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A POLICY FRAMEWORK FOR INVESTMENT: HUMAN RESOURCE DEVELOPMENT POLICY

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A POLICY FRAMEWORK FOR INVESTMENT:
HUMAN RESOURCE DEVELOPMENT POLICY

1. Introduction

1. This paper deals with how human resource development policies can contribute to a climate that is attractive to domestic and foreign investors and can enhance the benefits of investment to society. It is one of the ten topic areas covered in the Policy Framework for Investment[1] (PFI), which is part of the OECD Initiative on Investment and Development.[2] The paper is intended to serve as background documentation to the PFI checklist chapter dealing with human resource development (HRD).

2. A premise of the paper is the linkage between government and private investments in education, training and population health with other kinds of investment: increased investment in human resource development attracts higher capital spending by enterprises, provided the general business climate is appropriate. The objectives of the paper, therefore, are to examine and distil the lessons learnt from how government human resource development policies, including labour market policy, bear on business investment decisions and the key features that determine their success from a wider development perspective.

2. Human resource development promotes investment: the overall relationship

Has the government established a coherent and comprehensive HRD policy framework consistent with its broader development and investment strategy? Is the HRD policy framework responsive to new economic developments and does it engage the main stakeholders? Are periodic assessments made of the impacts of HRD policies on the investment climate?

3. In this paper HRD[3] is interpreted broadly as having four main elements. These are educational attainment, workforce skills, population health and the set of employment policies that connect people to business enterprises with the required skills to reap the maximum benefit from economic opportunities and to quickly adapt to new challenges. Each of these areas is thus a key driver in creating a favourable climate for both domestic and foreign enterprises to grow through new investment. Their relative roles and the overall importance of HRD depend, of course, on individual country circumstances, particularly the economic structure.

4. However, the quality of HRD policies cannot be seen in isolation. Attempts to boost workforce skills through vocational training without considering their interaction with basic educational attainment or flanking labour market policies are likely to be ineffective. Rather, it is important to tackle low HRD through a comprehensive strategy that takes full account of the linkages between, for example, improved

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1 The other policy areas in the PFI are: investment policy; investment promotion and facilitation; trade policy; competition policy; tax policy; corporate governance; corporate responsibility and market integrity; infrastructure development; and public governance.

2 For further background information on the OECD *Initiative on Investment for Development* and the *Policy Framework for Investment*, see www.oecd.org/daf/investment/development.

3 Sometimes the terms human resource development and social infrastructure, or 'social capital' are used interchangeably.

population health on educational attainment and, depending on employment policies, on labour productivity. This paper, therefore, aims to identify the key elements of education, health and employment policies within an overall institutional framework for promoting the development of HRD and attracting investment.

5. Particular emphasis needs to be attached to the flexibility of the institutional framework to accommodate the consequences of rapidly changing technologies and economic structures. Continued improvements in and the falling cost of information and communication technologies, for instance, is raising the demand for skilled workers, making low human resource development a bigger obstacle to inward investment. The same forces, however, also represent an opportunity for developing countries to more quickly integrate into the global economy, as businesses restructure their supply chain and operations to gain from regional comparative cost advantages. As well, international enterprises are strategically well positioned to build-up human and intellectual assets as the knowledge economy develops. HRD policies must, therefore, be adaptable and constantly fine-tuned in order to quickly respond to the changing skill needs created by new challenges and to ensure the contribution of investment for development. For this to happen, close co-operation between policy makers and the main stake holders is crucial and periodic assessments of the impact of HRD policies on the business and investment climates are needed.

3. Fostering a skilled and healthy workforce: a public and private partnership

6. Human resources are the principal asset of every country and required by all business enterprises. But without investments in developing the capacity to acquire skills, build knowledge and innovate, the potential for human resources to attract business investment is limited. More broadly, human resource development contributes to civil liberties, political stability, improved population health and reduced crime and corruption, advancing economic development and further attracting inward FDI.[4] This complementarity creates a virtuous cycle and a potentially sizeable source of sustainable economic growth. Many countries, however, under-invest in human capital, due in part to a range of market failures. This section of the paper deals with five fields of HRD policies to foster a skilled and healthy workforce.

(i) Start with the basics

What steps has the government taken to increase participation in basic schooling and to improve the quality of instruction so as to leverage human resource assets to attract and to seize business investment opportunities?

7. There is a consensus that education at the primary and lower secondary levels are the minimum necessary to attract investment and ultimately to boost economic development. A joint OECD/UNESCO study has found, for instance, that investment in human capital over the past 2 decades has accounted for about ½ a percentage point in the annual growth rate of 17 emerging market economies and among OECD member countries one more year of schooling can increase GDP per capita by 4 to 7 per cent (OECD, 2003a). These are the average impacts and individual developing country experiences span within a wide and not always propitious range, depending on the quality and delivery of education and on the incentives firms face to hire more skilled workers.[5] Concerning the relationship between education and FDI, a recent study of 36 developing countries found that human capital, using 3 different proxy

4 See World Bank (2005) for a review of the mechanisms and chapter VI of OECD (2002).

5 Topel (1999) surveys the literature on the contribution of education to economic development.

measures, is one of the most important determinants of the investment location decision and its importance has become greater through time (Noorbakhsh, *et al* 2001).[6] In another study covering Latin America and the Caribbean, a one per cent decline in the illiteracy rate was found to increase FDI by about 2.6 per cent (Daude, Mazza and Morrison, 2003).

8. Formal educational attainment also provides the foundations for further learning and safeguards the capacity to seize future business investment opportunities. Indeed, mastering core competencies of literacy and numeracy are pre-requisites for effective training programmes later on. Countries with very low basic education thus risk, down the road, missing out on opportunities to move up the value chain by upgrading worker skills. Positive developments in schooling enrolment rates over recent decades have lowered this risk, though in many countries progress has been slow.

9. Too often families living in poverty and unable to access credit markets have no option, but to prematurely withdraw their children from schooling, even though it is in their long term interest to continue. In these circumstances, without policy intervention, investment in early childhood, primary and lower secondary education will be sub optimal, perpetually feeding under-skilled workers into the labour market, disconnected with the requirements of business. Sub-Saharan Africa and South Asia offer a stark example. According to the World Bank, in year 2000 more than 40 per cent of those aged 25 and over in these regions had not completed any formal education.

10. Basic education is an area especially prone to be shaped by country specific constraints. Moreover, successful basic education systems vary widely, making general policy guidelines hard to formulate. But not just anything goes. First, governments need to aim to extend access to all, not just the elite. Second, they should consider further development of basic education by, for instance, extending the length of compulsory education to at least the lower-secondary level. Better quality of basic education is also important. This can be facilitated through streamlining of learning objectives designed to impart core competencies and promote creativity, and by strengthening the relationships of accountability.

11. One of the risks attached to a strategy that tries to rapidly boost the level of access and quality of primary and lower-secondary level education is it encounters supply constraints, delaying the improvements to the investment climate that flow from better human resources. This risk can be reduced by better service delivery procedures, such as voucher schemes and by giving schools and communities more autonomy for budget management, provided they meet pre-defined performance criteria.[7]

(ii) Ensure appropriate economic incentives to acquire a higher formal education

Is the economic incentive to invest in human capital sufficient to encourage individuals to continue higher education? Are there policy-induced obstacles that act to lower the financial returns to higher formal education, limiting improvements to the investment climate that flow from better human resources? What mechanisms exist to promote closer co-operation between higher education institutions and business and to anticipate future labour force skill requirements?

12. Higher secondary and tertiary educated workers are essential to help secure the full benefits of business investment. The potential gains stemming from the wider adoption of new and more productive

6 Earlier studies were more equivocal, probably reflecting the dominance of FDI in lower value added industries 20 years ago, where the need for skilled workers is less. See, for example, Root and Ahmed (1979) and Schneider and Frey (1985).

7 For a detailed review of educational reforms in developing countries and drawing from this evidence the best practices in the delivery of basic education services, see World Bank (2004), chapter 7.

technologies by businesses in high value-added activities depend on a skilled workforce. Further, new technologies typically require organisational changes, which a skilled workforce is better able to handle (Bresnahan, Brynjolfsson and Hitt, 2002). A more skilled workforce also gives firms a stronger incentive to engage in growth enhancing activities, raising both the private and social returns to education.

13. The externalities and market failures that characterise basic education tend to be less present in the case of upper secondary and tertiary education. Graduates are usually able to mostly internalise the benefits in the form of a higher wage (See Box 1). However, there is a danger that the benefits to society and the local business community are forfeited to the extent that freshly-minted graduates permanently emigrate. The evidence indicates that this risk is greater in small-sized economies. In the larger economies, high-skilled worker migration is also indisputable, but its nature is more aptly described as 'brain circulation', since return migration is common, likely further benefiting the business climate via the new skills and work experience gained while abroad (Dumont and Lemaître, 2005).

Box 1. How big are the returns to investment in education?

Beyond compulsory education the decision by individuals to continue to participate in learning programmes is mostly shaped by economic incentives. The internal rate of return is a summary measure that is widely used to gauge the overall size of the economic incentive to invest in human capital and as a measure of the economic sustainability of such investments.[1] It is the discount rate that equalises the costs of education during the period of study to the expected benefits from education following thereafter. The higher are the costs of education relative to the benefits, the lower the internal rate of return. Internal rates of return can be calculated for the individual and for society. They usually differ because the individual often only shoulders a fraction of the total cost of providing education and because the returns to society may include a range of indirect benefits, such as lower crime, better health and more social cohesion to name a few. In practice, however, it is difficult to attach a monetary value to every indirect benefit needed in rate of return calculations.

A variety of factors influence estimates of the internal rate of return. The costs side depends on the size of the tuition fees less any resources made available to the student in the form of grants and loans and the foregone net of tax earnings over the length of the course of study (adjusted for the probability of being in employment). The benefits are calculated as the estimated gains in post-tax earnings (adjusted for the higher probability of being in employment) less any repayments of public support during the period of study (e.g. student loans). Estimates are sensitive to the many assumptions made, particularly the age of the individual when the course is completed, the length of the course of study and the wage premium earned by a higher educated individual.

Bearing in mind the caveats, OECD estimates of the private internal rate of return to upper-secondary education for young graduates in member countries are positive everywhere and generally high, compared to rates of return on other productive assets, providing a strong incentive for individuals to continue to invest in human capital. Likewise, estimates of the social rate of return to upper-secondary education are typically above 5 per cent, suggesting that investment in education is likely be a productive use of public resources. Moreover, these estimates ignore the likely gains from a range of positive externalities. There are also a multitude of estimates of the internal rate of return to upper secondary education for non-OECD economies, which as well show large, but a wide dispersion across countries in the size of the returns to education.

1. Non-pecuniary benefits are also relevant, but these are hard to quantify at an aggregate level.

Sources: OECD (2001 and 2004a) and Psacharopoulos and Patrinos (2004).

14. Higher educational institutions themselves obviously play a key role in equipping youngsters with the workforce skills needed by businesses. But these needs change quickly and often learning institutions are slow to respond. In this regard, stronger links between universities, businesses and other stakeholders can help reshape course offerings to stay closely in line with evolving demands for specific skills. In Ireland, for example, the Industrial Development Agency (Ireland's investment promotion authority) works in partnership with educators and the business community to identify likely future skill requirements by industry. Co-operation can also bring a number of other benefits favouring the investment climate. For instance, it fosters an environment conducive to innovation and the diffusion of new knowledge more quickly (Borensztein, De Gregorio and Lee, 1995).

15. To provide an incentive to individuals to invest in human capital and to help secure all the spillover benefits of business investment are squeezed-out, governments can focus on education policies in three dimensions:

- *Increase total resources for higher and tertiary education.* Since in many countries private internal rates of return at the tertiary level tend to be high and lie substantially above social returns, increased total resources for education and broader access to tertiary education could be facilitated by having graduates finance more of their studies. In those countries where rates of return are low, short, focussed programmes and the removal of obstacles that compress the wage structure raise private returns, strengthening the incentive to pursue higher education, including among older adults. More generally, a better business climate lifts the financial returns to investing in education. Addressing failures in financial markets so that students are able to finance tertiary education through loans that use future labour income as credit collateral, would also improve access to higher education.

- *Raise the quality and efficiency of tertiary education.* These goals are more likely to be achieved if universities are meritocratic, granted more autonomy and competition among universities is allowed. The latter involves winding back policies, where they exist, that discriminate in favour of public sector providers. At the same time, minimum quality standards and quality assurance mechanisms through certification or accreditation schemes, with transparent procedures, covering both public and private providers is essential. Tightening links with the business community is also important to enhance the relevance of higher education.

- *Improve framework conditions*. Rent seeking associated with lack of competition in product markets, employment policies that inhibit labour turnover and job creation and the inability to exploit business opportunities because of underdeveloped financial markets are some of the reasons why earlier efforts to increase resources in education sometimes failed to result in economic development and to improve the business and investment climate. The experience underscores the importance attached to framework policies that favour competitive product and flexible labour markets (see below).[8] Some policy guidelines that improve framework conditions in product markets are covered in the PFI chapters dealing with competition, trade and public governance policies.

(iii) Training helps business to stay competitive

Does the government support training programmes and has it adopted practices that evaluate their effectiveness and their impact on the investment climate? What mechanisms are used to encourage businesses to offer training to employees and to play a larger role in co-financing training?

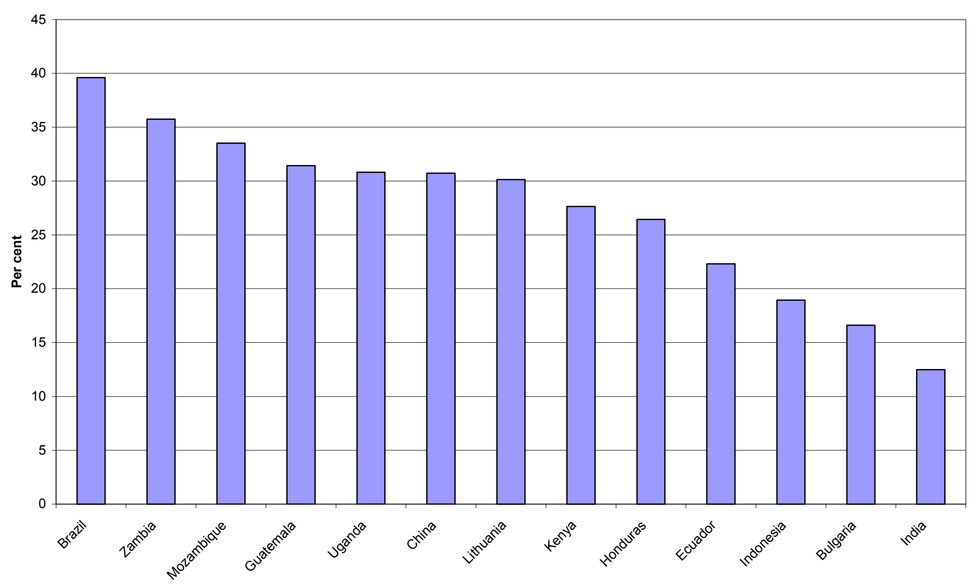
16. While formal education equips individuals with the skills needed to learn, new recruits tend to lack the firm-specific knowledge that businesses require to unlock the full productive potential of its employees and invested capital. Transmitting these firm-specific skills is the domain of on-the-job training and specialized off-site training. However, as with basic education, market failures lead to too little training by businesses and, what limited training has been undertaken, is concentrated within a narrow group of individuals (OECD, 2003c and 2004b). One reason for this predicament is the risk that workers leave the firm shortly after completing their training and before the employer is able to recoup

8 OECD (2003b), chapter VIII shows that framework conditions which support flexibility in labour markets attract inward FDI.

the cost incurred. The problem is universal, but is especially acute in many developing countries (Figure 1), and notably among smaller firms and those that plan to innovate and expand (World Bank, 2005).

17. The shortage of trained workers is thus an obstacle to expanding business investment and makes it particularly hard to attract high-skill industries to developing countries (Marin, 2004). As a consequence, and since multinational enterprises invest relatively more in worker training than domestically owned businesses (Tan and Batra, 1996), there is a risk that developing countries enter a cycle of under-trained workers that is subsequently hard to escape from. The macroeconomic costs in terms of lost potential output can also be sizeable, given the productivity gains linked to training (Batra and Tan, 1995) and because of the spillovers that training by multinational enterprises transmit to local firms (Miyamoto, 2003).

Figure 1. In many countries, businesses are constrained by skilled-worker shortages



Note: Percentage of firms reporting that skills and education of available workers is a major or severe obstacle to the operation and growth of their business.

Source: World Bank Investment Climate Surveys

18. This suggests that there is a role for government to support training programmes, which in tandem with formal education improves the business climate and attracts foreign investors in high-skill industries (See Box 2). Policy instruments to support training are many, including co-financing arrangements where payroll levies are used to fund training grants to employers, or through levy exemptions for employers that spend a given proportion of their payroll on training, tax incentive schemes and subsidies.[9]

19. Evaluations of these instruments in a developing country context are scant and in any case are likely to be country specific. In these circumstances what is important from the investment climate

9 See OECD (2004c) for a review of co-financing of adult education and training and the evidence on their effectiveness in OECD countries.

perspective is to ensure stable training programmes that are in line with business requirements and coupled with evaluations to favour those schemes which have a proven track record of high rates of return. As well, OECD experience shows that governments can play a role by creating the structural pre-conditions for raising the benefits of training, improving delivery and quality control and through efforts to improve co-ordination between the relevant stakeholders to ensure coherence and to secure the wider contribution of investment to sustainable economic development (OECD, 2005). In addition, foreign businesses can make a positive addition to promoting training. In this regard, the 39 OECD and non-OECD countries that have adhered to the *OECD Guidelines for Multinational Enterprises* recommend efforts to offer and to encourage training to local employees (See also Box 5).

Box 2. Singapore as a location for multinational enterprise regional headquarters

Singapore's highly skilled workforce has acted like a magnet, drawing many multinational enterprises to locate their regional headquarters in the city state. Of the approximately six thousand foreign enterprises operating in Singapore today, nearly two thirds have regional responsibilities and headquarter functions. But it was not always the case. After independence in 1959 it adopted, like many other developing countries, an import substitution strategy. With Singapore's small domestic market, this failed and was replaced in 1965 by an outward-focussed development strategy. There were many components to the strategy, but one of the central elements was an emphasis on developing and maintaining a skilled workforce, capable of adapting to new needs.

Initially, great importance was placed on secondary education, vocational training and the creation of technical universities. Businesses were encouraged to invest in human capital with funding financed by a skills-development fund and to protect and bolster Singapore's intellectual assets, inward-investing enterprises were required to provide and fund employee training. Further, since 1987 all Singaporean children are instructed in English and they must also study another language. With Singapore's economy becoming more services based the role played by a skilled workforce has gained further in importance. To ensure workforce skills are responsive to and evolve in line with business needs the Singaporean education system works closely with the Economic Development Board (the Investment Promotion Agency). In 1997, they established together the World Class Universities Programme. It aims to attract 10 world class educational institutions to locate branch campuses in Singapore and to deliver quality courses and research and development in line with the needs of industry.

The case of Singapore offers a concrete example of the importance of a skilled workforce developed through an emphasis on both formal education and training to attract FDI, and of the need to adapt human resource development policies in response to changing economic opportunities.

Sources: Miyamoto (2003) and Brown (2000).

(iv) Population health matters for investment decisions and performance

Does the government have a coherent strategy to tackle the spread of pandemic diseases and procedures to evaluate the costs and benefits of public health expenditures aimed at improving public health outcomes and through inter linkages, the investment climate?

20. Pandemic diseases are a human tragedy, ravaging societies through the premature loss of lives and entrapping many others in poverty. They negatively influence business investment decisions too, risking a vicious cycle between poor health, less investment, job creation and entrepreneurship and hence slower economic growth and fewer resources for tackling the sources of treatable diseases and disabilities (see Box 3 on the economic cost of HIV/AIDs).

21. However, the links between health, education and economic growth can equally work in a virtuous way. A less disease prone country strengthens the ability and increases the incentive to invest in, and the returns from investment in education and from worker experience. More generally, it boosts

morale, strengthens confidence in the future and increases the willingness to save and invest. These effects favour both higher productivity and participation in the economy and thus higher household incomes. There is also a direct impact on productivity, since a healthy population is more physically and mentally robust and less prone to absenteeism due to illness or the need to care for other family members.

22. Apart from the human and macroeconomic gains, population health promotes investment. This is because of the effect of good health on worker productivity and because foreign businesses tend to avoid sending expatriate employees to those areas where their health could be damaged and where access to health care is limited. In addition, uncertainty, a feature of uncontrollable, infectious diseases makes investors wary, leading to much larger economic costs in terms of foregone investment than is warranted by the size of the risk. This dimension of the investment climate was clearly illustrated following the outbreak of Severe Acute Respiratory Syndrome (SARS) in 2003, when FDI into China fell sharply (Tam, 2003). While investment inflows were restored once SARs had been brought under control, it demonstrated the sizeable adverse impacts that sustained epidemics, such as malaria and HIV/Aids can have on investment.

Box 3. The economic cost of HIV/AIDS

Over past centuries epidemics have had catastrophic effects on human well-being. The plague that swept through Europe in the mid-14th century took with it one third of the population and between 1918 and 1919 the Spanish influenza claimed more than 40 million lives. The HIV/AIDS epidemic is the most prominent contemporary pandemic disease. Worldwide, an estimated 42 million people live with HIV/AIDS and 22 million have already lost their life to the disease. A disproportionate number of these people and over three quarters of new infections in 2003 were located in Sub-Saharan Africa. In the most affected African countries, life expectancy at birth has dropped by more than 10 years to around 50 years and is projected to fall to as low as 30 years over the next two decades (UN, 2003).

When the declines in health status are this large, the economic impact is big as well. Estimates of the macroeconomic impact of AIDS vary widely. A review of 11 studies that quantified the effect on GDP per capita in Africa concluded that the net effect of HIV/AIDS is negative and substantial, with bigger impacts found in the most recent studies (Dixon, McDonald and Roberts, 2002). These recent studies suggest that the income and output loss associated with the epidemic has slowed the pace of economic growth in the region by 2 to 4 per cent per annum. Moreover, such estimates do not fully capture the dynamic losses associated with lower physical investment, the destruction of human capital and the weaker transmission of knowledge and abilities from one generation to another. All of these effects are harder to quantify, because they take decades before they become fully felt and because of the slow progression of AIDS.

The HIV/AIDS epidemic also imposes large costs on households and businesses. Since most fatalities from AIDS are adults in the prime of life, businesses lose skilled workers and valuable know-how accumulated through worker experience, and incur higher costs of employee health benefit schemes, where they exist. Productivity is also reduced due to increased absenteeism and possibly as a result of a wider impact on staff morale. In a survey of African businesses, nearly all respondents said they were concerned about HIV/AIDS and quantified its impact on the region's economic productivity at around 1 per cent of GDP.

Sources: Bell and Lewis (2005), Bloom, Rosenfield and River Path Associates (1999), Dixon, McDonald and Roberts (2003), UN (2003) and World Bank (2005).

23. The longer lasting effects of poor population health on foreign direct investment were investigated in a study of 51 low- and middle-income countries. It found that a one year improvement in life expectancy – roughly proxying the health of a country's population - led to about a 9 per cent increase in gross FDI inflows (Alsan, Bloom and Canning, 2004). The overall impact would likely be even greater if domestic investment is also taken into account. The potential benefits in terms of

economic development are also substantial. A range of studies have found that a five year gain in life expectancy – equivalent to the average increase over the past two decades – leads to about 0.4 per cent faster growth in GDP per capita per year (Strauss and Thomas, 1998).

24. The payoffs to controlling epidemic diseases are thus multifaceted and include increased investment. But designing the policies with limited resources that favour a virtuous cycle between health, investment and sustainable development is hard to get right. It takes time before the impact of policies is felt, making it less certain which factors play the fundamental role and difficult to justify sustained funding. Nonetheless, there are several lessons to be drawn from successful experiences. The first is the importance of a coherent framework of policies; there is no magic bullet. The provision of clean water and sanitation, control of disease vectors – the organism that transmits a disease – vaccination programmes and health education, are all needed to prevent epidemic outbreaks and to contain them in the event they occur. A second lesson is the need for regular evaluations of public health programmes to evaluate their effectiveness (e.g. treatment or preventative), since what works well in one country may not always be effective in a different country context. Thirdly, policies that exploit known inter linkages are important. A better educated population, for example, indirectly improves health, because it leads to greater awareness and access to information and also an improved capability by health authorities to respond to and manage public health matters.

(v) Bolster – don't undermine - a competitive labour climate

25. To create the business conditions to spur investment and to reap their full output expanding potential also requires a competitive labour force so that resources freely move towards their most productive uses. In most situations markets generally do a good job of allocating the most effective use of resources, but can also result in outcomes unacceptable to society. Governments, therefore, intervene in the labour market to achieve social and other objectives. But the design of policy interventions and how they are implemented and enforced may also, advertently or inadvertently, compromise the ability of businesses to adapt to changed circumstances, harming the investment environment.

26. This, of course, does not mean that governments should shy away from regulatory interventions. But rather care is needed to craft regulatory strategies that focus both on the aimed-for benefits, taking a wide range of interests into account and to ensure overall efficiency losses are minimised. Within this framework there are several dimensions to a competitive labour climate. These relate to the basic rights of workers, or core labour standards, labour market regulations that govern employment conditions and regulations that relate to the ability of workers from investor source countries to relocate to the host country. In each of these areas the considerations that need to be taken into account and how they bear on the investment climate differ and are therefore treated separately.

Enforce core labour standards

What mechanisms and steps are being put in place to ensure enforcement of core labour standards?

27. Core labour standards relate to fundamental principles and basic human rights in the workforce. As such, they are distinct from labour standards regarding work conditions and employment protection laws (discussed below). The international community, largely through the ILO, has made significant progress in developing a consensus with respect to the concept and recognition of a set of core labour standards.

28. According to the ILO *Declaration on Fundamental Principles and Rights at Work* these core standards relate to eliminating all forms of forced or compulsory labour; abolishing child labour; non-discrimination in respect of employment and occupation; and ensuring the freedom of association and the right to collective bargaining. Specific definitions of these principles are spelled out in a series of ILO Conventions, which a growing number of countries have ratified, establishing core labour standards, regardless of a country's stage of development. As of the beginning of August 2005, two thirds of ILO member states had ratified all 8 of the ILO conventions, compared with one third five years ago and less than one fifth in 1996 (ILOLEX, 2005 and OECD, 2000).

29. The rapid and widespread ratification of the ILO core labour standard conventions can be explained by the fact that they serve countries' economic self interest. They are a key element in the healthy functioning of market economies, create a level playing field for all investors, foreign and domestic and improve economic performance. According to a study by Palley (1999) covering 17 mostly developing countries, reforms that introduce greater freedom of association, raise GDP growth by 1.9 percentage points in the following five year period. And in a series of influential works, Rodrik (1997 and 1999) showed that democratic institutions have a positive effect on wages, reduce economic volatility and foster greater resilience to economic shocks. These results reflect the stronger incentives core labour standards give workers to improve skills and to the younger generation to accumulate human capital. Efficiency gains are also achieved through less discrimination in the workplace and possibly via a more favourable social climate and political stability.

30. Even though countries benefit from the adoption of core labour standards, compliance is uneven across signatory states, particularly in relation to child labour and in different forms of discrimination.[10] In some cases, violations are deliberate. For instance, a number of governments waive certain components of the core labour standards within special export processing zones because the authorities fear multinational enterprises' investment may be deterred by their presence (see OECD, 2000 and ICFTU, 2005 for specific examples).[11] However, there is no empirical support for this concern. Indeed, many researchers find that multinational enterprises are more likely to invest in countries with stricter safeguards and enforcement of basic human and worker rights than in those countries where such rights are absent or poorly enforced (see Box 4).

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10 As Busse (2002) showed, there is little correspondence between *de jure* ratification of the ILO Conventions and *de facto* compliance. The U.S and Myanmar, for example, have both signed only two of the ILO Conventions, yet no one would claim that these countries have the same respect for core labour standards.

11 In general, wages are higher and working conditions better in export processing zones than in the rest of the economy, with most exceptions occurring in low-skilled labour intensive assembly operations. Brown (2000) reviews labour standards in export processing zones.

Box 4. Do core labour standards discourage foreign direct investment?

It is often claimed that low labour standard countries are a location criteria for foreign investors, because they ensure a competitive advantage due to lower labour costs. This has sparked fears that there might be a ‘race to the bottom’ on fundamental worker rights. But the empirical support for this conventional wisdom is lacking. All of the available studies find no statistically robust connection between weaker measures of workers rights and greater inflows of foreign direct investment. Most of the variation in labour costs across countries disappears once adjusted for differences in productivity (Rodrik, 1999).

In fact, more often, available research has identified that core labour standards actually help to attract FDI. One of the first studies to examine the relationship between compliance with core labour standards and FDI was undertaken by the OECD in 1996. It focussed on the rights of freedom of association and to collective bargaining in 76 OECD and non-OECD countries and found a small positive link between compliance with these rights and FDI inflows (OECD, 1996).

Since the OECD report, a range of other studies have tackled this issue, using various proxies for compliance with ILO labour standard Conventions (e.g. Rodrik, 1996, Kucera, 2001, Busse, 2002 and Daude, Mazza and Morrison, 2003). All of these studies find no evidence to support the conventional wisdom that multinational enterprises favour countries with lower respect for basic human and worker rights. And in line with OECD work, several of the researchers found that higher child labour standards and greater respect for freedom of association are positively associated with investment.

Sources: Busse (2002), Busse and Braun (2002), Daude, Mazza and Morrison (2003), Kucera (2001), and OECD (1996 and 2000).

31. The main policy lesson to draw from the above is the need to reinforce efforts to increase enforcement and compliance with the core labour standards. There is no simple well-targeted instrument to do this. A broad strategy is required. The key features need to embrace programmes that raise awareness of the problems associated with low compliance, including the damage it does to the investment climate and the provision of financial and technical assistance by donor countries to develop the administrative capacity needed to enforce core labour standards. Where they exist, the removal of fees for basic education and supply responsive funding arrangements indirectly reduce the incidence of child labour, as do broader initiatives to combat poverty.[12] Finally, the promotion of standards, such as the *OECD Guidelines for Multinational Enterprises* helps to foster responsible business practices.

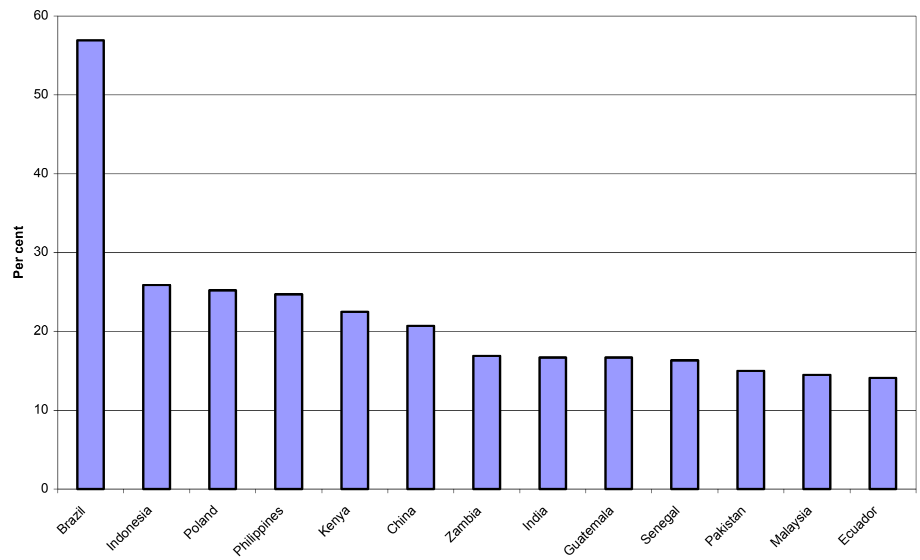
Keeping the labour market competitive

To what extent do labour market regulations support job creation and the government’s investment attraction strategy? What policy reforms have been introduced that balance social objectives, the goal of a competitive workforce and the incentives for business to invest and expand?

32. As already observed, interventions in the labour market aim to improve market efficiency and achieve social objectives. From an investment climate perspective the issue is how well such interventions achieve their goals without compromising other determinants of economic performance. Badly designed labour market regulations can reduce the opportunities and incentives for businesses to make new investments and expand. This situation appears to be the case in many developing countries where labour regulations are reported to be a significant obstacle to business operations (Figure 2).

[12] Brazil offers an example of this strategy. In 1998 it introduced new funding arrangements for schools, tightened targeted income support programmes and made some entitlements conditional on child school enrolment, resulting in a very sharp increase in primary-age school enrolments (Mello and Hoppe, 2005).

Figure 2. Labour regulations are rated as a major constraint in many developing countries



Note: Percentage of firms reporting that labour regulations were a major or severe obstacle to the operation and growth of their business.

Source: World Bank Investment Climate Surveys

33. The exact nature of the labour market regulations that are said to harm the business climate vary from country to country. But based on a World Bank Study (2005) and experience in OECD countries (OECD, 1994 and 1999) there are two areas of intervention where governments face a trade-off between promoting social goals and a conducive investment environment. The first relates to wage formation institutions that result in labour costs which are too high to spur job creation and in underutilised labour resources, preventing economies from making full benefit from its investments in HRD The second source relates to interventions that escalate other non-wage labour costs (e.g. paid leave) which employers are unable to pass on to employees through lower monetary remuneration, making some businesses economically unviable. According to World Bank research, regulations that affect business labour costs, such as worker hours and paid leave, are more stringent in developing countries than in many developed countries (Pierre and Scarpetta, 2004). Again, however, compliance and enforcement of statutory norms is weak.

34. There are a number of steps that the authorities can take to design labour interventions without unduly compromising a government's investment attraction strategy. For instance, the wage formation process and its responsiveness to labour market conditions could be reinforced by shifting salary bargaining to the firm and through streamlining negotiations. Other than setting minimum and economically responsible standards and facilitating an environment in which labour and management can bargain on an equal footing, governments should refrain from leading negotiations on work conditions with employers, leaving it to the individual worker or their elected representatives. At the same time, it is necessary to have institutional arrangements for conciliation, mediation or arbitration on issues and cases where no agreement can be reached.

The role of foreign workers

Do laws and regulations restrict the deployment of skilled workers from enterprises investing in the host country? What steps have been taken to identify and to unwind unduly restrictive practices covering the deployment of workers from the investing enterprise and to reduce delays in granting work visas to these employees?

35. Foreign investment often requires the deployment of experienced staff from more established parts of the organisation to ensure the smooth introduction of new facilities and the local implementation of corporate practices. Often, in time, these roles are passed on to locally-engaged employees. Some countries, however, put tight limits on the number of foreign employees granted work visas or impose local recruitment quotas linked to the number of expatriate staff. And frequently bureaucratic processes cause long delays in issuing work permits. These practices raise the cost of doing business and can discourage investment. As well as harming the investment climate, the country loses the opportunity of hosting skilled workers – a 'brain gain' – and the local diffusion of knowledge and international business practices that it brings.

36. The main conclusion to draw from the above is that governments should reconsider restrictions that prevent the deployment of skilled foreign workers associated with new investments by multinational enterprises and governments need to evaluate the costs and benefits of performance requirements that oblige foreign companies to hire a minimum number of local workers. In addition, procedures for applying and granting work and residence visas for foreign staff should be made transparent and delays shortened through less bureaucratic operations and the streamlining of qualification recognition procedures.[13]

4. Reaping the maximum benefit from investment: the role of human resource development in facilitating adjustment

37. Every economy is prone to upheaval, often linked to new technologies that lead to different work practices, opening fresh business opportunities and making others no longer viable. This puts businesses under constant pressure to innovate and adapt their operations. Those firms that are able to adapt quickly as the business environment changes are better placed to face new competition and to expand, by seizing the investment opportunities as they open. The ability to respond quickly is thus a key factor in the overall business climate, with the adaptability of labour markets playing a crucial role. This part of the paper, therefore, deals with how human resource policies can underpin a dynamic business sector while cushioning the transition costs of adjustment and then examines labour market policies that maintain an adaptable workforce.[14]

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13 This matter is also dealt with in the Investment Promotion and Facilitation chapter of the PFI.

14 Although treated separately here for the purposes of exposition, these two topics are intimately related and the policy implications are closely connected.

(i) Policies to cushion transition costs

Doe the government support programmes designed to assist large scale labour adjustment and indirectly the investment climate by better positioning firms to seize new investment opportunities? Do the incentive mechanisms in these schemes encourage broad support for change? What role is business encouraged to play in easing the transition costs associated with labour adjustment?

38. In many economies as much as 10 to 20 per cent of the workforce turns over each year, as new firms are created and grow and as others contract or cease to operate (World Bank, 2005). This is one of the channels through which technologies and know how are diffused, boosting productivity. Indeed, it is this process of 'creative destruction' that leads to higher output overall. But there are both winners and losers. The transition period can be a costly and traumatic experience for those employees affected, especially in the developing countries which have inadequate or non-existent social insurance mechanisms. This can cause resistance to change and, because of factors such as rent-seeking by interest groups, influence political processes to stall reforms that would otherwise benefit society as a whole.

39. Good policy can limit these dislocation costs and at the same time speed up the pace of adjustment. There are several elements to good policy practice. These include retraining and redeployment support, though these need to be well-targeted yet responsive to individual needs, put in place quickly and tailored to local circumstances, otherwise they risk failing to attract much demand. In countries where comprehensive social security is not available, employer pre-funded one-off severance payments can cushion the impact of restructuring and build support for change and thus quicken adjustment. In cases where adjustment is concentrated in a region and where a single enterprise dominates the local economy a wider range of support measures may be needed, including regional development programmes. Finally, full and early consultation and providing comprehensive information engages employees in the process of adjustment and helps to limit opposition to change. It forms a part of the recommendations made by the 39 countries that have adhered to the *OECD Guidelines on Multinational Enterprises* (See Box 5).

Box 5. The OECD Guidelines for Multinational Enterprises on employment and industrial relations

The OECD Guidelines for Multinational Enterprises constitute a set of voluntary recommendations by governments in all the major areas of business ethics. They are a multilaterally endorsed and comprehensive code of conduct that enjoys the backing of governments whose territories are home to almost 90 per cent of foreign direct investment flows and to 97 out of the top-100 multinational enterprises.

One of the Guideline chapters covers employment and industrial relations. In this respect, the principles and standards mostly relate to core labour standards, discussed above. However, they also cover certain aspects of working conditions, such as occupational health and safety. Concerning industrial relations, the Guidelines recommend that firms consult and inform employees. Specifically, it states: In considering changes in their operations which would have major effects upon the livelihood of their employees, in particular in the case of the closure of an entity involving collective lay-offs or dismissals, provide reasonable notice of such changes to representatives of their employees, and, where appropriate, to the relevant governmental authorities, and co-operate with the employee representatives and appropriate governmental authorities so as to mitigate to the maximum extent practicable adverse effects.

Promoting observance of the OECD Guidelines contributes to furthering human resource development in host countries.

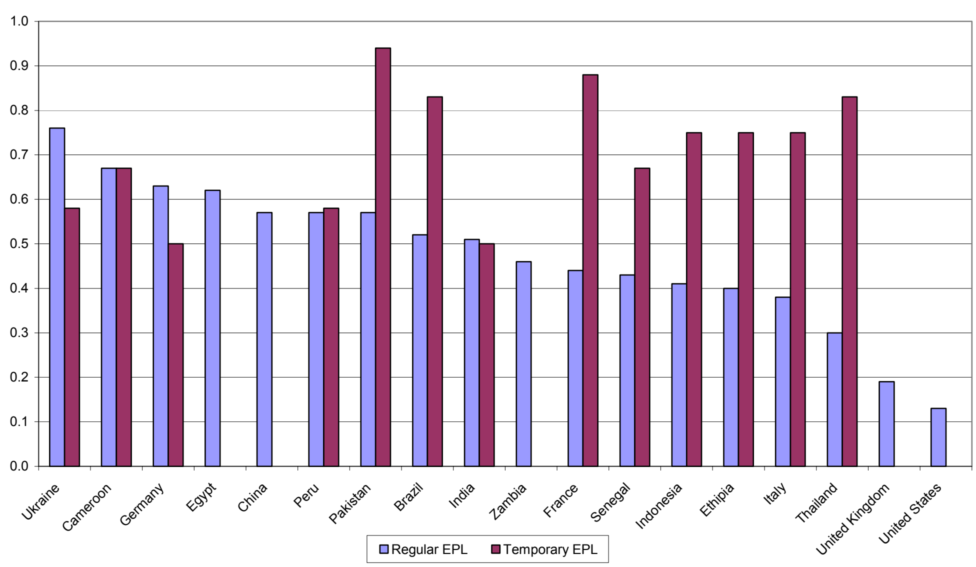
Source: OECD (2004,d).

(ii) Maintaining an adaptable workforce

What steps are being taken to ensure that labour market regulations do not stymie an adaptable workforce and excessively damage the ability of enterprises to modify their operations and investment planning?

40. Investments in HRD helps to maintain an adaptable and skilled workforce. However, this source of dynamism may fail to benefit the business climate if other interventions in the labour market create a context that blunts the process of workforce reorganisation. One notable example concerns the regulation of the hiring and firing of workers, also referred to as employment protection legislation (EPL). Strict EPL raises the cost of doing business, and especially exiting a business. Not all firms are affected to the same extent however. The most concerned are medium-sized enterprises, which are often the enterprises with the greatest potential for expansion and job creation. Strict EPL may, therefore, discourage business from innovating and adopting new productivity enhancing technologies and deters investment. On the positive side, it tends to lead to long-lasting work relationships, which encourage businesses to provide training, raising labour productivity. However, a recent OECD study found, in line with World Bank studies, that the overall impact of EPL on FDI is negative (OECD, 2003b). While this study relates only to OECD countries, it is notable that some developing countries have tighter labour laws than in developed economies (Figure 3).

Figure 3. Some developing countries have tighter labour laws than developed countries



Note: The index of employment protection legislation ranges between 0 and 1. Higher numbers mean more stringent employment protection laws.

Source: Pierre and Scarpetta (2004) and World Bank Doing Business Project

41. Governments can intervene in other ways to protect workers from income loss, but with less deleterious effects on the business climate. One approach, for example, is to shift the focus of interventions away from protecting the job and toward income insurance. In a developing country context, this is obviously a major challenge. But there are opportunities for improving the income support schemes and the pooling of risks across individuals. These include, for example, the introduction of pre-funded, financially feasible severance pay savings accounts. And the risks associated with job turnover that are born by individuals could be pooled through the introduction of unemployment

insurance benefits. More generally, labour market regulations need to be crafted to reflect the interests of the whole working age population, not just those in employment in the formal sector and to consult with a wide range of stakeholders, including the investment community.

Wrapping up

42. HRD policy is an integral part of the wider policy framework aimed at creating a climate conducive to attracting and encouraging investment by businesses and to ensure the maximum contribution of investment to sustainable economic development. The paper has stressed the importance of establishing a coherent institutional framework for HRD policies and identified three principles that should guide the design of such a framework. These are a comprehensive focus on the role of educational attainment, workforce skills, population health and employment policies, an understanding of the linkages between these four areas of human resource development policy and their relationship with the investment climate, and thirdly adaptability to new challenges.

43. When moving from general principles to practical HRD policy guidelines to foster a favourable investment climate, one must recognise that country circumstances will differ, and possibly in ways that shape policy prescriptions. Against this background, the approach of the PFI is to identify the key issues and questions that policy makers need to consider in framing specific HRD policies which directly or indirectly influence investment decisions and to offer guidelines on good policy practices. On this basis, the main issues and questions identified concerning HRD that policy makers should consider in the context of efforts to improve the investment climate are the following:

1. Has the government established a coherent and comprehensive HRD policy framework consistent with its broader development and investment strategy? Is the HRD policy framework responsive to new economic developments and does it engage the main stakeholders? Are periodic assessments made of the impact of HRD policies on the investment climate?

2. What steps has the government taken to increase participation in basic schooling and to improve the quality of instruction so as to leverage human resource assets to attract and to seize business investment opportunities?

3. Is the economic incentive to invest in human capital sufficient to encourage individuals to continue higher education? Are there policy-induced obstacles that act to lower the financial returns to higher formal education, limiting the improvements to the investment climate that flow from better human resources? What mechanisms exist to promote closer co-operation between higher education institutions and business and to anticipate future labour force skill requirements?

4. Does the government support training programmes and has it adopted practices that evaluate their effectiveness and their impact on the investment climate? What mechanisms are used to encourage businesses to offer training to employees and to play a larger role in co-financing training?

5. Does the government have a coherent strategy to tackle the spread of pandemic diseases and procedures to evaluate the costs and benefits of public health expenditures aimed at improving public health outcomes and through interlinkages indirectly the investment climate?

6. What mechanisms and steps are being put in place to ensure enforcement of core labour standards?

7. To what extent do labour market regulations support job creation and the government's investment attraction strategy? What policy reforms have been introduced that balance social objectives, the goal of a competitive workforce and the incentives for business to invest and expand?

8. Do laws and regulations restrict the deployment of workers from an enterprise investing in the host country? What steps have been taken to identify and to unwind unduly restrictive practices covering the deployment of skilled workers from the investing enterprise and to reduce delays in granting work visas to these employees?

9. Does the government support programmes designed to assist large scale labour adjustment and indirectly the investment climate by better positioning firms to seize new investment opportunities? Do the incentive mechanisms in these schemes encourage broad support for change? What role is business encouraged to play in easing the transition costs associated with labour adjustment?

10. What steps are being taken to ensure that labour market regulations do not stymie an adaptable workforce and excessively damage the ability of enterprises to modify their operations and investment planning?

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