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The Global Economic Crisis: Effective Responses and Policy Strategies to Address the Human Impact

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Executive Summary

The global economic crisis will continue to have significant adverse impacts on employment for some time. Falling incomes will also lead to lowering of individual well-being and fiscal sustainability issues for governments. Existing social safety nets and labour market institutions will come under intense pressure as unemployment climbs.

Governments will face large fiscal pressures in providing assistance to the unemployed through existing assistance schemes. However, existing assistance schemes that lack coherency and/or are not focussed on activation measures will deliver poor returns to government and citizenry.

International experiences with the design of social safety nets and active labour market policies suggest that integrated activation systems that focus on job-search assistance and job-matching processes as well as providing skills enhancement can lower unemployment. The fiscal costs of these schemes are significant, but can be broadly related to the tax/expenditure ratios of an economy. These expenditures would form a useful component of a stimulus package as faster employment turnaround times and increasing human capital levels would ease fiscal pressures and lead to a higher growth path for an economy.

In the words of the ADB,¹ “Clearly, a labor market does not operate in an institutional vacuum. In particular, governments intervene to make it well functioning [and] the nature and degree of this intervention varies widely across the world. It is possible that in some cases, these interventions may be seriously interfering with the full and productive employment objectives, especially in the context of globalization, technological change, and competition. In such cases, reform of labor market regulations might be necessary. However, reform must not entail indiscriminate elimination of labor regulations. Instead, reform requires identifying which specific elements of labor regulations are interfering with efficiency and fairness, and therefore, which elements are candidates for removal or adjustment. Equally, reform of labor market regulations involves identifying elements of labor regulations that are conspicuous by their absence, for example, protection against loss of income.”

Assessing both labour market reforms and social safety net design within the context of an APEC Jobs Framework would dovetail a complementary approach that would be consistent with a capabilities approach, efforts to maximise economic potential and growth in the APEC region and the emerging paradigm of Inclusive Growth. It would also complement the Bogor goals.

¹ ADB. 2005. “Labor Markets in Asia: Promoting Full, Productive, and Decent Employment”, special chapter in Key Indicators.

THE GLOBAL ECONOMIC CRISIS: EFFECTIVE RESPONSES AND POLICY STRATEGIES TO ADDRESS THE HUMAN IMPACT

In the current global economic crisis (GEC), the unwinding of asset prices, financial de-leveraging and risk-appetite reduction have been globally indiscriminate. Developed and emerging economies have been hit with slowdowns of similar magnitude despite vastly differing levels of culpability for the causes. This enveloping global recession is expected to reduce world trade by well in excess of 10 per cent this year. It has already unleashed protectionist sentiments and measures sufficient for the WTO to establish an official monitoring process and for APEC to lift its voice against protectionism and re-energise its efforts to achieve more liberal regional and global trade and investment settings.

This paper focuses on the human impacts of the GEC. It outlines some policy approaches that APEC members can take into account in implementing measures to support and accelerate stabilisation and recovery.

The paper also attempts to link the short-term exigencies for action to the need to prevent adverse impacts on longer term policy settings, which governments can design to maximise growth. The human element of the Bogor Goals was recognised by the inclusion in the 1994 Leaders' Statement of the need to "develop more effectively the human and natural resources of the Asia-Pacific region so as to attain sustainable growth and equitable development of APEC economies, while reducing economic disparities among them, and improving the economic and social well-being of our people. Such efforts will also facilitate the growth of trade and investment in the Asia-Pacific region."

Unemployment and well-being

Economic recessions unambiguously reduce the well-being of individuals and economies. A global recession hits home when a family member loses employment. For APEC members, one indicator of the human impact of the GEC is indicated in Table 1.

It shows unemployment data and forecasts over 2007 – 2010. The early signs of increasing unemployment became evident in the United States in 2008, while the forecasts for 2009 and 2010 show that increasing unemployment is expected to become widespread throughout the APEC region. The table also shows the lagging nature of employment; that is, jobs can continue to be lost after economic health returns.

For many economies, built-in stabilisers – cyclical features of the economy like tax revenues (which reduce in recessions) and safety net payments (which increase in recessions) do not require explicit government policy action, but automatically act to dampen fluctuations in real GDP. They will also, in the short-term, reduce some of the fluctuation in employment. Nonetheless, these automatic stabilisers only ameliorate the impacts of a recession. Explicit government policy is normally required in addition to support stabilisation. The actions of many economies would suggest it is evident that the current economic crisis requires explicit additional policy actions by governments, particularly to address shortfalls in employment opportunities. Care needs to be taken, however, to consider the overall fiscal sustainability of an economy and tailor responses so as not to create additional challenges.

Table 1: APEC Member Unemployment Rates 2007 – 2010

Economy	2007	2008	2009	2010
AUSTRALIA	4.4	4.2	6.0	7.8
CANADA	6.0	6.2	8.9	10.8
CHILE	7.0	7.8	9.7	10.8
PEOPLE'S REP. OF CHINA	9.2	9.2	10.3	10.8
HONG KONG, CHINA	4.0	3.5	6.2	6.9
INDONESIA	9.1	8.4	10.6	11.3
JAPAN	3.8	4.0	5.9	6.1
REP. OF KOREA	3.3	3.2	6.2	6.7
MALAYSIA	3.2	3.3	4.8	4.9
NEW ZEALAND	3.7	4.2	7.1	6.9
PERU	6.9	8.1	9.0	8.7
THE PHILIPPINES	7.3	7.4	9.7	11.8
RUSSIA	6.1	6.4	9.6	9.0
SINGAPORE	2.1	2.2	3.9	4.8
CHINESE TAIPEI	3.9	4.1	6.9	7.3
THAILAND	1.4	1.4	4.1	4.4
THE UNITED STATES	4.6	5.8	9.5	10.1
VIET NAM	4.6	4.7	8.6	8.5

Source: EIU

Strengthening Social Resilience

In the context of this paper, social resilience refers to the capacity for individuals to respond positively to economic adversity. It encompasses mechanisms that provide support and enables exit strategies for people to come out of adversity as well encouragement to direct productive efforts and energies into medium and long term sustainable sectors of an economy.

Economic adversity in the form of job losses can arise for several reasons other than recession, including changing patterns of demand, financial problems and trade and economic liberalisation. As noted later in this paper, specific short-term support in response to a particular economic shock should be consistent with and complement well-designed longer term policies and institutions that are incentive-compatible and reward greater effort by individuals to improve their own capabilities.

This combination is most likely to ensure continued fiscal sustainability and reap the greatest long-term benefit for individuals and economies. Not having a longer term perspective increases the risks that targeted and temporary programmes to particular shocks, especially of the scale of the GEC, become locked-in as default policies that cannot be unravelled easily as recovery occurs.

Social safety nets

A major role of many governments is to redistribute income through taxation and social security systems. Income transfers often include retirement pensions, disability payments and unemployment benefits. There has been ongoing international debate about how governments can more effectively manage these transfers while maximising growth prospects of their economies. The debate often centres on the issues of the coverage and adequacy, or otherwise, of the benefit payments; the effects upon behaviour of the transfer system; whether the preferred redistribution has been effective; and the sustainability of the whole system.

Design features of a social safety net (SSN) are particularly important during an economic downturn. This is due to the inherent nature of SSNs, which act as income shock absorbers and therefore improve economic welfare, but these same characteristics lengthen the persistence of the output gap in the wake of adverse shocks. To counter this, a well-designed SSN not only addresses hardship in a recession but facilitates mobility across jobs and regions to speed up employment growth in recovery. In contrast, a poorly designed SSN weakens incentives to adjust to changing economic circumstances and thereby slows the speed of recovery.

Another useful feature of SSNs is that by offering income compensation as a result of adverse shocks, they can help to overcome concerns about economic restructuring such as trade liberalisation and structural reform. However, for SSNs to play a role in acceptance of other economic reforms, SSNs themselves need to have design features that allow them to be adapted to ongoing reform.

Unemployment

Built-in stabilisers that dampen fluctuations in GDP often include unemployment benefits. As such, the design features of the unemployment benefit system have an impact upon the aggregate level of unemployment. These features include: the level of generosity of benefits; the duration of entitlement to benefits; benefits eligibility coverage; and effectiveness of the compliance regime.²

If the level of the unemployment benefit paid is a significant proportion of an individual's previous wage, then there is reduced incentive for the individual to seek new employment. That is, if income replacement rates are high, the level of unemployment duration will be longer and hence aggregate employment will be lower.

Similarly, a longer duration of unemployment benefits also has the effect of lowering aggregate employment. If eligibility for benefits is subject to a time limit, this is likely to lead to greater job search by individuals before the cut-off time. European studies have shown that around the time benefits are reduced, significant new employment occurs.

Many economies restrict access to unemployment benefits to citizens and/or permanent residents. Some economies require contributions to have been made to social insurance schemes before access to unemployment benefits is permitted. Effectively, this means that unemployment benefits are not available to persons who have never worked in paid employment. While such restrictions can result in aggregate employment being at a higher level than otherwise it might have been, they can also result in unintended income distribution issues. For example, young people entering the workforce for the first time at a time of an economic downturn would be ineligible for unemployment assistance despite very low work availability.

In many economies, unemployment benefit recipients are subject to some form of obligation in return for income assistance. These obligations usually require a recipient to actively seek work or to be in a form of training. However, effective enforcement of these obligations varies significantly. If only lip service is paid to these requirements, the results are essentially the same as that of a passive welfare system – where welfare benefits are provided unconditionally. However, welfare systems that effectively enforce obligations for certain transfer payments (such as unemployment benefits) generally also contain transfer payments

² Nickell, S., L. Nunziata and W. Ochel. 2005. "Unemployment in the OECD Since the 1960s. What Do We Know?", *The Economic Journal*, 115 (January), 1-27.

that are unconditional in nature (such as retirement and disability payments). If there is no effective mechanism to prevent individuals migrating from a payment with associated obligations to one that is unconditional, the integrity of the whole system will be undermined and the equilibrium level of employment will be less than optimal.

The four major design features of an unemployment system can thus have a significant effect on both the aggregate unemployment level and the aggregate employment level.

Even with very well designed unemployment benefits systems, the aggregate unemployment level can remain higher than would be expected if the economy were operating optimally. This is often due to a mismatch in jobs skills between the supply of labour and the demand for labour. For this reason, many economies have included training as an element of their unemployment benefits systems.

Facilitating Economic Restructuring

Beyond ensuring a social resilience rationale for government policies, economies also need to pre-position themselves for periods of adversity and be able to best handle the realities. The pandemic nature of the GEC gives rise to a prospect that the global economy is potentially entering a new era in which a new growth paradigm is required.

Programmes that actively facilitate and enable the gainful reallocation of labour into new activities, which expand the capabilities of individuals and the productive capacity of economies, can assist in repositioning economies to ride the next wave of growth. This is a much better option than closing one's borders and protecting the status quo in the hope that this would generate demand for products locally. Given the already globalised nature of our production supply chains, it is clear that such policies would do more to hurt the long-term prospects of economies than to support long-term growth.

Active labour market policies

A programme where unemployment benefit recipients are required to actively seek work or undertake a form of training in order to improve their chances of finding employment is classed as an Active Labour Market Policy (ALMP). ALMPs comprise a broad range of measures that are designed to improve the job matching process in the labour market as well as increase competencies and skills of job searchers. Measures include job matching services, education and training programmes, employment subsidies, and job creation schemes. Multi-country studies show that ALMPs are effective in reducing aggregate unemployment.

Substantial design challenges arise with ALMPs because: some successful job matching would occur in the absence of such schemes (deadweight problem); some individuals will obtain jobs under an ALMP that would have gone to other individuals in an open labour market (substitution problem); and some businesses will utilise wage subsidies to increase their competitiveness, thereby displacing other businesses in the economy (displacement problem).

These problems are not trivial; for example, some studies of wage subsidy schemes have shown combined deadweight and substitution effects in the order of 70 per cent to 90 per cent of the gross number of jobs created.

In general, studies show that job search assistance features of ALMPs lead to positive outcomes, whereas employment subsidy schemes and training need to be well designed to achieve a significant positive effect on unemployment.

Therefore, there are trade-offs between providing a range of activities through an ALMP that complements a country's SSN and achieving employment outcomes as quickly as possible. For example, there may be longer-term benefits to a society and an economy if training is provided to an individual rather than placing that person into an immediately available job. If a person in those circumstances is able to successfully complete training and find employment in a higher skilled job, there will be benefits to both the individual and the economy from higher productivity. However, if that person is unsuccessful in completing training, then the income foregone may never be regained.

While no ideal set of ALMPs has yet to emerge (and is unlikely to given the different labour market institutional arrangements across economies), there are some important learnings available from multi-country experiences. Perhaps the most comprehensive studies are those arising out of the OECD Jobs Strategy.³ Amongst the 10 recommendations was one to strengthen the effectiveness of ALMPs. In 2006,⁴ the Jobs Strategy was revisited and an evaluation made of the intervening period. The evaluation identified four different regimes of labour market functioning. Very briefly, they were:

- Liberal regimes of labour market policies and institutions were associated with good employment and unemployment outcomes. On average, low employment protection and product market regulations, low tax wedges and unemployment benefits, and low to moderate expenditures on ALMPs characterised these regimes. Union density and collective bargaining coverage tended to be below average in these countries.
- A second regime appeared to achieve equally good employment outcomes, with somewhat more interventionist policy settings, predominantly acting on the supply side. These countries (many of which were Northern European) were characterised by corporatist systems of industrial relations and a high degree of coverage of collective agreements often with strong emphasis on social dialogue. There was a comprehensive SSN for unemployed workers and relatively generous unemployment benefits accompanied by solid activation strategies. On the demand side, on average, there were relatively low product market regulations and moderate to high levels of tax wedges and employment protection. Employment protection provisions for permanent workers were rather strict and likely to impinge on transitions to employment. This may have been translated into – and possibly, partly counterbalanced by – high expenditures on ALMPs for the unemployed.
- Third, there were countries predominantly acting on the demand side and where labour market performance was below average. These countries had relatively stringent employment protection regulation and high tax wedges. On average, product market regulation also tended to be relatively strict. Overall, policies and institutions that directly impinged on labour demand were much more salient in this “interventionist” approach than in the previous group. In addition, these countries tended to devote less emphasis to activation policies than was the case in the previous two groups – despite the fact that some countries in this regime had generous unemployment benefits systems. The coverage of collective agreements was high and was supported by binding legal extension mechanisms.
- The fourth regime contained relatively “liberal” labour market frameworks but were associated with poor employment outcomes. Many of these were transition countries. In these economies, expenditures on both passive and active ALMPs tended to be very

³ OECD. 1994. “The OECD Jobs Study: Facts, Analysis, Strategies”.

⁴ OECD. 2006. Employment Outlook.

low and trade unions played a relatively minor role in the functioning of the labour market. By contrast, employment protection and product market regulations were relatively stringent and tax wedges high.

These results strongly suggest that there is more than one way for governments to achieve good labour market performances. Nonetheless, the results illustrate that successful policies were focussed on the supply side of the economy rather than the demand side.

In examining the outcomes of ALMPs across this period, the study found that rather than simply shifting resources from passive to active measures, reforms were better focussed on improving ALMP effectiveness at any given level of spending.

Most macroeconometric studies in this period that estimated the impact of ALMP spending on aggregate unemployment found that there was a significant favourable effect. That is, ALMPs sped up re-employment for unemployment benefits recipients and other jobseekers. Also, a robust finding in these studies was that higher spending on labour market training was associated with lower unemployment. However, individual country evaluations were not as robust, highlighting that design is a crucial feature of ALMPs.

Some studies also have found evidence for interaction effects between ALMP spending and other policies or shocks. For example, the impact of higher unemployment benefits which raise unemployment levels can be significantly ameliorated through higher ALMP spending. This result demonstrates that the effective integration of ALMPs with the administration of unemployment benefits can offset some of the disincentive effects of benefits.

Other studies also demonstrated the divergence in employment response from different components of ALMPs. For example, job-search assistance, which is relatively low-cost, showed positive results, whereas public job creation was typically disappointing. Intensive employment services, individual case management, and mixed strategies with selective referrals to long-term training programmes were also found to have a positive impact.

A major finding was the value of activation strategies. That is, arrangements that co-ordinate unemployment benefit administration with ALMPs, while enforcing more effective job-search obligations for the unemployed. Under activation strategies, jobseekers are provided with job-search support and in their efforts to find work are required to maintain regular contact with employment services, as well as compulsory participation in programmes after a certain period of unemployment.

In short, evaluation results were very mixed. However, there was sufficient evidence to show that properly designed ALMPs can reduce unemployment by improving the efficiency of the job-matching process and by enhancing the work experience and skills of those who take part in them. Costs were minimised where ALMPs with comprehensive activation strategies were subject to rigorous performance management and continuous monitoring of the long-run impacts on employment outcomes.

For the APEC region, the above findings would be more relevant if they were applied to economies with substantial informal labour sectors. What it suggests is that there may be benefit in cross-economy analysis along the lines of a Jobs Strategy that recognises and takes account of an informal labour sector.

A possible future direction for a multi-year APEC work programme may be adapting the OECD's Jobs Strategy to better suit the labour market structure of APEC members, and then

developing a Jobs Framework that is most relevant for the region and can guide member economies in their individual directions for reform.

Training

Improving the ability of the unemployed through the provision of training appears attractive not only because an individual's capabilities are increased, but also because the supply of human capital in the economy is also enhanced. However, evaluation of training provided under ALMPs has yielded mixed outcomes. When training is directly job-related, outcomes have been acceptable, but outcomes for males and youth have been poor. In contrast, outcomes for adult women have been positive.

Available evidence suggests three important features in the design of public training programmes: the need for tight targeting on participants; the need to keep the programmes relatively small in scale; and the need to have a strong on-the-job component and hence to establish strong links with local employers. At the same time, programmes which foster links with local employers are likely to encourage displacement – where those who get jobs do so at the expense of individuals who are not part of the ALMP programme.

If budgetary circumstances do not permit major training expenditures, one other policy option is to fund training through the use of an Income Contingent Loan (ICL).⁵ This is a loan provided by government for an individual to purchase training. If the individual is successful with an employment outcome after completing training, repayment of the loan commences when income exceeds a certain level that is set by government. In the event that the income level is not reached, or circumstances lead to later unemployment, no loan payments are required to be made. Some APEC economies use ICLs to partially fund tertiary education and a number of other APEC members are considering introduction of such schemes.

Institutional arrangements in the labour market

Wage setting arrangements can vary widely across economies, ranging from highly centralised practices to individual bargaining. For some time there was a view that both centralised and decentralised systems would outperform intermediate systems.⁶

However, further research revealed that it was co-ordination of wage bargaining which was having a positive impact on unemployment. Co-ordination occurs where wage determination takes into account aggregate employment. These circumstances can occur, for example, where government, employer federations and trade unions collectively agree the level of wage increases, while factoring in the impact of a wage increase on aggregate employment levels. By definition, co-ordination is also a centralised bargaining process, but its outcomes are significantly superior to a centralised process where trade union power in wage setting impacts on unemployment.⁷ Therefore, it is the degree to which institutional arrangements in the labour market impact on, and take account of, aggregate employment outcomes that are important, rather than the type of institutional arrangement in operation.

The impact of employment protection legislation (EPL) on unemployment also has been the subject of much research. It had been argued that strict EPL contributes to higher

⁵ Chapman, B. 2006. "Government Managing Risk: Income contingent loans for social and economic progress", Oxon: Routledge.

⁶ OECD. 2004. Employment Outlook.

⁷ Nickell, S., L. Nunziata and W. Ochel. 2005. "Unemployment in the OECD Since the 1960s. What Do We Know?", The Economic Journal, 115 (January), 1-27.

unemployment; however, the empirical evidence is somewhat mixed with a current view that there is little association between EPL strictness and overall unemployment. However, there is evidence that stricter EPL raises employment for prime-age men at the expense of the employment of youth and women. There is also evidence that stricter EPL is associated with longer durations of unemployment for the unemployed, an increase in self-employment, and lower turnover rates in the labour market.⁸

A further significant labour market factor is the size of the informal sector, an important consideration for many APEC members. A large proportion of the informal sector is comprised of small businesses, but non-regular workers can also form a significant component. Non-regular or part-time workers add to the flexibility of the labour market, but if regulations prevent them from transferring easily to regular employment, then a two-tier labour market will develop. In a two-tier labour market the second group is likely to have lower wages, poorer working conditions and little access to training. Because of uncertainty with obtaining reliable income information, persons in the informal sector are often not permitted access to SSNs. Hence, in a two-tier labour market, persons who would qualify for SSN support in a properly functioning labour market are denied access.

The ADB also places an examination of labour market reform into perspective. In its 2005 report, it concluded "...that, overall, labor market rigidities are not to be blamed for poor labor market outcomes (based on country studies for India, Indonesia, Philippines, and Viet Nam)." It "...rejected calls for across-the-board labor market reforms [but] advocated well-designed country-specific piecemeal reforms that target the particular policies that may inhibit employment creation."

"This is not to dismiss the key role of a well-functioning labor market in order to create employment. Quite the opposite, in fact. Without a well-functioning labor market it will not be possible to achieve full, productive, and decent employment. A labor market is said to perform well if it achieves the objectives of efficiency and fairness. These objectives imply that the job market will match workers with jobs, and that workers will be paid a wage rate that is related to their productivity. Moreover, a well-functioning labor market will protect workers against the risk of income loss. To this end, countries will have to reform labor markets to develop social protection systems and provide basic rights to all workers to achieve the objective of decent employment."

Specific structural adjustment measures

In a research report of Australia's Productivity Commission,⁹ a general consensus of views from economic commentators was that social safety nets "...should remain the primary mechanisms for support to those adversely affected by reforms, while noting that there is less consensus about when the support they provide may be considered insufficient and more targeted adjustment assistance is warranted."

The report identified several approaches for targeted assistance, including: direct compensation, specific adjustment assistance, phasing, broad-based reform, reform dilution, and ex post modification.

"The first two measures do not involve changing the content or timing of a reform proposal. Rather, they represent 'add-ons' designed to address adjustment and distributional concerns

⁸ OECD. 2004. Employment Outlook.

⁹ Productivity Commission. 2001. "Structural Adjustment – Key Policy Issues", Commission Research Paper, Canberra: AusInfo.

directly where they arise. The remaining measures involve modifying a reform proposal. This could occur either prior to, or as part of, the implementation phase, or, alternatively, at a later date.”

“A set of general principles to guide the selection of specific structural adjustment measures was formulated. The measures should: be targeted to those groups where adjustment pressures are most acutely felt and operate proactively as well as retrospectively; facilitate, rather than hinder, the necessary change; be transparent, simple to administer and of limited duration; and be compatible with general ‘safety net’ arrangements.”

As Malcolm Gray of Analytic Outcomes Pty Ltd stated in the report, “Supplementary measures may be justified where: the impact of a reform is large and difficult to anticipate; those affected are poorly placed to handle the consequences; there is a clear and close link between the consequences and the reform and the distributional impacts, even allowing for the safety net, affront usual notions of equity.”

Some examples of specific adjustment measures which have been employed include the United States’ *Trade Adjustment Assistance* (TAA), which was established under the Trade Act of 1974 to provide aid to workers who lose their jobs or whose hours of work and wages are reduced as a result of increased imports. Interestingly, in this case, “the Reagan and first Bush Administrations each attempted to consolidate the TAA program with other existing job training programs...based on the principle that job displacements caused by foreign competition are no different from job displacements caused by any other form of competition.”¹⁰

Ensuring Access to Economic Opportunities

Ultimately, the efforts in restructuring our economies and providing policies that encompass social resilience, address impediments and constraints, expand the productive capacity of an economy, and enable our economies to respond to changes (technology, consumer preferences, etc.) and adjust quickly to them is aimed at providing the greatest ability to harness and access economic opportunity.

Trade and economic liberalisation should have, as a cardinal principle, a role in enabling people to have access to new and sustainable economic opportunities that underlie growth.

Employment

The principal factor driving employment growth, and hence influencing the level of unemployment, is output growth. In general, the level of real demand in an economy will determine the level of unemployment in an economy. Over time, real demand and employment will tend towards the level consistent with stable inflation. In particular, labour market institutional arrangements drive the level of unemployment (and affect participation) when economic conditions are stable.

Recessions reduce the economy’s optimal level of employment. This is reflected not only in higher unemployment numbers, but also through under-employment (where those in employment desire to work more hours than are available to them) and the occurrence of discouraged workers, those who would be actively seeking employment if the economy were

¹⁰ Froning, D.H. 31 July 2001. “Trade Adjustment Assistance: A Flawed Program”, Heritage Lecture No 714, Washington, D.C.: The Heritage Foundation.

robust, but now opt out of the labour force pool because they do not consider there are sufficient employment opportunities.

In past economic downturns, the experience of many economies around the world has shown that in recovery, the rate of employment growth has often not matched the rate of recovery in GDP growth.¹¹ These experiences have also shown that the resulting higher than expected unemployment rates have primarily been driven by structural factors (which can also impede productivity) and place a “speed limit” on non-inflationary output growth.

At this time, the immediate challenge for governments is to pull the economy out of recession while avoiding, as far as possible, recourse to budgetary measures that would be difficult to undo later.

Taking the opportunity to implement institutional reforms around the same time not only helps to avert inferior policy, but also increases the potential output of the economy and can improve economic welfare and well-being through enhanced human capital outcomes. In this regard, expenditure reforms on human capital policies that increase employment can be fiscally self-correcting.

Relevant policy frameworks

It would be very neat if there were a policy framework in which to address short-term measures. The reality is that this is less clear, except for the need to resist inconsistency with longer term policy approaches.

Three policy framework approaches, without being an exclusive list, would appear relevant to both short and long-term requirements.

First, there is the capabilities approach. This rests on the view that the extent of the well-being of individuals is not just about their reduced command over goods and services due to unemployment in a recession. It is also about the reduction in their “capabilities.” Arguably, the use of a capabilities framework to assess well-being, most recently associated with the Nobel Laureate Amartya Sen,¹² provides a more informative method for government to judge the success, or otherwise, of its policies coming out of recession.

A capabilities framework takes into account a person’s ability to convert opportunities and other resources into capabilities. A key aspect of it is that freedoms (or capabilities) are *intrinsically* important, not income or wealth. The approach posits that “substantive freedoms” (or capabilities) are both the primary end and the principal means of development. Freedom is characterised as the ability for an individual to live a life they might have reason to value, consistent with their personal attributes and social circumstances, but also taking into account opportunities to expand those attributes and circumstances.

While low income and/or wealth have a direct influence on an individual’s capabilities and are therefore instrumentally significant, it is the relationship between low income and low

¹¹ More generally, the ADB found that while many Asian economies have “managed to achieve relatively high growth rates of output, the corresponding growth rates of employment have been somewhat disappointing.”

¹² Amartya Sen has revived the capabilities approach, which can be traced back through the works of John Stuart Mill to Adam Smith and then to Aristotle. Basu K. and L. Lopez-Calva. Forthcoming. “Functionings and Capabilities”, chapter in Arrow, K. J., A.K. Sen and K. Suzumura (eds), *Handbook of Social Choice and Welfare*, Vol. 2, Amsterdam: North-Holland.

capabilities that is important. For example, individuals' personal attributes largely determine their ability to convert income (or primary goods) into capabilities and functionings.¹³

From a policy evaluation viewpoint, the capabilities approach means looking beyond the *means* (for example, income) towards *freedoms* that allow individuals to pursue the ends that they value. This implies a substantial role for government to deliver the basic infrastructure to facilitate economic and social interaction – such as property rights, contract and criminal laws, and regulatory frameworks for products and services. Coming out of recession this also implies an opportunity for government policies to not only focus upon employment creation opportunities, but also to offer better access to more tailored education and other social welfare facilities.

Importantly, the policy perspective for government within a capabilities framework is consistent with a framework focussed on maximising growth. However, it is likely to provide a richer perspective to policy design because of the dual aims of maximising growth and economic welfare objectives. This framework also facilitates government in undertaking necessary institutional reforms that are consistent with implementing policies to close the output gap.

Institutional reforms also have the advantage of delivering a higher return from government expenditure on measures to address unemployment in a recession when fiscal pressures are at their peak.

A second approach would be a more mainstream macroeconomic perspective, consistent with a capabilities framework, driven by an analysis of the supply-side factors of contributions to GDP growth. This has been summarised in the “3Ps” of population, participation and productivity.¹⁴

In the short to medium-term, the focus is mainly on the participation and productivity components, but overall (and remembering that there is a demographic challenge already current in some economies and being fast approached by others), all the 3Ps need to be considered in analysing the causes of divergent growth in living standards among economies.

The approach decomposes GDP into: the number of people in the population of working age (taken to be 15 years and above); the proportion of the working age population that wants to work (the participation rate); the average hours worked by an employed person; and labour productivity.

With respect to employment, attention would be paid to addressing measures and policies that inhibited participation, establishing incentives to encourage productive rather than non-productive involvement in society and increasing flexibility to allow employment patterns to adapt to any changing composition of an economy's output.

¹³ “The concept of functionings, reflects the various things a person may value doing or being. Functions may vary from elementary ones, such as being adequately nourished and being free from avoidable disease, to very complex activities or personal states, such as being able to take part in the life of the community and having self respect.” Sen, A. 1999. *Development as Freedom*, Oxford: Oxford University Press, p 75.

¹⁴ This section draws substantially from a speech given by Ken Henry, Secretary to the Australian Treasury, titled “Economic Prospects and Policy Challenges”, Address to the Australian Business Economists, May 2003.

A third approach is that put forward by the Asian Development Bank.¹⁵ Its key policy perspective is that “... governments across the [Asian] region must give maximum priority to promoting full, productive and decent employment...”

“In the context of a [developing economy], *full* employment consists of maximizing the economy’s capacity to absorb and utilize its labor force, i.e., reducing unemployment as well as underemployment. To achieve full employment it will be necessary for [policy makers] to create the conditions under which the formal sector generates more jobs, and improve earnings prospects in the informal sector. The objective of *productive* employment helps ensure that economies do not implement policies that generate underutilized employment (by, for example, increasing unneeded employment in state enterprises). Moreover, unless the objectives of full and productive employment become central to macroeconomic policy, and time-bound, feasible, credible, and measurable policies [are implemented], Asia could continue displaying high growth rates of output during the next two decades and still be plagued by huge unemployment, underemployment, and poverty. *Decent* employment refers to the creation of employment that provides workers with basic rights (such as the freedom of association, protection from forced or compulsory labor, and elimination of discrimination) and security. This is most critical in the informal sector.”

These three approaches are not mutually exclusive. They tackle employment issues from different perspectives, but come largely to a central conclusion of having policy settings for employment that recognise individual capabilities or freedoms (Sen); maximise growth potential by utilising the full potential of the working age population; and achieve full, productive and decent employment in a developing economy (ADB).¹⁶

All of them would be consistent with an emerging new and long-term growth paradigm of Inclusive Growth.

A World Bank paper gives a very good description of what Inclusive Growth means and its relationship to other growth approaches such as pro-poor growth.¹⁷ Box 1 below, which is extracted from that paper, provides a summary description of the concept.

¹⁵ ADB. 2005. “Labor Markets in Asia: Promoting Full, Productive, and Decent Employment”, special chapter in Key Indicators.

¹⁶ This is not the focus of this paper, but it is worth noting that APEC’s Leaders’ Agenda to Implement Structural Reform (LAISR) focuses on areas in which reforms can be implemented to maximise the productivity component of GDP growth.

¹⁷ World Bank PRMED Knowledge Brief 10 February 2009. “What is Inclusive Growth?”

Box 1 What is Inclusive Growth (IG) About?

IG focuses on **economic growth** which is a necessary and crucial condition for poverty reduction.

IG adopts a long term perspective and is concerned with **sustained growth**.

- (a) For growth to be sustained in the long run, it should be **broad-based** across sectors. Issues of structural transformation for economic diversification therefore take a front stage. Some countries may be an exception and continue to specialize as they develop due to their specific conditions (e.g. small states).
- (b) It should also be **inclusive** of the large part of the country's labor force, where inclusiveness refers to equality of opportunity in terms of access to markets, resources and unbiased regulatory environment for businesses and individuals.

IG focuses on **both the pace and pattern of growth**. How growth is generated is critical for accelerating poverty reduction, and any IG strategies must be tailored to country-specific circumstances.

IG focuses on **productive employment** rather than income redistribution. Hence the focus is not only on employment growth but also on productivity growth.

IG has not only the firm, but also **the individual** as the subject of analysis.

IG is in line with the **absolute definition of pro-poor growth**, not the relative one.

IG is **not** defined in terms of specific targets such as employment generation or income distribution. These are potential outcomes, not specific goals.

IG is typically fuelled by market-driven sources of growth with the government playing a facilitating role.

Estimating expenditures

As noted earlier, because some economies utilise the tax system to provide some benefits and others also have mandatory private social expenditure requirements, it is not straightforward to estimate the cost of effective social safety nets and active labour market policies. Even concentrating solely on social expenditures is of limited value due to different treatment and coverage of the unemployed by economies.

There are, however, some broad indicators that prove useful. Across economies there are substantial differences in the design of SSNs and also, at first glance, large differences in levels of SSN spending by governments. However, while SSNs are expensive, they are only a subset of social expenditures, which include health and pension expenditures.¹⁸ Gross public social expenditure to GDP ratios are often used to compare expenditure upon welfare across nations. However, this gives a misleading picture because many economies levy taxes on beneficiaries of welfare benefits and provide tax concessions through the tax system. Some economies also have mandatory private social expenditure requirements.

Column A of Table 2 shows that general government expenditures as a proportion of GDP ranges from around 15 per cent to around 40 per cent for APEC economies. Gross public

¹⁸ Readers should also note that specific, but ongoing, "structural adjustment" programmes, like the United States' *Trade Adjustment Assistance* programme, can include elements of direct benefits to individuals in the form of training, job search and relocation payments and income support. It is unclear whether these are also included in aggregate social expenditure data.

social expenditure is a subset of this amount and is likely to be within the range of 5 per cent to around 20 per cent for APEC members. However, a 2005 OECD country study¹⁹ showed that a gap between the highest and lowest country's gross public social expenditure to GDP narrowed by around 25 per cent when mandatory private social expenditures and tax systems were taken into account.

Columns B and C illustrate, for APEC economies that were included in the OECD study, the potential sizes of the change under differing methodologies. It should be noted that defining social expenditures can be subject to a degree of subjectivity. Also, both collection and interpretation of the data is resource intensive even for developed economies,²⁰ so it is often the case that differing measurement sources are utilised to undertake comparisons. As a consequence of these data issues, it is more informative to focus upon trends and relative changes amongst the data, rather than the absolute numbers themselves.

Column D in Table 2 also illustrates that direct government expenditure on unemployment is often relatively small, suggesting that sensible targeting of additional assistance may be a viable policy option.

Table 2: APEC Expenditures

	A General Government Expenditures ¹	B Government Social Expenditures ²	C Adjusted Social Expenditures ³	D Government spending on unemployment ²
<i>as a proportion of GDP</i>				
Australia	34.8%	17.1%	20.1%	5.0%
Brunei Darussalam	32.5%	..	..	..
Canada	39.3%	16.5%	18.8%	6.0%
Chile	15.5%	..	..	..
People's Republic of China	18.5%	..	..	..
Hong Kong, China	16.9%	..	..	..
Indonesia	18.4%	..	..	..
Japan	38.4%	18.6%	22.2%	3.0%
Republic of Korea	28.9%	6.9%	11.4%	2.0%
Malaysia	23.9%	..	..	..
Mexico	16.5%	7.0%	8.5%	na
New Zealand	40.4%	18.5%	16.0%	4.0%
Papua New Guinea	35.0%	..	..	..
Peru	14.9%	..	..	..
The Philippines	17.7%	..	..	..
Russia	12.3%	..	..	..
Singapore	13.1%	..	..	..
Chinese Taipei	19.9%	..	..	..
Thailand	17.6%	..	..	..
The United States	36.6%	15.9%	24.8%	3.0%
Viet Nam	32.1%	..	..	..

¹Data is ADB and OECD, 2005, except for World Factbook 2008 (estimate) for Chile, Peru and Russia.

²OECD, 2005.

³Column B data adjusted to include tax transfers and mandated private social expenditures via Adema,W. and M.Ladaique (2005) calculations.

¹⁹ Adema, W. and M. Ladaique. 2005. "Net Social Expenditure, 2005 Edition: More comprehensive measures of social support", OECD Social, Employment and Migration Working Paper No 29, Paris: Organisation for Economic Co-operation and Development.

²⁰ For example, the Adema and Ladaique study is only the second occasion in which the OECD has undertaken measurement of net social expenditure.

For the first two groups of economies within the OECD that have successfully implemented effective ALMPs (refer back to p.7 of this paper) there are some clear budgetary signals. In the second regime of economies, governments spend on both active and passive employment measures about two and a half times more, as a percentage of GDP, than is the case in economies belonging to the first group. With regard to active measures only, expenditures are more than three times higher.²¹

Overall, for all economies, active spending rose from 34 per cent to 40 per cent of total spending on labour market programmes. ALMP spending per unemployed person also increased as a percentage of GDP per capita, rising from 25 per cent in 1994 to 33 per cent in 2002.

For OECD economies, expenditure on ALMPs averages around 1 per cent of GDP, although this hides a wide disparity across those economies, particularly in non-European economies where the average is less than one-half of 1 per cent of GDP. The former figure suggests that total expenditure on active and passive labour market programmes for many economies is around 1 per cent of GDP. However, central government expenditure as a percentage of GDP by these non-European member economies of the OECD is also similar to central government expenditure by APEC members. In broad terms, this suggests that expenditure of around 1 per cent of GDP on active and passive labour market programmes by individual APEC member economies can maintain good labour market outcomes when economic conditions are stable.

²¹ OECD. 2006. Employment Outlook.

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