

# Development Without Employment

## I

One of the most perplexing — and serious — problems now confronting many of the less developed countries (LDCs) is their growing level of urban unemployment. Perplexing — because the level of unemployment has risen in spite of a rise in the rate of investment and an expansion in output. Serious — because unemployment intensifies social resentment and political unrest and also questions the very fact of whether development is occurring: even if national income rises, and even if per capita income also rises, some might still not consider the economy to have developed if the absolute number of unemployed has at the same time also increased.

A number of studies have emphasized the broad dimensions of the problem: industrial employment has lagged behind growth in industrial output, behind growth of the urban population, and even behind the general growth rate of population. Only a portion of the annual increase in the urban-labour force has been absorbed in the urban industrial sector (1). In numerous developing countries, despite creditable rates in aggregate growth, it is not uncommon for the rate of *open* unemployment (not disguised unemployment or underemployment) in urban areas to be as high as 15 to 25 per cent. All this suggests that the Keynesian theory of unemployment does not fit these countries. But even more: it indicates that development plans have failed to achieve their objective of providing a substantial growth of employment opportunities in the modern industrial urban sector. Why has the planned industrialization

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(1) Whereas for all less developed countries, industrial output grew at approximately 7.5 per cent per annum over the period 1948-61, employment in industry expanded at less than one-half that rate — by only 3.5 per cent per annum. Over the same period, the growth in urban population in all LDCs — approximately 4.6 per cent — also surpassed the growth of industrial employment.

process not led to greater employment? In the next section we shall examine the major reasons why development plans have generally been unsuccessful in solving the unemployment problem. We shall then consider in section III possible correctives for the situation of increasing unemployment.

## II

Basic to an understanding of the employment problem in most developing countries are certain relationships between the modern industrial-urban sector and the traditional rural sector. Wages in the modern sector are based essentially on per capita income in the traditional sector.

Many of the LDCs are labour surplus economies in the sense that the supply of labour is greater than the demand for labour in the rural sector, and the productivity of labour in agriculture is extremely low through the pressure of population on the land. In such an economy, the urban industrial sector should be able to attract all the labour it needs at a wage rate sufficient to cover the foregone real income that labour would earn in the rural sector, plus a differential to compensate for the higher cost of urban living and any nonpecuniary disadvantages. Further, if wage rates do not rise when productivity increases in the industrial sector, then capital formation and technical progress in the industrial sector should allow the share of profits in the national income to rise. To the extent that the profit ratio rises, there should then be capital-widening investment in the industrial sector — so that the demand for labour continues to rise, and more industrial workers are employed at a constant real wage. Finally, the surplus labour from the rural sector will eventually be absorbed in the industrial-urban sector; and after this point, wages will begin to rise because labour will no longer be in unlimited supply from the rural to the urban sector (2).

In actuality, however, these possibilities have not been realized. In the first place, the real income gap between the modern and

(2) The foregoing is a brief outline of Sir Arthur Lewis' celebrated model of "Economic Development with Unlimited Supplies of Labour", *The Manchester School of Economic and Social Studies*, May 1954.

rural sectors has been much greater than that needed to cover the cost of transfer and the higher urban costs of living. And the differential above rural income has continued to widen in most of the LDCs. The wage level in the industrial sector has risen in spite of the open unemployment that has occurred and before the surplus labour of the rural sector has been absorbed. It has also continued to rise, although the real income of subsistence farmers in agriculture may have been even stagnant. The average real wage for workers outside of agriculture has commonly risen to two or three times that of the average family income in the traditional sector.

The amenities and public services of the urban area are in themselves an attraction to labour from the rural sector. But the strongest inducement has been this widening income differential between urban wages and rural income at the same time as rural employment opportunities have failed to expand. Fundamentally, it can be submitted that the growing rate of unemployment in the urban area has been due to a premature increase in the industrial wage level combined with a premature reduction in agricultural employment. To a lesser extent, but still significantly in some countries, labour has been released from the very labour-intensive indigenous handicraft industries which cannot compete with the growth in new manufacturing activities. "Rationalization" of labour practices in the tertiary sector has also tended to increase the supply of labour to the urban-industrial sector.

As already noted, the urban wage level has not been controlled by real earnings in agriculture. Urban wages have instead risen independently through the wages policies of the government and trade unions. Trade union pressures have increased in many countries, and labour-supported governments have shown some sympathy to such pressures. Moreover, the monopolistic structure of many product markets has facilitated the passing on of higher wages in the form of higher prices. In several countries, union pressure in dominant sectors of the economy — for instance, oil, copper, bauxite — has been instrumental in setting a pattern of wage increases in other sectors.

More significantly, governmental policies have been the direct instruments for raising urban wages. The public sector is frequently the largest sector of wage employment and also the only sector that is highly organized. Wages in the public sector have risen rapidly

and have commonly acted as the base for a wider pattern of wage increases.

In newly-independent countries, the salary scales are still basically those paid to expatriates during the earlier colonial period; but this scale does not now conform to the utilization of the domestic supply of labour, and it puts undue pressure on the wage structure. Nor can the heightened expectations from the extension of education be fulfilled. Further, minimum wage regulation has been influential in raising urban wages and in having a great impact on the total wage structure in a developing country. The minimum wage in a dominant industry is frequently negotiated with the government on a basis of "an ability to pay" criterion; but this wage tends to spread through other industries. The increase in the minimum wage will have considerable effect in raising the whole wage scale since the wages being received by most of the unskilled workers are at or near the current minimum wage. The generalization of a minimum wage may then become highly unrealistic as it is oblivious to conditions of supply and demand in the labour market, living standards in the traditional sector, and the effects on the wage structure as a whole. Workers who were only marginally useful — but nonetheless employed at the lower wage — become redundant when the minimum wage rises.

Minimum wage policies for unskilled labour also have the effect of making the skilled-unskilled wage differential too narrow, as has happened in many African and Asian countries. Market forces of supply and demand are left to determine wages for skilled labour, but demand rises only slowly so that the market-determined wage for skilled labour also tends to rise slowly. If governments then insist that unskilled wages should increase independently of demand and supply conditions in the unskilled labour market, there is a likelihood that unskilled wages increase faster than skilled wages, and that relatively low-wage labour becomes overvalued (3).

In default of adequate profit taxation or other tax policy, governments have also found it convenient to in effect "tax" companies — especially foreign companies — through wage increases. The government's policy of encouraging higher wages may initially

(3) Cf. KOJI TAIRA, "Wage Differentials in Developing Countries: A Survey of Findings", *International Labour Review*, March 1966, pp. 286-287.

be directed only at foreign companies in order to prevent "excess" profit repatriation and to raise the share of income for domestic factors. But the demonstration effect of higher wages in the foreign enterprises also causes a spread of higher wages to other enterprises.

Although government policies have supported urban wage increases, no particular attention has been given to the level of agricultural wages. The result has been a widening gap between the urban and agricultural wage levels. In Puerto Rico, for instance, the average wage earner in agriculture received in 1952 one-half of the average factory worker's earnings, but by 1962 the wage earner in agriculture received only one-third (4). Or, note the situation in Uganda: wage payments for an unskilled urban worker averaged £125 in 1966, while cash income of farmers averaged only £25, and the cash and kind income was only £60.

Such a large differential has served to attract the disguised unemployed from the rural sector to the urban sector, but at the same time it has kept industrial labour overpriced. Moreover, the differential between urban and rural wages has proceeded to widen in face of the substantial and growing urban unemployment. With the rising expectational wage, it has become increasingly difficult to absorb the excess supply of labour. Thus, those formerly in disguised unemployment or underemployment in the rural sector have, in effect, transferred into visible unemployment in the modern urban sector.

Although we earlier envisaged sufficient capital-widening investment in the industrial sector to absorb the labour inflow, the actual result has been a substitution of capital for labour in the modern sector. Wage rates in most of the LDCs have actually risen more rapidly than productivity; in many cases, real wages have increased at rates comparable to those in the advanced industrial countries. But whereas in the industrial countries real wages have increased roughly in line with average national productivities, the rise of wages in the developing countries often implies an increase considerably faster than that in real national product per capita. In many African and Latin American countries, average real wages in the urban sector have been rising some 4 to 5 per cent per annum,

(4) L. G. REYNOLDS, "Wages and Employment in the Labour-Surplus Economy", *American Economic Review*, March 1965, p. 28.

compared with an increase in real product per capita of only some 1 to 1½ per cent per annum (5).

The consequence of this has been the use of more capital-intensive production methods, either through the introduction of labour-saving machinery in response to rising wages or through improvement in personnel and production management practices which trimmed the labour requirements per unit of output. A well-documented case of the latter result is provided by Puerto Rico where over the period 1954-61, both capital per worker and output per worker approximately doubled — i.e., there was a reduction in the use of labour relative to both capital and output because of improved production management (6). In Latin American countries — notably Chile, Brazil, and Colombia — there is considerable evidence that union pressure and minimum wage legislation have raised the wage rate above the opportunity cost of labour and induced investors to adopt excessively mechanized techniques of production (7).

Capital-intensive methods of production have also been subsidized by other price distortions — especially through too low a rate of interest and too low a price for foreign exchange. When interest rates in the urban sector do not reflect the true scarcity of capital, a bias is imparted to capital-intensive production methods. This is often intensified by inflation which lowers the real rate of interest below the nominal rate, possibly even to a negative real rate. So too is there a bias toward more advanced production techniques when the LDCs currency is overvalued in terms of foreign currency, and the true cost of importing machinery is hence undervalued. Governments have also lowered the relative price of producers' equipment by measures such as allowing duty-free importation of equipment, a preferential exchange rate, and making available foreign exchange for servicing loans from overseas machinery suppliers. When domestic enterprises are protected by tariffs and import quotas, the pressure to economize on capital is also less than it would be in more competitive markets.

(5) H. A. TURNER, *Wage Trends, Wage Policies, and Collective Bargaining: The Problems for Underdeveloped Countries*, Cambridge, 1965, pp. 13-14.

(6) REYNOLDS, *op. cit.*, pp. 32-33.

(7) K. B. GRIFFIN, "Latin American Development: Further Thoughts", *Oxford Economic Papers*, March 1968, p. 129.

It is most significant that the strategy of industrialization via import substitution has dominated the expansion of the industrial-urban sector. The attempt to industrialize via import substitution has generally been accompanied by inflation and an overvalued exchange rate. These policies have resulted in a distorted price structure in many LDCs: too low a rate of interest in the urban sector; too low a rate for foreign exchange; and too high a level of urban wages.

The bias is also supported by a number of other measures. Employers tend to seek means of reducing their labour requirements when the government uses wage policies as a substitute for social legislation by requiring family allowances, pensions, licensing and health measures, or other fringe benefits bordering on social insurance. Officially required fringe benefits and wage supplements may commonly amount to as much as 30 to 40 per cent of the basic wage. When the employers are foreign enterprises, they are also likely to be simply imitating the advanced techniques of production known in the advanced country — techniques which are appropriate for the factor supply of the advanced country but not for the labour surplus of the less developed country. The tying of foreign aid to imports from the donor country also goes in the direction of biasing projects in the recipient country toward capital-intensive projects. The relative ease of securing supplier credits on the importation of machinery has the same effect. Domestic tax laws may also contribute to the bias when corporate tax laws allow accelerated depreciation and investment allowance.

Contrary to the earlier expectations of most development plans, the expansion of the modern sector has actually tended to slow down in many LDCs. Being based on import substitution, the industrial sector might be expected to have initially a substantial rate of growth as imports are replaced. But this may be a once-for-all expansion with little subsequent reinvestment — unless the home market continues to grow, or the process of import substitution can proceed on from the final stages of production down through the production process to the replacement of intermediate goods, or the import-replacement industry is able to gain a competitive advantage in export markets. Such opportunities for the continual expansion of the modern sector have not, however, materialized: thus capital-widening investment with an ever-expanding demand for the surplus labour has not been sustained.

At the same time as domestic policies have had the effect of subsidizing capital-intensive import-substitution industries, they have implicitly imposed a levy on domestic agriculture. This has gone against an expansion in labour-intensive agricultural output and a rise in rural employment. Moreover, it has not allowed real wages in the modern sector to rise via a fall in the cost of living through increasing productivity in agriculture, instead of through the rapid rise in money wages that has occurred.

### III

What now are the possible correctives for this situation of rising unemployment? Several general principles may be offered as a basis for policy measures to slow down the rise in unemployment:

(a) A reduction of urban-rural real income differentials would be helpful; but this is probably the most difficult objective to achieve. Although efforts to restrain the rise in urban wages would appear in order, a number of institutional and political considerations militate against this. It is also questionable by how much the demand for labour would actually be stimulated by wage restraint. And even if the demand for labour did increase, this could also raise the supply of labour *pari passu* as the expectation rose of obtaining employment in the urban high wage sector.

(b) If it is difficult to institute a "wages policy" that would increase urban employment, it is all the more important to emphasize the "supply side" of the problem. When the urban sector cannot absorb the inflow of labour from the rural sector, special consideration must be given to policies that will remove the causes of the rural "supply push" and help contain the labour force in rural areas.

The modern sector must avoid producing what can be produced in the rural sector — e.g., village handicraft employment should not be displaced if this entails the wasteful use of capital in the modern sector to produce an output which could be produced equally well by surplus labour. It is to be recalled that in Japan's case of successful development, both agriculture and village industry became more labour-intensive. There may also be considerably greater scope for rural-based industry involving simple technology and the processing of agricultural materials.

Beyond this, however, a full-scale program of rural development is needed to absorb and retain large amounts of manpower. If the rural to urban migration is to be reduced, it is necessary to modify policies that have turned the terms of trade against the agricultural sector. Ceiling prices on foodstuffs, export taxes or restrictions on primary products, and tariff protection on industrial inputs and consumer goods have acted as disincentives to agricultural producers, while artificially increasing the urban-rural differential. Efforts should also be made to disperse some of the public services now concentrated in urban areas to the rural sector.

Of greatest consequence will be the type of strategy pursued for developing the agricultural sector. Perhaps the most important single factor influencing a developing country's ability to absorb a growing labour force into productive employment is whether a labour-using, capital-saving type of approach to agricultural development is followed (as in Japan and Taiwan). For most developing countries, the employment potential in rural modernization can be greater than that of the modern urban sector — provided that the countries avoid implicit taxation of agriculture and "unduly labour displacing" measures in agriculture.

(c) Additional attention must also be given to the problems of devising a technology in the industrial-urban sector that is superior to the country's indigenous traditional technology but is not as advanced and labour-saving as is the modern technology that has been imported for use in the urban sector. The choice of a more labour-intensive production technique may, of course, conflict with other investment criteria — in particular, the maximum absorption of labour may yield only a low return per unit of capital and not maximize the future rate of growth in output. At this point, however, the important consideration is the emphasis on devising new technology that is "capital-stretching" in the sense of decreasing capital-intensity while maintaining the essential quality of the tool element in equipment without the superfluous labour-saving appendages of the advanced technology of industrial countries.

(d) To lessen the bias toward relatively capital-intensive techniques, policy measures must be undertaken to remove the distortions in the price structure. A rise in interest rates, currency devaluation, and a restraint on the increase in urban wages would lessen the attractiveness of using capital-intensive techniques of production.

(e) As long as labour is induced to migrate from the rural sector and the manufacturing sector cannot absorb labour in sufficient quantities, it will be necessary for the labour to seek employment in the tertiary sector. This has occurred in many of the LDCs, with employment in services and commerce actually rising more rapidly than in other sectors. In Latin America, for instance, employment in the tertiary sector rose by more than 4 per cent per annum over the period 1950-65, while employment in industry increased only by approximately 2.8 per cent per annum; and the proportion of the labour force in the services sector (excluding construction and utilities) rose from 24 per cent to 30 per cent.

From the standpoint of providing an employment outlet, it is therefore advisable not to promote too rapid an increase in efficiency in employment practices in the services sector. As remarked by Professor Galenson (8), the pushcarts should not be too readily replaced by the supermarket; the bicycles by the trucks; a casual but large labour force by a permanent and stable but smaller labour force. The inefficient use of labour in the tertiary sector will not, of course, have the undesirable cost effects that would occur if this were done in the import-replacement or export sectors.

It also follows that while the manufacturing sector in itself does not provide many jobs, a more rapid growth of manufacturing capacity and output remains of major importance in creating more effective demand and thereby supporting more employment in commerce, transportation, communication, and services. This induced employment in complementary activities is apt to be more significant than any direct contribution that the manufacturing sector can make to the alleviation of mass unemployment.

(f) Finally, over the longer period, more attention must be given to the "supply side" of the problem in terms of population control policy and the "outputs" of the country's educational system. If the employment problem is now aggravated by the sheer quantitative dimensions of the labour force, its ultimate solution will in large part depend upon the qualitative development of the people as productive agents. In this respect, there may be more scope for optimism as a result of present efforts to reinforce

family planning programs and human resource development through manpower training and extension of educational opportunities.

Although the eventual solution will depend upon population control and human resource development, the immediate requirements are for changes in domestic policies so as to stimulate the use of more labour-intensive methods of production both in agriculture and in the manufacturing sector. In the immediate future, it can thus be expected that more of the LDCs will have to forsake longer term development plans in favor of shorter term employment plans.

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(8) W. GALENSON, "Economic Development and Sectorial Expansion of Employment", *International Labour Review*, January-June 1963, pp. 505-519.