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# The Political Economy of Formal Sector Pay and Employment in Developing Countries

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Background paper for *World Development Report 1995*

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Policymakers concerned about migration to high-income countries must take into account the political economy of the labor market. Labor market pathologies, like macroeconomic mismanagement, can be extremely costly — severely constraining growth of output and employment and increasing inequality.



## Summary findings

Domestic labor market outcomes influence the direction and magnitude of the flow of international migration. When wages are low and jobs are scarce, workers tend to migrate to environments where jobs are available at higher wages. But as labor demand grows, a labor-exporting country may become a net labor importer.

Such a "migration transition" — already much in evidence in East and Southeast Asian countries and beginning for skilled workers in India — is analogous to the demographic transition. The process of political economy described by Banerji, Campos, and Sabot affects the level and growth of wages and of formal sector employment. So it is important for policymakers concerned about migration to high-income countries to take it into account.

An efficient, flexible, responsive labor market contributes to growth by creating an appropriate economic environment. In this respect, labor policy is like macroeconomic and trade policy. Unlike the

accumulation of physical and human capital and technical progress, a well-functioning labor market is not itself a source of economic growth. Yet labor market pathologies, like macroeconomic mismanagement, can be extremely costly, severely constraining growth of output and employment and increasing inequality.

Similarly, failure to adequately address the labor-market aspects of policy reform can result in the failure of other dimensions of reform.

The smooth functioning of the labor market feeds on itself, enhancing the credibility of both workers and the elite. Conversely, poor labor market performance can also be self-reinforcing. Attempts to reform the labor market are likely to be hampered by the lack of credibility of both labor and the elite.

The payoff on labor reform can be high for both groups. The challenge is to find mechanisms whereby the credibility of both groups can be bolstered.

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**THE POLITICAL ECONOMY OF FORMAL SECTOR PAY  
AND EMPLOYMENT IN DEVELOPING COUNTRIES**

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Background paper for the 1995 *World Development Report*. Versions of this paper were also presented to a seminar at the World Bank and to the 1994 Northeast Universities Development Conference at Yale University. The authors are grateful to participants at those meetings and in the OECD Development Centre seminar for helpful comments. In particular, they would like to acknowledge John Knight, David Lindauer, Jonathan Morduch, Dwight Perkins, David Turnham, Edward Taylor and Michael Walton for their comments.

## 1. BACKGROUND: TWO CONTRASTING CASES

In some developing countries, such as those in East Asia, we observe in the market for wage labor the felicitous combination of non-confrontational labor and a non-distributional, or encompassing, elite. By "non-confrontational" we mean that wage labor was willing not to, or was unable to, use its collective power to extract short term wage and employment gains.<sup>1</sup> Rather, wage earners accepted wage and employment levels determined, respectively, by the interaction of labor supply and demand and by the equalization of wages and the marginal product of labor. When labor decided on the non-confrontational stance voluntarily, they did so in the expectation that this market oriented approach would yield attractive labor market dynamics -- that future levels of wages and employment would be higher if workers cooperated with management than if they did not.

The key feature of the "non-distributional" or "encompassing" elite's behavior was that they acted as if their future well-being was a function of the future well-being of those not in the elite<sup>2</sup>--all groups benefited as the elite adopted a labor demanding development strategy that was in accord with factor endowments and comparative advantage. This strategy, with its favorable implications for labor market dynamics, not only yielded high rates of growth, but ensured that the benefits of growth were widely shared. In this way, it also helped ensure that labor's expectation regarding the payoff to non-confrontation would be fulfilled. This in turn reinforced labor's non-confrontational attitude.<sup>3</sup>

In many other countries in Africa, Latin America and South Asia, we observe in the labor market the less attractive combination of confrontational labor and a distributional elite. In these countries, wage earners consolidated and exercised their collective power, successfully lobbying to raise wages above market levels, and above income levels prevailing among the self-employed in agriculture and elsewhere. This segmented the labor market and

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<sup>1</sup> Therefore, the word "non-confrontational" may or may not indicate the result of a purely voluntary decision.

<sup>2</sup> The terms "encompassing" and "distributional" for the elite are, therefore, used in a similar general sense as used by Olson (1982) for coalitions.

<sup>3</sup> The elite could also have been said to have been far-sighted, or non-myopic, in the sense that they were aware of the long-term gains from the policies, and were willing to enact policies to achieve those gains.

created a wage labor elite. Confrontational labor also succeeded in driving a wedge between wages and the marginal product of labor -- as employers, particularly in the public sector, succumbed to pressure to provide more (of the now scarce, relatively high wage) employment opportunities than warranted by the derived demand for labor. The resulting labor market dynamics tended to be unattractive: that is, labor demand, wages and employment grew more slowly than in the non-confrontational case and were eventually eroded in many countries.

The development strategies adopted by distributional elites caused the benefits of what growth there was to be concentrated in the hands of a few. The elites behaved as if they believed that their own future well-being was independent of the future well-being of non-elites, and nearly everyone was less economically secure as a consequence. Their economic strategies tended not to be in harmony with factor endowments and comparative advantage. While these strategies may have yielded rents to the elites in the short run, over the longer run output growth was slow and employment growth slower still. This behavior of the elites reinforced labor's confrontational stance.<sup>4</sup>

One of these two combinations -- non-confrontational labor paired with non-distributional elites, and confrontational labor in a distributional regime -- seem to characterize most developing countries. In a few instances we observe non-confrontational, marginalized labor coexisting with a distributional regime. For fairly obvious reasons, however, the fourth possible combination -- confrontational labor and a non-distributional, market-oriented elite -- is not sustainable.

Table 1 illustrates the results of the two most common combinations. Over the last two decades, countries such as those in East and South-East Asia, which had non-distributional elites and non-confrontational labor, demonstrated far superior outcomes for both labor and the elite than did other developing countries where distributional elites coexisted with confrontational labor.

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<sup>4</sup> The distributional elites thus behaved myopically, discounting the future heavily while striving to get as much rent out of the present as possible.

*[Insert Table 1 about here]*

The welfare of labor as a group is improved by a rise in real earnings, and by a rise in employment in the high-wage manufacturing sector. In this way workers are drawn out of low-wage, low-productivity activities at the same time that earnings in the high-wage sector are rising. This is reflected in increases in the wage bill. Between 1970 and 1990, the wage bill in the East Asian countries grew at a rapid rate -- in Korea and Indonesia, it was doubling about every five years. The lower panel of Table 1, on the other hand, demonstrates that in some countries labor's welfare actually eroded, while in others (such as India, the Philippines and Trinidad and Tobago) wages and/or employment stagnated.

In this latter group of countries, the elite also fared badly. Although they might have been able to carve out a larger share of the national economic pie, that pie grew very slowly. Per capita incomes in half of the ten countries shown in the lower panel of the table fell over the 1970s and 1980s, and grew very slowly in the others. The difference is especially marked if we look at the growth of per capita incomes in East Asia. The economic pie there grew rapidly -- so that the non-distributional elite in these countries, even if they did not increase the size of their slice of the pie, would have ended up with larger returns than their peers in Latin America, Africa and South Asia.

Although, for most of this paper, we will be referring to the two groups very broadly as "labor" and "elite," it is useful to recognize the obvious -- that neither are monolithic groups. This is especially true for the elite. In this paper, we will confine our attention to only those elite groups who directly affect the policymaking process and labor-elite interactions. These are usually alliances of three distinct groups -- the political elite (the ruling party, president or junta), the economic elite (large industry and commercial leaders) and the policy elite (intellectuals and bureaucrats). A fourth group, the military, is often a major influence in policymaking in some developing countries, and may be identified with the non-

policymaking political elite. Labor in this paper almost always refers to organized wage labor, either represented by large national trade unions or industry groups.<sup>5</sup> Given the possibility of heterogeneity within both groups, there is occasion for dissent and conflicting objectives. In cases where they arise, the preferred outcome -- non-confrontation or confrontation -- may be less likely.<sup>6</sup> When there is a less unified elite, similarly, the preferred outcome by the policymaking group may not be endorsed by competing elites.<sup>7</sup>

These contrasting cases pose two questions. First, what determined whether a country adopted and sustained the non-confrontational, non-distributional mode of labor market behavior or the confrontational, distributional mode? Table 1 suggests that the combination of non-confrontational labor and non-distributional development strategies have "paid off" for the countries that followed them, while distributional strategies and confrontational labor have resulted in slower growth and lower welfare for most groups in society.

This raises our second question. When countries in which labor market problems have contributed to poor performance are faced with this reality, why doesn't labor become non-confrontational and why don't elites adopt a non-distributional policy? In essence, this change in the stance of the two groups is what the labor market dimension of structural adjustment programs is trying to accomplish, but with only limited success. To rephrase the question, if the advantages of non-confrontation and encompassment are so great, why is it so difficult to accomplish labor market reform? In this paper, we will concentrate more on answering the

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<sup>5</sup> There may be circumstances -- for example, when there are rents to be shared from an inward-looking growth strategy -- in which a "labor elite" forms an alliance with the political elite at the expense of the majority of the labor force. See our discussion below.

<sup>6</sup> We are, in this paper, especially concerned with such "coordination failure" when labor is organized into conflicting trade unions. We discuss this in Section 5. Possible coordination failure among Brazil's elites -- with a struggle for power between the rural and urban elites, domestic industry and multinationals, parts of the bureaucracy and the political (military) leadership -- is discussed in Evans (1992), pp. 166-72.

<sup>7</sup> For example, Bradford (1994) argues that in East Asia, the elite was "more cohesive and singular in direction than in more pluralistic or politicized societies." Therefore, this cohesion would have aided the formation of an unified, encompassing, far-sighted policy in these countries. Zeitlin and Ratcliff (1988), on the other hand, found that, historically, rural and urban elites in Chile were united, and would not allow an East-Asian type industrial focus.

first question. However, in our discussion, it will become evident that the answer to the second question is dependent on the answers to the first.

Section 2 draws on a two-sector model of the labor market, to draw out the implications for the two polar combinations of elite and labor strategies. Section 3 then elaborates on some key factors that are instrumental in the choice of these strategies for the two groups. Section 4 draws on these factors to illustrate the operation of labor-elite relations for a few countries. Section 5 is a brief discussion of the political economy of labor market reform, and section 6 concludes by linking the process described here to trade, migration and growth.

## 2. SOME SIMPLE ANALYTICS

Figures 1 and 2 help to illustrate why non-distributional policies lead to better outcomes, if combined with non-confrontational labor? First, we look at a simple two sector model of the labor market, comparing the non-confrontational labor, non-distributional elite (NCL-NDE) case and the confrontational labor, distributional elite (CL-DE) case with regard to their static implications for incomes and employment in each sector. We then focus on the sector in which wage employment is concentrated and compare the labor market dynamics of these two cases.

In Figure 1, total labor supply is depicted on the horizontal axis, with employment in the non-wage economy (denoted as rural employment for convenience) being measured from the left hand origin  $O$  and urban (or formal sector wage) employment from the right hand origin  $O'$ . Marginal products and wages (returns to labor) are measured on the vertical axis.<sup>8</sup> The marginal product curves of the "rural" sector and the "urban" sector are  $mpl_r$  and  $mpl_u$ . In competitive equilibrium, of the sort yielded by non-confrontational labor, non-distributional elites, a common wage rate ( $w_{10} = w_{20}$ ), which equals the common marginal product of labor,

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<sup>8</sup> We assume for this simple illustration that wage labor is concentrated in the urban sector while self-employment is concentrated in the rural sector.



is established and employment in sectors 1 and 2 is respectively  $O_A$  and  $O'A$ . There is no unemployment and, since wage jobs are not more attractive than self employment, there is no lobby to expand wage employment opportunities beyond the level justified by the derived demand for labor.

*[Insert Figure 1 about here]*

By contrast, in the confrontational labor, distributional elite case labor power raises the urban wage to  $w_{21}$ , creating a wage-earning elite, with the following consequences: the labor market is segmented,  $w_{21} > w_{11}$  and  $mpl_u > mpl_r$ , implying an intersectoral misallocation of labor, with rural employment expanding and urban employment contracting. Moreover, given the intersectoral earnings gap, a probabilistic migration relationship then generates urban unemployment.<sup>9</sup>

Also, because urban wage employment is now so much more attractive than rural self employment, both the unemployed and those employed in the rural sector have the potential to become a lobby for the creation of more high paying urban jobs. There is the risk that the public sector responds by employing more workers than warranted by the derived demand for labor, implying that the demand for labor shifts, e.g., to  $d_u$ , while the marginal product curve remains the same.<sup>10</sup> In this case a wedge has been driven between the wage and labor's marginal product, which may even be zero. The implication of  $w > mpl$  is that enterprises with excess employment will be loss-makers and thus will require subsidization.<sup>11</sup>

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<sup>9</sup> As in Harris and Todaro (1970) more workers will migrate to the urban sector than there are jobs available implying that the sum of rural and urban employment is less than the labor force. The unemployment is not explicitly depicted in Figure 1.

<sup>10</sup> As Gelb, Knight and Sabot (1991), p. 1188, point out: "Job-seekers rarely form a single cohesive lobby but widely expressed concerns lead politicians to provide employment - for political stability and to co-opt potentially threatening groups. ... The strength of demand for public sector employment should increase with the gap between the public sector wage and the supply price of labor. Government resistance to the employment lobby may also increase, however, because of countervailing pressures from taxpayers and creditors. These are among the factors that determine the extent of overmanning."

<sup>11</sup> Hence, public enterprises are more likely than private enterprises to hire surplus labor. See Banerji and Sabot (1994), Campos and Esfahani (1994) and Gelb, Knight and Sabot (1991).

Figure 2 illustrates the difference between the two cases NCL-NDE and CL-DE, in their implications for the evolution of wages and employment over time. Figure 2a focuses on the case of non-confrontational labor in combination with a non-distributional elite, as exemplified by Korea or Taiwan. From the outset wages, at  $W_m$ , and wage employment, at  $L_m$ , were market determined.<sup>12</sup> Figure 2b focuses on the case of confrontational labor in combination with a distributional elite, as exemplified by Ghana or India. Though in the first period the underlying supply and demand conditions are the same in both cases, in the CL-DE case wages, pushed up to  $W_n$ , are considerably higher and wage employment, at  $L_n$ , is considerably lower than in the case of NCL-NDE.

*[Insert Figure 2 about here]*

Consider some of the ways in which the differences in labor market statics influenced labor market dynamics:

- In the first case, (relatively) undistorted factor prices encouraged the adoption of appropriate technology and a structure of production in accord with comparative advantage. This, in turn contributed to the international competitiveness of domestic enterprises, hence to rapid growth of demand for their output. The combination of strong demand and low wages contributed to profitability. The non-distributional elite invested a high proportion of retained earnings which resulted, by the second period, in a substantial increase in output, hence in the derived demand for wage labor. The growth of labor demand outstripped supply. Not only did employment increase, to  $L_{m2}$ , but because of the dramatic demand shift, *wages were pulled up* and rose steeply, to  $W_{m2}$ .
- By contrast, in the second case, because of the distortion of factor prices, inappropriate, labor-saving technologies were adopted and the structure of production was less in accord with comparative advantage. As a consequence, the international competitiveness, and the

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<sup>12</sup> In countries like Singapore, cooperation by labor implied wages being driven down to *below* market levels.

profitability of domestic enterprises, was reduced. The net effect was a reduction in the rate of growth of output and, hence, labor demand. Moreover, the subsidies required to finance employment when  $w > m^p$  diverted savings from productive investment, further diminishing the rate of growth of labor demand. In the second case the growth of labor demand did not outstrip supply to the same extent as in the first case. Because the demand shift was smaller, employment increased only to  $Lm_3$  ( $O-Lm_3 < O-Lm_2$ ) and, on the assumption that over time labor's capacity to sustain wages above the market clearing level was eroded, wages stagnated. The growth of labor demand was not sufficient to raise wages above the level to which wages were pushed in the first period by labor power.

- As Figure 2b is drawn, even if the shift in labor demand was as great in the second as in the first case, wages would still be lower. This is because there is less of a shift in the supply of labor in Figure 2a than in 2b. We are suggesting that the slower labor force growth observed in countries following a labor demanding growth path may, in part, be endogenous. The growth of employment opportunities and earnings in the non-confrontational labor, non-distributional elite case raises the opportunity cost for women of having children. Also, the greater shift in demand is likely to raise the expected returns to investment in education, and to ease the household liquidity constraints on such investments, thereby raising the demand for schooling. Likewise, public resources for schooling may be more abundant, raising the supply of educational opportunities.<sup>13</sup> Higher levels of investment in education slows the growth of supply of unskilled labor by lowering fertility rates (particularly among educated women) and by raising the proportion of the labor force that is skilled. As skill levels rise, countries can also exploit newer, skill-based manufacturing technologies, which shifts out the labor demand curve further.<sup>14</sup>

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<sup>13</sup> See Birdsall and Sabot (1993) for a more detailed discussion of the feedback from more rapid output and employment growth to higher investment in education.

<sup>14</sup> As suggested by Wood (1994).

In sum, the result of the interaction of non-confrontational labor with non-distributional elites was, as shown in Figure 2a, that both employment opportunities and wages increased as a result of rapidly increasing labor demand. A growing proportion of the labor force held wage jobs at steadily increasing levels of remuneration. Likewise, for non-distributional elites there may have been two advantages of the non-confrontational, encompassing approach: first, faster output growth and greater profitability of enterprises implies higher absolute incomes and, if labor is satisfied by rapidly growing absolute incomes, perhaps even a larger slice of the pie; second, non-confrontational (and, in most cases, content) labor meant that non-distributional elites could extract these high returns in more periods (i.e., they were not deposed or forced to adopt growth-constraining populist policies to placate labor).

The result of the interaction of confrontational labor with a distributional elite was quite different. Initially, confrontational labor gained relative to non-confrontational labor by pushing wages (and often employment) to levels higher than market forces alone would yield. Likewise, a distributional elite may have initially benefited relative to a non-distributional elite from the more capital intensive, rent-seeking growth path on which it embarked. However, the problems, to which the distorted labor market contributed, resulted in slower growth of wages and employment, so that by the second period levels of wages and wage employment were considerably lower in this case than in the non-confrontational labor, non-distributional elite case. Indeed, in many countries, under adjustment programs, wages and wage employment were reduced to levels below those which prevailed in the initial period. In these cases the proportion of the labor force in wage employment would also have declined, with a corresponding increase in employment in the non-wage economy. Similarly, the incomes of distributional elites were likely to be lower in the second period than the incomes of non-distributional elites. Moreover, in this case labor unrest and economic ills posed an increasing threat to the political and economic security of the elite. And the elite would be more likely to

resort to other growth-constraining populist policies in an attempt to maintain their hold on power, leading to a vicious cycle of wage-employment stagnation and inappropriate policies.

### **3. DETERMINANTS OF THE CHOICE BETWEEN NCL-NDE AND CL-DE IN A SIMPLE STRATEGIC FRAMEWORK**

Envision a "social contract" between the elite and labor, the nature of which is the result of a process of negotiation, implicit or explicit. The elite needs the support of labor (organized, as in India, or unorganized, as in Egypt or Ghana) to stay in power. Labor needs the elite to set up the productive framework to provide its returns —employment and/or high wages. The initial period can be thought of as either the period following independence for a developing country, or one where there has been a major regime change. At this time, both labor and the elite have to decide on their respective courses of action for future periods. What determines whether, initially, the non-confrontational/non-distributional combination or the confrontational/distributional paradigm emerges?

We focus on five determinants. Three of these factors — the degree of contestability, intellectual heritage and the structure of the labor market — are exogenous; they affect the two endogenous factors — the credibility of both labor and the elite in their dealings with the other group, and the elite's choice of agricultural and trade policies. Chart 1 summarizes how these factors influence the choice of stances by labor and the elite.

*[Insert Chart 1 about here]*

#### ***i) Contestability:***

A consideration for the elite is whether they will continue to enjoy power, and hence the fruits of their policy decisions. Thus, the extent to which their power is "contestable" by

other groups in the economy is important to them.<sup>15</sup> In particular, the ruling elite's choice about whether to be distributional or not is likely to be influenced by the magnitude of the threat from groups whose power base is the poor. The poor generally do not benefit from distributional policies. Such policies, therefore, may increase the poor's support of contesting groups. By contrast, all groups are likely to be beneficiaries of the growth promoted by non-distributional policies.

East Asia provides an example of how the elite can use non-distributional policies to reduce the threat of contestability by groups who rely on the poor as their source of power. The legitimacy of governing elites was not securely established there, and they were in competition with domestic communist insurgents, backed by powerful external forces, for the political allegiance of those in the bottom half of the distribution of income. Therefore, the governing elite in East Asia came to perceive that their future political and economic well-being depended on the future well-being of the poor.

To widen the base of their political support, leaders used a variety of tools, including land reform in Korea and Taiwan, public housing in Hong Kong and Singapore, investment in rural infrastructure in Indonesia and widespread high quality basic education. Most important was their commitment to a labor demanding growth path. The aim of these "shared growth" policies was to ensure that all groups in the population benefited visibly from growth.<sup>16</sup> As more and more workers were pulled into the wage sector with higher and higher wages, the threat to the elite posed by the poor declined.

In Africa, Latin America and South Asia, the power of the ruling elite was less contestable. Hence their willingness to adopt policies that increased their *share* of the "pie" and—by acquiescing to premature increases in wages and employment—the share received by organized labor groups, at the cost of a slower rate of increase in the size of the pie as a

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<sup>15</sup> As Grindle (1991), p. 53, says: "Political stability and the maintenance of power tend to be major preoccupations of ... political actors [in developing countries] because, in many cases, they are vulnerable to the loss of political power."

<sup>16</sup> See Birdsall, Ross and Sabot (1994), Campos and Root (1994) and Chapter 4 of World Bank (1993a) for additional discussion of "shared growth" in East Asia.

whole. Implicit was a pact between the elite and wage labor to maximize their shares of the pie at the expense of the poor. The political costs of long run stagnation of wages and employment were not as high as they were in East Asia. Moreover, repression of dissent was often a more feasible option in Africa, Latin America and South Asia than in East Asia, where potential dissidents could enlist the support of powerful allies.

In more recent years, there has been a new source of contestability for the elite in Asia and the middle east. The rise of religious fundamentalism -- including Islamic fundamentalism in countries like Egypt, Algeria, Pakistan, Bangladesh and Turkey, and Hindu and Sikh fundamentalism in India-- has drawn heavily on the unemployed and economically deprived sections of society for their sustenance. Fundamentalist movements, therefore, may have provided an element of contestability for the distributional elite in some of these countries. However, whether this contestability influences the elite in these countries to adopt more non-distributional policies will depend, in addition, on the importance of other factors such as their intellectual heritage, natural resource endowments, and the strategies chosen by labor.

***ii) Intellectual heritage:***

The dominant intellectual heritage influenced labor's choice between confrontation and non-confrontation and the elite's choice between distributional and non-distributional policies. This framework of ideas, often inherited from ex-colonial rulers or post-colonial advisors, influenced the evaluation of the relative attractiveness of future options. In extreme cases, ideology seemed to preclude a strategy choice from the feasible set of options; in other cases it affected the expected size of payoffs.<sup>17</sup>

For example, Fabian socialists believed that strict reliance on the market might yield rapid economic growth in the short run, but also a highly unequal distribution of income

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<sup>17</sup> Beliefs are often held as uncontested or axiomatic. Members of the group subscribing to an ideology *sincerely* believe in its universal validity, even though it may seem irrational or unsound to the outside observer (see Gondwe, 1992). We will characterize groups holding such deeply held beliefs as "ideological," as opposed to more "pragmatic" groups who have a predisposition towards, but not a blind commitment to, these beliefs.

which, in addition to being unfair, would undermine the political stability necessary to sustain such growth. They recommended state control of the "commanding heights" of the economy and extensive government intervention as a means of preventing unpalatable distributional side-effects of the free operation of markets. This set of ideas had a profound influence on such leaders as Nasser, Nehru, Nkrumah, and Nyerere who were instrumental in designing the initial policy framework for their countries. Distrust of markets was a factor in their choice of inward-looking policies which, in turn, was a factor in their acquiescence to the wage and employment demands of wage labor. The result of negotiations with labor with regard to the distribution of the rents from import-substitution often yielded high short-term returns to the elites in these socialist economies.

Socialist thought, with its roots in Marxism and the necessity of conflict between the interests of labor and private capital, also influenced labor's view of the world, of what was feasible and desirable. Ideologically "leftist" groups dismissed as naive the idea that everyone's welfare would be enhanced by cooperation between labor and capital. They believed that the elite (in their role as capitalists) were fundamentally incapable of sharing the fruits of growth equitably. This was coupled with a distrust of markets, which were perceived to be manipulated by the elite. Leftist labor concluded that the only way to avoid being exploited by capitalists was to organize collectively and press for the most favorable terms of employment.

In a similar way, the structuralist beliefs of Raul Prebisch and others, and their associated export pessimism, influenced the decisions of Latin American leaders to follow an inward-looking development strategy. A commitment to structuralism implied a rejection of the labor-demanding non-distributional strategy. World markets were seen to be so biased against low income countries that policies that encouraged development in accord with relative factor prices and comparative advantage would not yield rapid growth. Hence, external orientation was rejected as an option at the outset, i.e., excluded from the information set.



By contrast, capitalistic, market oriented ideologies were influential in countries in East Asia and in post-1973 Chile. In Korea and Taiwan, which had been Japanese colonies, Japanese notions of appropriate development strategy appear to have been influential. It was Japan that pioneered both the export oriented development strategy and the paradigm of cooperation between labor and corporate management. In East Asia, therefore, the ideas underlying encompassing policies were part of the information set, and the policies were perceived to be potentially effective. Pro-market American ideas and mercantilist British ideas (e.g., in Hong Kong) reinforced the market-orientation of Japanese ideas. In post-Allende Chile, an influential group of economists and policy-makers was schooled in the University of Chicago doctrine of free markets.

*iii) Specific policies adopted by the elite:*

a) A dynamic agricultural sector:

In most developing countries, pricing, public investment, taxation and trade policies all tended to be biased against agriculture. The rationale: the transfer of resources to the potentially more dynamic urban industrial sector. The consequence: stagnant agriculture. The exception were East Asian countries, which tended to avoid such a policy bias against agriculture. A larger share of public investment was allocated to rural areas in East Asia than in other low and middle income economies. Equally important, levels of direct and indirect taxation of agriculture were lower in East Asia than in other regions.<sup>18</sup>

Whether agricultural incomes are stagnant or increasing rapidly has important implications for the wage labor market and for labor's choice between non-confrontation and confrontation. In particular, when rural incomes are stagnant, then so too is the supply price of urban labor. In this case, even if the demand for urban labor is growing, the market wage will not increase -- trying the patience of labor, and jeopardizing any inclination by them to be non-confrontational. If, at the same time, the output and profits of urban enterprises are

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<sup>18</sup> World Bank (1993a), pp. 32-37.

increasing while urban wages are not, the stage will be set for collective action by labor to push up their returns and segment the market. Arguments for higher wages will be made on the basis of ability to pay and fairness in the distribution of factor shares, and sight is likely to be lost of the inequity of large rural-urban income gaps and of the long run costs of labor market segmentation. In sum, policies that discriminate against agriculture and yield stagnant rural incomes, are also likely to result in non-confrontation giving way to conflict in the urban labor market.

By contrast, when rural incomes grow rapidly, so too will the supply price of urban labor. Increases in the demand for urban labor will, therefore, yield increases in urban wages. In this case, rapid growth of urban incomes is consistent with an integrated labor market. There is, therefore, less incentive for labor to demand better outcomes than those yielded by the interaction of labor supply and demand, less of a tendency for labor to shift from non-confrontation to conflict, and a lower probability that the labor market will be segmented. The bottom line here is that, when the agricultural sector is dynamic and the supply price of labor is rising, it is easier to adhere to market determined outcomes in the wage labor market. With a stagnant agricultural sector, on the other hand, the ruling elite is more likely to use non-market or interventionist mechanisms to "partition the pie".

In Taiwan, for instance, manufacturing wages are only a fifth higher than agricultural wages. This remarkably integrated labor market made it easier to pursue the non-confrontational labor, non-distributional elite strategies. By contrast, workers with the same skill level in Colombia and Jamaica earn 150 percent more in non-agricultural activities than in agricultural work. In India, manufacturing wages have consistently been about four times agricultural wages since the 1960s. Even larger differentials have been seen for East African countries. Market-determined outcomes were more difficult to adhere to in these countries.<sup>19</sup>

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<sup>19</sup> Birdsall and Sabot (1993).

## **b) Export Orientation:**

**Countries which chose the non-distributional, non-confrontational combination tended to have policies which encouraged exports. In countries that chose the distributional, confrontational combination, policies tended to result in more closed economies. Export orientation implies competitive pressure from abroad. This competition helped both labor and the elite to realize that in firms producing tradables, pushing levels of wages and employment beyond those determined by the market would result in their products being non-competitive. This would jeopardize the very existence of the firms yielding returns to both groups.**

**Moreover, the same competitive pressures helped create a lobby of exporters which demanded more efficient performance from those firms, often public enterprises, which provided the necessary non-tradable inputs for production. This limited the tolerance for excess wages and employment in the public sector. Finally, those economies that adopted a policy of openness benefited from the easier access to imported capital equipment and technology, which in turn improved the productivity and wages of wage labor.**

**In inward-looking economies, on the other hand, protected markets meant that inefficiencies in the utilization of labor could be passed on to consumers in the form of higher prices. There was less risk that lack of competitiveness in world markets would result in the failure of the firm, making it easier for both the elite and labor to concentrate on ways to increase their short-term returns.**

**This begs a question: why did policy makers in East Asia or Chile choose a more export-oriented strategy than did policymakers in other regions? The discussion, above, of the difference among regions in intellectual heritage suggests one factor. The discussion of contestability and lack of policy bias against agriculture suggest others. In inward-looking economies, low income consumers had no real power to threaten the tenure of the elite, and thus no credible way to oppose excessive prices for consumer goods.**

**There is yet another reason. Countries with abundant natural resources are less compelled to adopt outward oriented policies, since they can rely on commodity or mineral**

exports to finance inputs needed by import substituting manufacturing industries (Ranis, 1991). The Southeast Asian countries (Malaysia, Indonesia and Thailand), which are much better endowed with natural resources than their counterparts in Northeast Asia (Japan, Korea and Taiwan) have on average a lower reliance on trade.<sup>20</sup>

*[Insert Table 2 about here]*

Avoiding an overvalued exchange rate is crucial to an export promotion strategy; an overvalued exchange rate tends to discriminate against the agricultural sector. Hence, those factors that reduce the likelihood of discriminating against agriculture, such as the risk that discrimination will strengthen the hand of insurgents in the competition for the political loyalty of rural residents, are also likely to provide an environment conducive to an export-oriented strategy. Moreover, if rapid and sustainable improvements in the standard of living of the poor are considered necessary to win the competition with insurgents, then increasing the demand for labor is likely to be a goal. Undercutting prevailing prices in foreign markets is one way to ensure virtually infinitely elastic demand for output and rapid growth of demand for labor.

*iv) Credibility:*

Labor's choice between confrontation and non-confrontation and the elite's choice between distributional and non-distributional policies was influenced by perceptions about the other group's commitment to an avowed stance. The issue here goes beyond the question of whether these groups are capable of visualizing the time-paths of returns yielded by the alternatives they face. The relevant point is whether each group perceived the other to be

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<sup>20</sup> The greater trade orientation of the Northeast Asian countries also influenced their agricultural policies. Their relatively stronger focus on exporting labor intensive manufactured products created increased demand for the processing of agricultural products which in turn led to greater demand for labor during the off season (Oshima, 1993).

capable of sustaining their commitment to the chosen path. For example, it may be clear to both parties that if non-confrontational and non-distributive policies are sustained, the labor market dynamics and the returns to the elite are superior to those offered by confrontation and distributive policies. Nevertheless, if they perceive the probability of defection of the other group to be high, labor or the elite may conclude that the *expected* returns to them of confrontational or distributional policies are higher.

The choice of paths is thus linked to the perceived likelihood of non-defection by the opposing group—to its "reputation." The *history of interaction* between the groups is a determinant of reputation. If past actions have shown that the elite has a predilection for distributive policies, for example, labor would be suspicious of a sudden profession of more encompassing intentions. Similarly, the elite would be wary of promises of cooperation from a traditionally antagonistic labor force.

How much these concerns would affect the actual choice of strategy would depend partly on the relative sizes of alternative payoffs from each strategy, and partly on whether or not there are external factors—*commitment mechanisms*—which help to cement each group's adherence to a professed strategy. Commitment mechanisms differ among countries. In some societies, social "*focal points*", which are culturally determined "meeting points" for expectations of the different groups, may help cement or destroy labor-elite relations.<sup>21</sup> *Political risk* may also affect credibility. For example, in a politically unstable society, the elite might perceive that future payoffs would accrue to a political rival. Thus, the elite might be tempted to maximize the short-term returns (from distributive policies) rather than hold out for larger future gains. To the extent that this is understood by labor, the credibility of the elite's promise of cooperation and encompassing policies may be lower.

#### v) *Labor Market Structure:*

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<sup>21</sup> Schelling (1960).

a) "Insider-Outsider" Divisions: Wage labor may not care as much about employment growth as it does for increases in wages. A division between "insiders" and "outsiders" could explain why. Negotiations with the elite are conducted by "insiders"--a labor elite who already hold wage jobs. They do not necessarily care whether "outsiders" obtain wage employment. Insiders may see attempts to push wages up, above the competitive level, as more rewarding to them than a growth in labor demand which may pull wages up at some point in the future. They may actually oppose employment increases if they believe such increases would erode rents.<sup>22</sup>

Insiders have been adept at negotiating rent-sharing pacts with distributional elites, with an adverse impact on outsiders. In several of the countries that followed the confrontational labor, distributional elite path, this was achieved by restrictions on labor retrenchment in both the public and private sectors, which assured stability in employment for wage labor, allowing them to concentrate on seeking increased wages.<sup>23</sup> Such a pact generally precluded an outward oriented labor demanding growth strategy. Outsiders were left worse off than before, as the persistence of inward-looking strategies prevented them from obtaining wage jobs.

b) Coordination failures: In some countries, the lack of a unified voice representing labor may influence whether favorable labor market outcomes are adopted. There are two distinct forms of labor organization that are relevant here. First, there may be relatively few powerful trade union organizations which jockey for power and rents--one might call this a labor union "oligopoly". This is currently the case in India, for example. Second, laborers may be

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<sup>22</sup> This could happen if, for example, public enterprises increase employment beyond those justified by the derived demand for labor. At the same time, if the wage bill is prevented from rising, wages would be reduced to levels closer to labor's supply price. For evidence of such behavior in developing countries, see Banerji and Sabot (1994).

<sup>23</sup> Increases in real wages may or may not have materialized. For example, average wages seem to have declined in Zambia. However, two factors suggest themselves. First, real wages may have been even lower (given Zambia's steep economic decline) in the absence of labor lobbying. Second, and perhaps more important, in countries like India, labor may believe that lobbying is necessary to avoid an erosion of wages even if employment grows. This belief may influence the behavior of insiders.

relatively unorganized, or organized into numerous small, firm-level associations, as exemplified by Japan. In each of these two cases, the failure among the different labor unions to coordinate their strategies may affect the final outcomes of their implicit negotiations with the elite.

In the first case of oligopolistic unions, there may be tensions among unions of sharply differing ideologies, with some being fundamentally opposed to non-confrontation. Even when other unions recognize that non-confrontation is a superior outcome, lack of credible communication among the competing union organizations may result in the inferior outcome being adopted. Since non-confrontation is only a superior outcome when adopted by *all* labor, mutual mistrust could thus force even the less ideological unions to reject non-confrontation and to attempt to maximize short term gains. In the second case, when unions are fragmented, the reverse could be true. Even if individual labor organizations are interested in adopting a confrontational stance in order to form a rent-sharing pact with the elite, they may be unable to pull together all the widely dispersed labor factions into a credible group which is committed to confrontation and rent-extraction.

The factors outlined above -- contestability, intellectual heritage, elite policies, credibility and labor market structure -- are not of equal importance; neither do they affect each group equally. For the elite, contestability and intellectual heritage are the two exogenous factors (as was shown in Chart 1). These two determinants interact in their influence on trade and agricultural policy. The policies, as well as the intellectual heritage and the degree of contestability, generate the level of credibility the elite bring to their interactions with labor. For labor, there are also two exogenous factors--labor's own intellectual heritage, and the structure of the labor market, particularly the division between insiders and outsiders and possible coordination failure. These interact to define labor's bargaining stance, and its credibility to the elite.

#### 4. STRATEGIC INTERACTIONS AND OUTCOMES

We focus on a few country case studies to highlight the various dimensions of the strategic choices by the elite and labor. We envision these choices being made in the context of a "game" played by the elite, who choose between being distributional or non-distributional, and by labor, whose choice is between confrontation and non-confrontation.<sup>24</sup> Each group is seeking the maximum payoff from its strategy, having taken into account their assessment of the strategy the other group would adopt. This focus on strategic considerations can aid our understanding of why the combination of confrontational labor and a distributional elite emerged in so many economies, while the more attractive combination of non-confrontational labor and a non-distributional elite prevailed only in a few economies.<sup>25</sup>

Why did the elite in India choose distributional policies while Indian labor chose confrontation? Why did these strategic choices persist? And why, by contrast, did some of India's neighbors in East Asia choose a more encompassing and non-confrontational strategy? And why did the elite in some of them (e.g., Singapore and Malaysia) consider it necessary at times to *enforce* the non-confrontational stance of labor? The factors discussed above suggest answers to these questions.<sup>26</sup>

*A) Distribution and Confrontation: India in the 1950s.* At independence, the framework for India's economic policy was set by a group of elite bureaucrats, who shared an ideological commitment to Fabian socialistic policies with India's first prime minister, Jawaharlal Nehru.<sup>27</sup> They did not believe that the interactions between buyers and sellers in unfettered

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<sup>24</sup> The game-theoretic model is developed in greater detail in Banerji, Campos and Sabot (forthcoming, a).

<sup>25</sup> As North (1990:15) rightly points out: "... there is a vast gap between the relatively clean, precise, and simple world of game theory and the complex, imprecise, and fumbling way by which human beings have gone about structuring human interaction." However, game theory does provide the framework for a basic understanding of strategic decisions, as is demonstrated by North using the framework himself later in the same book (1990: 56-8).

<sup>26</sup> Factors other than the ones discussed, such as the presence of a substantial stock of exportable natural resources may have also influenced the choice of strategies by labor and the elite.

<sup>27</sup> Nehru has been characterized as "a Kashmiri Brahmin ... [who] was also a Fabian socialist with Marxist sympathies who had suffered an upper-class English education." (Joshi and Little 1994, p. 8)



markets could stimulate growth and reduce either inequality or poverty. The expectation was that "market failures", which resulted from "structural rigidities", would both constrain growth and perpetuate inequality.<sup>28</sup> Their skepticism about the benefits of trade was based on the belief that the de-industrialization of India in the eighteenth and nineteenth centuries was caused by the free inflow of British manufacturing products. Indeed, one of the defining moments of the Indian independence movement had been the *swadeshi* epoch, where foreign goods were boycotted and burnt in public.

The Indian government, which, it was assumed, would behave as a benevolent social guardian, took control of the "commanding heights" of the economy (large, capital-intensive, formal sector industry) and attempted to compensate for market failures. Prices of many industrial products were administered, as were exchange and interest rates. An inward-looking, public enterprise led development strategy was adopted, with the government as a major formal sector employer.<sup>29</sup>

Of the factors we have considered, "intellectual heritage" had the strongest influence on the initial strategic choice made by the Indian elite. Contestability was not an issue: the Congress Party, drew its support from rich and poor alike; while the small communist party did influence trade unions, it had no real chance of assuming power. The elite's choice of a distributional strategy was not the result of short-term rent-seeking but based on the belief that a non-distributional strategy would have low returns. The elite's choice does not seem to have been much influenced by their expectations of labor's choice between confrontation and non-confrontation.

Therefore, when choosing their strategy, Indian labor already knew the strategy of the elite. It was evident that since market forces would not determine wages and employment, rents would emerge from elite-labor negotiation. Under the import-substituting regime,

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<sup>28</sup> Structural rigidities, defined as a lack of responsiveness to price signals, were considered to be much more severe in low than in high income countries. See Krueger (1990).

<sup>29</sup> Krueger (1990) notes that "the scope and height of protection was...far greater than could be defended on infant industry grounds." Bhagwati and Srinivasan (1975) found that in 1968-69 more than half of India's industries had effective rates of protection in excess of 100 percent.

there was a greater opportunity for the costs of higher wages and excess employment to be passed on as higher prices. In the absence of contestability from poor consumers, it was less likely that the elite would resist pressure by labor to push their wages and employment beyond the levels the market would determine. In sum, the elite's commitment to non-market oriented policies under a non-contestable regime ensured that Indian labor perceived confrontation to be a superior strategy, though Indian labor's own leftist ideological stance would have led them towards the same conclusion.

*B) Distribution and Confrontation continued: India in the 1970s.* Why were distributional-confrontational policies still followed during the regime of Nehru's daughter, Indira Gandhi, when she and the Indian elite had become much less ideologically committed and much more pragmatic in their world-view? The question is especially relevant because evidence was accumulating that the non-distributional, non-confrontational paradigm was bearing fruit in the countries which had adopted it.

The answer is more complex, since in the 1970s, neither labor nor the elite in India had prior knowledge of what the other group would do--i.e., the game was played with "incomplete information". For the more pragmatic Indian elites, it was clear that negotiating with non-confrontational labor in a distributional environment would tend to yield rents to the elite much larger than the short-run returns yielded by the choice of non-distributional policies. The pie might be smaller, but the elite's share of the pie would be larger in a situation where shares are negotiated, and labor does not agitate for higher shares. This presumes that, as before, the elite had no fear of contestability, and so were not concerned about the effects of depriving the poor of the higher returns they would have obtained under a non-distributional policy regime.

But what if labor chose to be confrontational? Even in this case, the elite in India seemed to realize that non-market, distributional policies would be better for them. The elite saw the possibility of an alliance with wage labor that would enable these two groups to

extract rents from the wage sector at the expense of stakeholders in the rest of the economy.<sup>30</sup> These stakeholders would be denied the benefit of increased wage employment; moreover, they would face higher prices for goods produced by wage labor. The elite, therefore, had to be concerned about popular unrest. Once again, the lack of contestability is an important factor.

What about labor's choice? If the elite chose to be distributional, then, as in the situation discussed above, it would be in labor's interest to be confrontational. But what might labor have done if the elite had decided to be non-distributional?

The ideological bent of organized labor in India is a factor. Leftist labor did not believe that market forces would yield higher returns to labor. On the contrary, they saw the potential for market forces to erode the gains (rents) they had made.<sup>31</sup> Having a high discount rate, labor groups focused on more certain present losses than on doubtful future gains. This reinforced their commitment to the confrontational status quo. The structure of the Indian labor market further reinforced labor's tendency to confront the elite. Because the labor market was segmented, those with wage jobs in the formal sector became "insiders", a labor elite. Labor might have recognized that employment would not grow as much under a distributional as under a non-distributional policy regime. However, they were more concerned with increases in their own wages than with employment opportunities for outsiders. For all these reasons, Indian labor perceived confrontation to be a better strategy for themselves even if the elite chose to be non-distributional.

With the elite choosing distributive policies regardless of labor's choice, and labor choosing confrontation regardless of the choice of the elite, the situation devolved into a simple "Prisoner's Dilemma" game. In the 1970s, a more pragmatic elite and the leftist labor insiders both chose to continue with the distributional, confrontational policies adopted

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<sup>30</sup> See Bates and Krueger (1993) and Turnham (1993) for examples of such elite-labor pacts.

<sup>31</sup> Since the Indian agricultural sector was relatively stagnant until the mid-1970s, the supply price of labor was low (see Ravallion and Dutt, 1994). Increases in urban wages, which segmented the Indian labor market, resulted from labor power and not from market forces.

decades earlier. From the perspective of an objective outsider, the cooperative, encompassing policies would have proven superior in the long run. To insiders in India, they appeared to be inferior and therefore were rejected.

Even if labor had not distrusted the market, and had, in fact, preferred to be non-confrontational, the result may not have been different if the elite had chosen to adopt non-distributional policies. Labor would still have had to assess the probability that the Indian elite would actually sustain these policies. This is where credibility matters. Given the history of confrontational skirmishes with capitalists, and in the absence of strong commitment mechanisms in India in the 1970s, labor would have been inclined to believe that the elite would renege on their promise of non-distributional policies. Therefore, labor would have chosen confrontation, and would have tried to forge (or continue) a rent-sharing pact with the elite.

***C) Non-distribution and Non-Confrontation: Japan in the post-War period.*** After the Second World War, the elite in Japan faced a serious problem—that of re-establishing its legitimacy after the country's wartime debacle, and rebuilding the economy. The weakening of the military by American occupation forces meant that the emerging elite was dominated by the bureaucracy and the Liberal Democratic Party. In this relatively uncertain post-war situation, this new elite group's choice of policy was thus governed by the recognition that it needed to gain the confidence of the populace—its leadership role was contestable.

The structure of the labor market in Japan during this time was a key determinant of the strategy adopted by labor. Since labor unions were enterprise-based, there were no overarching national organizations that could legitimately claim to represent the views of Japanese labor as a whole. Unable to easily coordinate its activities, coordination failure predestined labor to be non-confrontational.

Given that labor was non-confrontational and that the elite's rule was contestable, the elite found it more attractive to pursue non-distributional policies that expanded the economic pie. They realized that making portions of this ever-increasing pie available to the wider population would ensure that they would continue to remain in power. With lower political risk, their discount rate was reduced, and they recognized that the higher rents that could be made in the short term, using distributional policies, were outweighed by the smaller per period rents that would flow continuously over the long term with non-distributional policies.<sup>32</sup>

The success of the non-distributional policies in Japan reinforced labor's disposition to remain non-confrontational. This willingness was enhanced by the elite through a commitment to continually ensure that labor's wages were closely tied to increases in productivity (Johnson 1982). As a result, the real earnings of Japanese workers grew steadily.<sup>33</sup>

***D) Non-distribution and enforced non-confrontation: Malaysia and Singapore in the 1950s and 1960s.*** The elite in Malaysia and Singapore faced a significant communist threat - that is, their power was contestable. Therefore, they saw that it was in their interest to adopt a principle of shared growth -- and to ensure that all groups, not just themselves and wage labor, benefited from growth. While distributional policies might yield high short-run rents, they realized this could only be at the cost of the poor.<sup>34</sup> Their ideological priors did not precommit them, they saw that market-friendly policies would yield a more labor-demanding growth path and hence would improve the economic prospects for the poor.

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<sup>32</sup> One of the most important contributors to the success of the non-distributional policy in Japan was the successful land reform. This was partly undertaken because of calls for "democratization" by the middle class, and executed under pressure from the American occupying forces (Hayami 1991).

<sup>33</sup> Growth in real earnings for Japanese workers averaged about two-and-a-half percent a year even during 1970-90 (World Bank 1993a). This compares favorably with wage growth over the same period in some of the more rapidly growing economies such as Malaysia and Thailand (see Table 1).

<sup>34</sup> See, for example, World Bank (1993a), pp. 157-89.

In our framework, the policy choice of the elite would be determined by their assessment of payoffs, given each of labor's two possible strategies. If labor chose to be non-confrontational, non-distributional policies would dominate for the elite in Malaysia and Singapore. In these countries, unlike in India, the elite did not have ideological objections to export orientation. On the contrary, they appeared to believe that an export-oriented strategy offered the potential for high and sustained returns for all segments of society. But what if labor chose to be confrontational? Contestability implied that improving the welfare of the poor was important to ensure the elite's own continued tenure. Thus, forming an alliance with confrontational labor that yielded high returns to both groups at the expense of the poor was not a desirable option. Non-distributional policies appeared to be the only feasible choice.

The problem was resolved by labor's evaluation of possible payoffs under the elite's two strategies. Labor in both Malaysia and Singapore had ideologically leftist underpinnings. As far back as the 1940s, Malaya's trade unions were used by the Malayan Communist Party, which had been declared illegal, to build support for itself. Confrontational tactics, which sometimes even went as far as physical attacks against employers in plantations and mines, were used.<sup>35</sup> The ruling elite in Singapore also faced a threat from the leftist union movement, which was supported by the *Barisan Socialis* or Socialist Party, during the country's formative years in the late 1950s and early 1960s.<sup>36</sup>

Thus, labor had an inherently confrontational ideological bias. The structure of the labor market did nothing to offset this bias. There was very little chance of non-confrontation being achieved through coordination failure among the labor groups, since the most vocal unions all seemed to adopt a confrontational stance. Moreover, unions were almost all comprised of insiders, who did not seem to care that confrontational policies might lead to lower employment growth. Thus, their evaluation of payoffs was that confrontation was preferable, irrespective of the elite's choice of policies.

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<sup>35</sup> Arudsothy and Littler (1993), pp. 111-113.

<sup>36</sup> Leggett (1993), pp. 224-25.

The equilibrium here would have had labor being confrontational and agitating for higher rents even within a non-distributional, market-friendly, export-oriented economy fostered by the elite. This would have been an intrinsically unstable equilibrium, since higher than market wages in an open economy are not sustainable. With exports becoming uncompetitive, the payoffs to both the elite and labor would have decreased. For the non-distributional elites in Malaysia and Singapore, who foresaw that labor would choose confrontation, the only way to preserve their own payoff was to *impose* non-confrontation on labor, repressing their ability to agitate for greater rents. In Malaysia and Singapore, non-distributional elite policies were eventually paired with non-confrontational labor, but not necessarily because that was labor's preferred choice.

***E) The Role of Credibility: Malaysia and Singapore since the 1970s.*** The enforced non-confrontation of labor unions described above was a response by the elite to ideological labor. When labor is more pragmatic, more voluntary forms of non-confrontation are feasible, although this result is dependent on the credibility of the elite. Labor-elite interactions in today's Malaysia and Singapore illustrate this equilibrium.

In the 1970s, the assessment by labor in these countries of the best strategy to follow differed from that of their more ideological counterparts in earlier years. Pragmatic labor saw that it would benefit them to be non-confrontational, if the elite continued to follow non-distributional policies. On the other hand, confrontation would still be best if the elite chose distributional policies. Thus, if labor had no idea of what the Malaysian elite would do, it would try to guess their motives, assigning a probability to each of the elite's choices.

It is here that the *credibility* of the Malaysian elite can be considered to have played a key role -- since it was important for labor to know that the elite would not attempt to switch to a more distributional set of policies once their compliance was assured. Labor was willing to ascribe a high probability to the elite maintaining a non-rent-sharing, market-oriented regime. The key commitment mechanism backing up the elite's stance was the 1971 New

Economic Policy (NEP), which mandated the eradication of poverty among the *bumiputeras*, ethnic Malays who comprised most of the poor.<sup>37</sup> Labor saw this as a credible sign that the elite intended to remain non-distributional.

A roughly similar situation characterized elite-labor interactions in Singapore. The elite, after imposing cooperation on labor, established export-oriented economic policies based on attracting multinational corporations. But they recognized that labor could not be kept non-confrontational forever unless it established a means of ensuring that labor felt that voluntarily foregoing confrontation was in its interest (Campos and Root, 1994).

To achieve this, the elite in Singapore created the National Wages Council (NWC), a consultative committee consisting of representatives from the government, labor, and business that deliberated on employment policies. One of its principal functions was to ascertain that wage increases were tied to productivity increases. Labor was thus assured that everyone would share in the long-term benefits of growth. The NWC was credible and thus an effective commitment mechanism because it was given *de facto* authority over employment policies—all matters pertaining to employment had to be discussed in the council, and no policies would be adopted unless recommended by the council. Thus labor was willing to continually accept the premise that the elite was non-distributional. In turn, the elite could feel confident of remaining in power for a long time without having to face any serious challenges. This lowered the elite's discount rate and made them willing to continue with non-distributional policies.

The choice of non-confrontation by labor in Malaysia and Singapore was not a foregone conclusion. The choice was made warily, as a result of labor's belief in the credibility of the elite's commitment to non-distributional policies. Thus, policies that reinforced this

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<sup>37</sup> Malaysia had consistently followed a market oriented trade and industrial policy since independence. Moreover, agricultural policies, such as lower taxation and rural electrification, had ensured that the agricultural sector was growing, raising the supply price of labor. The policies worked well -- for example, between 1973 and 1987, the number of poor Malaysians was halved (World Bank 1993a, p. 33).



belief, such as commitment mechanisms like the NEP and NWC, contributed to maintaining this equilibrium.

## **5. IMPEDIMENTS TO LABOR MARKET REFORM**

Since it is clear that the combination of non-confrontational labor and encompassing policies yields outcomes superior to the alternative, why don't labor and the ruling elite in economies like India simply alter their stance and become non-confrontational and non-distributional? Why doesn't Indian labor choose non-confrontation, given that the present discounted value of returns to this choice would most likely vastly exceed the returns to the alternative?

The analysis above suggests three reasons for the failure to initiate labor reform.<sup>38</sup> One important reason is labor's fear that the elite would not keep their part of the bargain. They foresee ending up with the low returns that result from being non-confrontational in a distributional environment, and therefore prefer the slightly higher returns they can get from being confrontational. For the elite, too, a lack of trust in labor's promise to be non-confrontational may induce caution regarding the adoption of non-distributional policies -- since the combination of confrontational labor and non-distributional policies would be likely to yield lower returns to the elite than the distributional, rent-sharing regime with which they have grown comfortable.

Second, the fear of job loss is obviously another cause of labor resistance. The immediate adjustment to a more market-oriented policy regime usually involves loss of jobs. Some "insider" workers would thus lose their jobs, and arguably, the most affected will be the least able -- those who have their jobs due to political influence. They are the workers who are likely to have the most difficulty finding alternative employment, especially if the private sector can afford to be selective or is not dynamic with respect to job growth. Political

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<sup>38</sup> This question is analyzed in greater detail in Banerji, Campos and Sabot (forthcoming, b).

appointees may also have the greatest ability to persuade the leadership to maintain the status quo.

Third and more generally, there is the issue of hysteresis. Labor insiders are likely to fear losing their rents. The value placed by vested interests on the erosion of their wages may exceed the value they place on their perceived gains from reform. They may expect the former to be larger than the latter -- that is, they may have a kinked utility function or a high discount rate.<sup>39</sup> In this case, confrontation would continue to be the dominant strategy despite the expectation that in the long run labor would benefit from reform. Note that for Malaysian or Indian labor in the 1950s, this tradeoff between short-run costs and long term gains did not exist -- since they did not have any entrenched and *assured* returns. In the short run, the losers know who they are, and resist the erosion of their rents, while the winners, more diffuse, cannot explicitly promise compensation to the losers from the future gains to all.

There are, however, solutions to these problems, especially if labor and the elite understand the potentially large benefits that would be enjoyed by them if they chose a more non-confrontational stance in a non-distributional policy environment. The credibility of the elite's position (and that of labor) becomes important. Confrontation in the past is a source of mistrust in the present, as Indian labor and the elite may both doubt the strength of the commitment to the new strategy of the other group. A history of administrative determination of labor market outcomes further complicates matters, as neither party have had experience in interpreting the signals generated by the labor market and therefore would have difficulty monitoring the success of the new strategy. The creation of appropriate commitment mechanisms, like the NEP in Malaysia and the NWC in Singapore, thus become important as a means of assuring the credibility of both labor and the elite.

## 6. CONCLUSIONS

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<sup>39</sup> Work by Knetsch (1989) and Kahneman and Tversky (1979, 1984) find that individuals value the loss of a given amount of income more than they value the gain of an equivalent amount.

Domestic labor market outcomes influence the direction and magnitude of the flow of international migration. When wages are low and jobs are scarce, there is an incentive for workers to migrate to environments where jobs are available at higher wages. As labor demand grows, however, a labor-exporting country may become a net labor importer. Such a "migration transition," which is already much in evidence in the countries of East and South-East Asia, and has begun for skilled workers in India, is analogous to the demographic transition. The political economy process described here affects both the level and growth of wages and formal sector employment. Therefore, it is important for policymakers concerned about migration to high-income countries to take into account.

An efficient, flexible and responsive labor market contributes to the growth process through the creation of an appropriate economic environment. In this respect, labor market policy is like macroeconomic and trade policy. In contrast to the accumulation of physical and human capital and technical progress, a well-functioning labor market is not, in itself, a source of economic growth. Yet, labor market pathologies, like macroeconomic mismanagement, can be extremely costly, severely constraining growth of output and employment, and increasing inequality. Likewise, failure to adequately address the labor market dimension of policy reform can result in the failure of other dimensions of reform.

Good labor market performance feeds on itself, enhancing the credibility of both labor and the elite. Likewise, poor labor market performance can also be self-reinforcing. Attempts at labor market reform are therefore likely to be hampered by the lack of credibility of both labor and the elite. The payoff to reform can be high for both groups; the challenge is to find mechanisms whereby the credibility of both groups can be bolstered.

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**Table 1: Average Annual Percentage Changes, 1970-90**

<i>Stylized Case</i>	<i>Country</i>	<i>Manufacturing Sector</i>			<i>Per capita GNI</i>
		<i>Real Earnings of Labor</i>	<i>Wage Employment</i>	<i>Real Wage Bill</i>	
<b>NDE-NCI, (Non-Distributional Elite, Non- Confrontational Labor)</b>	<i>Korea, Rep. of</i>	8.19	6.58	15.31	8.81
	<i>Indonesia</i>	5.15	8.50	14.08	5.44
	<i>Malaysia</i>	2.21	8.23	10.61	4.41
	<i>Singapore</i>	4.43	5.37	10.04	6.50 <sup>3</sup>
	<i>Hong Kong</i>	5.65	1.66	7.40	6.20 <sup>3</sup>
	<i>Thailand</i>	3.00	5.13	8.28	4.43
	<i>Chile</i>	4.89	1.02	5.96	1.88
<b>DE-CL (Distributional Elite, Confrontational Labor)</b>	<i>Philippines</i>	0.44	4.06	4.52	1.06
	<i>India</i>	2.19	2.00	4.23	2.19
	<i>Kenya</i>	-1.87	5.56	3.58	0.73
	<i>Trinidad &amp; Tobago</i>	2.10	0.59	2.70	1.69
	<i>Colombia</i>	0.62	1.85	2.48	2.12
	<i>Zambia</i>	-0.91	1.97	1.04	-5.00
	<i>Jamaica</i>	-1.05	1.79	0.72	-0.98
	<i>Mexico</i>	-1.05	1.09	0.03	1.57
	<i>Peru</i>	-3.25 <sup>1</sup>	2.59 <sup>1</sup>	-0.74 <sup>1</sup>	-1.57
	<i>Argentina</i>	-0.87	-2.46	-3.31	-0.69
<i>Ghana</i>	-5.49 <sup>2</sup>	2.20 <sup>2</sup>	-3.41 <sup>2</sup>	-1.23	
<i>Tanzania</i>	-9.02 <sup>1</sup>	4.86 <sup>1</sup>	-4.60 <sup>1</sup>	-0.20 <sup>3</sup>	

Notes: <sup>1</sup> 1970-1988; <sup>2</sup> 1970-1987; <sup>3</sup> 1965-90, Gross National Product per capita

Sources: Calculated from World Bank BESD data, World Bank (1992)

**Table 2: Trade Orientation in East Asia**

<i>Countries</i>	<i>Trade/GDP, 1970-92</i>
<i>North-East Asia</i>	
Hong Kong	137.5
Korea	56.6
Singapore	284.9
<b>Average</b>	<b>159.7</b>
<i>South-East Asia</i>	
Malaysia	93.4
Indonesia	37.3
Thailand	45.4
<b>Average</b>	<b>58.7</b>



Figure 1: A Model of Labor Allocation

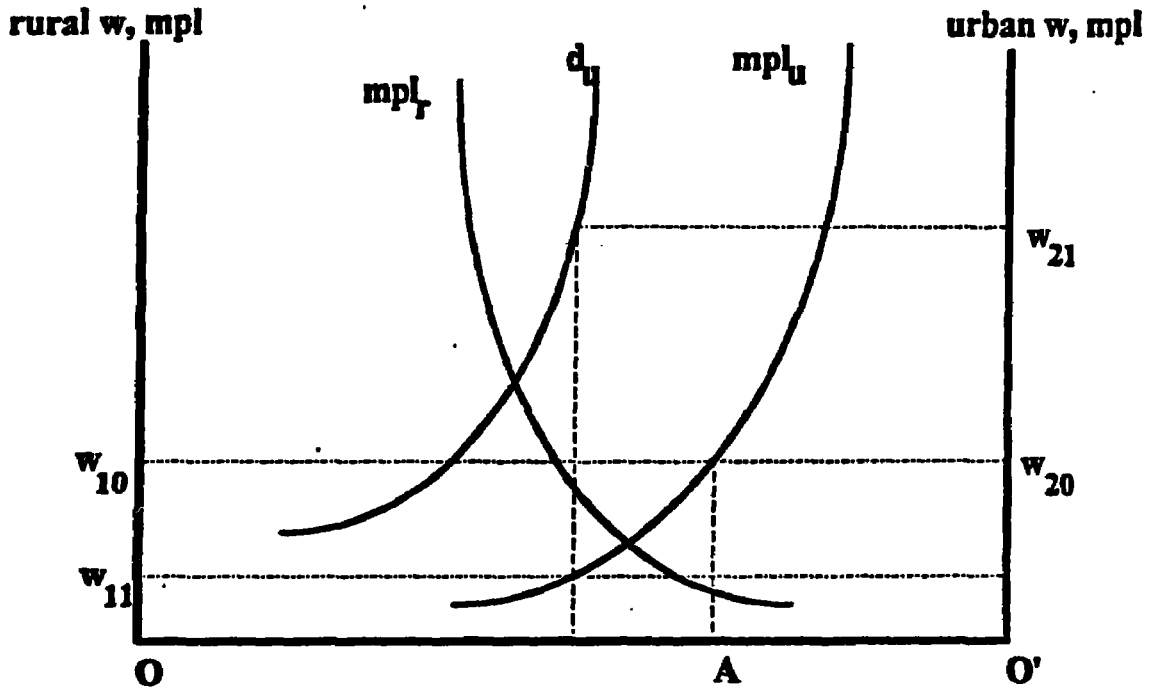


Figure 2: Labor Market Dynamics

2a: NDE-NCL interactions (e.g. Taiwan, Korea)

2b: DE-CL interactions (e.g. India, Ghana)

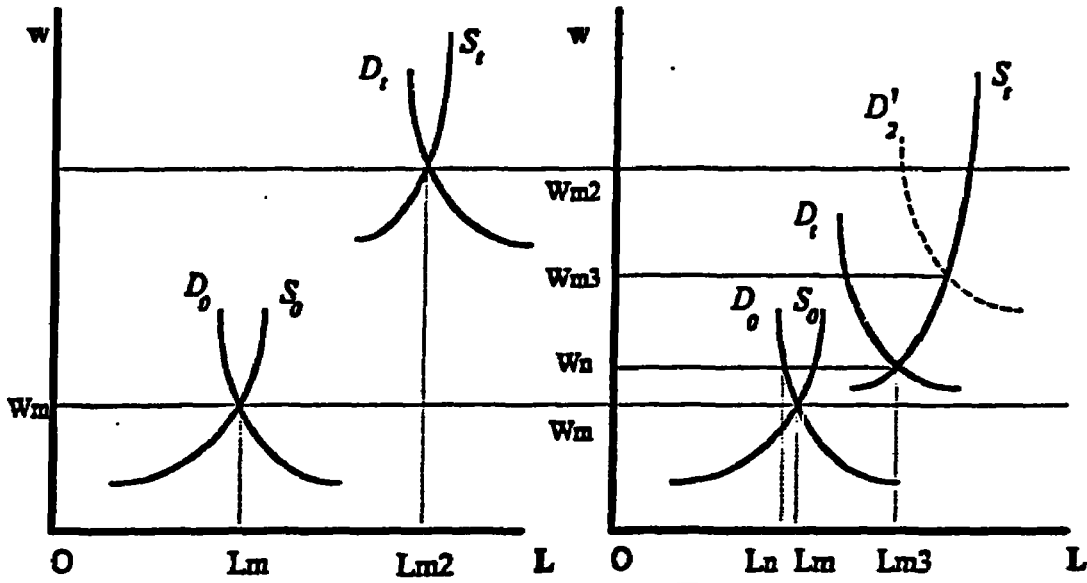
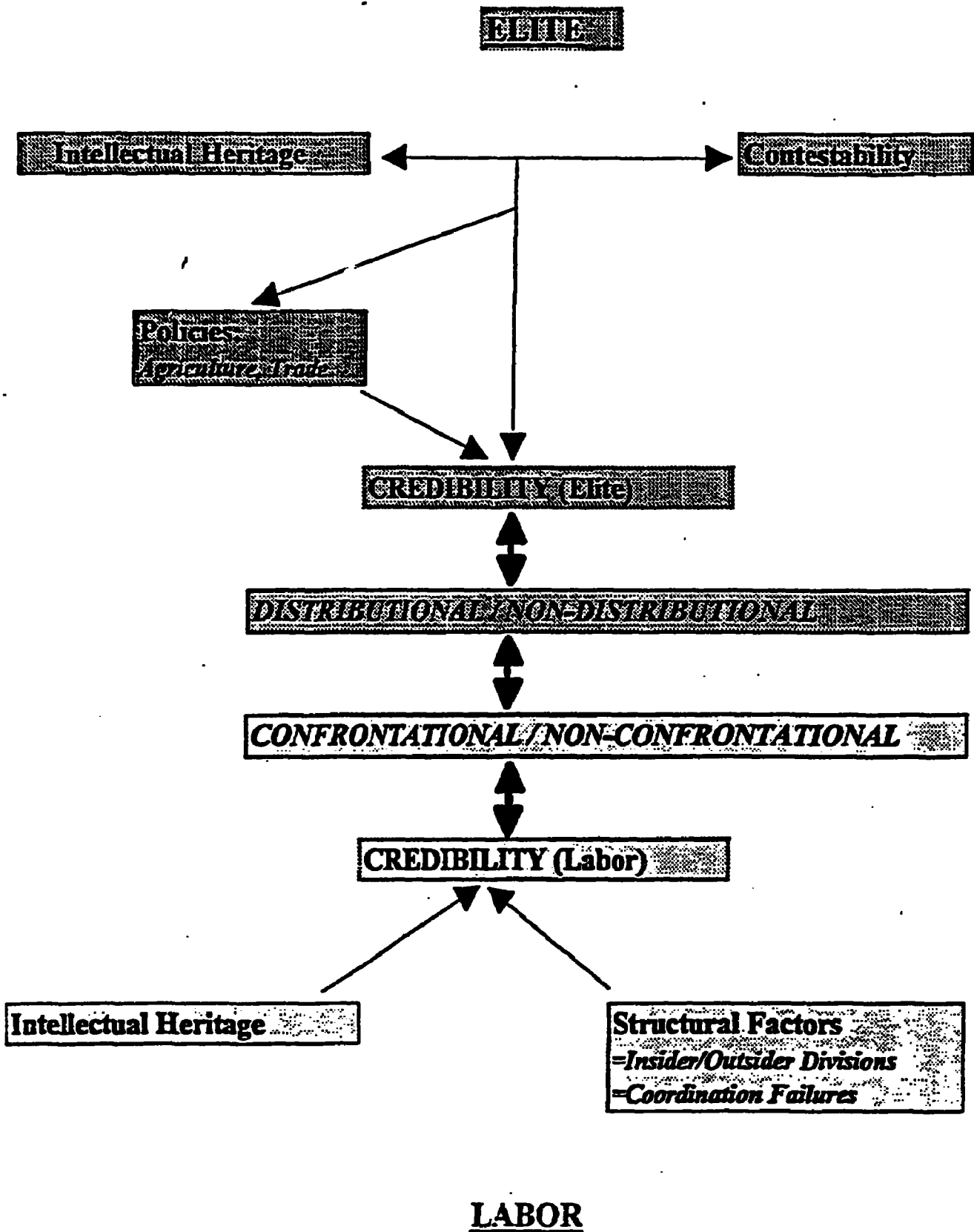


CHART 1: Elite-Labor Interactions



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