel all three development transformations, with only a minimal need for policy intervention. However, at a critical point when urbanization is already well advanced, one or more of the three development transformations can start to lag. In East Asia Pacific countries, the evidence presented in Chapter 3 suggests that these lags are indeed starting to appear in China and Indonesia. In the Philippines, lagging productivity gains and a slower rise in living standards have been apparent longer.When these lags appear or become significant, people can begin to question the extent to which work is still a conduit of wellbeing -whether economic growth is sufficiently inclusive- and demand governments to adopt employment strategies. Notably, the development trajectories of East Asia's high-income country success stories – Japan, Singapore, Korea and others - all included periods when calls for "jobs strategies" were heard. But the answers that made sense for those countries at the time may not be viable today, as we discuss in Spotlight 2.

7.53 For countries that are still mainly agrarian, the priority policy challenge is to increase the productivity of agriculture, to free labor to work in rural off-farm enterprise and eventually to migrate to towns and cities. The policy instruments for increasing agriculture productivity and facilitating the structural transition are land reform, agriculture extension programs, deregulation of prices, rural infrastructure and good quality education and health services to build human capital. Policies and programs that create implicit or explicit restrictions to labor moving off the farm and into rural non-farm industry and to manufacturing and services in cities, will be the main obstacles to sustaining the supply and demand for labor and human capital. Government action should enable as fluid a structural transition as possible. The WDR showcases Vietnam's experience in the 1990s and the first decade of the 21st century as an example of success. The danger to be avoided is urbanization in-spite of rather than enabled by policy. This is characterized by unproductive use of land, migration in the search of better health and education services, cities unprepared for fast population growth, and rapid divergence in living standards between town and country. This is the history of the Philippines' notably less successful transformation.

7.54 For countries that are already rapidly urbanizing, the priority policy challenge is to make cities work. Somewhat counter-intuitively in a discussion about work, the factor market that policy makers should pay the greatest attention to is the market for land. Since land is the least mobile factor of production, good urban planning, registration and land titling, liberalization and appropriate taxation becomes the key instruments to increase the flexibility of land use. Urban planning becomes the area of policy making with the greatest impact on the incentives of firms in towns and cities to form, to grow, to move up the value chain, and thus to create and sustain employment. Also important are planning and management of connective urban infrastructure and service provision. Adequate connective transportation infrastructure and service (water, sanitation, health and education) provision can ensure that growing cities with plenty of skilled people, foster economies from agglomeration rather than incur burdening costs from congestion. Korea's example is instructive in this regard and provides valuable guidance for policy makers in fast-urbanizing countries of East Asia Pacific.

7.55 For countries where most people live in cities and a rising share of economic activity is formalizing, the priority challenge lies in avoiding the formation or entrenchment of a policy and regulatory environment that causes segmentation. Segmentation creates the problem of cleavages in factor markets that impede competition, impair labor mobility, and limit the coverage of essential work-risk and social protection. In this way, segmentation creates unnecessary constraints on a country's productivity, rations gains in living standards to connected groups, and in so doing threatens social cohesion. Segmentation of the factor markets can be caused by differences in how income from different sources is taxed; by rules for providing credit that explicitly or implicitly exclude self-employed people; by the types of work that are recognized in the labor code and those which are not recognized; and how non-wage social protection benefits are designed and financed. Models of labor regulation and social protection that tie eligibility to certain forms of work, and which are financed from mandatory contributions from employees and employers, create segmentation by design, even when they are administered perfectly. In most low and middle-income countries, segmentation by design is aggravated by weak institutional and administration capacity.

7.56 Avoiding and eliminating segmentation of factor markets is essential if countries of East Asia Pacific are to grow in wealth before they have to face the more difficult challenges of an aging economy. This is the current quandary of many middle income countries in Central Europe and the Southern Cone of Latin America that got old before they got rich. Their example should strike a strong note of caution for policy makers in East Asian Pacific countries where the average age of the labor force and the share of the elderly in the population is quickly rising.

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Chapter 8: Wellbeing from Work in the Pacific Island Countries

Small and distant from world markets, labor mobility represents the most significant and substantial opportunity for overcoming geographical constraints on employment in the Pacific island countries.

8.1 This chapter presents a brief overview of employment challenges in small Pacific island countries and recommendations for addressing them. It is of a very different nature from the rest of the report in the sense that this chapter can serve as an almost self-contained piece. The Pacific island countries are not only very different from the rest of the East Asia Pacific region but also unique in the world. Therefore, to be useful, a coherent discussion of work in these countries requires its own space to describe the context, analyze employment outcomes, and recommend policies.

8.2 We begin with an assumption that, due to realities of economic geography, small Pacific island countries are unlikely to follow the employment trajectory of fast-growing East Asian economies. Given the particular challenges and opportunities facing these countries, discussion in this chapter relates to the World Bank Group member island states of the Pacific, with populations of significantly less than one million. These are Solomon Islands, Vanuatu, Samoa, Tonga, Tuvalu, Kiribati, Republic of Marshall Islands, Federated States of Micronesia, and Palau. Economic growth and diversification has been very limited in these countries because of the barriers imposed by smallness and distance, and these barriers will not be quickly overcome. Policy tweaks to the business environment aimed at fostering the emergence of an export-oriented private sector are unlikely to be effective in generating substantial work. The challenge for policy-makers is therefore to think about how to meet employment challenges within the formidable constraints imposed by geography.

8.3 Slow economic growth, rapid population growth, and accelerating urbanization mean that employment creation is a pressing priority for small Pacific island countries (PICs).[i] The appropriate employment strategy will vary between these countries, given diversity in size, location, natural resource endowments, and demographics. But the chapter proposes the following five priorities that are likely to be broadly applicable to this unique group of countries.

8.4 Stakeholders' expectations about the trajectory of development will need to be realistic. Due to inherent geographical obstacles, PICs are unlikely to experience export-driven development and associated employment creation of the scale seen in the broader East Asia Pacific region. While business environment reforms can open up new opportunities for private sector development and employment creation, such measures are unlikely to spur sufficient work to meet emerging demands even if the best possible business environment settings could be put in place. Employment strategies must therefore include less conventional policy options and focus on areas where PICs have established strengths and advantages.

8.5 The volume of international labour mobility should be increased through the erosion of regulatory barriers and investment in transferable human capital. PICs will never be able to achieve the scale and integration seen in larger regional economies. The greatest potential for work is therefore through mobility of Pacific Islanders to areas where employment opportunities are concentrated. The priority for policy is to provide people from the PICs with access to work wherever it exists. Echoing the conclusions of earlier World Bank reports (World Bank, 2008), this will require both changes in the immigration policies of the nearest large economies, and careful investment in internationally transferable human capital by small PIC governments.

8.6 Governments can harness the power of urbanization through investment in improved rural services, connective infrastructure, and improved urban administration. Urbanization is a reality in most PICs, and one that should be enthusiastically embraced. Urbanization accompanies development, allowing the realization of scale economies, greater thickness in markets, and increased specialization. Urbanization driven by these positive economic benefits should be facilitated. But urbanization occurring as a result of poor services in rural areas, conflict, food insecurity, or land shortages simply leads to congestion and urban unemployment, delivering few economic benefits, and placing pressure on social cohesion. Policies should not be biased towards employment in either urban or rural areas, but rather seek to ensure acceptable standards of living across all communities and allow individuals to respond as they choose to the inevitable concentration of economic opportunities in urban areas. This will require: i) a movement away from policies aimed at preventing urbanization, such as inadequate legal protection for recent arrivals in urban areas, under-provision peri-urban services and infrastructure, and production subsidies to rural areas; ii) sufficient public investment in infrastructure links between agricultural areas and cities; iii) improved land administration and increased investment in services in urban areas; and iv) interventions to assist agricultural productivity and support rural services and standards of living.

8.7 Public spending and ensuring adequate service delivery can create employment. Large public sectors in PICs are often a source of concern, with public sector employment thought to exist at the expense of increased private sector employment. In reality, scope for private-sector led employment creation is often constrained by geography. Public sectors, while large relative to the size of the economy, remain small in absolute terms and when diseconomies of scale in administration and service delivery are taken into account. Public sector employment is therefore likely to continue to provide a substantial share of work in PICs. Policy attention can usefully focus on ensuring that such employment is productive and sustainable rather than on necessarily reducing the number of public sector jobs. Private participation can provide incentives for efficient delivery of public services, but needs to be approached carefully and selectively. Broader public sector reforms to ensure efficiency and effectiveness need to continue. Donor agencies and governments can work to ensure that development expenditure supports the creation of local employment opportunities.

8.8 Natural resource industries can be a sustainable source of employment creation. Natural resource industries can flourish despite higher cost structures in PICs, offering opportunities for employment. But work in natural resource industries is often unsustainable and contributes little to living standards. Judgements about policy intervention to create employment within these industries should consider the quality and sustainability of the work they are likely to create. PICs might often benefit most from converting rents from natural resource industries into improved infrastructure, services, and human capital, rather than seeking direct large-scale employment in those industries through implicit or explicit subsidization.

8.9 In the remaining sections of this chapter, we present an overview of work in the Pacific and a summary of emerging employment challenges. We then provide recommendations for dealing with these challenges. In the final section, we provide a summary of policy conclusions.

8.1 Employment challenges of the small Pacific island countries

8.10 The Pacific island countries are following a different employment trajectory to the rest of the region. As shown in the early chapters of this report, much of East Asia Pacific has enjoyed rapid economic growth and economy-wide productivity increases over recent years, driven by the large emerging economies of East Asia. This has occurred with an explosion of work opportunities in higher-productivity manufacturing and service sectors, often globally-integrated and focused on exporting, and almost entirely in urban areas. This transformation has fed on itself, with productivity gains from agglomeration and increasing wage incomes fuelling domestic demand. In short, export-driven structural transitions of East Asian economies have contributed to creating employment and boosting the wellbeing people get from work. The experience of East Asia, however, has not been the experience of most Pacific island countries. There is little sign in PICs of the broader economic changes that are transforming much of the region. Access to regular paid work is limited, and labor productivity remains almost static. Real GDP per capita has increased by 650 percent for the East Asia Pacific region since 1982, but for the larger of the economies discussed in this chapter, output per person has increased by only 38 percent. Real exports from East Asia Pacific as a whole have increased by a factor of nine since 1990, while exports from these Pacific countries are only about twice their 1990 value (Figure 8.1). The percentage of the population living in cities in the average small PIC is about the same as the percentage of the East Asian population living in cities in 1960 (Figure 8.2).

Figure 8.1: PICs have not transitioned to export-led manufacturing and services

Real Export Values – PICs and EAP

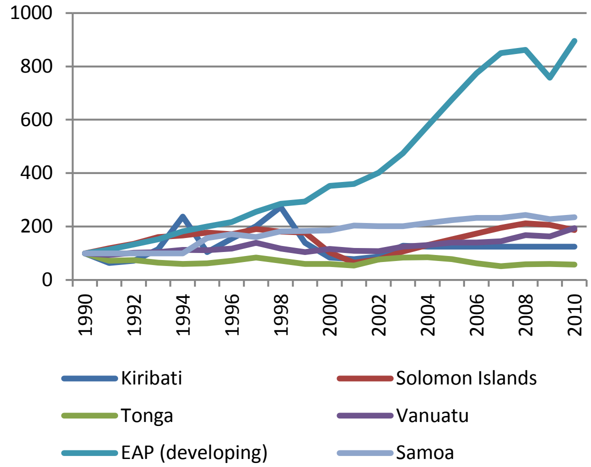
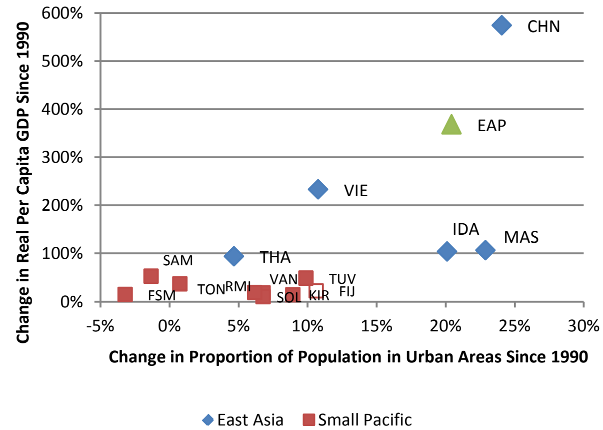


Figure 8.2 : PICs have lower rates of growth and urbanization

Urbanization and Growth (%) - PICs and EAP



8.11 Data on employment in the Pacific island countries is scarce. Official statistics provide an incomplete picture of employment and work in small Pacific island countries. Little data on employment is available beyond that which is collected from Household Income and Expenditure surveys and censuses. There are important inconsistencies in definitions used in available surveys across countries, leading to large variation in reported labor force participation and unemployment rates that do not reflect underlying economic or social realities.

8.12 Some employment patterns are common across most PICs. A small number of Pacific Islanders have formal employment, most of which are in cities and a large number of which are in the public sector (Box 8.2). Most Pacific Islanders engage in some combination of agriculture, for a mixture of subsistence and cash or barter exchange, and informal small-business activity, either as part-time employees or business-owners. In cities, many individuals are employed on a part-time or casual basis by small businesses, operating informally, while many others generate income through a range of informal and part-time own-business trading opportunities such as operation of temporary retail stalls or selling products in the town market. Many Pacific Islanders move between agricultural production for exchange, subsistence agriculture, and informal small-business activities, and cannot easily be assigned to a single employment category. Those with formal employment may also engage in agricultural or subsistence activities at various times to generate additional cash income or meet various social obligations.[ii]

Box 8.2: Where is the work?

The following chart, based on data from the National Provident Funds of Kiribati, Solomon Islands, and Vanuatu shows employment shares in the formal private sector, the public sector, and various forms of informal employment.

Of formal employment, the share within the public sector is very large, ranging from 30 percent in Solomon Islands to nearly 80 percent in Kiribati. Given that the vast majority of Pacific Islanders are engaged in some form of work, the dominance of informal employment, including agriculture for exchange, is also clear from the size of the working-age population without formal work.

Source: National Provident Fund and census data

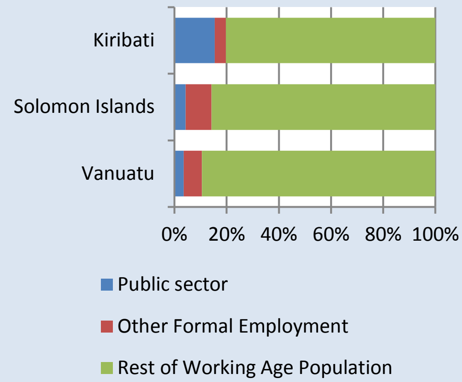
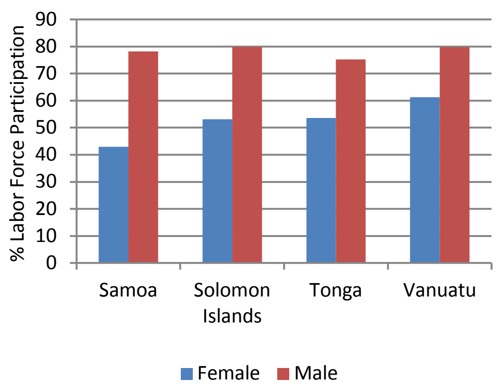


Figure 8.3: Women are less likely than men to participate in the labor force
Labor Force Participation rate (%), by gender



8.13 Work patterns vary strongly by gender. Across Pacific island countries, men dominate paid employment opportunities outside of agriculture, with approximately half as many women accessing these opportunities. In Melanesia, women occupy only one third of positions within the formal economy. Women's economic activity tends to be concentrated in the informal sector, and especially in agriculture (UNESCAP, 2007). While data constraints preclude extensive analysis, it is clear that women have access to a narrower range of employment opportunities than men, and often lack access to higher-paid work. This imposes costs on the economy, with analysis from the broader East Asia Pacific region suggesting that elimination of barriers to women's participation in certain sectors and occupations could improve labor productivity by up to 25 percent for some countries (UNESCAP 2007).

8.14 Growing youth populations put pressure on the economy to generate enough work. High fertility rates are driving rapid population growth in several PICs, with the Pacific population expected to double over the next 28 years. PICs also face a youth bulge: 54 percent of the population is below the age of 24 – a higher proportion than East Asia, all developing countries, and the world. The number of people between the ages of 0-14 substantially exceeds the proportion of the population between 14-25, and the number of working-age youth is expected to grow quickly over the next decade. Previous work by the World Bank has shown that it will be a challenge for the private sector to generate enough new jobs to meet expected increases in labor supply. Formal employment opportunities are already limited relative to the labor force in many PICs. Recent estimates from the ILO suggest the percentage of men aged between 20 to 24 years that are not engaged in *productive activities* (defined as "paid or unpaid activity that contributes to their personal livelihood or that of their family and community as a whole") is as high as 58 percent in Kiribati, 44 percent in Marshall Islands, and 46 percent in Samoa (International Labor Organization, 2013).

8.15 Other factors will also impact on the demand for work. Social services have achieved remarkable success in improving health and education outcomes across small Pacific countries over recent decades. At the same, the spread of telecommunications and mass media has fuelled aspirations for higher living standards and increased awareness of the wider world. Relatively better-educated and healthier people are more likely to have aspirations beyond village-based and family-oriented agricultural and fishing activities. The pressure associated with these growing aspirations is already spilling over into increased rates of urban migration as young people seek cash incomes and broader opportunities. It is likely to be felt most acutely in countries with currently low levels of emigration and limited formal sector employment opportunities. While global trends suggest agricultural based livelihoods are becoming less desirable, they may also become more difficult. In some countries, including Kiribati and Solomon Islands, rural population growth is placing pressure on subsistence systems, leading to falling productivity and crop-yields (Reddy, 2007). Pressure on subsistence systems may become an additional driver of urban migration, and further increase demand for alternative employment opportunities.

Figure 8.4: PICs have very young populations

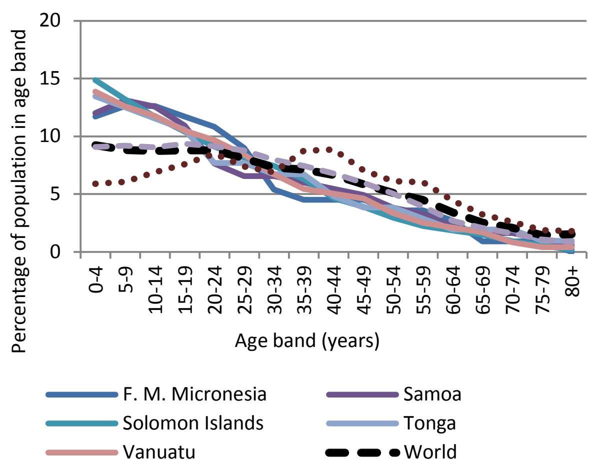
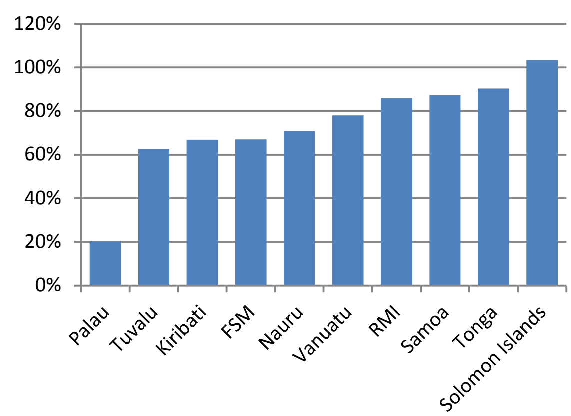


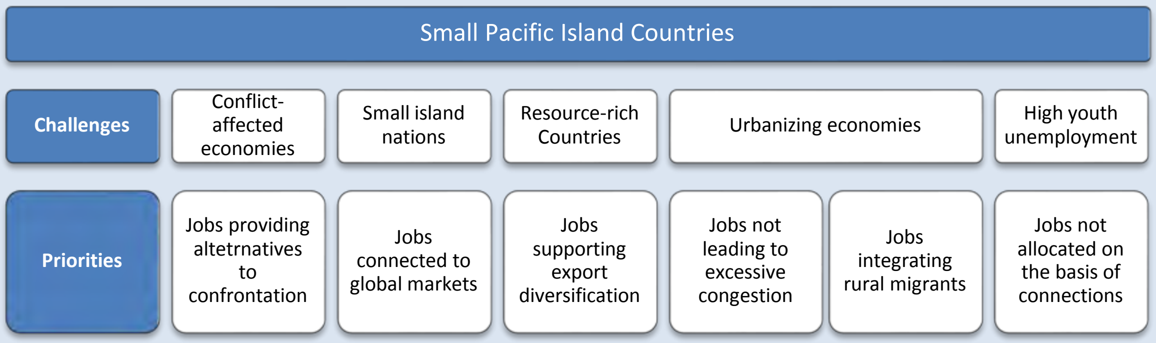
Figure 8.5: Rapid growth in the number of youth is expected over coming years

Expected growth in 15-24 yo Population by 2020



Box 8.3: Overlapping employment challenges

WDR 2013: Jobs explicitly recognizes that different employment challenges will require different policy responses, discussed at length in Chapter 7. Small Pacific Island countries face a complex and overlapping range of challenges, including at least five of the challenges specifically identified in the WDR 2013 report. The following figure shows challenges relevant to PICs, and the associated priorities for policy makers identified in the 2013 WDR. These priorities are reflected and elaborated in the recommendations of this chapter.



All small island countries face inherent barriers of scale and distance, which can preclude the development of manufacturing and service industries associated with high productivity, better-paid work. Many countries in the region are endowed with natural resources, in the form of mineral deposits, forests, and fisheries. The development of these industries can lead to uneven and unsustainable development and squeeze out growth in parts of the economy. Solomon Islands remains a post-conflict country, and faces continued conflict pressures arising partly from uneven distribution of economic opportunities, including concentration of formal sector employment in the capital city, Honiara. Urbanization continues to generate pressures for small Pacific Island Countries like Solomon Islands, Vanuatu, Marshall Islands, and Kiribati, with the pace of growth in urban populations outstripping the pace of employment creation, and feeding concerns regarding youth unemployment and associated social problems. These problems are exacerbated by very large and growing youth populations in many PICs, especially in Melanesia.

Source: World Bank 2012b

8.16 Small Pacific island countries face a cluster of overlapping employment challenges (Box 8.3). Without the opportunities generated by rapid economic transformation, PICs face several challenges to creating employment. Many PICs have rapidly growing populations of young people that are unlikely to be satisfied with the limited opportunities for self-advancement offered by agricultural subsistence. Some small PICs are already facing the related challenge of rapid urbanization and struggling to generate work for growing urban populations. Some have emerged from conflict and face ongoing conflict pressures, with the accompanying need to maintain access to opportunities and ensure their careful distribution between groups and regions. Several countries are struggling to ensure sustainable benefits from extractive resource industries, including encouraging the development of ancillary industries, diversification, and sustainable employment generation.

8.17 Governments and donors are concerned about the quality and quantity of employment available to Pacific Islanders. Governments and donors in PICs and elsewhere have previously implemented policies to support employment creation in specific geographical locations or sectors, based on prior assumptions about what “good” employment is. Often, policies have sought to support rural employment over employment in urban areas; work within the local economy over work in larger markets; private sector employment over employment in the public sector; and through concessions or subsidies to encourage employment within specific natural resource industries. Results of this approach have mostly been unsatisfactory, with underlying economic realities derailing well-intentioned plans. As discussed in the WDR 2013 and in prior chapters of this report, the employment strategies that are most likely to succeed focus on how to ensure work raises living standards, drives greater productivity, and contributes to greater social cohesion, regardless of the geographical location or sector where that work takes place.

8.2 Five employment priorities for Pacific island countries

8.18 In this section we present five employment priorities for the PICs. The applicability of these priorities varies across countries according to size, location, demographic profile, natural resource endowments, and nature of existing economic activities. No single strategy will be appropriate for all countries. Nonetheless, shared geographical characteristics of PICs suggest some shared challenges and potential for some common solutions.

Priority 1: Expectations about the trajectory of development will need to be realistic

Summary of Priority 1:	Due to inherent geographical obstacles, PICs are unlikely to experience export-driven development and associated employment creation of the scale and nature seen in much of the East Asia Pacific region, even under the best possible business environment settings. Employment strategies must therefore include less conventional policy options and focus on areas where Pacific Countries have established strengths and advantages.
Countries of Relevance:	All PICs, especially those where populations are very small and dispersed.
Living Standards:	Forces of economic geography mean that PICs are unlikely to see rapid improvements in living standards from private-sector employment creation. Alternative means of supporting higher living standards through work are required.
Productivity:	Scale and concentration are vital for productivity. Small, dispersed, and distant populations face inherent limits to productivity that need to be reflected in employment strategies.
Social Cohesion:	Social cohesion can be undermined by unrealistic expectation regarding prospects for economic and employment growth.

8.19 Export-driven, private sector development is unlikely to be the answer to employment challenges facing small Pacific Island countries. A common message in reports regarding economic growth or employment creation in PICs is the importance of reforms aimed at improving the environment for the private sector. Improving the business environment can deliver important benefits to small Pacific Island countries. A legal and regulatory framework that supports investment and the sound functioning of factor markets can facilitate the creation of employment within businesses supplying local markets or in niche export industries. Continued investment in reforms to reduce costs of doing business (for example, see figures 8.6 and 8.7) therefore remain an important priority, especially for those Pacific countries where compliance costs facing businesses are out of line with regional or global norms. It is important, however, not to overstate the likely impact of such reforms on employment creation. Due to inherent geographical obstacles, PICs are unlikely to experience the scale of export-driven development and associated employment growth seen in much of the East Asia Pacific region under any regulatory or policy settings.

Figure 8.6: Costs to start a business are higher in many Pacific island countries

Costs to start a business as % GNI per capita

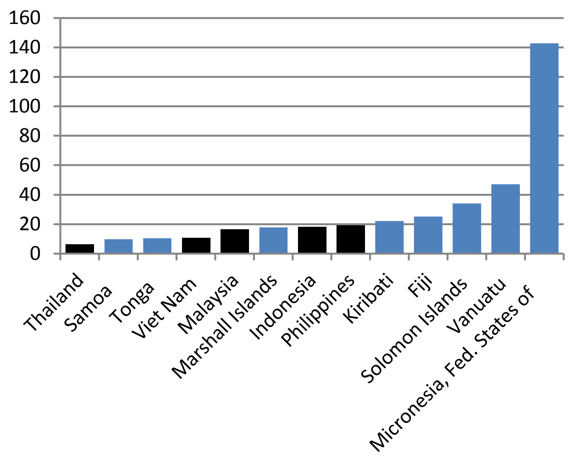
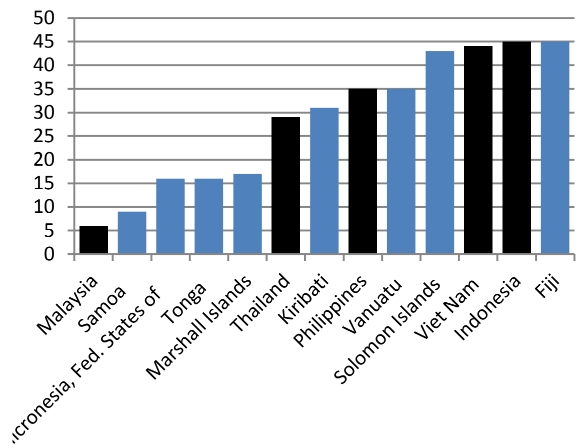


Figure 8.7: The time required to start a business is burdensome in Pacific island countries

Days needed to start a business



8.20 The formidable geographic challenges of smallness and distance impose costs**.** The small PICs discussed in this chapter are all among the world's fifty smallest countries. *Smallness* makes it hard for businesses to achieve economies of scale. With relatively few domestic businesses, firms find it difficult to outsource upwards and downwards through the supply-chain. Firms also experience less exposure to positive knowledge externalities, as they are unable to observe the practices of other firms in the same industry, and lack access to a pool of workers with experience in different firms. In other small countries, firms overcome some of the costs of smallness by trading internationally. But PICs are also some of the most isolated countries in the world, when measured using a variety of economic measures.[iii] Great distances increase the costs of exporting and the price of imported inputs.

8.21 The combined cost impacts of smallness and distance are sufficient to undermine competitiveness of the industries that have supported growth in larger economies. Recent quantitative research has investigated just how significant the costs arising from small scale and remoteness might be for countries like those of the Pacific (Yang et al. 2012; Tumbarello, Cabezon and Wu 2013). Winters and Martin (2004) find that capital would earn negative returns if it were invested in export manufacturing in nearly all of the Pacific island economies. Even if wages were zero in most Pacific countries, total costs would still exceed world prices both in manufacturing and also for a service industry such as tourism.

Figure 8.8: PICs are unique in their combination of smallness and isolation

Size and Isolation by Country Group

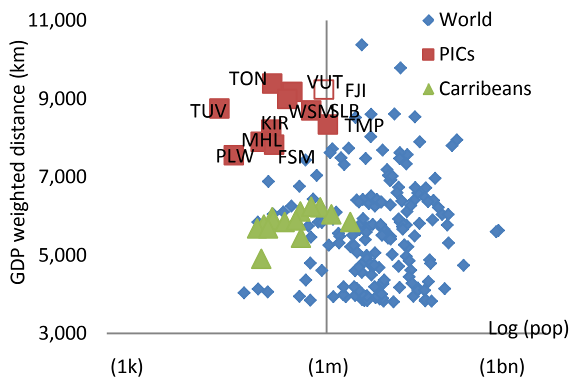
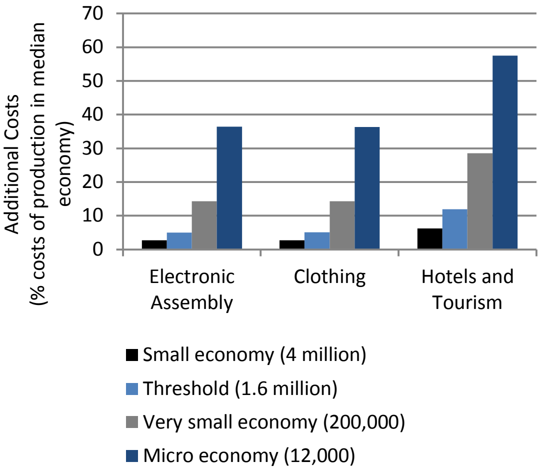


Figure 8.9: Costs of smallness and isolation undermine competitiveness in transformational industries.



8.22 Constraints of geography have been consistently reflected in the structure and performance of small PIC economies. The economies of small PICs have remained dependent on aid, remittances, and natural resource industries (Bertram and Watters 1985). Large structural current account deficits have continued for all but a few natural resource-rich Pacific countries. Growth in consumption, fuelled by aid and remittances, has been almost entirely met by increased imports rather than increased domestic production, reflecting higher local cost structures. Economic activity and employment has occurred in areas where inevitably higher costs do not undermine viability, and local activity does not face direct international competition (World Bank, 2011). These areas include: i) public services and infrastructure, which account for a large share of formal employment; ii) non-tradable private-sector goods and services, often focused on meeting demand from the public sector or public-sector employees; and iii) natural resource industries, including tourism, where rents can be generated despite higher cost structures. It is important to note that while economic drivers in small PICs are different to those in larger economies, they have served PICs very well in lifting incomes and living standards well above those in many larger and less isolated developing economies.

8.23 The geographical forces that determine what work is available in PICs will remain significant over time. Contrary to the East Asian experience of diversification, PICs might expect further concentration in traditional areas as preferential access arrangements for key export industries are removed and countries move to further liberalize trade and investment, and improve transport and communication links. Loss of preferential access will mean that PICs face the full competitiveness impacts of higher costs in manufacturing and services for export, while economic integration will reduce barriers to competition from imports. As global economic activity becomes more and more concentrated, and the benefits of agglomeration in large urban centers increase, the scale disadvantages faced by PICs will become relatively more significant.

8.24 Employment strategies will need to be feasible within the constraints imposed by geography. The extent of employment creation from improvements in the business environment should not be overstated. Even under the best possible business environment settings, it is not clear that the private sector would be able to generate significant employment through export-driven growth, due to cost disadvantages of geography. This is not, however, reason for pessimism. Policy options are available that build on Pacific island countries' existing strengths, despite inherent geographical constraints.

Box 8.3: Are Costs of Distance Declining?

Advances in technology might be expected to have reduced the costs of transport over time, mitigating the disadvantages faced by PICs in accessing international export markets, and reducing the cost of imported inputs. A trend of falling transport costs might suggest new export and economic development opportunities for PICs, and a decline in the significance of geography in constraining employment creation in the private sector. Unfortunately, available evidence suggests that geographical proximity remains a primary determinant of trade links and show no significant reduction in costs of distance over time.

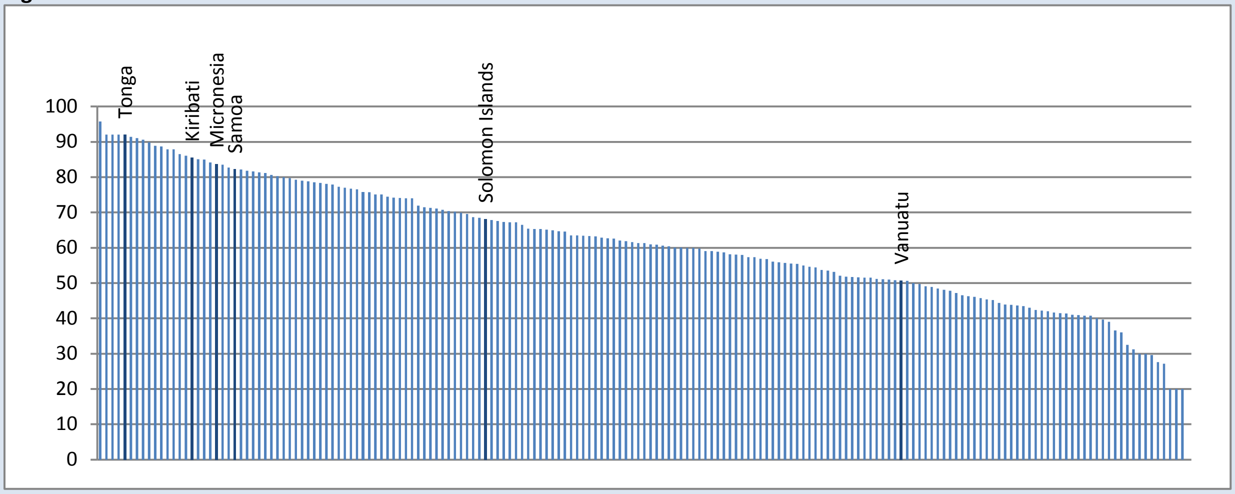
Analysis from economic "gravity models" show that even in the current age of globalization, 90 percent of the trade that occurs over a distance of 1000km would cease at a distance of 9000km. Because costs of distance are so important, around 23 percent of global trade occurs across a shared land border between countries. This proportion has been constant for several decades. Hummels (2007) provides a detailed analysis of air and ship freight costs over time. He finds that, despite innovations including containerization and the introduction of the jet engine, there has been no significant reduction in shipping costs (as a proportion of the value of products shipped) since the 1950s, while air transport costs have actually increased substantially over the past decade. Cost trends have been driven by higher fuel costs, with oil price increases more than offsetting the cost reductions associated with new technologies.

Source: Venables (2006), Hummels (2007), Yang et al. (2012)

Box 8.4: Is labor regulation "off the plateau" in PICs?

Very limited data is available on labor market policies and their impacts from PICs. The Labor Freedom Index – a component of the Heritage Foundation's Index of Economic Freedom – provides a ranking of the restrictiveness of labor regulations from an employer perspective, using data collected through the Doing Business Survey. Reaching any firm conclusions regarding labor regulation in PICs would require better information, and labor regulations imposed on firms are just one element of labor market policies (see chapter 6 of this report). This data suggests, however, that labor regulation in PICs is not unusually restrictive. Four of seven PICs included in the index are among the 25 countries with least-restrictive policies. Only Vanuatu is among the "more restrictive" half of countries covered by the index. On the basis of this evidence, it seems unlikely that overly-prescriptive labor regulation is a primary constraint to private sector growth and productivity in most PICs.

Figure: Labor Freedom Index – All countries



Source: Heritage Foundation

Priority 2: Improved international labour mobility through erosion of regulatory barriers and investment in transferable human capital

Summary of Priority 2:	**Geographical realities will constrain work opportunities in PICs. Governments and donors can facilitate access of Pacific Islanders to employment opportunities even across national boundaries. This will require both changes in the immigration policies of the large regional economies, and careful investment in internationally transferable human capital in PICs.**
Countries of Relevance:	All PICs, especially those where population growth is rapid and current access to international labour markets is limited.
Living Standards:	Overseas employment opportunities have been shown to support higher living standards for migrant workers and their families.
Productivity:	Mobility allows labour to flow to areas where it can be most productively employed. Labour mobility can encourage investment in human capital, benefitting both sending and receiving countries.
Social Cohesion:	Labour mobility can reduce pressures arising from youth unemployment and defuse contests over access to economic opportunities.

8.25 Labor mobility represents the most significant and substantial opportunity for overcoming geographical constraints to employment in the Pacific island countries. A key lesson from the 2009 World Development Report "Reshaping Economic Geography" (World Bank, 2008) is that productivity is associated with scale, density, and concentration. The geographical location of a worker is an important determinant of that workers' productivity and, therefore, income. Even within the same densely populated industrialized country, a worker in a large city typically earns more than a worker with identical experience and skills in a smaller city because of the productivity benefits associated with scale, specialization, and knowledge spillovers (Venables, 2006). Work in small PIC economies, with small, dispersed populations and thousands of kilometers distant from global centers of production, is likely to remain, on average, substantially less economically productive, and therefore paid less, than work in larger, better integrated economies. GDP per capita in Australia is now around twenty times that of Vanuatu, and forty times that of Solomon Islands. Living and working in nearby Australian and New Zealand economies provides a range and depth of economic opportunity far beyond what is likely to be available in small Pacific economies for the foreseeable future, given low rates of growth and limited opportunities for economic diversification (World Bank, 2011). A key opportunity for improving living standards and productivity of small PIC workers is to provide improved access to employment opportunities in places that do not face the same constraints of smallness and isolation. A growing body of evidence demonstrates that improved labor mobility for Pacific Islanders would provide gains to migrants, their families, sending countries, and receiving countries.

Box 8.5: Pacific labour mobility arrangements in Australia and New Zealand

New Zealand and Australian migration policies continue to have an important impact on Pacific Island labour mobility and broader development outcomes in PICs. Rapid increases in Pacific populations living in New Zealand and Australia have fuelled remittance flows, offset population growth, and expanded economic opportunities. Since 1971, the Pacific-born population of New Zealand and Australia increased from 46,000 to more than 250,000, with around 140,000 in New Zealand and 110,000 in Australia (Bedford, 2012). The growth in Pacific-born populations has occurred through very different channels, reflecting divergent policy approaches to Pacific migration.

Alongside its country-neutral points-based immigration schemes, New Zealand has maintained a range of special access arrangements for PICs. These are targeted towards those countries that have the strongest constitutional or historical links to New Zealand. Measures include:

- **Special citizenship relationships.** The populations of Cook Islands, Niue, and Tokelau have full New Zealand citizenship and associated rights to work in New Zealand.
- **The Samoan quota.** New Zealand allows allocation of residence visas, allocated by ballot, to 1,100 Samoans between the ages of 18 and 45 each year. Successful primary applicants must obtain an offer of work in New Zealand before immigration is approved. The scheme is typically oversubscribed, partly due to the number of places taken up by secondary applicants included within the quota cap. Over the past three years, 1,201 out of 19,326 registrations were drawn from the ballot, representing odds of around six per cent (Gibson, McKenzie, & Stillman, 2011, p. 11).
- **The Pacific Access Category.** Under the Pacific Access Category, 250 citizens of Tonga, 75 citizens of Tuvalu, and 75 citizens of Kiribati can be granted residence-class visas in New Zealand each year. The cap includes principle applicants, partners, and dependent children. Applicants must meet English language proficiency standards, and require a "suitable offer of employment" that provides a salary equal to a specified minimum income requirement (currently NZ$31,500). This scheme is also oversubscribed, despite offer-of-employment requirements.
- **Recognized Seasonal Employer scheme.** Under this scheme, up to 8,000 PIC workers can be hired by New Zealand farmers in the horticulture and viticulture industry on a part-time basis.

In contrast to New Zealand, Australia has very limited special labour access for Pacific Island Countries. Consequently, three times more Pacific people migrated to New Zealand than to Australia between 2003 and 2007, despite Australia's much larger population and economy (Bedford, 2012). Nearly all Pacific-born workers in Australia either qualified for entry through country-neutral schemes (including large numbers of relatively highly-educated Fijians, following recent coups) or travelled to Australia after acquiring New Zealand citizenship through the Trans-Tasman Travel Arrangement, which allows free movement of Australian and New Zealand citizens across both countries. A very small number of Pacific-born workers have accessed employment opportunities in Australia through the recent pilot of the Pacific Seasonal Workers Scheme, which operates on a similar basis to New

Zealand's Recognized Seasonal Employer scheme. Places within the scheme were limited to 2,500 over the four years from 2008-2012, and only around 1,600 places have actually been offered due to low uptake by employers (Reed, Southwell, Healy, & Stafford, 2011).

8.26 Migrants and their families benefit from labor mobility. The attractiveness of migration is reflected in large proportions of the working-age population of some PICs now living in Australia and New Zealand. While social and economic indicators for recent migrants to these countries can lag those of the broader population in migrant-receiving countries, migrants generally foresee broader educational and economic opportunities for their children, even for those whose own immediate opportunities are limited. Recent analyses of the Recognized Seasonal Employer scheme, which provides short-term access to New Zealand labor opportunities, primarily in horticulture, and broader survey data of families with members working overseas, demonstrate the benefits to families in sending countries of both short-term and permanent migration (McKenzie & Gibson, 2010; Gibson, McKenzie, & Stillman, 2011; Luthria, Duncan, Brown, Mares, & Maclellan, 2006; Gibson and McKenzie, 2011). Households in PICs with family members working overseas experience:

- Higher per capita incomes over comparator groups, driven by remittances;
- Increased subjective economic welfare, with households reporting that they benefited from labor mobility opportunities;
- Improvements in asset ownership, including ownership of radios, ovens, and DVD players;
- Higher rates of financial inclusion and savings including a greater likelihood of holding a bank account;
- Improved education attainment, with school attendance rates shown to have increased, and broader evidence of positive impact of remittances on primary and tertiary educational attainment, likely due to improved affordability with higher incomes.

8.27 Labor mobility provides economy-wide benefits to migrant-sending countries. Remittance-receiving households benefit the broader economy through increased investment in business activities (McKenzie & Gibson, 2010). The existence of migration opportunities can also generate incentives for increased human capital development, which can potentially offset any human capital loss from emigration experienced by sending countries. Recent evidence from Fiji demonstrates that the expectation of migration opportunities generated an increase in the level of tertiary education of Fiji-Islanders, with the stock of tertiary educated Fiji-Islanders remaining within Fiji also increasing (Chand & Clemens, 2008). Available evidence from small countries suggests that the benefits to sending countries from emigration of high-performing students and academics – including remittances and knowledge transfer – generally outweigh costs, especially when high rates of return migration are taken into account (Gibson and McKenzie 2010; Gibson and McKenzie 2013). Knowledge transfer is particularly significant, with 13 per cent of expatriate Tongans from a sample of academic high achievers providing advice to the Tongan government while overseas, more than 50 per cent providing advice to Tongan residents on study and work opportunities, and 20 percent providing sponsorship for other Tongan residents seeking work overseas (Gibson & MacKenzie, 2010). Diaspora tourism resulting from large emigrant populations is also an important benefit to sending countries, accounting for a large share of tourism industries in Pacific countries, with 40 percent of arrivals in Samoa from New Zealand visiting friends and relatives (Scheyvens & Russell, 2009). It is also clear that remittance flows can reduce income inequality and create new opportunities for the disadvantaged. Remittances from long-term migrants have been shown to reduce disparities in income between households in Tonga and Fiji, while participants in the New Zealand seasonal workers are typically from poorer rural households in Tonga (Luthria et al., 2006; Gibson & Mckenzie, 2009).[iv]

8.28 Remittances provide an important and relatively stable source of foreign exchange. Remittances provide a substantial proportion of foreign exchange receipts in several PICs, which allow increases in imports and consumption (see Figure 8.10 and Figure 8.11). While some PICs have been heavily impacted by remittance declines in the context of the Global Economic Crisis, over the longer-term, remittances tend to provide a more dependable source of foreign exchange than the natural resource industries or donor aid flows on which small PICs typically rely.[v]

Figure 8.10: Remittances are very significant for some Pacific economies

Remittances as % GDP

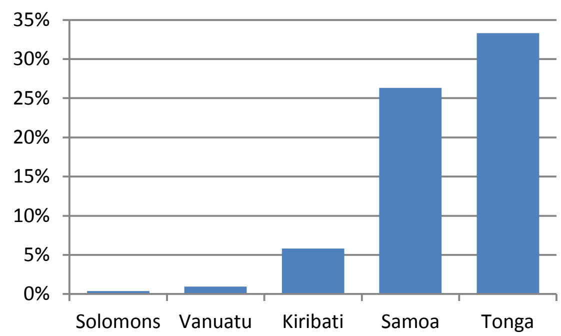
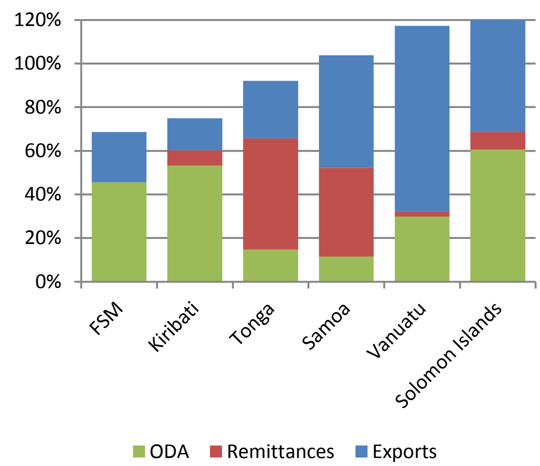


Figure 8.11: Remittances support imports, consumption, and living standards.

Foreign Exchange Receipts by Source

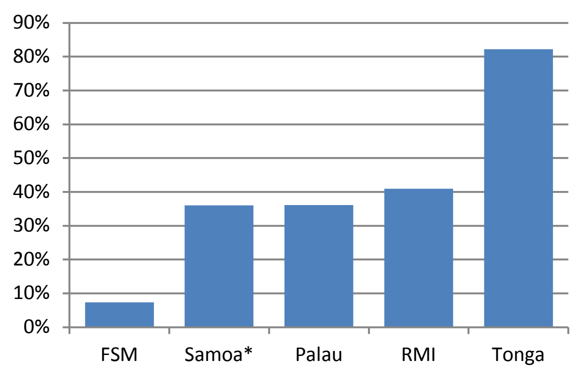


8.29 Demographic shifts are creating opportunities for greater mutual benefit from mobility. Patterns of demographic change vary between countries in the Pacific region. While some PICs have large and growing youth populations, the populations of the larger regional economies are aging and likely to decline over coming decades. The larger regional economies face impending labor shortages that could partially be met by Pacific labor. Permanent migration to New Zealand during FY2010/11 was below planned levels by 9,000 places, even as the Samoan quota and Pacific Access entries remained oversubscribed (Department of Labour, 2011). In FY2011/12, net permanent and long-term migration to New Zealand was negative for the first time in over a decade (Department of Labour, 2013). Shortages of unskilled labour during the construction boom following the Christchurch earthquake have led to calls for increased migration opportunities from the local business community (Anon., 2013). Labour shortages in

Australia, where Pacific-born workers currently comprise a negligible proportion of migrants and the total workforce, have also recently led to appeals from the business community for increased temporary work arrangements from developing countries (Earl, 2012).

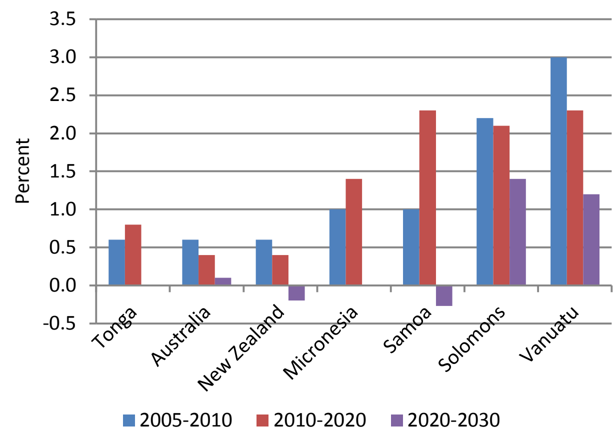
8.30 Differences in the supply and demand for labor across countries present opportunities for mutual benefits from mobility (Bedford, 2012). The net economic gains from labor mobility have been long-established in economic literature (World Bank, 2006; Walmsley et al. 2005). Recent evaluations have demonstrated how businesses have benefited from reliable and relatively low-cost labor provided through the RSE scheme at the micro-level (Department of Labour, 2010). The benefits of labor mobility will increase further as demographic trends lead to a scarcity of young workers in the larger regional economies.

Figure 8.12: Migrants to high income countries make up a substantial portion of Pacific working people.
Migrants in Australia, New Zealand and the United States as % Population of Sending Country populations



*Note: Permanent labor mobility opportunities are greatest for Polynesian countries. *Samoa excludes the United States diaspora due to inability to isolate American Samoa in census data.*

Figure 8.13: Demographic differences make the mutual gains from mobility clear for receiving and sending countries.
Predicted population growth of age 15-35



Note: Population pressures are building in Melanesia while the working-age population will decline in nearby large economies.

8.31 Distribution of opportunities could be better matched with development needs. Many PICs already enjoy relatively easy access to larger labor markets, including the North Pacific countries with access to the US labor market. Samoa and Tonga have strong historical ties with New Zealand, and preferential access to the New Zealand labor market has translated, through step migration, into large populations in Australia. Partly because of migration opportunities and their large Australian and New Zealand populations, Samoa and Tonga have some of the best development outcomes in the Pacific. Strong education outcomes and transport links support participation in seasonal workers schemes, with Samoa and Tonga accounting for 50 percent of participants in the first seasons of the New Zealand scheme, and more than 80 percent of participants in the Australian scheme. Other Pacific countries, where domestic economic opportunities are most constrained by smallness and isolation (Tuvalu) or where incomes are lowest (Solomon Islands and Kiribati), tend to have less access to short-term and permanent migration opportunities and have been constrained in their participation in seasonal schemes by costs of transport and institutional weaknesses.

8.32 Greater policy effort is required by receiving countries to expand access. Achieving the greatest mutual benefits from emerging demographic transitions will require more action from large economies in the region on several fronts.

- *Expansion of temporary worker schemes.* Continued efforts to expand participation in the seasonal workers scheme could bring substantial benefits to PICs. Seasonal schemes currently provide only a small contribution to overall remittance flows to Pacific countries. Samoa and Tonga alone receive around US$270 million per annum in remittances from permanent migrants, compared to around $30 million per annum of remittances currently being generated by the seasonal workers schemes in Australia and New Zealand. If Australia was to offer as many seasonal worker places as New Zealand relative to its population, however, total remittances from the scheme could reach 10 percent of the GDP of participating countries, or 60 percent of current aid flows to participating countries (see box). Scope to expand seasonal workers schemes in both Australia and New Zealand can be demonstrated by the relatively small number of seasonal workers arriving from Pacific countries, compared to the number of job opportunities available to citizens of much wealthier countries through "working holiday" visa schemes (see Figure 8.14 and Figure 8.15). Expansion of the Australian scheme into new sectors and efforts to address regulatory constraints to participation facing employers are important first steps to generating development impacts that are significant at the macroeconomic scale.

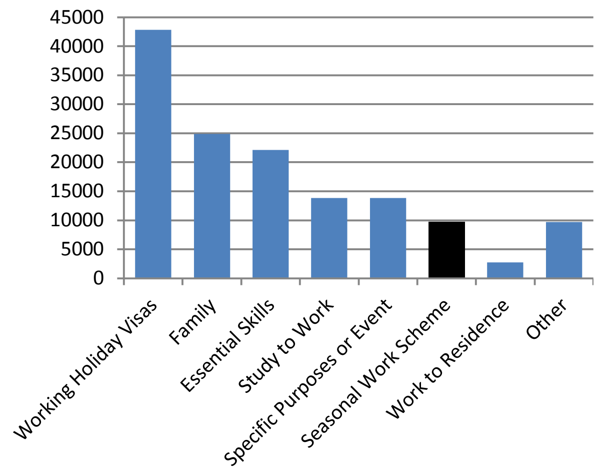
- *Increased permanent migration.* While seasonal schemes may provide important opportunities for remittance generation, evidence demonstrates the broader range of benefits accruing to Pacific island countries from permanent labor access. Such benefits include skills and knowledge transfer, increased tourism receipts, and huge improvements in living standards for those migrating on a permanent basis. Under any scenario, seasonal schemes will not close the very large gap in incomes between large regional economies and small Pacific islands, and the best opportunities for improved productivity and incomes for many Pacific Islanders will be to move to where greater opportunities exist. Seasonal schemes must be viewed as a complement to, rather than a substitute for, increased permanent labor mobility. An important priority will be to develop processes through which seasonal workers can transition to more permanent visa types.

- *Reorientation of mobility links.* With the exception of high Ni Vanuatu participation in the New Zealand seasonal work scheme, existing labor mobility arrangements deliver greatest benefit to the Pacific countries where incomes are highest and development outcomes strongest. To boost wellbeing from work, further expansion of both seasonal and permanent labor mobility arrangements should be targeted towards countries such as Kiribati and Solomon Islands where domestic economic prospects and mobility opportunities are heavily constrained and challenges from growing youth populations and accelerating urbanization are most severe.

Figure 8.14: Immigration policies in Australia favor guest workers from high-income countries.
FY2011/12 Australia Working Holiday Visa Approvals by Country Vs. Total Seasonal Worker Approvals

Note: Working Holiday Visa approval numbers in Australia demonstrate potential to expand seasonal worker opportunities.

Figure 8.15: Even New Zealand's guest worker scheme benefiting Pacific people is still very limited.
FY2011/12 New Zealand Temporary Visa Approvals by Class



Note: Pacific seasonal workers account for a small proportion of total temporary workers in New Zealand

8.33 These policy shifts will require careful balancing of several important objectives. Balance is required between: protecting labor rights while ensuring access to employment for relatively low-skilled immigrant workers; expanding low-skilled immigration while avoiding the displacement of opportunities for low-skilled New Zealand and Australian workers; and expanding migration opportunities to lower-skilled and less-educated Pacific Islanders while ensuring that these workers have adequate skills for employment within Australian and New Zealand businesses. New Zealand and Australia have both demonstrated strong commitment to improving development outcomes in neighbouring Pacific countries over recent decades. Improved labour access for Pacific workers offers one of the most effective means of achieving this objective and can help address growing labour shortages as the Australian and New Zealand populations age.

8.34 Policy action is also needed from governments in sending countries. Within Pacific Island Countries, continued investment is needed to build human capital through both health and education, so that working-age Pacific Islanders have the capacity to take advantage of the overseas opportunities that are available. This is an immediate priority in the "Compact Countries" of the North Pacific, where – despite populations having access to the United States labour market – remittances flows and development impacts have so far been limited due to migrants being able to access only very low paying work (Connell & Brown, 2005). As argued in chapter 5, basic numeracy, literacy, and behavioural skills are transferable across work types and countries, and should continue to receive strong emphasis within human development strategies. More specifically, PIC Government could ensure some qualifications are recognized internationally, through the adoption of Australian, New Zealand or US education standards. Kiribati Institute of Technology, for example, now offers a curriculum and qualifications fully aligned with Technical and Further Education Australia, while international accreditation has been achieved by the Marine Training Centre, allowing its graduates to access a wide range of international opportunities.

8.35 Policies should be designed to improve opportunities for women. Women have limited access to labour mobility options. The majority of participants in the Australian and New Zealand seasonal worker schemes are men exacerbating gender differences in access to paid work. Such disparities arise primarily because of disproportionate male representation in the pool of workers nominated for potential selection by recruitment agencies and authorities within Pacific Island Countries. Such gender disparities may be of particular concern given evidence that women migrants remit a greater proportion of their income more regularly, and are more likely to send remittances to other women members of the household (Connell and Brown, 2005: 23). Movements to expand the Australian seasonal scheme into other sectors, such as hospitality, may create new opportunities for women. Expansion of permanent migration schemes may also have positive gender impacts. Evidence from Fiji and Tonga suggests equivalent numbers of men and women are able to access long-term and permanent migration opportunities (Luthria 2006). Family access provisions under preferential New Zealand schemes allow spouses to access the New Zealand labour market, regardless of the gender of the primary applicant, ensuring rough gender balance. Ensuring equitable access to education opportunities for women (including support for dependent family members for scholarship recipients), increasing women's participation in seasonal schemes, expanding permanent migration opportunities for families, and closely monitoring the impacts on women from long-term absences of males from households participating in seasonal schemes are important priorities.

8.36 International assistance is needed to support the policy and institutional improvements required for increased international mobility of Pacific Islanders. Institutions with responsibility for negotiating international labour arrangements need to be strengthened, including through increased technical assistance to PIC trade negotiation teams, which may have opportunities to pursue labour mobility through regional and international trade agreements. Financial and technical support continues to be needed for agencies facilitating participation of workers in regional or global schemes, such as divisions within PIC foreign ministries responsible for selecting workers for participation in Australian and New Zealand seasonal worker schemes. Finally, ongoing aid assistance to all levels of education – including provision of tertiary scholarships – can provide a major boost to prospects for increased labour mobility through seasonal and permanent schemes.

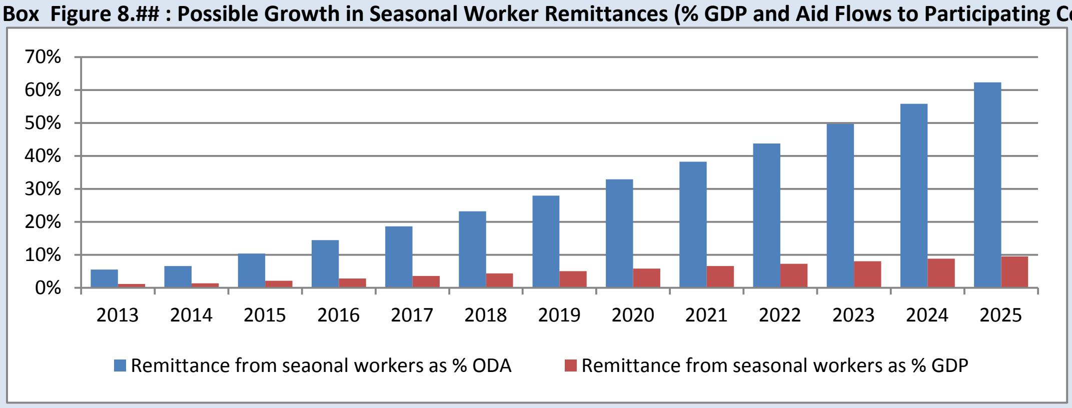
Box 8.6: Potential impacts of an expanded seasonal workers scheme

Existing data from seasonal worker schemes in New Zealand and Australia can be used to model potential impacts of an expanded scheme. As a starting point, we assume that seasonal worker numbers to New Zealand remain constant at around 8,000 per annum, while Australia expands its scheme to provide an equivalent number of places relative to population (roughly 40,000 places, by 2025). We further assume:

- Workers work an average of 20 weeks per year
- Workers remit the same proportion of income as observed in the New Zealand scheme and under the Australian pilot, allowing for deductions and worker spending
- Places offered in Australia increase to 8000 in 2014, and then grow at 30 per cent per annum until the target of 40,000 places is reached (this is equal to 30 per cent of the number of current working holiday visas issued annually)
- All places are offered to citizens of small Pacific Island Countries currently participating in the scheme (Kiribati, Solomon Islands, Tonga, Samoa, Vanuatu, and Tuvalu).
- Wages increase at a rate of 3 per cent per annum, allowing economy-wide total factor productivity growth and labour productivity improvements associated with repeated participation in the scheme.

Given these assumption, total remittances from the Australian and New Zealand schemes could reach US$390 million by 2025 (in 2013 USD terms), equivalent to 10 per cent of GDP of currently participating small Pacific island countries, or 60 per cent of total aid flows to those countries. These estimates rely heavily on an expansion of participation of Solomon Islands and Kiribati within the scheme which will be required in order to avoid an damagingly large, accelerated drain of human capital from Tonga, Vanuatu, and Samoa.

Box Figure 8.## : Possible Growth in Seasonal Worker Remittances (% GDP and Aid Flows to Participating Countries)



Box 8.7: Seasonal Worker Schemes in New Zealand and Australia: The most significant and substantial way to expand work opportunities for Pacific people.

New Zealand's seasonal labor scheme was launched in 2007, and allowed 5,000 workers to fill positions for seven months over an 11 month period in the horticulture and viticulture industries. Kiribati, Samoa, Tonga, Tuvalu, and Vanuatu were selected for special assistance in mobilizing workers, but the scheme is open to all Forum Island Countries other than Fiji. A "New Zealander first" principle is applied, under which vacancies have to be lodged with government agencies responsible for social welfare benefits so that local employment-seekers can be offered available opportunities before they can be opened to migrant workers. Pacific workers can either be directly hired by employers, through agents, or through a pre-screened "work ready pool" administered by government agencies. Strong demand for places in the scheme has been demonstrated by numbers in the "work ready pool" far outstripping available places. Since its introduction, 24,600 workers have now arrived to participate in the scheme (with annual quotas of 5,000-8,000 workers). Over half of workers return at least once, and 23 percent of workers have participated in all four seasons of the scheme, suggesting the scheme can provide a sustainable source of income. Knowledge of and access to the scheme is uneven across PICs, with the majority of workers from Vanuatu and Tonga.

The scheme has been subject to several evaluations (Department of Labour, 2010 & 2012; McKenzie & Gibson, 2010; Merwood, 2012; Research New Zealand 2012). Key evaluation findings include:

- *The scheme benefits employers.* Employers rate Pacific RSE workers higher than all other employee groups for their dependability, enthusiasm while working, and their productivity. Specifically, Pacific RSE workers are viewed as significantly more dependable (mean 9.04 out of 10), productive (mean 8.82) and enthusiastic (mean 8.75) than all other categories of seasonal worker. 86 percent of employers believe that returning workers are 'much more productive' than those in the initial season. Almost all employers (93 percent) believe that benefits of participating in the scheme outweigh the costs. At least 95 percent of employers agree that participation in the program has resulted in: i) better quality and more productive workers; and ii) a more stable workforce than in previous years.
- *The scheme benefits worker-sending families.* Research carried out in Vanuatu and Tonga finds that participating in the RSE has a large and statistically significant positive impact on household income per capita. Household expenditure per capita is also found to increase with participation in the RSE in Tonga. Substantial, statistically significant increases in subjective well-being are identified, along with positive impacts on housing quality and increased rates of durable asset ownership.
- *The scheme increases incomes of workers.* The median after-tax income earned in New Zealand reported by the seasonal migrants is approximately NZ$12,000, several times the income per capita of those not participating in the scheme (approximately NZ$1,400 in Tonga and NZ$2,500 in Vanuatu).

The Australian seasonal worker scheme was introduced more recently following the completion of a pilot scheme in 2012. The scheme operates at a much smaller scale to the New Zealand scheme (2,300 places were offered over the period of the pilot, and only 1,600 of these were actually filled) and has been subject to various implementation problems. Low uptake by employers reflects: i) the absence of labour shortages in targeted industries due to policies allowing primarily–European "backpackers" to work on holiday visas and the prevalence of illegal labour in the horticulture industry; ii) lack of knowledge of the scheme among potential employers; and iii) perceptions that the scheme involves high transaction costs and red tape (Howes & Hay, 2012). The number of workers recruited under the Seasonal Worker Program was around 100 a month in 2012, about half the cap, and one third of the number hired under the similar New Zealand program. An evaluation of the scheme's development impacts showed significant benefits for the small number of participating households in Tonga, with incomes per household increasing by almost 40 percent. Australia has recently decided to expand the scheme, opening opportunities in additional sectors, including tourism, and with a higher cap on the total number of participants.

Priority 3: Making the most of urbanization through investment in rural services, connective infrastructure and improved urban administration.

Summary of Priority 3:	**Urbanization brings employment benefits if it allows the realization of scale economies, greater thickness in markets, and increased specialization. But urbanization occurring as a result of poor services in rural areas, conflict, food insecurity, or land shortages simply leads to congestion and urban unemployment, delivering few economic benefits and placing pressure on social cohesion. Policies should not be biased towards jobs in either urban or rural areas, but rather seek to ensure acceptable standards of living across all communities and allow individuals to respond as they choose to the concentration of economic opportunities in urban areas.**
Countries of Relevance:	Rapidly urbanizing PICs, including Marshall Islands, Kiribati, Vanuatu, and Solomon Islands.
Living Standards:	Access to paid employment is, and will likely remain, concentrated in urban areas. People should be free to seek the broader opportunities available in cities. But adequate living standards, involving access to adequate services, must be maintained in rural areas.
Productivity:	Population concentration allows specialization and some economies of scale. Urbanization therefore presents an important opportunity for productivity growth. Subsidization of work in particular places, on the other hand, is an inefficient use of resources, and undermines the potential benefits of concentration for private sector development.
Social Cohesion:	Poorly managed urbanization can lead to losses of social cohesion. Public investment should be prioritized towards improved urban administration and services rather than in attempts to prevent urbanization from occurring.

8.37 Urbanization is an important phenomenon for employment in the Pacific. Pacific cities are growing very rapidly. Measured in terms of percentage growth of urban populations, Solomon Islands, Vanuatu, and Kiribati are urbanizing at similar rates as the rapidly-growing East Asian economies.[vi] Even in countries where recorded rates of urban growth are slower, urbanization is frequently cited as a major policy issue. A challenge for policy-makers is to ensure that the potential benefits of urbanization can be realized while minimizing the costs.

8.38 Urbanization can be an engine of growth and employment opportunities. Urbanization is typically associated with higher incomes, improvements in service quality and coverage, lower fertility rates leading to slower population growth, integration with global markets, and a broadening of economic opportunities through diversification (World Bank, 2008; United Nations Center for Human Settlements, 1994). Urbanization in PICs can provide an engine for employment creation. Increased urban populations offer businesses the opportunity for integration into supply chains, thicker labor and input markets, and larger markets for goods and services. While prospects for export-driven diversification into manufacturing and service exports are likely to remain limited even in the largest Pacific Island cities, the best prospects for any expansion of private sector opportunities in provision of services for local markets, including the public sector, lie in a more urbanized future. Urbanization also offers governments the chance to provide services and infrastructure at efficient scale – reducing the costs associated with provision to disbursed and inaccessible rural populations – and facilitating important improvements in quality and coverage. Many Pacific Islanders demonstrate a strong revealed preference for urban life, given improved, access to earning opportunities, relief from the insecurity and physical labor associated with rural subsistence, access to consumer goods and services, and the prospect of upward social mobility.

Figure 8.16: Pacific populations remain largely rural.
Proportion Rural Population (%)

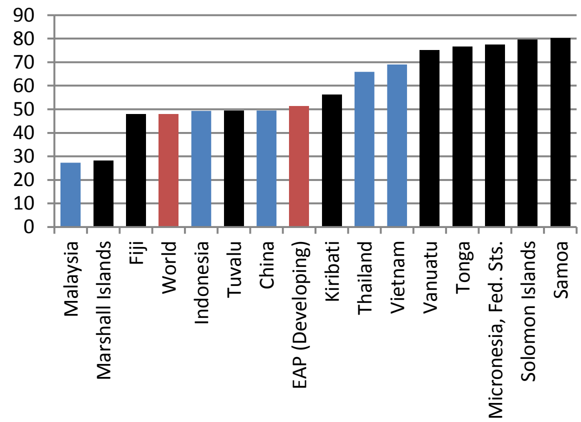
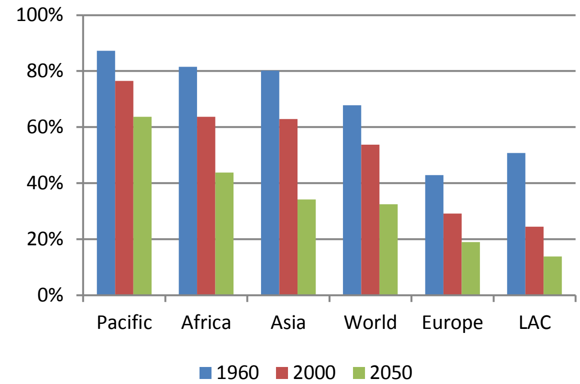


Figure 8.17. And this will continue despite urbanization..
Rural Population (%) by Region - Projections



8.39 Urbanization in PICs is not always happening for the right reasons. Those moving to cities in PICs are not always doing so because of the expectation of more productive and better-paid work. Rather, urbanization is also being fuelled by a lack of adequate services and declining living standards in rural areas. Even when relatively broad coverage is achieved in rural areas, quality of services typically lags far behind what is available in urban areas. Inadequate services are compounded by poor agricultural productivity. Agricultural production in PICs remains concentrated around small-holder subsistence production, with marketing options often constrained by insufficient scale, poor transport links between islands or regions, limited access to finance, and lack of knowledge and training on agricultural production techniques. Subsistence farming in rural areas is often only weakly linked to food markets in urban areas, with PICs heavily reliant on food imports despite large agricultural sectors. There is little evidence of any significant increase in agricultural productivity in PICs over recent decades, while population growth has placed pressure on agricultural subsistence systems in some areas.

Figure 8.18: Access to sanitation in rural areas is not as good.

Access to Improved Sanitation (% population)

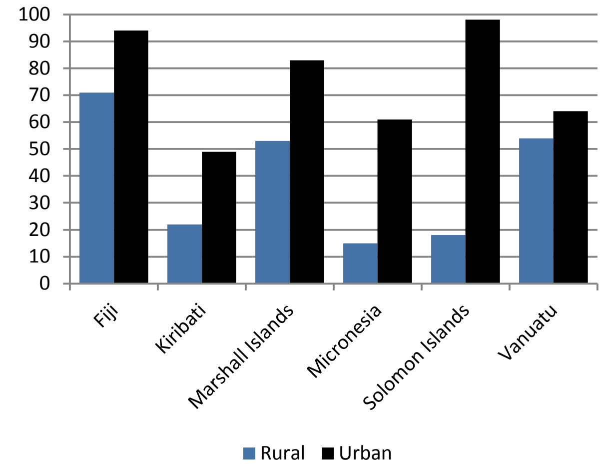
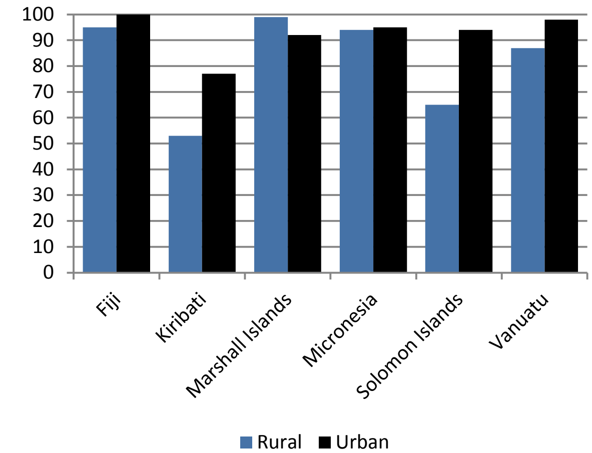


Figure 8.19: Access to water in rural areas is not as good.

Access to Improved Water Source (% Population)



8.40 Potential benefits are in danger of being outweighed by a range of social and economic costs. Rather than moving into productive work that spurs economic growth and finances increased service delivery, many urban arrivals in PICs face limited prospects and simply add to the burden on overstretched urban services and infrastructure. Urbanization in PICs is therefore often associated with a higher risk of poverty, high youth unemployment and frustrated aspirations for social mobility, feeding into increased rates of substance abuse, crime, and loss of social cohesion (World Bank, 2014). The breakdown in family structures and informal social safety net systems as young people move to cities has led to unprecedented levels of inequality and crime. These dangers are frequently cited in analyses of Pacific urbanization and reflected in available statistics on crime and violence (Connell, 2011; Asian Development Bank, 2012; UNODC data, Storey 2003).

Figure 8.20: Slow growth is not preventing urbanization in some PICs.

Urbanization and Economic Growth (1991-2011)

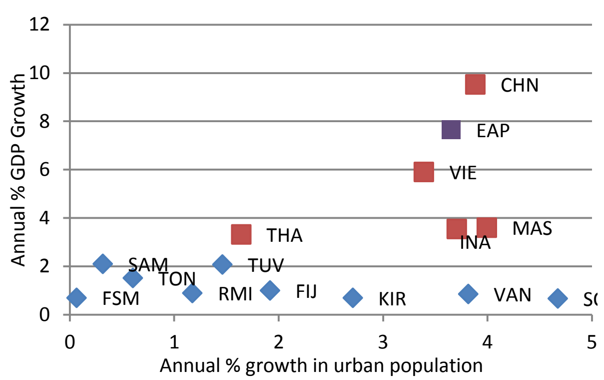
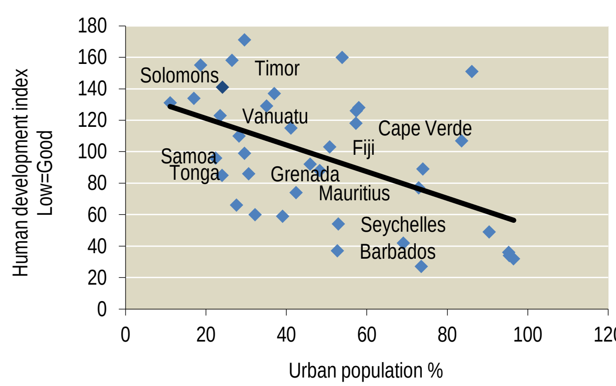


Figure 8.21: Urbanization is associated with improved human development.

Urbanization and Human Development (Small Countries)



Box 8.8: Rural development in Kiribati through the Copra Subsidy Scheme

Kiribati has one of the most widely dispersed populations in the world. While nearly half the populations of 100,000 live in and around the urban center of South Tarawa, the other half is distributed across 20 islands spread across 3.5 million square kilometers of ocean. Since independence, the Government has operated a copra subsidy scheme, through which inhabitants of outer-islands can sell copra to a state-owned enterprise at a regulated price. Copra production has become the primary source of cash incomes for many communities in the outer islands and the scheme is explicitly intended to protect livelihoods in outer islands and reduce urbanization pressures.

But with volatile world copra prices, inefficiencies in processing, and high transport costs, the scheme is imposing increasingly unaffordable costs on Government. There is an economic loss of more than one dollar for every kilogram of copra produced in the outer islands with total costs of the scheme reaching nearly 5 percent of GDP. The scheme is also regressive, given that food and basic-needs poverty is concentrated in urban areas. Government is working with the World Bank to reform the scheme. Difficult trade-offs will need to be made between subsidizing rural livelihoods to avoid urbanization pressures and redirecting available resources into more efficient investments in urban services and infrastructure links which may encourage urbanization.

Source: The World Bank

8.41 The right reforms can facilitate both urban and rural development. Policy discussions of urbanization in PICs often pose an artificial choice between rural employment and urban employment. Obvious problems of urbanization, accompanied by stagnation in rural livelihoods, has fostered opposition to urbanization and fed perceptions that economic development in urban centers is occurring at the cost of development in rural areas. Common complaints include: the inequitable concentration of public and private sector employment in urban areas; the loss of human capital in rural areas as working-age people move to cities; and growing disparities in access to services and infrastructure between urban and rural areas. But economic development is not a zero-sum game and urban development does not have to impose costs on rural areas. Urbanization can provide a pathway to employment for many if it occurs for the right reasons. With appropriate linkages between urban and rural areas, economic opportunities in cities can support improvements in rural standards of living. At the same time, reasonable services and living standards in rural areas can ensure that urbanization is driven by opportunity rather than desperation and leads to good outcomes. Focus on the following policy areas may increase the likelihood of complimentary urban and rural development:

- *Avoid policies to prevent urbanization.* In several PICs, policies have been discussed or implemented that are explicitly intended to slow or prevent urbanization, and redistribute economic production to rural areas. Examples include: i) the explicit or implicit subsidization of economic activities in rural areas (including production subsidies, or government investment in production facilities); ii) deliberate underinvestment in provision of urban services and infrastructure to growing urban populations (especially in squatter settlements where recent arrivals are concentrated); iii) absence of measures by which squatters can acquire formal land rights; and iv) destruction of residential and commercial properties in settlement areas by state or municipal authorities. Such measures have destroyed jobs, and seldom been successful in either fostering sustainable economic growth in rural areas or arresting the pace of urbanization.

- *Provide adequate basic services across all communities.* Urbanization fuelled by uneven access to services leads to the congestion of urban facilities and excess supply of low skilled labor in urban areas. Relatively large aid flows to PICs provide an opportunity to finance a basic standard of services in all communities, allowing migration decisions to be based on economic opportunities and preferences, rather than basic service needs.
- *Invest in connective infrastructure.* Rural areas can share the benefits of increased employment opportunities and improved service delivery in urban areas if people, goods, and information can move freely and at reasonable cost. Infrastructure links between capitals and other areas of population concentration are vital to facilitate the supply of urban markets by rural producers. Subsidization of transport links can facilitate access of rural people to urban services, reducing urbanization motivated by the desire to access services. Good quality, low cost, reliable transport can also allow people to move to take advantage of work opportunities on a short-term basis, as they arise, allowing reversibility and reducing the risks faced by those seeking urban jobs.
- *Facilitate efficient use of urban land.* Lack of access to land and dysfunction in land markets often undermine living standards and private sector development in urban areas. It is important to ensure that housing is available to new arrivals in urban areas, and that land can be allocated to its most efficient use. Measures that provide formal recognition of land ownership and transactions in squatter areas can provide vital security to new migrants and facilitate improved access to finance when property rights over land can be used as collateral. Reforms to land administration in urban areas, where land has typically been alienated from traditional ownership, can often be implemented without undermining collective land ownership systems in rural areas (AusAID 2008).

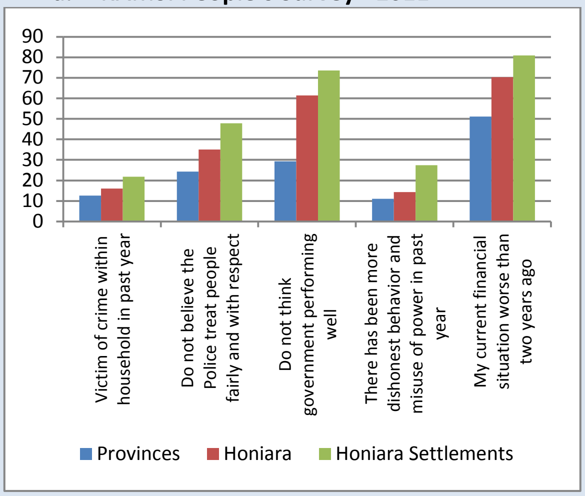
8.42 Urbanization gains can be increased through urban investments that take account of the needs of women. Research from the region demonstrates that women stand to benefit from improved services and access to income generation opportunities resulting from urbanization, supporting broader economic and development gains. Gains, however, are often constrained by household work requirements limiting time available for broader economic participation. Infrastructure that meets the different transport needs of women can free up women's time for new economic activities, as can good sanitation and water coverage. Adequate public investment in laws and institutions to prevent crime and sexual exploitation can also facilitate participation of women in a broader range of economic activities.

Box 8.9: Urbanization, poverty, and social cohesion in Solomon Islands

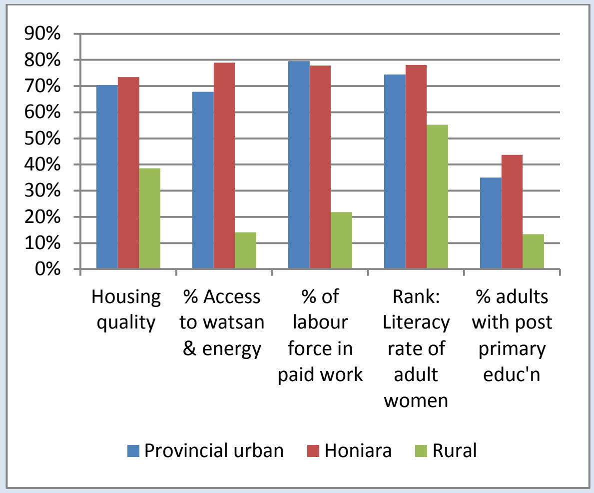
The squatter settlements of Honiara illustrate many of the issues associated with rapid urbanization in PICs. Evidence from the national census and the "people's survey" commissioned by the regional peacekeeping and reconstruction force reflect the risks associated with rapid urbanization partly driven by uneven access to services.

Box Figure 8.##. Rapid urbanization in Solomon Islands is accompanied by risks.

a. RAMSI People's Survey - 2011



b. National Census - 2009



These surveys show that those living in urban areas not only have far greater access to paid employment than those in rural areas, but also far greater access to services and infrastructure. As Solomon Islanders move to access both economic opportunities and better services, the population of Honiara has grown at around 5 percent per annum. Weaknesses in land administration have led to inflexibilities in land use, contributing to housing shortages, with many immigrants being forced to live in squatter settlements, outside the formal town boundaries, and with more limited access to services and infrastructure.

With urbanization being driven by both economic opportunities and the desire to access services, labor supply has outgrown demand. Underemployment is widespread, especially among youth (in a recent survey, 67 percent of youth residents of the squatter settlement of White River reported that they had no regular source of cash employment and were looking for work). These dynamics have led to declines in social cohesion, including higher levels of crime and violence, and broader dissatisfaction with the performance of police and government.

There is little evidence of significant return-migration to rural areas and challenges in urban areas need to be addressed. Improved administration, improved services, and better infrastructure in urban areas might allow Solomon Islanders to continue to seek the economic opportunities associated with urbanization without facing such severe costs to living standards and social cohesion. Increased investment in rural services might reduce incentives for migration for those with little prospect of finding employment.

Source: World Bank 2010; RAMSI People's Survey 2011; Solomon Islands National Statistics Office

Priority 4: Ensuring that public spending delivers efficient services and enables employment

Summary of Priority 4:	**Public sectors in PICs are often viewed as a source of concern, with public sector employment thought to exist at the expense of increased private sector employment. In reality, scope for private-sector led employment creation is often constrained by geography and public sectors, while large relative to the size of the economy, remain small in absolute terms. This is especially true when diseconomies of scale in administration and service delivery are taken into account. Policy attention can usefully focus on improving the quality of public sector jobs, in terms of what they provide for civil servants and society, rather than on necessarily reducing public sector employment.**
Countries of Relevance:	All PICs, especially those where populations are very small and employment concentrated in the public sector.
Living Standards:	Public servants tend to enjoy higher living standards, with salaries often supporting larger family and community networks.
Productivity:	Incentives for effort and skill-acquisition are sometimes blunted in the public sector. Selective use of private participation and continued public sector reform has the potential to achieve productivity gains.
Social Cohesion:	Social cohesion would be strengthened with merit-based appointments in the public sector and equitable distribution of employment opportunities among social groups and geographic areas.

8.43 The public sector provides a large share of cash employment in many PICs. PICs face challenges in meeting the high fixed costs associated with a fully functioning sovereign government. Because there are large economies of scale in operating the various institutions required for governance and service delivery, the costs of government is high relative to the size of the economy. At the same time, barriers of geography prevent rapid employment growth in export-oriented manufacturing and services. Consequently, public sector employment is likely to continue to represent a large share of total formal and cash-earning employment, especially for the smallest of the PICs. Given the continued importance of the public sector, an important challenge for PICs is to ensure that public sector jobs are good jobs, both for public servants and society.

Figure 8.22: Government in Pacific islands countries is large.
Government Expenditure as % GDP

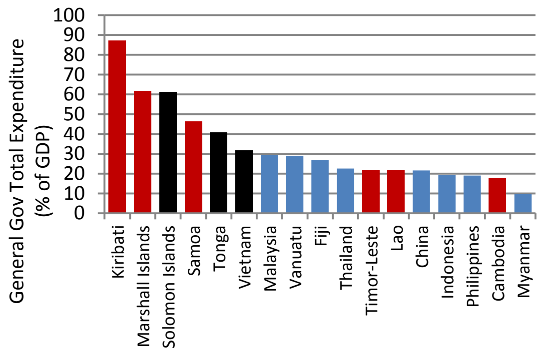
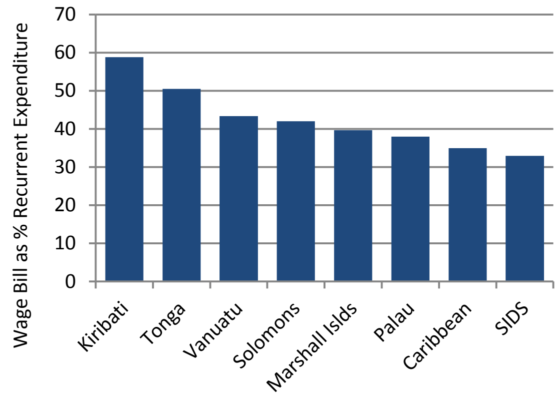


Figure 8.23: Public service employment is substantial.
Payroll as % Recurrent Government Expenditure



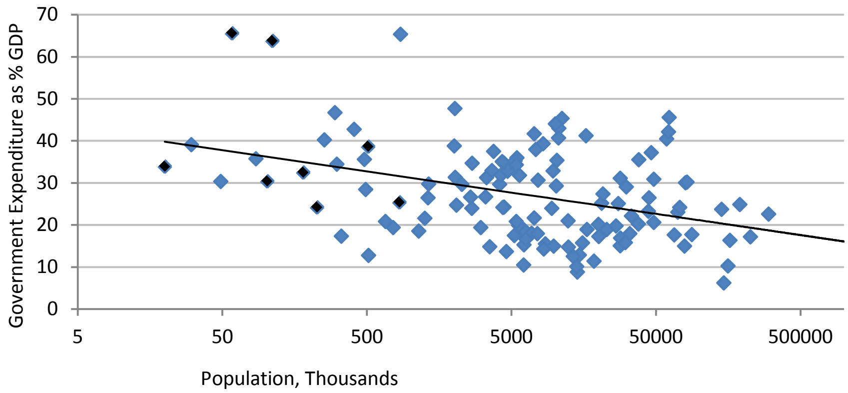
8.44 The benefits of public sector employment are broad and widely-shared. Public sector salaries are often well above average levels of income. Recent analysis suggests that the average public servant earns around five times GDP per capita in Kiribati, and around 2.8 times GDP per capita in Tonga, compared to indicative global norms of about 1.2 times. In both countries, HIES data suggests that public service salaries are also greater than average private-sector salaries. Benefits of public sector employment also include training opportunities, international travel, and opportunities to form global networks that would be very unusual in most private sector employment. Given strong social pressures for sharing of wealth, the benefits from higher pay and broader opportunities are often widely shared, with every public sector job often supporting living standards of a wider family group or community. Training and networking opportunities available to public sector employees are often a key gateway to international labor market opportunities and much higher standards of living, sometimes via scholarships and further higher education.

8.45 Public sectors in PICs experience the same incentive problems as public sectors in the rest of the developing world. Given the extent to which economy-wide resources of PICs are invested in the public sector, efficiency in public administration and the delivery of public services is especially important. Good public sector jobs in PICs would provide strong incentives for human capital development and productivity while also supporting adequate living standards for public sector workers and their families. Public services in PICs, however, face common challenges, including limited accountability and weak performance management systems and severe capacity constraints that impede delivery of core government outputs and functions (Asian Development Bank, 2010). The severity of these challenges varies across countries, but public sector employment, while providing benefits for public sector employees and their families, often do not have as positive an impact on society that they could (Asian Development Bank, 2010). These issues often led to calls to reduce government spending and reduce the presence of government in the economy.[vii]

8.46 There is little evidence that simply reducing public spending would lead to improved employment opportunities in PICs. Well-paid jobs in large public sectors can come at a cost to the private sector, with businesses facing higher taxes to support bloated governments and increased public sector competition for labor and associated wage inflation. It is not clear that the public sector is crowding out the private sector in PICs, however, for several reasons.

- Firstly, a large proportion of government revenues typically come from natural resource royalties and aid. Government spending therefore often supplements domestic demand, with public servants supporting the emergence of private-sector service economies, especially in capital cities. For some countries, economic growth has closely tracked expansions in public spending, with changes in public sector demand exerting a determining influence on private sector performance (see box 8.10).
- Secondly, given sluggish growth, reliance on natural resource industries, and the predominance of agricultural work, it is not clear that public sector workers could find employment acceptable to them in the private sector if the size of government was substantially reduced. For many jobs, competition for labor between the public and private sector is not always apparent. In some cases, higher public sector salaries for more senior or specialized staff often reflect a legitimate attempt to retain the vital skills required to undertake key government functions in the context of a very narrow pool of appropriately educated professionals and competition from overseas employers, NGOs, and donor agencies. Recent reviews of the experience of public sector reforms in the Pacific cast serious doubt on any assumption that the private sector will necessarily absorb retrenched public employees in the context of widespread redundancies (Asian Development Bank, 2009; Collins & Warrington, 1997). Experiences with large-scale retrenchment of public sector workers in Cook Islands and Marshall Islands led to emigration of qualified workers, rather than their absorption into the private sector.
- Finally, public sector spending and public service numbers may need to be large, relative to very small economies and populations, to ensure the delivery of vital services (Brown D. , 2010). Cross-country evidence shows that small countries tend to have larger public sectors and public sector employment, reflecting diseconomies of scale in service delivery and administration (Figure 24). Reducing the capacity of governments to hire and retain enough people to carry out all necessary functions of government and provide the public goods required for successful private sector activity is likely to have an adverse impact on living standards, employment creation, and productivity (World Bank, 2011).

Figure 8.24: Government is bigger in smaller countries.
Population and Government Expenditure as % GDP



8.47 Outsourcing and privatization should be approached cautiously, but can sometimes bring benefits. Outsourcing the delivery of services and privatizing government agencies that can operate on a commercial basis is often seen as an effective means of overcoming the agency problems associated with public sector service delivery. The profit motive and competition can sharpen incentives for productivity, feeding through into better services at lower cost. Privatization of SOEs that are directly competing with the private sector in Samoa, Kiribati and other PICs has led to expansion of employment opportunities and improvements of services, as inefficiencies associated with poor public sector management have been eliminated (Asian Development Bank, 2011). Restructuring of the road transport sector in Samoa to allow the outsourcing of road maintenance has facilitated the emergence of several efficient and well run private-sector firms that provide both employment and vastly-improved services to government. But privatization and outsourcing in the absence of a competitive market environment can also undermine service delivery and employment creation. Inadequately regulated private monopolies are no better than public monopolies at expanding access to services, and are more likely to involve loss of local employment and expatriation of monopoly rents. Efficient delivery of outsourced government services relies on competition for contracts and effective monitoring of delivery by government agencies. While outsourcing and privatization continue to provide important opportunities for increasing work in the delivery public services, these opportunities need to be pursued carefully, taking account of:

- The economic significance of efficiency benefits that could be achieved through the introduction of private participation;
- The impacts on living standards and social cohesion arising from associated public sector employment losses, especially in contexts where the private-sector employment opportunities are limited;
- The capacity of government to effectively monitor and enforce contractual or regulatory arrangements to realize any potential benefits of private participation.

Box 8.10: Public Sector Expenditure and Economic Growth in Vanuatu and Marshall Islands

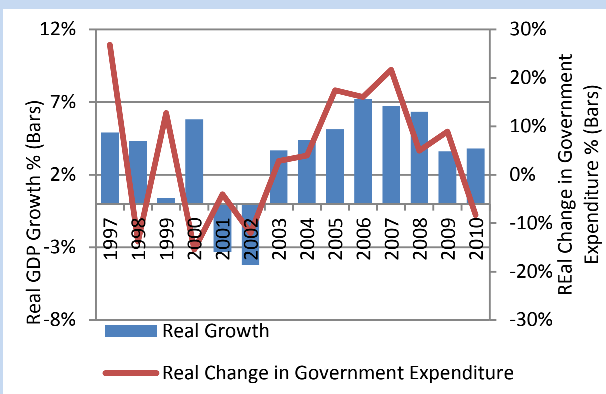
The recent experiences of Vanuatu and Marshall Islands illustrate the potential for public expenditure and public employment to "crowd in" private sector activity, supporting broader economic growth.

In Vanuatu, tourism-based private sector growth during the previous decade drove a rapid increase in government revenues. This revenue growth supported rapid increases in Government expenditure and employment (with an increase in real wage expenditure of more than 50 percent), with changes in aggregate economic growth, tourism arrivals, and government spending closely aligned. With many tourism operations weakly integrated into local supply chains, growth of public expenditure through increased tax revenues supported a broader expansion of paid employment opportunities both within the public sector and in private sector businesses supplying goods and services to public servants and government entities.

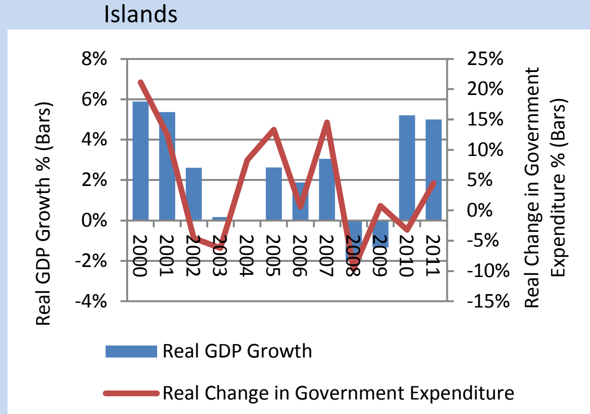
In Marshall Islands, under renewed Compact arrangements for fiscal transfers from the United States, public expenditures grew by an annual average rate of 12 percent between FY2003 and FY2007. Employment in the public sector expanded by 507 jobs or at an annual average rate of 6 percent over the same period. Expansion in public spending fuelled growth of 1.9 percent between FY2003 and FY2007, peaking at 3 percent in 2007. With the flattening off of public expenditure, growth fell during 2008 and 2009, but recovered during 2010 and 2011 partly due to the impact of new publicly funded infrastructure projects. Public expenditure was the dominant driver of both employment creation, within and outside the public sector, and economic growth in an economy with limited alternative prospects.

Box Figure 8.##. In small Pacific countries, public expenditure and economic growth move in tandem.

a. Growth and Public Expenditure in Vanuatu



b. Growth and Public Expenditure in Marshall Islands



8.48 Basic public sector management systems are important. Given constraints on the range of government functions that can effectively be delivered by the private sector, dramatic reductions in the size of the public sector and the public service are unlikely in PICs over the medium-term. Because of this, progress with improving basic systems for public sector management, performance, and accountability needs to continue. Performance-based budgeting and performance-based pay are likely to be too capacity intensive for effective implementation in PICs over the medium-term, and require institutional underpinnings that are seldom present. Public financial management systems that improve transparency and encourage public dialogue regarding the use of resources may often represent a useful initial priority to improve the alignment of public sector incentives with efficient service delivery, along with public sector pay scales and merit-based promotions that generate substantial incentives for skill development and productivity on behalf of individual public servants. Ensuring merit-based appointment and promotion in the public sector is also vital, given the likely continued importance of the public sector as a source of employment. Recent experiences in during the “Arab Spring” indicate the extent to which frustrations regarding nepotism and inequality in the distribution of public sector opportunities can undermine social cohesion and fuel conflict pressures (World Bank, 2010a & 2012).

8.49 Donors can support increased local employment in delivery of projects. With a substantial proportion of public expenditure in small PICs being financed by ODA, donors can also contribute to local employment creation through increasing the participation of local vendors and labor in project delivery. Donors could introduce preferences in their procurement processes for businesses utilizing local labor or produce. Donors could also work to make greater use of general and sector budget support, with expenditure of this kind typically having a larger local employment impact than project financing.

Box 8.10: Outsourcing aid?

Experience with involving local private sector firms in delivery of aid projects in PICs suggests that such arrangements are not always easy, but can provide long-term benefits both through better projects and the creation of employment opportunities. Lessons for donors include:

- **The need to actively build, rather than expect the spontaneous emergence, of a private sector able to meet donor needs.** This means providing a sustained source of demand to keep growing firms in business as their capacities grow.
- **Do more to advertise procurement opportunities and streamline procurement processes.** Pacific firms may not be likely to come across donor procurement opportunities as they are currently advertised. Ensuring local awareness of opportunities is an important priority. Donors could also either ensure that bidding processes aren’t too complicated for capacity-constrained Pacific firms, or provide direct assistance in preparing tender documents etc.
- **Ensure that contracts are offered at a size and scope that facilitates local participation.** While not always feasible, dividing work into smaller contracts may provide more opportunities for local firms.
- **Move beyond a single-project perspective when considering participation of local firms.** Putting the time and effort into engaging local firms may not look appealing for the purposes of any one project. But if gains can be expanded and capitalized on by subsequent projects – through reduced costs and better quality delivery – the cost-benefit equation is likely to look more favorable. It is therefore vital that decisions made at the project level take the potential for broader benefits into account.
- **Make tradeoffs between project-level efficiency and broader social and economic benefits.** Involvement of the local private sector may sometimes delay projects and force compromises on quality relative to reliance on international contractors. These costs need to be systematically traded off against broader development benefits when decisions are made.

Priority 5: Generating sustainable employment from natural resource industries

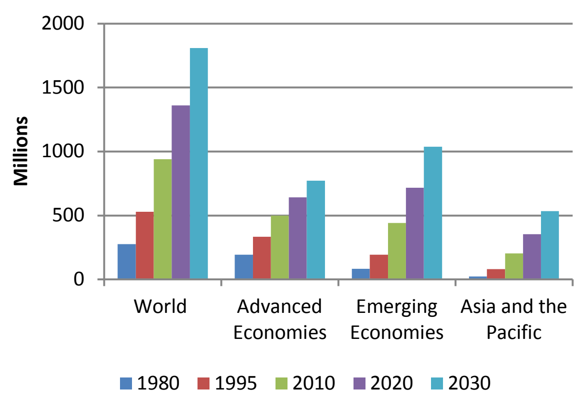
Summary of Priority 5:	Natural resource extraction is often seen as an easy source of new employment.

	In reality, employment in natural resource industries in the Pacific is often unsustainable, of poor quality, and reliant on implicit or explicit subsidies. Countries with natural resource endowments should support employment creation in natural resource industries based on careful consideration of the likely quality of associated work, taking careful account of the opportunity costs of implicit and explicit subsidies often required.
Countries of Relevance:	PICs with natural resource endowments, including fisheries, minerals, and forestry.
Living Standards:	Natural resource industries have a poor regional record in delivering sustainable improvements in living standards. The most sustainable living standard improvements may often come from investment of rents from these activities in areas that open new employment opportunities in other sectors, locally or internationally.
Productivity:	Investing rents from natural resource industries into improved service-delivery and human capital can avoid the problems of low-productivity employment in natural resource industries.
Social Cohesion:	Social cohesion can be undermined by geographically concentrated and short-term natural resource related employment. Public investment from natural resource rents can provide broader and more equitably distributed opportunities.

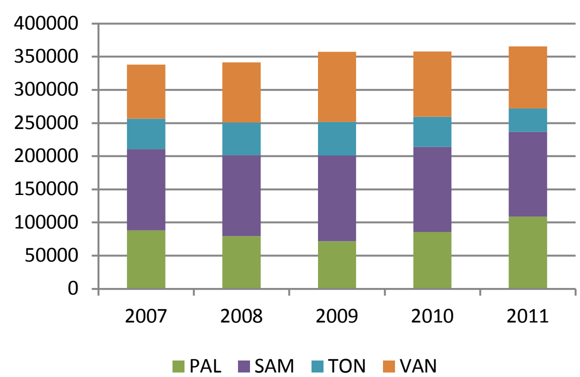
8.50 Natural resource opportunities, including tourism, attract investment to areas where resources and attractions are located rather than to where business costs are low. High business costs in PICs do not, therefore, preclude investment, as economic rent can be earned from the exploitation of natural resources even with high costs of distance. This is reflected in Pacific island countries' historically high reliance on fisheries, minerals, forestry, and tourism for foreign exchange and income. With projected rapid growth in international tourism arrivals over coming decades, a large share of global stocks of certain fish species located in Pacific waters, and ongoing discoveries of new mineral wealth in the region, PICs will continue to attract the attention of natural resource investors.

Figure 8.25: Tourism to the Pacific island countries is expected to keep growing.

a. Global tourism arrival projections



b. International tourism arrivals



8.51 Policy makers and the public often want to see substantial direct employment created from natural resource endowments, given growing populations. Sometimes, governments have considered or pursued mandates for local employment creation as a negotiated condition of resource access, or provided tax exemptions or subsidies to encourage tourism investments expected to bring employment. The labour-intensity of extractive natural resource industries is typically very low. Work with higher pay and productivity within natural resource industries is often highly specialized and tends to be performed by expatriates, rather than local labour. Because PICs lack economies of scale, there are limited opportunities for development of ancillary industries around natural resources, and natural resource industries are not typically integrated into local chains of production. It is generally cheaper for natural resource investors to process products overseas than to develop local production chains, given high operating costs and skill shortages. The forestry industry in Solomon Islands, for example, which has provided double-figure shares of GDP and government revenues for several decades, employs only around 5,000 unskilled workers, mostly at wage rates below the national minimum established for all other industries (World Bank, 2010). Nearly all processing is undertaken offshore while forestry methods are purely extractive with very little local investment. Pacific tuna fishery resources are among the largest in the world and generate more than 10 per cent of government revenue for four PICs. But on-shore processing and value-added has been difficult to establish, with employment in the industry contracting in the years since independence (Gillett, 2009).

8.52 The need to subsidize tourism investment reflects pressures of regional and global tax competition. In contrast to extractive industries, tourism is relatively labour intensive, with the large majority of labour expenditure on local workers, and can be better-integrated into local supply chains with broader economic impacts (Scheyvens & Russell, 2009). For this reason, tourism investment is often attractive to PIC governments, with several governments offering tax concessions for tourism investors. This has fuelled “tax competition” in the region, with government’s competing to offer the most favourable tax or investment incentive package to international tourism investors, despite high fiscal costs and limited evidence that such concessions exert a determining influence on investment decisions (James, 2009).

8.53 While tourism has been proven to generate employment that is reasonably sustainable and can open the doors to broader opportunities in Pacific countries, work based around extractive natural resource industries is often short-term and limited to the lifespan of extractive activities. Non-sustainable employment creation creates risks of declines in living standards and pressures on social cohesion when natural resources are exhausted and employment opportunities cease. Work based around extractive natural resource industries also tends to be geographically concentrated around the location of resources. Such concentration of employment opportunities can lead to rapid growth in inequality, rapid internal migration, and a corresponding emergence of conflict pressures – a possibility illustrated by natural resource development in much-larger Papua New Guinea (Collier and Hoeffler, 2004).

8.54 Employment in natural resource industries can have negative impacts on women. Gender discrimination limits the role of women in fisheries in many Pacific islands countries, due to prevailing cultural divisions of labour (Novakzec, Mitchell, & Veitayaki, 2005). As a result, access to economic opportunities around the vital tuna industry is strongly gendered in favour of men (Barclay & Cartwright, 2007). Fishing, logging and mining activities have been associated with increased sexual abuse and exploitation in Pacific island countries (Herbert, 2007). More generally, cross-country evidence suggests that reliance on natural resource industries reduces and discourages female labour force participation, which in turn reduces women's political influence (Ross 2008; World Bank 2012a). Pacific islands' historical reliance on natural resource industries may help to explain, at least in part, slow progress toward gender equality, particularly with respect to voice and influence in society (World Bank 2012).

8.55 Decisions to subsidize employment creation in natural resource industries and tourism should be informed by careful analysis the opportunity costs of alternative public investments. The costs of tax concessions and employment creation mandates are ultimately borne by the public. Concessions lead directly to foregone tax revenue. Mandating job creation for natural resource industries is only required if such jobs are not efficiently undertaken locally, and government is likely to be required to meet the costs of associated economic inefficiencies from reduced royalties, access payments, or reduced profit taxes from investors. As an alternative to mandating or subsidizing direct employment creation in natural resource industries, PICs could support overall employment in other ways: directly – through sustainable increases in public employment – or indirectly – through investment in the human capital, infrastructure, and social services that can support new economic opportunities in a broad range of sectors, locally and overseas. It is therefore important that policy makers carefully consider the full explicit and implicit costs and benefits of subsidizing employment in natural resource industries, and take account of the potential alternative employment creating investments that could be financed with these resources. This requires:

- Careful long-term costing of employment creation concessions agreement for tourism or access arrangements for extractive industries prior to decisions being made;
- A good understanding of likely impacts of employment created by these measures on productivity, living standards, and social cohesion;
- Comparison of these benefits against employment creation or other public policy goals that could be achieved through alternative public investments financed from foregone tax or royalty revenues;
- Careful design of concession or employment mandate schemes to ensure that they incentivize new investment and employment creation, rather than rewarding investors for activities that would have occurred regardless of subsidies provided
- Close monitoring of the effectiveness of subsidies and concessions, and compliance of investors with employment creation requirements, to ensure that expected benefits are being realized.

Box: Employment in fisheries or employment supported by fisheries revenues?

The fisheries industry in the Pacific is a good example of the pressures faced by government to create work in natural resource industries.

For several decades, Pacific islands countries have been working to conserve fish stocks and increase license revenues through coordinated control of access of distant water fleets to fisheries resources. Substantial progress has been achieved over recent years through the establishment of a Vessel Day Scheme by eight Pacific countries with the most significant tuna resources (Federated States of Micronesia, Kiribati, Marshall Islands, Nauru, Palau, Papua New Guinea, Solomon Islands and Tuvalu). Under this scheme, participating countries are allocated a fixed number of 'vessel days', through which rights to undertake any fishing activity are allocated to purse seiner fishing vessels on a 24 hour period basis. Vessel days can be traded between countries, with the total number of vessel days issued under the scheme nominally equivalent to total effort in 2008. Through imposing coordinated controls on access, implementation of the vessel day scheme has allowed Parties to the Nauru Agreement to generate significantly higher license fees and improve data collection, strengthening prospects for sustainable management of the resource. Estimates based on limited public data suggest the value of a fishing day may have increased from around US$1350, in 2004, to more than US$5000 due to the impacts of the scheme (Havice 2013).

Progress towards maximizing license revenues, however, is being slowed by a countervailing trend towards granting of special access rights or discounted licenses to foreign fishing firms that commit to supporting domestic economic development and employment (typically through offloading, provisioning, infrastructure investments, and employment of crew). Such discounted access arrangements are sometimes also accompanied by tax concessions and various forms of subsidization to fishery operators. The number of vessels operating under such arrangements has increased from 16 in 2001 to 53 by mid-2012, contributing an 18 per cent increase in total purse seiner effort between 2004 and 2010. While PIC governments are often of the view that the employment and direct economic impacts of such arrangements are worth more than the corresponding loss of license fees and revenues, policy decisions to grant special access or discounted licenses have seldom been informed by detailed analysis of the costs and benefits. Revenue costs have not been fully calculated. Expected employment-creation has sometimes not been realized. Dividends from government shares in joint venture companies have not been forthcoming due to poor accounting practices. As a result, the primary beneficiaries to date have been foreign fishing companies.

Pacific island countries with the greatest fisheries resources now face a difficult decision between granting of further discounted licenses which guarantee onshore economic and employment impacts or increased focus on ensuring the best possible price for each license sold. The former option may lead to greater short-term employment in fisheries (dependent on varying degrees of subsidization). The latter may provide a more sustainable and substantial stream of revenues with which to finance public investments for broader employment growth. Whatever option is pursued, good outcomes for PICs rely on the full costs and benefits different options being accurately assessed before potentially costly decisions are made.

Box 8.11: Regulatory requirements for extractive industries to support overall employment creation

Sound regulatory and public finance frameworks are indispensable if extractive natural resource industries are to support employment creation in small PICs. International and regional experience illustrates both the importance and the difficulty of establishing basic systems to ensure sound investment of natural resource revenues. Building such frameworks represents a key priority for small PICs which face particular capacity and political economy challenges. Priorities include:

- **Policies and legislation governing royalties and taxation.** Good regulations and policies can ensure that a fair share of benefits from natural resource industries flow to government and resource owners. Licensing and tax provisions need to be specified in the law, and appropriate regulations and legislation drafted and passed.
- **Strong capacity in natural resource agencies and the tax departments.** Ministries responsible for regulating natural resource industries need capacity to ensure that policies and regulations are well designed and implemented. There is no point having good policies or fair benefit-sharing arrangements if compliance cannot

be monitored and enforced. Specialist capacity may also be required in tax departments to ensure that investors are complying with local tax rules. Some of this capacity is likely to need to be sourced from donors or regional facilities, given the shortage of specialist local capacities.

- **Appropriate measures for managing revenue flows to government.** Increases in government revenue from natural resource activities will only deliver benefits if they are managed and used wisely. Policies are needed to ensure that revenue inflows do not fuel unsustainable and short-term growth in expenditure, but rather allow for sustainable improvements in infrastructure and services, such as health and education. Strong basic public finance management systems are required to ensure that revenues are allocated to areas where investment can facilitate the creation of sustainable employment. Such areas might include connective infrastructure between urban and rural areas, improved administration and services in urban centers, improved extension services for agriculture, and investments in education and health to open local and international employment opportunities for Pacific island workers.

8.3 Conclusions

8.56 Pacific island countries will follow a different path to improving employment outcomes. Population growth and rapid urbanization are causing understandable concern in the context of weak historical growth performance and a shortage of cash-employment opportunities. Common policy prescriptions and responses tend to involve a combination of: i) attempting to stem rates of urbanization by subsidizing private-sector activities in rural areas; ii) attempts at broad business-environment improvements, often including retrenchment of the public sector, in the hope of attracting investment and facilitating private-sector employment creation; and iii) efforts to spur employment in natural resource industries, including tourism, often through implicit or explicit subsidization. But these strategies should be considered carefully and implemented selectively.

8.57 Firstly, international experience shows very limited success with policy interventions aimed at stemming urbanization. If well-managed, the benefits of urbanization – in terms of economies of scale in service delivery and potential for new service sector opportunities with population concentration – can often outweigh the costs. Secondly, while improving conditions for the private sector is important, realism is needed regarding the likely extent of private sector growth and employment creation, especially following any large-scale public sector retrenchment. PICs face inherent difficulties of geography, which are often cited as the primary constraint to growth by private sector firms. There is limited financial and human capacity available to provide all of the institutional, infrastructure and regulatory needs of globally competitive export-sectors. Finally, the employment that is associated with natural resource endowments is seldom sustainable, and the subsidies provided to employment creation in these sectors could often have been put to better use creating employment in other areas.

8.58 The most appropriate employment strategy will vary even between Pacific island countries, as will the respective importance of various options and opportunities. However, strategies should take account of the following realities:

- Pacific Islanders have proven adept at taking advantage of economic opportunities, wherever they exist, and converting these opportunities into widely shared improvements in living standards. Facilitating internal and international mobility is likely to be more successful in improving employment than encouraging people to remain in areas where, by accidents of history and geography, opportunities are inevitably limited. To ensure that benefits of urbanization are widely shared, it is important to invest in infrastructure to connect urban and rural areas, and provide agricultural producers with the tools to take advantage of increased market opportunities accompanying growing concentrated urban populations.
- Public sectors in Pacific island countries have achieved impressive improvements in social indicators over recent decades, and employment created in delivering these improvements can be socially and economically valuable. But it is important that incentives for efficiency in the use of public resources are strengthened. This can sometimes be achieved through carefully considered and selective involvement of the private sector, but continued progress with public sector reforms will also be vital.
- Natural resource industries, which can flourish despite higher cost structures in PICs, offer employment opportunities. But improvement in employment supported by natural resource industries does not have to involve creation of jobs within those industries. Natural resource industries have a poor track record of delivering substantial increases in sustainable jobs. But well-regulated natural resource industries can generate sustainable flows of revenue to support employment in the delivery of public services, and improved local and international employment opportunities through improvements in human capital.

8.59 Economic growth is not sufficient to create employment and or to sustain wellbeing from work. A key question posed in the WDR 2013 is whether a ‘job strategy’ is any different to a ‘growth strategy’. In PICs, growth – in itself – is not a sufficient goal, considering the role of work in supporting productivity gains, higher living standards, and improved social cohesion. But labor mobility offers the best employment prospects for many Pacific Islanders. The output produced by Pacific Islanders working overseas will not be recorded in GDP statistics at home. The remittances that they send to families will fuel consumption of imports and improve living standards, but have a negligible impact on growth. Efficiency improvements in public sector work are notoriously difficult to capture in GDP accounts, and the associated improvements in social indicators are not reflected. Natural resource extraction tends to have a similar impact on growth figures regardless of whether it is sustainably managed or the employment provided to local populations. Overall, the factors that influence GDP in PICs are very different to those that influence living standards and wellbeing from work. A key priority is therefore to develop better information on employment, economic opportunities, and living standards for people from these countries, wherever they might be living and working, with which to establish targets and monitor progress.

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[i] Because of the specific set of challenges faces by the smaller independent Pacific Countries, we restrict our analysis to countries with populations of significantly less than 1 million, therefore excluding Papua New Guinea, Timor Leste, and Fiji.

[ii] Strong institutions of informal reciprocity within kinship groups mean that a broad range of social considerations influence participation in economic activities and the distribution of benefits. Labor (or goods and other services) may be provided in return for access to various common-pool resources without immediate or direct cash compensation. Wages from a single individual with a regular formal-sector job are often shared widely and support living standards across family groups. See Attahir (1999) and Curry (1999).

[iii] The average Pacific Island is 11,456 km from any other randomly selected country weighted by rest-of-the world GDP, compared to 8,103 km for small countries in the Caribbean. The countries that Pacific Island countries trade with are typically smaller and more distant than the trade partners of other small states, especially Caribbean countries with easy access to the large US market.

[iv] Ni Vanuatu participating in the New Zealand seasonal worker scheme, in contrast, tend to be from wealthier households, but would still be unlikely to have access to overseas labor markets through any other available channels (McKenzie et al., 2008).

[v] While remittance flows typically fluctuate as the composition of, and economic conditions facing remitting migrant populations change, evidence shows no secular decline in the amount remitted by Pacific migrants over time, although smaller amounts are remitted less regularly by second and third generation migrants (Brown, 1998; Connell and Brown, 2005).

[vi] Recorded growth in urban populations may understate the pace of urbanization in many PICs. Calculations of urban populations are based on populations within formal municipal boundaries. These boundaries often exclude peri-urban settlements where population growth has been most rapid.

[vii] For examples, see ADB economic reports on Pacific Island Countries.

Chapter 9. A region at a crossroads

Slowing productivity gains, more modest advances in living standards and rising inequality in some countries indicate governments in East Asia Pacific will need to intervene to sustain wellbeing from work, but in order to prepare for the onset of aging, they should do so in ways that support all working people, regardless of where or how they work.

9.1 In the past few years, the news headlines from countries in East Asia Pacific have started to change. The exclamations and superlatives about growth and productivity that the world has gotten accustomed to reading are still there. And China's eventual economic supremacy has been foretold so frequently by the press and pundits on television, that most of the public now take it as a forgone conclusion, even if the country's average annual growth rate is slowing. Yet squeezed between the usual applauding coverage have started to appear stories of a very different character, seemingly at odds with the widely accepted narrative of the region's rise.

9.2 When reports emerged in 2009 that a worker at a Chinese factory committed suicide in despair and protest against poor working conditions, the incident was as unexpected as it was tragic. That this act was then repeated by several apparently desperate people throughout 2010 against what they claimed were unreasonable work requirements for meager pay became a cause for concern for many. In the year that followed, news from Indonesia reported several strikes by mining unions involving thousands of workers, and one at Freeport which led to the death of at least three people. And a wave of reports from Vietnam charted a doubling in the number of illegal "wildcat" strikes in 2011. From May through July 2013 reports of striking garment factory workers clashing with police in Cambodia appeared in the press almost daily.

9.3 What were once rare accounts of worker discontent and mobilization are becoming more frequent. Images of demonstrating workers that might have emerged from time to time during the 1980s and 1990s from Seoul or Busan, are today more likely to be transmitted from places like Chengtu, Longhua, Hue, Ho Chi Minh City, Surabaya and Kompong Speu. These new headlines out of East Asia Pacific may reflect a substantive shift, or the arrival of countries in the region at a critical development threshold. They might signal a need for more than quick-fix measures to appease demands for higher pay and fewer hours. And when considered alongside appreciating exchange rates, rising real wages, and "re-shoring" of manufacturing back to Mexico, Morocco and Turkey, they may indicate that with respect to the wellbeing they derive from work, the people in East Asia Pacific are at a crossroads.

9.4 In the concluding chapter of this report, we aim to address the questions: Do the emerging economies of East Asia Pacific need employment strategies? What might such strategies entail? Just a few years ago, these questions might not have been expected from many governments in the developing countries of East Asia Pacific. Improving wellbeing through better employment outcomes has not been a core concern of policy makers in the region in quite the same way as it has long worried governments in Latin America and the Caribbean, Central and Southern Europe, and more recently in many countries in the Middle East and North Africa and South Asia. But that has started to change.

9.5 This report has shown that many countries in the East Asia Pacific region -certainly the most populous countries- are fast approaching a critical development threshold where the wellbeing that people derive from work cannot be taken for granted. Youth inactivity and unemployment, rising income and consumption inequality in a number of countries are putting pressure on social cohesion. But what appear at first mainly as challenges to social cohesion are also linked to a general slowing of economic growth in the region, which is more pronounced in countries where productivity and living standards have been lagging for a long time. For example, in the past decade, the Philippines experienced much slower poverty reduction than its neighbors, despite respectable economic growth. This stagnant progress in living standards is linked to slower employment creation and the low productivity of most work created by that economy (World Bank 2013b). Many economies in the region, including Cambodia, Lao PDR, Indonesia, and the Philippines have to find ways to create and sustain productive work amidst more difficult global economic prospects and more intense international competition.

9.6 Furthermore, despite the region's long standing reputation for welcoming investment and enabling enterprise, several countries still have relatively restrictive business environments. Timor Leste, Lao PDR, Cambodia, Indonesia and the Philippines still fare poorly in global Doing Business rankings, while Vietnam, China and Mongolia rank only moderately (World Bank 2013d). Access to finance and financial services is the most frequently reported obstacle keeping businesses in East Asia Pacific from expanding and creating more employment. Although new small and medium enterprises are an important engine of employment creation, they are particularly constrained in their ability to find financing to expand.

9.7 In addition, skills shortages and mismatches in many East Asia Pacific countries are becoming a binding constraint on productivity gains and improvements in living standards. Skill gaps threaten growth when health and education systems and the labor force adjust slowly to fast-evolving demand. This is especially the case in countries where incentives for people to invest in skills are distorted by programs driven mainly by centralized planning and government supply rather than market demand. Even shortages in basic skills such as functional literacy and numeracy are a problem in Cambodia, Lao PDR and several Pacific island countries.

9.8 Slowing gains in productivity, more modest advances in living standards and rising inequality in some East Asia Pacific countries indicate that governments will need to intervene to sustain wellbeing from work. Business as usual is not an option. This chapter proposes that in order to prepare for the onset of aging, governments should adopt employment strategies that support all working people, regardless of where or how they work.

9.1. What should an employment strategy set out to achieve?

9.9 Governments in countries around the world are rushing to piece together strategies not only to boost employment, but to create "better jobs". As elsewhere, few in East Asia Pacific countries can agree on what "*better*" means exactly (box 9.1), but there is a commonly held intuition that despite relatively high rates of participation in the labor market, high levels of employment and low rates of unemployment, current labor market outcomes are no longer good enough.

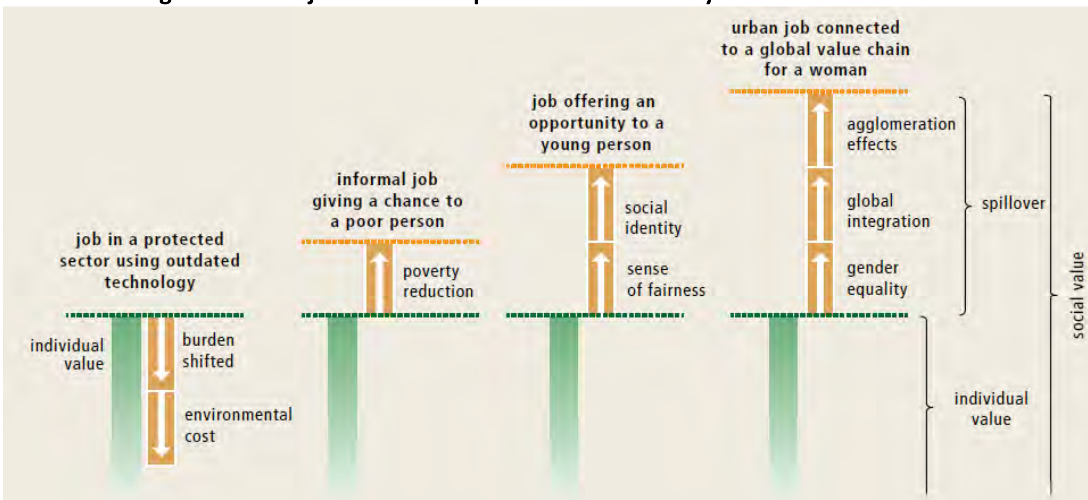
Box 9. 1: What are "*good jobs for development*"?

Households and governments seem no longer content with "more jobs". With increasing frequency, calls are heard for "better jobs". This can make economists uncomfortable: surely a "better job" is in the eye of the proverbial beholder, or more precisely, she who accepted work of her own free will. For example, whereas one person may not have enough work in a week, another might welcome the flexibility of working part time, irregular hours. While the episodic income and sometimes fluid nature of owning a business may frighten many people, it may be a non-negotiable, essential aspect of earning a living for others. And although many like to leave the rigors of saving and investing for their retirement to their employer or to the State, others look upon the mandate to save for retirement as an affront to their liberty and intelligence, preferring instead to invest and insure on their own. However, in countries and contexts where markets are missing or only function poorly; institutions are weak; and when "free will" is an elastic concept – where access to opportunities for advancement through merit and enterprise are not as abundant, and can be skewed by personal connections, affiliation to a class, religion, or tribe – this is too glib a dismissal.

So what is "better"? Will the things that make work better for some, make it better for all? Arriving at a definition of 'better' employment than will be satisfactory to everybody would be a formidable task. For this reason, policy makers, employers and civil society took the relatively easier step long ago to define at least what work should *not* be. From this ongoing deliberation emerged the Core Labor Standards, the Declaration on Fundamental Principles and Rights at Work; and other global resolutions and conventions monitored by the International Labor Organization (ILO). It is on these Core Labor Standards that the WDR 2013 constructs a conceptual framework through which policy makers can determine the quality of work. To give dimension to "better" the WDR refers to the three transformations that drive development, discussed in Chapter 3. "Better" work contributes to greater productivity, raises living standards, and increases social cohesion. However, the value of employment cannot be measured simply in terms of wages and working conditions enjoyed by individuals. The broader social contributions or costs of work need to also be considered.

According to the WDR, a better or "good job for development" provides sufficient income to improve standards of living, while also contributing to economy-wide productivity growth and to social cohesion. In well-functioning market economies, jobs that are good for employees will often also be good for society. Work that provides a high salary, but is in an environmentally damaging industry and financed by subsidies, however, might be beneficial to the worker, but could not be considered good due to its damaging social impacts.

Figure 1. Good jobs for development benefit society as well as individuals.



Thus, the WDR 2013 proposes that "good jobs for development" are those that act as conduits for higher incomes, greater productivity, and enhanced social cohesion, by maximizing positive internal AND external benefits. As discussed at length in Chapters 7 and 8, the challenges (constraints) to an economy creating more work that meets these criteria will vary widely across countries and even in the same countries over time. This is particularly the case in countries that are experiencing fast-paced economic and social change, like those in the East Asia Pacific region.

Source: World Bank 2012

9.10 Several observers of development in the region warned that East Asia Pacific countries entering middle income status could get caught in a "trap" in which rising labor costs could threaten competitiveness, productivity could stagnate and more moderate rates of growth would benefit fewer working people (Gill and Kharas, 2007). In the parlance of the 2013 WDR, and as shown empirically in Chapter 7, the middle-income East Asian countries in particular have reached a point in their structural transformation process -out of mainly 'agrarian' economies and well into 'urbanization'- at which gains in productivity, living standards, and social cohesion are no longer made at the same pace. The evidence presented in earlier chapters shows how lags are starting to appear in the pace of all three transformations, although to different degrees and in some countries more acutely than in others. It is at this point in the development trajectory of most countries when policy makers are forced to accept that although necessary, growth is no longer sufficient and may need a helping hand. The unprecedented speed of population aging in East Asia Pacific countries may motivate policy makers in the region to offer more than just one.

9.11 Governments in East Asia Pacific's emerging economies have been slower to intervene in markets to influence employment outcomes than their peers in other low and middle-income countries, preferring instead to set a broad course of export-led growth and to let markets function more or less unfettered. However, the emerging lags in the three development transformations have brought the debate about how to sustain wellbeing from work to the political forefront in many East Asia Pacific countries and, if ignored, could threaten the social contract. In contrast to the history of today's high income countries, the rapid economic changes in the emerging countries of East Asia Pacific have not been accompanied by a parallel development of social and civic institutions to accommodate the interest of different groups and classes. As discussed in Chapter 6, labor unions have historically been much weaker in East Asia Pacific countries than they were in Southern and Central Europe and in Latin American countries even when these were at similar stages of development. Where organized labor is strong in the region, unions tend to represent only a small segment of working people, and have not yet grown to represent the interests of self-employed or many services workers, as is happening in South Asian countries and even in the United States.

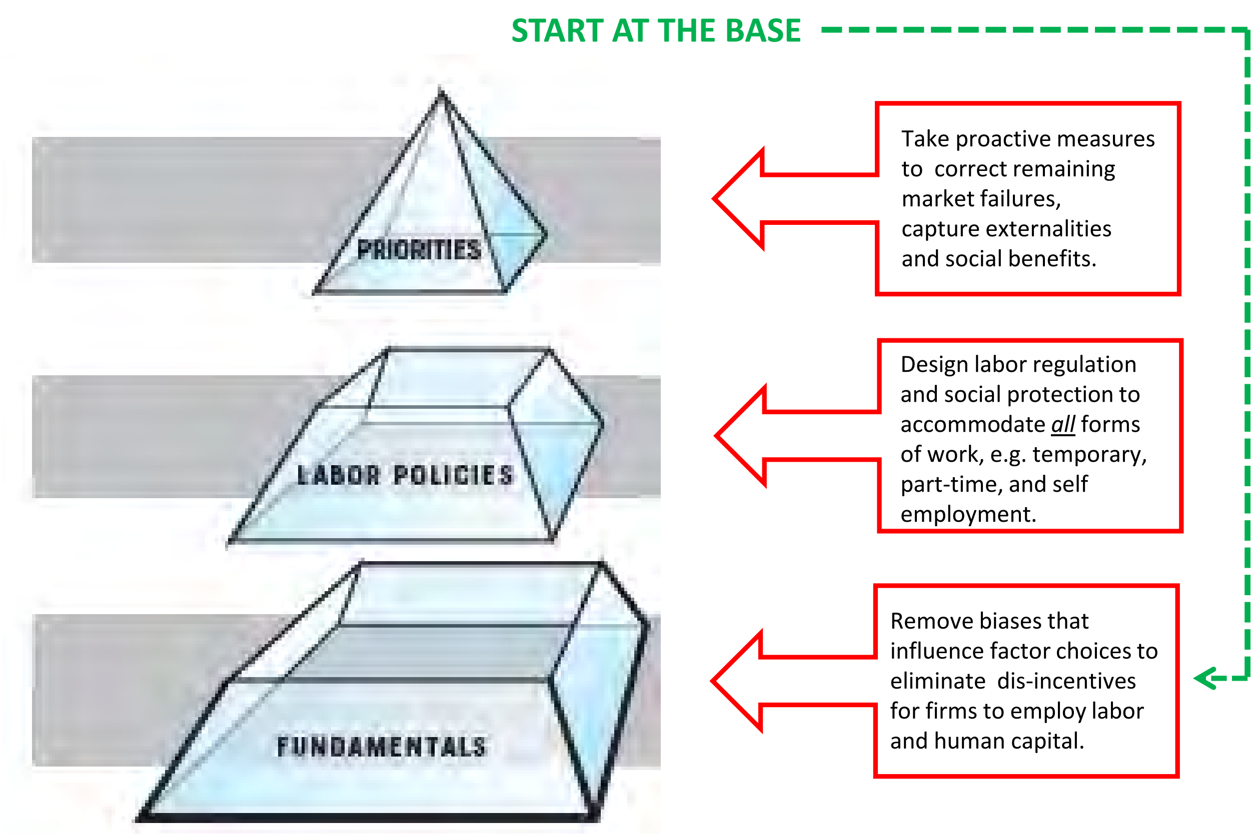
9.12 Without strong formal civic, labor and social welfare institutions, many East Asia Pacific governments are now facing the challenges of moderating economic growth, eroding labor cost advantages, and increasing inequality in the swelling cities of countries where the structural transformation happened far faster than anywhere previously. At a similar point in their development, those at the helm of East Asia's present-day, high income economies –Japan, Singapore, Korea and Taiwan, China- also had to consider whether employment strategies would be required to sustain productivity, raise living standards, and to see off threats to social cohesion. At this critical juncture, leaders in today's high-income East Asian countries responded quickly and actively. Most embedded explicit employment strategies in broader programs of centralized industrial policy, which included a wide array of measures, from market protection to directed credit for industries they identified as strategic.

9.13 Do the high-income countries in the region offer lessons to their low and middle income-neighbors? The answer is "yes" and "no". Yes, it is appropriate to be concerned by lagging productivity, that the living standards of some people might be rising far faster than for most people, and that this could threaten social cohesion and stability. Yes, some intervention to help labor, capital and land markets work better for firms and households is required. No, the strategies that worked for the likes of Singapore and Korea in the past may no longer be viable in a far more integrated regional and global economy, and especially now that countries are part of an international system of institutions with increasingly binding rules, as argued in Spotlight 2. No, intervention in the factor markets and social protection policies do not have to take the form they have in the past and in other regions where the profile of working people is very different. The list is long on both sides.

9.14 In this chapter we do not propose a single employment strategy for the countries of East Asia Pacific. That is not the purpose of a regional report. Indeed, in the preceding two chapters even though we have shown how countries in East Asia Pacific can be categorized into types, and from this categorization have gained insights as to where their priority employment challenges might lie, we have also taken great care to demonstrate why each country's priority challenges differ and will require its own package of policies in response. This said, along with the conceptual diagnostic tools offered by the WDR 2013 and used in this report, we add some broad principles in this chapter to guide what employment strategies could set out to achieve for policy makers eager to increase and sustain wellbeing from work.

9.15 In an ever more integrated, interdependent global economy, for countries to sustain productivity gains, ensure rising living standards for a broader segment of the population, and to increase social cohesion, a good way for activist governments to start is by eliminating structural biases that can hurt working people, and which may favor one form of work over others. In doing so, governments can better identify and correct market failures, as well as take actions to exploit economic and social externalities. To organize the broad policy guidance in this concluding chapter, we return to the WDR's policy pyramid in three segments introduced in Chapter 1: 'fundamentals' (which we covered in Chapters 4 and 5 of this report); 'labor policy' (discussed in Chapter 6); and 'priorities' (the subject of Chapter 7 and Chapter 8 on the Pacific island countries). The policy pyramid is reproduced in Figure 9.1. Each segment is accompanied by our interpretation of what an employment strategy should set out to do.

Figure 9.1 Employment strategies consist of actions at each level of the policy pyramid



Source: Adaptation from WDR 2013 (World Bank 2012)

9.2. Remove biases that hurt working people

9.16 Policy makers worried about employment outcomes and eager to increase and sustain wellbeing from work, should concern themselves first and foremost with ensuring sound *fundamentals*, namely macroeconomic stability underpinned with prudent fiscal policies, and an attractive environment for building human capital, investment and doing business. This is because the forces that fundamentally determine the demand and supply of labor and human capital are shaped by policy making in arenas other than the labor market (World Bank, 2012, Development Committee, 2012). The placement of these fundamentals at the base of the policy pyramid in Figure 9.1 is intentional. Too often employment strategies consist only of actions to regulate and support factor markets, and sometimes focus even more narrowly on the labor market. Without sound and strong macroeconomic and human capital foundations, labor regulation, social protection and others measures deployed to correct market failures and capture productive and social externalities, will fall short of their objectives.

9.17 In Chapters 4 and 5 we argued that although there is considerable variation, the macroeconomic, business and human capital *fundamentals* in East Asia Pacific are generally sound. Across the region, there has been greater price stability than in the past, with inflation decelerating in recent years to low and stable levels. Contributing to stability and reflecting difficult lessons from the East Asian financial crisis in the late 1990s, exchange rate policies among the worst affected countries have shifted towards greater flexibility. A long track-record of fiscal prudence allowed East Asia Pacific countries to react quickly in the recent global fiscal crisis, sustaining support for aggregate demand, and even launching substantial fiscal stimulus packages that, along with more flexible exchange rates, helped contain the costs of the crisis borne by households. Countries in the region also stand out on the whole as places where basic health and education is widely available. Furthermore, firms seem neither overly burdened by the level of tax, nor by the costs of complying with tax obligations. This is in stark contrast to countries in Eastern Europe and in Latin America and the Caribbean. And governments have created a generally encouraging environment for enterprise, although access to finance and skills shortages are now unnecessarily constraining growth and demand for labor and human capital.

9.18 In setting the "levers" of monetary and fiscal policy as well as shaping the playing field for enterprise, governments should not only strive for low, stable inflation, fiscal prudence, and a higher ranking in the Doing Business league tables. Governments concerned with the quantity and quality of employment should set out to achieve all of these in a manner that eliminates any explicit or implicit incentives that systematically favor one factor of production over the other. Borrowing from well accepted (if not always applied) principles of taxation (Fruman, 2008, Pikkety and Saez, 2012), macroeconomic policies should seek to be *neutral* with respect to the factors of production. For example, all else equal, using one set of revenue instruments more intensively than another could, at the margin, influence firms to invest in one more unit of capital rather than an additional unit of labor. For the same rate of inflation, monetary and exchange rate policies might have a similar effect unless government intentionally sought a more neutral stance that did not bias the factor choices of firms.

9.19 Similarly, in the face of skills shortages, the development of human capital should take a form that does not implicitly or explicitly favor, for instance, financing the provision of technical formation of certain technical skills over foundational behavioral and cognitive skills. Public resources would be much better invested in building fungible foundational behavioral and cognitive skills. Close study of skills shortages in several dynamic economies, including in East

Asia, shows that foundational skills are always in short supply, relative to demand. In response to skills shortages, governments can do much more than simply push more resources into technical vocational education and training programs. More often than not, however, this is the first and only policy response. Many TVET programs are only poorly connected to and informed by markets, and struggle to keep up with the pace at which they shift and grow in complexity. Along with more support for foundational behavioral skills, given the importance of agriculture and rural non-farm industry as well as the prevalence of self-employment in the region, policy makers crafting employment strategies cannot afford to ignore measures to augment the productive skills of farmers, owners of non-farm enterprises and entrepreneurs. In the health sector, governments can complement these human capital investments with more and better quality early child nutrition and preventive care.

9.20 In crafting employment strategies, with respect to fundamentals, policy makers should be alert to policies, laws and regulations that intentionally or unintentionally influence firms' decisions at the margin to engage capital or labor. The fundamentals in East Asia Pacific countries are already more neutral between the factors than elsewhere. For example, countries in Central Europe over tax earnings from work. Governments in almost every country under tax property. Self-employed people in most Latin American countries have a hard time registering their businesses and paying taxes even if they want to. Globally, between 2004 and 2012 the burden of taxation shifted away from profits to labor earnings, and taxes on labor are now the largest segment of the total tax rate (World Bank, 2013c). As governments in East Asia Pacific respond to demands for new employment strategies, however, they will need to be vigilant against these biases. The dangers of a policy stance that biases firms' decisions one way or the other are structural imbalances: too much capital and not enough labor in one part of the economy, or vice versa. These imbalances can become embedded economically and even politically. When they do, they can create barriers to the productive process, hinder countries' ability to adjust, evolve and grow as deeper integration with the global economy accelerates the necessary pace of change.

9.3. Make labor regulation and social protection work for all

6.1 With sound fundamentals in place, activist governments will stand on far more solid ground as they turn their attention to the labor market. Labor market regulations and interventions are formulated according to each country's institutions in an attempt to address market imperfections, such as uneven power between those who seek and those who sell labor and human capital; information failures on all sides; and limited or weak insurance to mitigate risks to household wellbeing from loss of work. Readers will recall from Chapter 6, the 2013 WDR's conclusion that the parameters of labor policy should ideally be set at a "plateau" level that avoids the extreme "cliffs" of *too little protection* and *too much restriction*.

9.21 Comparable measures of regulation drawn from the labor codes of these countries show that the average level of employment protection in East Asia is actually higher than the OECD average, and that there are notable outliers like Indonesia, where workers whose employment is regulated enjoy more de jure protection than workers in France, Greece, or

Portugal and only a little less protection than workers in Spain. As sustained high levels of unemployment and informal employment in several Southern European countries make plain, these countries have erred on the side of too much restriction. In China, workers in regulated employment are de jure more difficult to dismiss than workers in Belgium and Italy. Similarly, reflecting what is codified in labor laws the Philippines has the highest average statutory minimum wage in the region, followed by Cambodia and Indonesia. When ranked by the ratio of the minimum wage to value added per worker, the average statutory minimum wage in the Philippines is among the highest in the world.

9.22 In East Asia Pacific countries restrictions *de jure* may not be fully felt *de facto* while many people still work on farms or avoid detection in the informal economy. But the body of empirical evidence pointing to problems created by overly restrictive labor regulations is growing, and as urbanization advances, the risk of partially and poorly enforced policies creating barriers to factor mobility is also growing. While restrictions on dismissal and wage regulation are being loosened in most middle income and high income countries in other regions, the observed movement of regulation in East Asia Pacific is in the opposite direction: the regulatory framework in East Asia Pacific countries is becoming more restrictive. And as more people seek work in the manufacturing and services sectors, the ability of governments to enforce regulations grow, and firms find it harder to evade, these extreme levels of regulation in the labor code will become more binding constraints. Indeed, for a segment of firms in many East Asia Pacific countries that are already too large to evade –many of them international companies- onerous levels of regulation are a problem, and for many a source of unfair competition from smaller rivals who can still ignore the rules and hire informally.

9.23 This said, several East Asia Pacific countries have written their labor codes in a manner which places them on the WDR's conceptual plateau. However, because evidence of the modest negative impact of policies set at this level comes mainly from upper-middle income and high income countries, their impact may not be as benign in countries with less administrative capacity and more fragile institutions. And even on the plateau, the prevailing models tend to be biased against working women, young people and those outside of full time dependent work.

9.24 Does this mean that low and middle-income countries should not intervene in the labor market at all? Absolutely not. Labor market imperfections and failures are particularly rife, and as argued in previous sections, cannot be ignored. But there is no good reason for activist governments concerned with the inequitable opportunities and outcomes of labor market imperfections to respond with policies designed to benefit prime-aged men in full time employment – the group that made up the largest segment of the workforce at the time when these models were put in place in countries elsewhere. When they advance to the middle section of the policy pyramid (Figure 9.1), policy makers should craft labor regulation and social protection policies that favor *all* working people, even if they work part time, work for themselves or hire others to work with them.

9.25 The performance of existing and proposed new labor regulations and social protection programs should be evaluated on the extent to which they serve all working people, and not just certain segments, sectors or types of work. As governments in East Asia Pacific get ready to respond to ever more frequent calls for greater activism and intervention, some have responded in a manner that favors one form of work over another. Greater restrictions on the use of term contracts and labor from third-party agencies in Indonesia are a case to caution against. In contrast, the scrutiny and debate around minimum wage policies in several East Asian countries in recent years is an excellent illustration of the important assessment of policy impacts on all working people (Box 9.3).

9.26 Examples have emerged of labor and social protection policies and institutions that support all working people. The Scandinavian countries' emphasis on protecting people rather than protecting employment is a prime example of State activism which achieves a relatively unbiased, neutral stance in how labor market risks are managed. In separating protection from where or how people work, these measures do not have to compromise the contestability of markets and efficiency (Box 9.2). In addition, institutional structures for collective representation can be more inclusive and enable voice for a broader body of working people than just those in formal labor unions. Associations of self-employed workers--for example, India's Self Employed Women's Association (SEWA)--are growing in numbers and bargaining power to protect the rights and working conditions of those who work outside of dependent wage employment(World Bank 2012).

Box 9.2: Denmark's "Flexicurity": Protection does not have to come at the cost of efficiency

Scandinavian countries have become famous for "protecting workers, not jobs". This general characterization of their social protection systems grew from Denmark's approach to helping households manage creative destruction. The approach shows that when the State takes a more neutral stance, how extending protection to working people does not have to come at the expense of labor market efficiency.

Every year, one out of five Danes loses his or her employment. But they don't lose their incomes. Unemployment benefits replace close to two thirds of their earnings, and the government helps them find work. This combination of flexibility for employers and income security for workers is called "flexicurity". The arrangement has been in place since at least the 1970s. But it has evolved over time, principally in that the active component, assistance with retraining and employment search. And it seems to work well. Between 1995 and 2008, Danish unemployment rates averaged 4.9 percent, while the rest of the high income countries in the European Unions suffered rates close to 8.5 percent.

Danish employment laws have evolved from the "Gent system", in which unemployment benefits were paid by labor and trade unions, not the government. In the 1970s and 1980s, employment rates remained high, while those without jobs got good incomes. The arrangements became too expensive and were reformed in the 1990s. The new approach is sometimes called the "Golden Triangle" because it added active labor market programs to flexible hiring and firing laws and generous unemployment benefits.

- The first component, flexibility of firing and hiring. Denmark is resolute not to create obstacles to the creative destruction process. The OECD EPL index for Denmark fell from 2.4 in 1983 to 1.5 today; the OECD average is 1.9. Relatively flexible laws work in Denmark because the country has a history of self-regulation by employers and unions, going back to the "September Compromise" of

1899 which set out rules for resolving labor disputes.

- The second part of the Danish model is unemployment insurance financed from contributions and taxes. Membership is voluntary, but it covers around 80 percent of the labor force. Benefits last up to four years and replacement rates cannot exceed 90 percent of wages up to a capped amount. After 4 years of getting benefits, recipients have to switch to social assistance which means a reduction of between 20 and 40 percent of their benefit income (Andersen and Svarer, 2007).
- The new system uses active labor market programs like job search assistance and training to nudge the unemployed back to work. The spending on these programs is sizeable: out of €13 billion spent on labor market programs in 2010, about 75 percent was spent on active instruments.

How well does flexicurity really work? The unemployment rate dropped from 10 percent in 1993 to 3.3 in 2008 before the global financial crisis. The incidence of long-term unemployment (those without work for more than a year) decreased from a third of total unemployment in 1994 to one tenth in 2009. Despite liberal firing and hiring practices, employment has not fluctuated too much in response to output variability.

There are some important qualifications to Denmark's success though: First, although official unemployment has fallen, there is a gap between actual unemployment (adding up the unemployed, those in "activation", and early retirees) and official statistics. Second, it is difficult to assess how much of the fall in unemployment rate is due to flexicurity on its own. Economic performance matters too, of course: active labor policies are useless if the economy is not growing. Finally, the already high fiscal burden can become enormous in a protracted slowdown. The Danish model costs 4.5 percent of GDP. And Denmark spent 2.6 of GDP for labor market programs in 2008 (a good year prior to the crisis), compared with 1.4 percent for the OECD as a whole, 1.5 for Sweden, 2.2 for Finland, and 2.3 in the Netherlands. The Danes have flexicurity because of their history, and can afford it in part due to high participation rates of 81 percent; the OECD average was 71 in 2009.

Is this something countries in East Asia Pacific can achieve? Although with difficulty, and adapted to their own needs, yes. Most of the countries in the region have the prerequisite growth and fiscal discipline. Although labor market policies have been moving in a direction opposite to the "flexicurity" model, very restrictive policies or structures that favor one form of work over another are still new and are only applied to a small segment of workers. The key challenge is administrative and institutional strengthening, to increase the confidence of people and firms.

Source: Based on Gill and Raiser (2012)

Box 9.3: A more neutral labor policy? Moving towards national minimum wages

A recently published companion report from the World Bank (2013) on minimum wage policies in ASEAN countries, quotes Friedrich Hayek. *"A general flat minimum-wage law for all industry is permissible…. I know much better methods of providing a minimum for everybody. But once you turn from laying down a general minimum for all industry, to decreeing particular and different minimum for different industries, then, of course, you make the price mechanism inoperative, because it is no longer the price mechanism which will guide people between industries and trades."* While Hayek may not have appreciated being quoted in a report on minimum wages whatever the context, his argument is a nice illustration of what we mean by neutrality applied to a prevalent form of labor market regulation.

In the Philippines, Indonesia and other East Asian countries, prevailing labor policies allow different minimum wage levels to be in place. This hinders factor mobility, raises enforcement and compliance costs, and may compromise the credibility of their collective bargaining institutions. Multiple minima require a thicket of de jure regulation and an accompanying cadre of people engaged in the process of setting the floor on wages in each province, or district and even in different industries of the same localities. If these seem like intimidating labor codes to comply with or even enforce, imagine what they must be like to orchestrate and organize to ensure that the interests of employers, working people and the public (consumers) are adequately represented.

Like the Philippines and Indonesia, Thailand had a complex governance structure prior to the unified minimum wage of 300 baht introduced in 2012. Before the national minimum wage was implemented, the law specified the appointment of the National Wages Council (NWC) to make recommendations on suggested wage rates and to ensure that proposed wage rates coming from the provinces remained consistent with what "an employee deserves" and "sufficient for an employee's living." The provincial committees deliberated on the adjusted wage rate, given their own context and using tripartite deliberation, and made proposals to the central committee. The final decision was then taken by the Minister of Labor based on recommendations from the NWC, provincial committee, and the Subcommittee on Technical Affairs and Review (STAR). The country had about 32 levels of minimum wage rates in 2011, ranging from 221 baht in Phuket (the province with the highest cost of living in Thailand), to 159 baht in Payao.

The case of Thailand prior to the adoption of the unified minimum wage illustrates the challenge of ensuring that all three sides in a tripartite system of governance are well-represented and equipped to negotiate. In Thailand, the pool of worker representatives in the smaller provinces is limited. This is a concern for countries where unionization levels are low and levels of labor informality are high, because a large number of workers are not represented in the negotiation.

In a system with multiple minimum wage levels it can be difficult to keep the tripartite process balanced in many localities, enforce the law once announced and ensure compliance, and avoid further distorting the labor market. The complexity of managing multilevel systems is further exacerbated where enforcement capacity is low. Because of these dangers, the general trend around the ASEAN region (and the world) is to move away from differentiating wage levels by geography, occupation, and economic sectors and to move toward having just one national level of the minimum wage.

In Indonesia, recent changes announced by the Government (largely in response to repeated worker demonstrations) may reduce the level of minimum wage dispersion in the country in the near future, if the suggested increases made by the Government—a rise for Jakarta by 44 percent (equivalent to USD 228 per month) and the rest of the provinces to a uniform level equivalent to USD 208 per month—take effect. The size and speed of the increase could push many people into unemployment or the informal economy, particularly as there have been several recent increases in the minimum wage, and little loosening of regulations on dismissal.

In Vietnam, recent reforms have separated the common minimum wage used in the domestic private sector from that of the public sector as well as gradually unified the minimum wages for the private domestic sector and foreign sector. Effectively since October 2011, domestic and foreign firms have had the same level of minimum wages. In Malaysia, the government chose to implement two distinct minimum wage levels in the country, one for Borneo and one for Peninsula, given that these geographic areas have very distinct labor markets.

Many countries around the world set only one national level for the minimum wage and allow for a few exceptions or reductions. The reductions are mainly granted in the case of particularly low-productivity workers whose employment opportunities become extremely limited when the minimum wage is set at a high level. Some of the most common reductions are granted for younger employees, disabled workers, and apprentices.

In South Korea, for example, a single minimum wage is applied without any regional or occupational differences. The law initially included only manufacturing establishments and firms with more than 10 employees, but it gradually expanded to universal coverage of all sectors and firms, regardless of size. Currently, the minimum wage does not apply to family businesses that hire only family members and housework employees. It also exempts those working on ships and ship owners. With respect to special groups, workers with limited working capacity (the disabled) are exempt from the law, with the Ministry of Labor granting permission on a case-by-case basis. Workers on probation receive 90 percent of the hourly minimum wage rate, while security guards and caretakers receive 80 percent of the hourly minimum wage rate.

Similarly, the minimum wage law in Hong Kong applies to every employee whether full-time or part-time regardless of nationality or type of contract. There are no deductions or exclusions based on worker age, nor are there sectoral differences mainly to avoid distortions. However, a few exceptions are allowed for: (i) people not covered by the Employment Ordinance, (ii) domestic workers who live in their employers' households free of charge (nearly 280,000 workers, mostly Filipino and Indonesian), (iii) workers excluded from coverage due to difficulty in calculating their work hours given the round-the-clock nature of their work and the monetization of other benefits such as housing, food, medical care, and free travel to their home countries, (iv) apprentices registered under the Apprenticeship Ordinance, and (v) student interns and specified work experience students. Disabled workers are paid a proportion of the minimum wage, estimated by their degree of productivity as assessed in their person-with-disabilities (PWD) certifications.[1].

In order to better serve working people, statutory minimum wages should be benchmarks that prevent exploitation, protect household purchasing power, and ensure working people share in the benefits of greater productivity. Minimum wage policies should not inadvertently cause the exclusion of lower-skilled people from work or from the benefits of formal employment. To this end, a country's statutory minimum wage should be set at a level consistent with the productivity of its unskilled workers. Setting the minimum wage too high encourages non-compliance, reducing social protection and tax revenues. Where it proves necessary to make accommodations for special groups whose average marginal productivity is lower, such as young people, exemptions to the national minimum could be considered as part of apprenticeships or other targeted training programs. Simplifying and standardizing earnings regulations by moving to a unified national minimum wage can help improve employment outcomes. Standardized minimum wages levels -set with reference to the productivity of unskilled workers and adjusted transparently according to clear economic criteria- reduce distortions and compliance costs, and improve predictability for employers. With a national minimum wage set at reasonably low levels, governments are also more likely to see improvements from greater investment in monitoring and enforcing compliance.

Source: World Bank 2013a

Finally, instruments designed to protect household income and consumption from the risks of unemployment can favor all working people. They need not be organized at the firm-level (probably the least efficient level at which to pool risk of unemployment) or the sector. A national system of modest, "non-contributory" unemployment benefits, financed from general revenue could relieve employers of costly severance schemes, and provide some incentive for workers currently without any protection, to bring their activities to the attention of government by registering. Technology has expanded governments' ability to monitor and verify sufficiently, so that it need no longer delegate this burden to firms. In several countries, governments are already experimenting with de-linking financial protection and risk pooling for

[1] To avoid the risk of abuse, the right to invoke such an assessment is vested in the employees with disabilities rather than the employers

health from where and how people work. Thailand's universal health coverage model is the most successful example of this approach, and credited not only for extending coverage but also increased usage of health services.

Box 9.4: Universal Health Coverage in Thailand: Protecting people no matter where they work

Motivated by the vulnerability of a large segment of the population working without financial protection from the costs of health care, Thailand decided to redefine "social insurance" to meet its own needs. In 2001 the Thai Government introduced a national risk pooling mechanism that extended protection to people no matter where or how they worked. In 2012 the independent Thai Health Insurance System Research Office (HISRO) published an evaluation of this bold departure from the prevailing social insurance model to assess the impact the new coverage scheme in its first 10 years (HISRO, 2012).

Prior to the introduction of the new scheme up to 30 percent of the Thai population (or about 18 million people) — mostly people who worked informally beyond the reach of regulation or taxation—had no health insurance, nor access to affordable medical care. Out-of-pocket payments for health care accounted for 33 percent of total health expenditure in 2001. Payments for medical care out of pocket, where highest as a share of household income for people living near or below the poverty line. Impoverishment from the costs of healthcare was common.

Within a year of its launch in 2001 the new Universal Coverage Scheme (UCS) extended financial protection from the cost of health care to 47 million people, or 75 percent of the Thai population including those who were previously unprotected. The other 25 percent of the population were already covered by traditional social health insurance plans: the Civil Servant Medical Benefit Scheme (CSMBS) for public sector workers and the Social Security Scheme (SSS) for workers in registered and taxed forms of private employment.

Thailand's UCS has three defining features: "general-revenue" or budget financing, which allows health services to be provided free of charge or for a small payment (a copayment of 30 baht or US$ 0.70 per visit or admission was initially enforced, was lifted in 2006, but re-introduced recently); a well-defined and comprehensive benefits package focused on primary care, including prevention and health promotion; and a fixed budget with caps on provider payments to control costs.

Critical to the labor market and the welfare of working people and their families, the UCS achieves pre-payment, risk-pooling, and redistribution toward disadvantaged groups –all essential elements of effective, even progressive financial protection- without the degree of distortion or the exclusion created by mandatory employer and worker contributions. Furthermore, the scheme achieves greater efficiency from scale by pooling risks and redistributing at a national level, rather than at the sector, industry or firm level. Since most traditional social insurance plans are constrained by relatively small risk pools, these efficiency gains are critical to long-term fiscal sustainability of the UCS.

In its first ten years, the UCS improved access to health services, increased equity of service utilization and prevented medical impoverishment. Between 2003 and 2010, the number of outpatient visits per member per year rose from 2.45 to 3.22 and the number of hospital admissions per member per year rose from 0.094 to 0.116. Impoverishment -measured by the additional number of non-poor households falling below the national poverty line as a result of paying for medicines and health services, decreased significantly from 2.71 percent in 2000 to 0.49 percent in 2009. Not surprisingly, the UCS led to a significant increase in government health spending and a marked decline in out-of-pocket expenditure. However, the difference in out-of pocket expenditure between poor and wealthy households was eliminated. HISRO's evaluation found that the UCS increased the equity of public subsidies, and that overall health expenditure was very "progressive" or pro-poor.

Looking ahead, there are concerns for inequities in benefits between UCS and the remaining

traditional social health insurance plans; discouragement of labor mobility from the plans operating in parallel; and fiscal sustainability. However, Thailand's experiment is not without precedent in East Asia Pacific. Both the Republic of Korea and Taiwan, China preceded Thailand on the path to universal health coverage by breaking with traditional social insurance models. Korea gradually expanded coverage from 9 percent of the population in 1970 to 100 percent by the mid-1990s, and Taiwan China moved faster with reforms in the early 1990s that raised the level of coverage from under 60 percent to full protection (Baeza, Montenegro and Nunez, 2002). In both cases fiscal space created by economic growth, reliance on financing models with a much broader base than pay-roll taxes, and close attention to the composition and eventual harmonization of the state-financed benefits package were critical to their success.
Source: Staff drawing on HISRO 2012 and Baeza, Montenegro and Nunez, 2002.

9.4. Take proactive measures to address remaining failures and capture externalities

9.27 After eliminating biases in policy fundamentals that could be prejudicing firms' factor choices away from labor; and having established labor and social protection policies that accommodates all working people; there will still be market failures that leave many people without work and underemployed, or that leave productive externalities unexploited. At the top-most segment of the WDR's policy pyramid, space is left for employment strategies to address remaining priority challenges. As shown in Chapter 7 for a region as diverse and dynamic as East Asia Pacific, these remaining priority challenges will vary widely across countries and in the same country over time. Chapters 7 and 8 discussed these challenges and proposed responses in depth. In this section, we summarize that discussion briefly for three categories that present the most salient priority challenges in the region, and show how addressing them fits the overall approach.

9.28 *Small island countries.* In small island countries, employment creation led by private enterprise is significantly constrained by small and dispersed populations. Outside of niche sectors, small size makes it almost impossible to achieve scale economies. Moreover, the Pacific island countries are particularly constrained by great distances, which make them very different from the small island countries of the Caribbean or sub-Saharan Africa, and conspire against their competitiveness even in activities where endowments should otherwise have given them a comparative advantage. While the Pacific island countries are too constrained by economic geography to compete in manufacturing and find it difficult to process their natural resources for export, managing the exploitation of these resources and tourism offer opportunities for work. As information and communications technology improves to bring the islands economically "closer" to distant markets, the opportunities for work in call centers and business processing services may become more readily available. Policy makers should focus on preparing young people with the human capital they will need to take advantage of these opportunities or to succeed abroad as migrant workers. Indeed, increasing the volume of migration to work in neighboring large markets is the single most powerful measure to boost wellbeing from work for people from the Pacific island countries. To increase human capital, service provision itself can become a force for employment creation when populations are dispersed on difficult-to-reach islands.

9.29 *Agrarian economies.* For countries that are still mainly agrarian (particularly Cambodia, Lao PDR, Myanmar, Papua New Guinea and Timor Leste), the policy priority to increase wellbeing from work is to raise the productivity of agriculture, in order to free labor and human capital to work in rural off-farm enterprises and eventually to migrate to towns and cities. The instruments for increasing agriculture productivity and facilitating the structural transition are land reform, agriculture extension programs, deregulation of prices, rural infrastructure and good quality education and health services to build human capital. To sustain wellbeing from work, governments should identify and remove policies and programs that create implicit or explicit restrictions to working people moving off the farm and into rural non-farm industry and to manufacturing and services in cities. China's hukou is a notorious example. Vietnam's experience in the 1990s and the first decade of the 21st century is an often-cited example of success. The danger to be avoided is urbanization *in spite of* rather than enabled by policy, characterized by efforts to discourage people from moving, unproductive use of land, people migrating in search of better health and education services, cities unprepared for fast population growth, and rapid divergence in living standards between town and country.

9.30 *Urbanizing economies.* For countries that are already rapidly urbanizing (particularly China, Indonesia, the Philippines, Vietnam, and Mongolia), the policy priority is to make cities work better. Somewhat counter-intuitively in a discussion of wellbeing from work, the factor market that policy makers should pay the greatest attention to is the market for land. Since land is the least mobile factor of production, good urban planning becomes the key to increase the flexibility, efficiency and thus the productivity of land use. Urban planning becomes the area of policy with the greatest impact on the incentives of firms in towns and cities to form, to grow, to move up the value chain, and thus to create and sustain demand for labor and human capital. Also important are urban infrastructure and service provision, to ensure that growing cities with plenty of skilled people foster economies from agglomeration rather than incur burdening costs from congestion. Both Japan and Korea's examples are instructive in this regard and provide valuable guidance for East Asia Pacific's policy makers.

9.31 When they reach the top-most segment of the policy pyramid in Figure 9.1, activist governments will need to proactively correct remaining market failures and capture externalities and social benefits.. This may involve taking account of the special requirements of particular groups of people (women, young people, ethnic minorities, and older people). Even though countries in East Asia Pacific tend to have higher rates of labor force participation of women than elsewhere (Timor Leste, Fiji and Malaysia are notable exceptions), persisting gender gaps in earnings and segregation in economic activity can limit the economic and development potential of countries. Also of concern are disengaged young people, and as people live longer, the needs of older workers. If these groups were fully economically engaged, they could fuel further gains in productivity, living standards and social cohesion.

9.32 Some of these problems may be the consequences of past biases in a country's fundamentals or factor market policies that require corrective action, or that have left external benefits unexploited. This would be the rationale for policy measures in response to very high levels of youth disengagement and unemployment, substantial gender gaps in access to economic opportunities, or policies aimed at rural areas to improve the incentives and increase the productivity of farmers.. They address the externalities, market failures, and possibly past distortions that are not covered by the neutral policies proposed in the bottom two layers of the policy pyramid actions.

9.33 For example, as discussed in the case of mostly agrarian economies, in a country where most farmers may have had few real opportunities to gain ownership of their land, and little incentive to apply new technology, the outcome of biased fundamentals would be low agricultural productivity. If this were aggravated by under-investment in service provision in rural areas, people would have strong incentives to migrate to towns and cities for decent schools and healthcare as well as work. But this sort of migration –pushed by low agricultural output and a lack of rural services- is the kind more likely to add to congestion rather than contribute to agglomeration (World Bank, 2008). This is precisely the problem described in last year's Philippine Development Report (World Bank, 2013d). A proactive policy package to increase land tenure, extend the use of fertilizers, support rural non-farm industry, and ensure that people in rural areas had adequate schools and health care, would be required to undo the damage of past policy biases. Similarly, proactive measures to encourage more women into market work, to lower the risk of scarring among young people, and to encourage business to lower the size of their carbon footprint are likely to be justifiable, either due to past policy biases or the externalities that would be left uncaptured otherwise.

9.5 Why should this approach to crafting employment strategies appeal to governments in East Asia Pacific?

9.34 As they face a future of moderating rates of economic growth, as well as pressure to respond to rising threats to wellbeing from work, why might the general principles presented in Figure 9.1 appeal to policy makers in East Asia Pacific countries? As a theoretical construct and description of a general approach there is nothing especially "East Asian" about what has been described in the previous sections of this chapter. This said, we think there are three specific reasons why the approach we have described will be more appealing to policy makers in East Asia Pacific countries than to their peers in other regions. Among these lie the priority challenges to sustaining wellbeing from work in *formalizing* countries, the fourth country category from Chapter 7 of particular relevance in East Asia Pacific.

9.35 First, the pursuit of a neutral stance, especially when it comes to policy fundamentals, might better appeal to policy makers' generally more conservative orientation in East Asia Pacific countries than activist governments elsewhere. Doing nothing and continuing with business as usual is not an option. Chapter 3, Chapter 7 and the introduction of this chapter suggest that the consequences of a "*do nothing*" option will increasingly threaten social cohesion and, as growth moderates, constrain productivity and limit gains in living standards. Some governments in the region have started to intervene in the arena of labor regulations and social protection. But policy actions taken to improve employment outcomes by removing structural biases and achieving a neutral stance toward all working peoplewill look very different from what these governments have been doing.

9.36 Second, because the history of interventions in the labor market and social protection in East Asia Pacific countries is short relative to that of countries in Latin America and Southern Central Europe, the cost of transitioning from an arguably biased stance that protects only workers in full time dependent employment, to a neutral stance that ensures protection to all working people are likely to be much lower. For example, while technocrats serving in Latin American and Central European governments might find the idea of providing low, basic 'non-contributory' forms of social protection appealing, instead of income-replacement benefits financed from employer and worker contributions, the transition costs of such a move may be something their already heavily indebted governments can ill afford. Low "legacy costs" are an advantage that extends from the fiscal to the political arena: there are fewer social protection "sacred cows" in the countries East Asia Pacific region.

9.37 Third, the risks of ignoring or aggravating biases in the current policy framework are higher for countries in East Asia Pacific due to their rapidly shifting demography. In Chapter 2 and Chapter 7 we presented evidence of the speed at which the East Asian countries are aging. The pace of this demographic wave is likely to pick up in a couple of years and roll over the region faster than it has over any other. In China the statistics authorities reported the first ever contraction of their working-age population in 2012. Korea already has the lowest population replacement rates in the world. And if the average longevity of people in Japan is a suitable benchmark, many people in East Asia can expect to live very long lives. Yet at the margin, most policy models currently in place are likely to discourage longer working lives; constrain the productivity of older working people; deprive working people of the foundational skills they need to easily re-skill throughout their lives; or discourage formal forms of work that appeal to the elderly (part time, irregular hours). Structural discouragements of longer working lives in East Asia Pacific are nowhere near as bad as they are in Latin American or Southern and Central European countries, where it often pays to withdraw from the labor force at early ages (Gill, Koettl and Packard, 2013). Today, people in East Asian countries work longer into old age, because they do not have any other choice. But this is a poor, residual outcome, rather than the intended consequence of a coherent employment strategy. Better policy fundamentals, labor and social protection institutions, and proactive measures targeted at older people, could create stronger incentives for people to remain productive longer. Across the entire region – particularly in the Pacific island countries that despite a "younger" demographic profile, face a health and financial burden of non-communicable diseases of much "older" countries – greater emphasis on better nutrition and prevention is likely to lengthen productive working lives, and ease the burden of health care costs.

9.38 While preparing for the onset of aging, several governments in the region are also facing the challenges of "formalizing" more work, in part to increase the coverage of social protection, but also to sustain productivity and increase the tax base for financing public goods. As shown in Chapter 7, in the region's most populous countries, the majority of people will soon live in towns and cities The key principle for policy making in these countries is to avoid *segmentation*: cleavages in factor markets that impede competition, impair labor mobility, and limit the coverage of essential work-risk and social protection. Segmentation is caused mainly by intended and unintended biases in countries' policy frameworks - differences in how income from different sources is taxed; by rules for providing credit that explicitly or implicitly exclude self-employed people; by the design of non-wage social protection benefits and how these are financed; and when only certain types of work are recognized in the labor code while others are not.

9.39 Avoiding and eliminating biases and segmentation of factor markets is essential if countries of East Asia Pacific are to grow in wealth before they have to face the more difficult challenges of an aging economy. This is the current quandary of several middle income countries in Central and Southern Europe and the Southern Cone of Latin America that got old before they got rich. Their example should strike a note of caution for policy makers in East Asia Pacific countries where the average age of the labor force and the share of elderly in the population is quickly rising.

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Spotlight 1. Work in the Informal Economy

What is the informal economy?

1. Few of the phenomena that occupy the time of governments, economists and others in the business of crafting and executing policy, are as ambiguously defined and as difficult to measure as the "informal economy". It is inherently difficult to observe that which, by its very nature, people are trying to hide (Schneider, Buehn and Montenegro, 2010). A form of economic activity that first captured the interest of anthropologists and sociologists in the 1950s, and came under the scrutiny of development economists in the early 1970s with a seminal report by the International Labor Organization (ILO), became a central focus of policy in the late 1980s and early 1990s when sufficient data were available to show that the informal economy was far more than cottage industry, taxi drivers and children selling candy on street corners.

2. So what is the informal economy? Definitions change according to who is asking and what motivates their question. A minister of finance might ask in order to know where and how many untapped sources of additional tax revenue can be found. But a minister of labor or the leader of a trade union might ask in order to have a better idea of where to concentrate their efforts to ensure that the rights and protections of labor market regulation are upheld. A minister of trade and industry or the head of the local chamber of commerce might ask in order to know where opportunities to expand sales, ensure fairer competition, and improve productivity might lie. A neighbor, frustrated by the time it takes to get his electricity service installed, might want to know who could do the job sooner, faster and probably for less if paid cash in hand. And from each of these different perspectives, a different definition can be drawn of what exactly the informal economy is.

3. In 2002, at the 90th Session of the International Labor Conference (ILC), the term "informal economy" was defined as "*all economic activities by workers and economic units that are not recognized, regulated, or protected by existing legal or regulatory frameworks and non-remunerative work undertaken in an income producing enterprise*" (ILO 2002a).[1] Although the 2002 convention seems comprehensive, it can be unwieldy. The Organization for Economic Cooperation and Development (OECD, 2004 and 2008) offered a more parsimonious definition *"….employment or other economic activity engaged in producing legal goods and services where one or more of the legal requirements associated with employment and production are*

[1] Informal employment, according to ILO, includes own-account workers and employers employed in their own informal sector enterprises; unpaid family workers, irrespective of whether they work in formal or informal sector enterprises; members of informal producers' cooperatives; own-account workers engaged in the production of goods exclusively for own final use by their household; and finally employees holding informal jobs in formal sector enterprises, informal sector enterprises, or as paid domestic workers employed by households. For this last category, *informal jobs* are those where the employment relationship is not subject to legislation, income taxation, social protection, nor entitlement to codified benefits such as advance notice of dismissal, severance pay, paid annual or sick leave (ILO, 2003).

not complied with". This is a more widely applicable definition, although still challenging to measure.

4. In this report, we use the overarching term "informal economy" in reference to market-based production of goods and services that are in essence legal under prevailing laws, but concealed to avoid payment of income taxes and social insurance contributions and to escape product and factor market regulation. We count as the "informal" work force the self-employed and employers who employ five or fewer workers; workers without a written employment contract, unpaid family workers and/or those who do not make social insurance contributions. Data limitations discussed later in this section, rarely allow measurement to be as precise as definition, however, and force us to use one observable feature or another throughout this report.

Why does it matter?

5. Why should policy makers be concerned about informal employment and the informal economy? People work and do business outside the confines of social, labor and business regulation for a variety of reasons. Some *exit* the structures of the formal economy to escape regulatory costs or to enjoy greater flexibility, while others are *excluded* by a lack of opportunities for advancement and actual barriers to better protected, higher-productivity jobs (Perry, et al, 2007, Packard et al, 2012).

6. But whether they are working informally because they "exited" or are "excluded" from formal employment, widespread informal work and a large informal economy can be treated as evidence of inadequate and unsustainable social institutions: the very institutions the State puts in place to help households build, sustain, and protect their investment in human capital as they enter the labor market to seek a return on this investment. Indeed, a large and growing informal economy can been seen as the consequence of a mass opting out of institutions by firms and individuals and "… *a blunt societal indictment of the quality of the State's services provision*…" (Perry, et al, 2007).

7. Informal employment has long been a phenomenon that worries policy makers for several reasons.

- Firstly, it is the problem of the individual and her family. People working informally and their dependents, face explicit and implicit barriers to public and privately provided insurance instruments to manage potentially impoverishing shocks to their income. Even if people are able to manage many risks to their wellbeing without the help of the State, they may find it difficult to assess the costs of certain needs accurately, such as their health care, or a period of job-search, or make sufficient provision for losses far in the future, such as adequate income arrangements when they can no longer work in old age. Nor do people who work informally have easy access to credit, or recourse to rights and the legal protections these afford when things go wrong.

- Secondly, it is the problem of a firm. In countries with large informal economies, bigger firms are often over-taxed to make up for revenue lost to the government from widespread evasion. This can discourage investment and hinder growth. Further, firms that operate within the rules, face unfair competitions from those operating outside the rules. Firms that operate informally in the informal economy can be constrained to a small size to escape detection by the tax authorities, and may have to forgo a more efficient scale of production. And like households where the main breadwinner works informally, these informal firms also have limited access to credit and recourse to legal protection when they need it.

- Third and finally, the problem for society as a whole is that a large informal economy imposes heavy costs that deteriorate services and public goods. This is what economists like to call a "free rider problem", and in extreme cases can corrode civic structures to such an extent as to contribute to state failure. As a specific example of this corrosive process, a country's social "risk pools" such as public old age, unemployment, health insurance and the tax and transfer system, become fragmented, inefficient, and too expensive to remain viable.

8. What to do about the extent of informal employment and the size of the informal economy is a dilemma that has been gaining urgency. The forces that accompany globalization put a premium on mobility and skill-renewal. Rapid population ageing will require that people work longer and be far more productive. To achieve this, social institutions have to be more "pro-work", encouraging greater participation. As the rate of growth moderates, public financial resources will be increasingly scarce, giving urgency to measures that can significantly and sustainably increase tax revenue.

How is it measured?

9. It is particularly challenging to measure the informal economy and informal work in East Asia Pacific countries. Microdata from household and labor force surveys are abundant and for some countries of excellent quality. Using these data to identify employers, people in self-employment and those working in a family business without payment is trivial. We have employed firm surveys to identify the demand for labor from smaller enterprises and compare this with demand from larger business that are more likely to be formal.[2] However, none of the surveys we have exploited for this report ask respondents the crucial questions required to identify non-regulated dependent employment. In most low and middle income countries in Latin America and the Caribbean and Europe and Central Asia it has now become standard in labor force surveys to ask respondents: (i) the size of the firm in which they work (i.e. number of people employed); (ii) whether they have a written labor contract; and (iii) whether they make contributions to a social insurance plan (retirement pensions, health care, or unemployment insurance) and/or whether their employer does so on their behalf. The last two are particularly important to identify people working informally in otherwise formal

[2] We have not, however, separated firms into those registered and those not registered, which would be the best accepted practice to quantify demand for work from businesses who operate fully in the informal economy.

enterprises. To the best of our knowledge, in East Asia Pacific only in Indonesia and the Philippines have the statistics authorities included these questions in their surveys and only in a one-off, special purpose survey in the later.

10. The limitations of available microdata have left us with three measures used throughout this report as proxies for the extent of informal work: self-employment, "vulnerable" employment, and the share of the labor force not making contributions to social insurance. Each has its problems.

- Even if they are a minority, there are certainly a significant number of people who report self-employment as their main form of economic activity, and who comply with all the regulatory and tax requirements. While it is the proxy that is most observable and widely available across countries and over time, it is likely to capture people who are not working informally in any of the dimensions discussed above.

- So called "vulnerable" employment is derived simply by adding people in unpaid family work to the self-employed and thus, while just as widely available, has the added ambiguity of including people who although not receiving wages, may be residual beneficiaries of family enterprises.

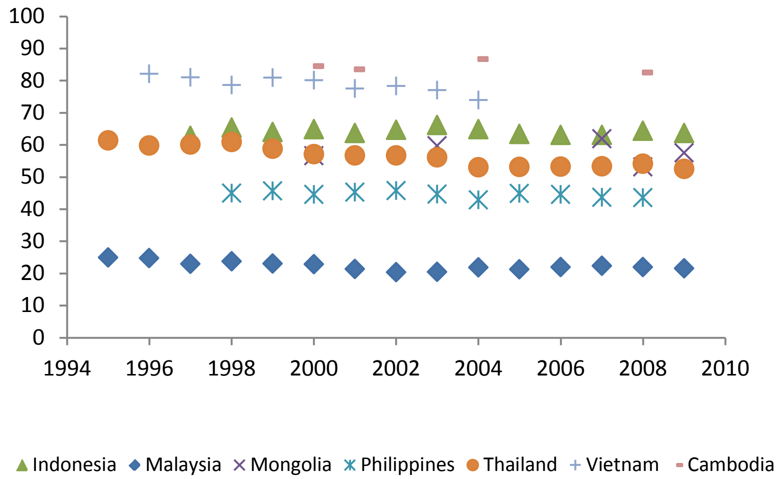
- The share of the workforce not contributing to social insurance is the inverse ratio of two aggregate statistics –the number contributors to the economically active population- and although a precise measure of people working without protection (at least in countries where access to protection requires a history of contributions) is not very widely available.

Informal employment in East Asia Pacific

11. At this point, the question on every readers mind is: Have the economies of East Asia Pacific been creating more formal than informal work in recent years? Figure S1.1 shows that the share of unpaid family and own account workers has remained fairly stable in most countries of the region during the past decade, except for Mongolia which experienced a slight reduction. This is in sharp contrast to low and middle income countries in Latin America Caribbean and Europe Central Asia. However, when measures by the share of contributors to social insurance, formal work has increased in Vietnam, China and Mongolia (Chapter 7). By this same measure, there has been little change in Indonesia and the Philippines.

Figure S1.1. Vulnerable employment has remained steady in most East Asia Pacific countries.

Vulnerable employment (unpaid family worker + own-account), 1995-2009, WDI



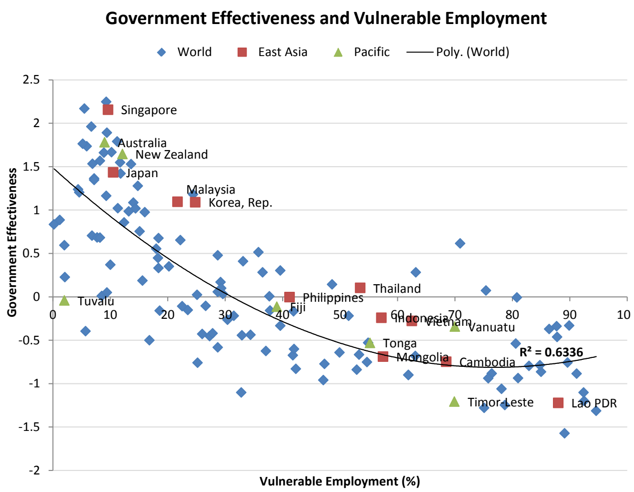
12. By any proxy measure, the low and middle income countries of East Asia Pacific stand out as places with extensive informal employment. Only countries in Sub-Saharan Africa tend to show higher rates of informality by some measures, while those in South Asia can show higher rates by other measures. Much of this is, however, "structural" informality: reflecting a large portion of people still working in subsistence and small-scale commercial agriculture beyond the reach of regulation and taxation, as well as the speed of migration to towns and cities. While there are good reasons to expect widespread informality to persist even with urbanization (Ghani and Kanbur, 2013), a significant portion of the informal sector tends to disappear as countries grow in wealth.

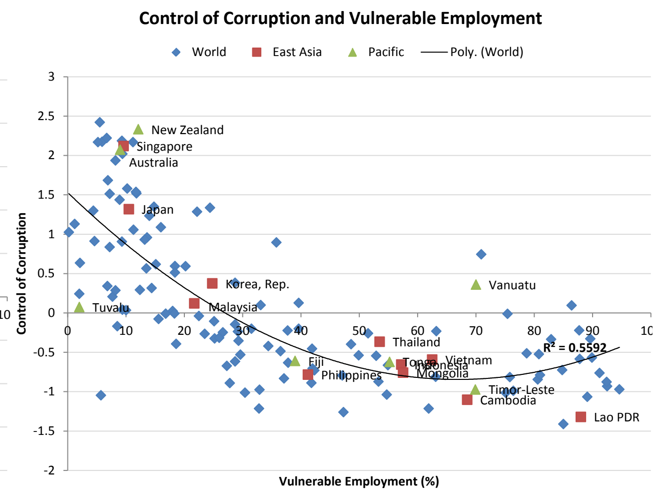
13. However, in the chapters of Part II, we present evidence that associates the extent of informal employment to taxation and, more evidently, to labor market policies. These factors are important to take into account. But as research from Latin America and Eastern and Southern Europe will show, neither differences in taxation or regulation provide a fully satisfactory answer to the question of what drives informality. What matters just as much as labor regulation and taxation, is the credibility of the State as provider of services and public goods.

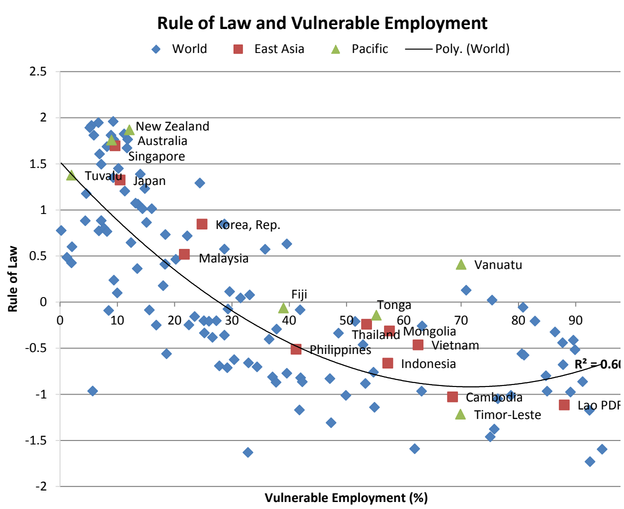
14. Figure S1.2 shows that vulnerable employment tends to be higher in countries with weaker institutions and governance. Just as policy makers have to look beyond the labor market for ways to sustain demand for employment, "formalizing" a greater share of economic activity can require measures to improve governance and the credibility of the State in the eyes of working people.

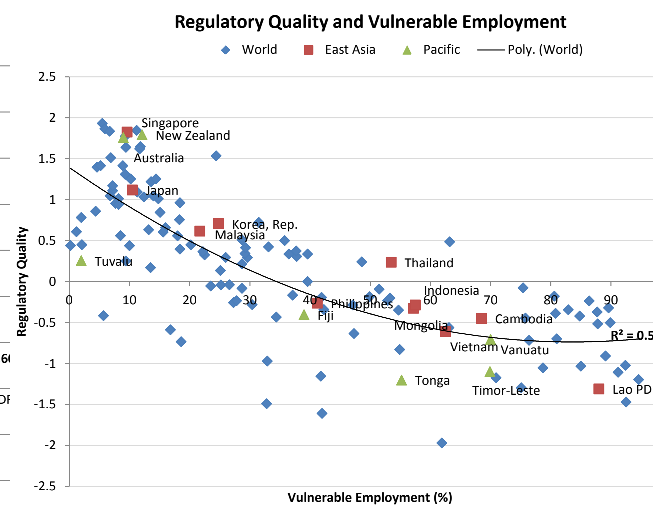
Figure S1.2. Informal employment is higher where governance is weaker

Vulnerable employment (own account and unpaid family workers) share of labor force, and government effectiveness, control of corruption, rule of law, and regulatory quality









Source: Staff estimates using WDI and WGI

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Spotlight 2. Past "Jobs strategies" in East Asia: Can they work today?

What exactly are employment- or "jobs" strategies?

1. Few participants in the debates about inclusive growth policies can agree on where to draw the boundaries of employment- or "jobs strategies". To some, the concept refers narrowly to the set of regulations and direct interventions in the labor market discussed in Chapter 6 that aim to improve employment outcomes: ranging from employment protection regulations, and wage policies, to passive and active labor market programs. For example, the European Employment Strategy (EES) is a legal mechanism designed to coordinate employment policies in the European Union Member States. This strategy set out annual employment guidelines and emphasized priority areas for action over the period 2008-2010, including raising the employability of the labor force through training, changing regulation to make the labor market more flexible, and strengthening structures that provide working people with income security.[1] An employment strategy even more narrowly focused on skills development, could range from manpower planning--setting targets, based on forecasts, for building specific technical skills—to more fluid and integrated approaches to workforce development, as discussed in Chapter 5.

2. However, employment strategies are often cast more broadly and encompass actions across a wide range of government activity. As discussed in detail in earlier chapters, many policies directly or indirectly affect the supply and demand for labor and human capital, either by design or collaterally. Some governments find it effective to package monetary, fiscal, and economic policy measures together into a single strategy, to better coordinate the actions they take and to make plain their commitment to improving employment outcomes. A broad employment strategy can also include government interventions in the product and factor markets that directly affect employment outcomes. Indeed, many governments go as far as to design and deploy policies that support certain industries or areas of production which they consider strategic and aligned with national goals. Jobs strategies that are embedded in this sort of 'industrial policy' will often explicitly promote sectors which the government thinks have the most potential to create employment.

3. An employment or "*jobs strategy*" may not differ much in content from a growth or "inclusive" growth strategy, other than an explicit focus on employment. The WDR 2013 argues that when measures taken to boost and sustain economic growth are designed to capture the external "spillovers" and social value of work, there is little need for a separate, stand-alone jobs strategy. However, in some circumstances where these external, social benefits of work are underappreciated by decision makers, left unidentified, or are not fully realized, an employment strategy may be warranted to assess and remove constraints to creating employment and sustaining wellbeing from work.

[1] Goetschy 1999 (http://www.eucenter.wisc.edu/omc/papers/archive/goetschy99.pdf);
http://www.eurofound.europa.eu/areas/industrialrelations/dictionary/definitions/europeanemploymentstrategy.htm

East Asia's experience with employment strategies

4. The East Asian Tigers—Korea, Singapore, Hong Kong, SAR, and Taiwan, China-- achieved high-income status and fairly inclusive growth over the past several decades, sometimes in the course of a single generation (World Bank 1993, Gill and Kharas 2007). At some point in their development, most adopted explicit "jobs strategies", designed and administered from the top to achieve national objectives, and either embedded in or separate from growth strategies. For example, Taiwan, China introduced preferential policies for "strategic industries" in the 1980s, mainly mechanical products, information technology and consumer electronics sectors (Yang 1993).

5. Singapore, with a tradition of openness to international trade and foreign investment, has simultaneously a tradition of strong state intervention to promote the economy's competitiveness in targeted industries and raise employment outcomes and living standards. After the country shifted from colonial rule to self-government in 1959, it needed to tackle high unemployment and rising ethnic tension, and so the focus on "jobs" in the government's strategy was explicit. An Industrial Promotion Board was created to foster private-sector led manufacturing and to boost employment. In the period 1960-1965, an import substitution phase of industrialization, the government concentrated on processing industries such as petroleum refinement, processing of food, wood and rubber, the garment industry, assembling electronic products, and ship repair. The government moved toward an export and foreign direct investment (FDI)-led development model in 1965. During the period 1979-1990, in reaction to low-cost manufacturing spreading across Southeast Asia, Singapore supported industrial upgrading to high value-added activities and increasing the demand for high-skill labor. This strategy involved, for example, improving the education and skills base, as well as promoting high-tech manufacturing. The objective of raising employment outcomes was implanted in the objective of economic growth. Over this period, Singapore transitioned from assembling to producing electronics and also transformed into a services hub for transport, trade, communications and finance. Singapore's industrial strategy features the following core components: a strong state, an economy with a strong orientation toward free trade and FDI, infrastructure and education investments to reduce supply constraints, and solid macroeconomic stability (Siow Yue 2005).

6. In its early stages of development, the Government of South Korea supported and protected young, emerging industries with the objective of increasing exports and speed up economic development. Importantly, its support for manufactured exports focused first on low technology goods so that the difference between the skills needed and those locally available would not be very large. In the early 1960s, the industries that were selected for support were cement, fertilizers and refinement of petroleum. At the end of the 1960s and in the early 1970s, the iron and steel industry as well as petrochemical products were targeted with support. By the end of the 1970s, the policy focus shifted to naval construction, capital goods and durable consumer goods as well as chemical products. And in the 1980s and the 1990s, the government supported electronic industries. Among the measures adopted, the government

ensured preferential credit for targeted industries, and import quotas to protect the young, emerging industries by securing the domestic market (Ray 1997).

7. Embedded within the broad national development planning during this period were explicit employment strategies. Korea engaged in intensive manpower planning to link education, training, and development of the labor force to the requirements of growing industries. With forecasts of industrial and sector needs for human resources based on medium to long-term macroeconomic plans, human resource development policies supported Technical Vocational Education and Training (TVET) and university training. Critically, these policies had strong foundations in prior investments that ensured basic education for all, starting in the 1960s and continuing in the 1970s.

8. China has also employed various forms of industrial policy with the implicit and explicit objective of increasing productive employment and raise well-being. Since economic liberalization began under Deng Xiaoping in the 1970s, China's industrialization has been driven by industrial policy programs (Heilmann and Shih 2013). China's special economic zones and preferential treatment to the targeted sectors dominating those zones played a role in drawing large amounts of labor from rural agriculture to light manufacturing in the coastal areas. In addition to mobilizing labor, China's success is the result of tremendous capital investments that provided the necessary underpinnings for fast economic growth. To sustain capital investment, the Government of China made intense use of directed credit—credit allocation by the government through state-owned or private banks—and financial repression in the banking system. Since a narrow tax base and weak revenue collection systems made traditional ways of raising public revenue difficult, the central—and often local—government would depress commercial interest rates, borrow at these low rates to invest in capital projects (Huang 2012a, 2012b, 2012c). China's stellar growth has reignited discussion about industrial policy after it being largely discredited in the 1980s (Lin 2012).

Are these strategies viable for emerging East Asia Pacific countries now?

9. The benefits of industrial policy are heatedly debated in theory and mixed in practice. Proponents of a principal role of the state base their arguments on three forms of market failures: knowledge spillovers and dynamic scale economies, coordination failures, and information externalities. Several policy approaches have furthered the thinking on industrial policy. The *New Structural Economics* proposes that planners and administrators in a country analyze other countries with similar endowments but slightly higher levels of income to identify and target industries with a solid export history and potential (Lin 2012). Another approach is to promoting public-private partnerships to help tackle coordination failures and facilitate the exchange of information between the public and private sectors. Finally, several researchers argue that spillovers of productive knowledge can be fostered to support the development of industry with higher knowledge content and greater value added (Cimoli, Dosi and Stiglitz 2009).

10. Skeptics of industrial policy argue that most low and middle income country governments lack the information and capacity to "pick winners", to identify and capture knowledge spillovers or to exploit dynamic scale economies in certain industries. Another challenge is the need for governments to be able to shift resources from old to new industries. Few low and middle-income governments that have engaged actively in industrial policy in the past are easily able to withdraw protection from industries in which the country no longer has a comparative advantage. Thus, industrial policy can be not only costly, but remains politically risky for many countries with low state capacity, given the high potential for rent seeking and locked investment in unproductive activities (Krueger 1974).

11. Experiences with industrial policy in other parts of the world –also often deployed with explicit employment objectives- have been more sobering than the story of now East Asia's high-income countries. Within East Asia Pacific, critics point to only individual cases of mistakes in Japan's history of industrial policy, such as when the government discouraged Honda from entering the automobile industry and Sony from entering consumer electronics. However, examples outside the region such as the track record of import substitution in Latin America up to the 1980s and India's protected industrial groups prior to trade liberalization in the 1990s featured overall slow economic growth and high fiscal costs, frequently as subsidies captured by interest groups. Such strategies ended up creating various distortions and hampering broad-based improvements in employment outcomes rather than correcting the market failures and addressing the externalities they were designed for. Some argue that these unsuccessful experiences were due to poor design and implementation rather an issue with the idea of industrial policy per se, but many would agree that setting the right institutions is a key element in any inclusive growth and "jobs strategies." In countries with weak political institutions, industrial policy measures are likely to result in large misallocations and inefficiencies (Beck 2008). In Pakistan, for example, directed credit helps boost the performance of small exporters but has little impact on the performance of larger exporters. Yet large exporters, usually companies with political clout, are the main benefactors of cheaper loans (Zia 2008).

12. Even some of the policies that have served the Chinese economy well in the past, such as directed credit and interest rate ceilings, have been less positive elsewhere and may not be appropriate for China any longer. Financial repression is no longer a sustainable strategy toward high-income, contributing to the inflation of asset prices, the risk of property price bubbles and fuelling the emergence of a large shadow banking system. As the Chinese private sector becomes more sophisticated, deregulating interest rates will become an imperative for the private sector to respond adequately to growing demand (Huang 2012a, 2012b, 2012c).

13. History offers useful lessons. But as tempting as it may be for emerging East Asia Pacific countries to strive to replicate past strategies of high-income neighbors, their earlier forms of rigid, top-down industrial policy–with and without an explicit employment objective- may not be viable options now in a more globalized, rules-based, and fast-changing economic environment. Instead, the useful lessons to take away may very well be the need to coherently set the right institutions and policy fundamentals, labor policy and social protection, and

priority public investments to release any constraints to the creation of employment that propels productivity, improves living standards, and strengthens social cohesion.

14. The kind of national development strategies described earlier requires sufficient information and institutional capacity to design and implement flexibly and effectively. The governments of Singapore, Korea, and China have all developed very high levels of capacity not only to identify target sectors and industries for preferential policy but also to jumpstart and implement these policies which requires the creation and destruction of specific industries and continual restructuring of the economy. The low and middle income countries of East Asia Pacific, however, have less state capacity to count on. Attempting to replicate past top-down strategies with limited capacity and information raises the risk of government failures and rent seeking, and can exacerbate the very market failures that policies are intended to correct. In addition, 'jobs strategies' embedded in top-down industrial policy were typically pursued in East Asian countries by authoritarian regimes, aside from Singapore. Top down industrial policy may be more difficult to undertake in a pluralistic democracy of the sort found in Indonesia, Malaysia, the Philippines, and Thailand today.

15. Especially now and in the near future, policy makers in the emerging economies of East Asia Pacific operate in a very different world from two or three decades ago and may not be able to follow the same strategies. Today's global policy environment gives possibilities and tendencies to influence national economic policies through multilateral, regional and bilateral agreements. For example, many of East Asia Pacific's developing countries are now members of the World Trade Organization (WTO) and therefore in principle subject to its restrictions on export subsidies and rules on intellectual property rights, among others. Moreover, the potential costs of government failures in implementing the sort of employment strategies and industrial policies that could be successful in the past are likely on the rise with increasing global and regional integration. The fast pace of globalization intensifies competition in the product and factor markets, making it increasingly costly to unnecessarily interfere with households' and firms' incentives and responses to market signals. In the East Asian economies with rapidly-evolving demand for work, "top down" approaches like past forms of targeted sectors and manpower planning could become too rigid and adjust too slowly, as well as overemphasize technical skills over foundational cognitive and behavioral skills, a danger discussed in Chapter 5.

16. Korea provides a notable example of the changing nature of its "jobs strategy." Leipziger and Petri (1993) argue that in the early 1990s, Korea's industrial policy had not kept pace with the enormous political and economic, domestic and international changes, leading to increased conflicts between government and business and confusion in economic policymaking, for example, policies toward conglomerates (chaebols). In 1996, Korea abandoned the top-down industrial policy and development planning that it used to adopt with much vigor. Skills development turned away from central manpower planning to a more integrated and comprehensive system to support the quality and market-relevance of education, and form closer partnerships between the skills-supply structures and the private sector (Kim 2002). The

government recently shifted to a focused, market-led employment strategy. In 2010, Korea adopted an employment strategy with the objective of increasing the employment rate of the working-age population to 70 percent by 2020. The new employment strategy has four main components: (i) “employment-friendly” economic and industrial policies; (ii) labor regulation reform to improve flexibility and fairness; (iii) skill development and measures to increase the labor force participation of women, youth and older workers; and (iv) active labor market programs to facilitate the transition from welfare-to-work (World Bank 2012).

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