



## FIRST ITEM ON THE AGENDA

**Trade liberalization and employment:  
An update of the paper presented at the  
282nd (November 2001) Session of the  
Governing Body**

1. This note summarizes new studies on trade liberalization and employment that have appeared since the completion of the paper on that topic,<sup>1</sup> presented to the November 2001 meeting of the Working Party on the Social Dimension of Globalization. It will be recalled that the discussion of that paper had been postponed to March 2002. The role of the present note is to ensure that the Working Party has all the latest information available before it discusses the topic.
2. A dozen new relevant studies have appeared since the completion of the original paper in September 2001. Their contents do not warrant any significant change in either the main arguments or policy conclusions of the original paper. On the contrary, several of them provide further confirmation of particular points in that paper.
3. A recent World Bank study on globalization<sup>2</sup> takes a less sanguine view of the employment effects of trade liberalization than some of its earlier studies. A previous major World Bank study in 1990 had claimed that trade liberalization did not raise unemployment even in individual sectors and led to an improvement in income distribution. In contrast, the new study, while reiterating the benefits of trade liberalization for both employment and wages over the long run, recognizes that there are significant transitional problems that need to be faced. It notes that the skill premium, and hence wage inequality, has risen in several countries in the aftermath of trade liberalization. It also notes that “a series of case studies on the effects of trade liberalization shows a considerable dispersion of the net impact on employment” (page 109). More significantly, it highlights the problem that “small declines in employment may hide substantial job churning” and that “some of the important losers from globalization will be formal sector workers in protected industries”. In view of this, the policy conclusions of the study include the recognition that “government social protection and labour market policies are

<sup>1</sup> GB.282/WP/SDG/2.

<sup>2</sup> World Bank: *Globalization, growth and poverty: Building an inclusive world*, by David Dollar and Paul Collier (Oxford University Press, New York, Dec. 2001).

very important – both for the immediate welfare of affected workers and for the longer term welfare of all workers”. The social protection and labour policies endorsed by the report include the development of unemployment insurance schemes in developing countries and minimum wages. The report fails, however, to recognize the important role that core labour standards can play in ensuring the better economic governance that it considers to be essential for enabling developing countries to benefit from globalization. Its discussion of the elements necessary for good economic governance does not mention labour standards. At the same time, its discussion of labour standards (pages 117-119), begins with a preamble on the adoption of the Declaration on Fundamental Principles and Rights at Work by the ILO but then immediately switches to a discussion of the link between poverty and child labour and the inadvisability of adopting a sanctions-based approach to enforcing labour standards.

4. Four country studies touching on the labour market effects of trade liberalization have been published since last September. Two of these were on the impact of trade liberalization on wage inequality in Mexico, while another dealt with the same issue in the case of Brazil. This is indeed a very topical issue since, as will be discussed below, a special issue of the *Journal of International Economics* also dealt with this subject. In the case of Mexico, both studies<sup>3</sup> document the rise in wage inequality after trade liberalization, but offer differing explanations for this phenomenon. The paper by Feliciano shows that wage inequality increased in the years following trade liberalization. “Changes in the wage structure in Mexico during this period are consistent with a story of decreasing relative demand for low-skilled workers ... Wage dispersion also increased between workers with a college education and those with less than a high school diploma.”<sup>4</sup> It further shows that “the relative demand for low-skilled workers decreased more severely in industries directly affected by the trade reform”.<sup>5</sup> It then notes that, while not conclusive, this suggests that trade liberalization was one of the factors causing the rise in wage inequality. The specific mechanism through which this occurred was that “trade liberalization affected wages by substantially decreasing workers’ bargaining power. Workers understood that industry rents were declining and were willing to accept lower wages”.<sup>6</sup> The paper by Cortez covers a longer period than the years immediately after trade liberalization and does not specifically test for a causal relationship between trade liberalization and the observed rise in wage inequality. Yet its main conclusion that a major factor explaining the rise in wage inequality was the decline in unionization rates is not inconsistent with the findings of the first paper. This is because the decline in wage premiums caused by trade liberalization is also likely to have been a major cause of the decline in unionization rates.<sup>7</sup>

<sup>3</sup> Zadia M. Feliciano: “Workers and trade liberalization: The impact of trade reforms in Mexico on wages and employment”, in *Industrial and Labor Relations Review*, Oct. 2001; and W.W. Cortez: “What is behind increasing wage inequality in Mexico”, in *World Development*, Nov. 2001.

<sup>4</sup> Feliciano, op. cit., p. 6.

<sup>5</sup> *ibid.*, p. 7.

<sup>6</sup> *ibid.*, p. 11.

<sup>7</sup> An earlier paper by Raymond Robertson: “Trade liberalization and wage inequality: Lessons from the Mexican experience”, in *World Development*, 2000, had shown that prior to liberalization Mexico had protected less-skill-intensive industries and trade liberalization caused the loss of the wage premium enjoyed by unskilled workers.

5. A paper on Brazil also finds that the demand for skilled labour increased after trade liberalization.<sup>8</sup> “From 1992 onwards there was a significant and substantial rise in the returns to college education. This coincided with a time when trade reforms were beginning to bite, a connection that is unlikely to have been accidental.”<sup>9</sup> The paper establishes that this rise in the returns to college education was not due to changes on the supply side but to an increase in the relative demand for skilled labour, a fact that it explains “as resulting from an influx of skill-biased technology following trade liberalization”.<sup>10</sup>
6. As mentioned earlier, interest in the issue of the impact of trade liberalization on wage inequality has been very pronounced. A special issue of the *Journal of International Economics*<sup>11</sup> explored several other channels, apart from the standard Hechker-Ohlin and Stopler-Samuelson one, through which trade could affect wage inequality. The first of these is that “trade liberalization can affect the relative bargaining power of labour versus capital. For example, if trade liberalization increases the elasticity of demand for labour, this would reduce the bargaining position of workers and therefore wages”.<sup>12</sup> An article in the same journal conducts an empirical test of this proposition. It starts with the hypothesis that “trade can make labour demand more elastic in two main ways: by making output markets more competitive and by making domestic labor more substitutable with foreign factors”.<sup>13</sup> It finds that between 1961 and 1991 the elasticity of the demand for unskilled labour did indeed increase in the United States but did not do so for skilled labour. But it could not establish conclusively that trade liberalization was the cause of the increase in the elasticity of demand for unskilled labour. Of related interest is the argument advanced in another article on the impact of increased mobility of capital. It argues that this will have even stronger effects than trade liberalization in weakening the bargaining position of labour. It notes that “a subsidy for workers financed by a tax on capital income is the obvious remedy for redistributing the gains from international capital mobility”,<sup>14</sup> but this requires tax coordination at the international level since tax competition becomes a greater problem with higher capital mobility.
7. A second channel through which trade is thought to affect wage inequality is the increased role of outsourcing and the relocation of labour-intensive (and low-skilled) parts of production processes from advanced to developing countries. This shedding of relatively labour-intensive production in the advanced economies is likely to shift demand to skilled workers and increase their relative wage. There is evidence that outsourcing has increased but its impact on wage inequality in the advanced countries remains to be clearly

<sup>8</sup> Francis Green, Andy Dickerson and Jorge Saba Arbache: “A picture of wage inequality and the allocation of labor through a period of trade liberalization: The case of Brazil”, in *World Development*, Nov. 2001.

<sup>9</sup> *ibid.*, p. 1936.

<sup>10</sup> *ibid.*, p. 1936.

<sup>11</sup> *Journal of International Economics*, Vol. 54, 2001.

<sup>12</sup> Robert C. Feenstra: Introduction, *Journal of International Economics*, op. cit., p. 1.

<sup>13</sup> Matthew J. Slaughter: “International trade and labour-demand elasticities”, in *Journal of International Economics*, op. cit., p. 28.

<sup>14</sup> Dani Rodrik and Tanguy van Ypersele: “Capital mobility, distributive conflict and international tax coordination”, in *Journal of International Economics*, op. cit., p. 58.

established.<sup>15</sup> For developing countries, it has also been argued that participation in the production chains created through outsourcing has been a factor contributing to a rise in wage inequality. The basic reasoning here is that, given the large gap in skill levels between advanced and developing countries, the low-skill jobs transferred from the former constitute relatively skilled jobs (e.g. requiring a high school education) in a developing country. There is some empirical verification of this having operated in the case of Mexico.<sup>16</sup>

8. A third channel through which trade liberalization can affect wage inequality is through strengthening incentives to produce for export markets. It has been argued that, in order to compete successfully in export markets, firms have to invest in more sophisticated and relatively more skill-intensive machinery, hence pushing up the demand for skills.<sup>17</sup> However, there has been very little empirical testing of this hypothesis so far.
9. All this new work on the links between trade liberalization and wage inequality has been inspired by the need to explain the why, contrary to the predictions of the Hechker-Ohlin and Stolper-Samuelson framework, wage inequality has increased after trade liberalization in several countries. But it should be noted that this has been a phenomenon that has been largely confined to several Latin American countries, in sharp contrast to the experience in Asia. It remains an open question as to what has accounted for this difference.
10. The remaining country study on trade liberalization that has been published since the completion of the November paper was on South Africa.<sup>18</sup> It sets out to test the hypothesis that trade liberalization has improved efficiency in the South African economy. It concludes that the empirical evidence presented in the paper indicates “that trade liberalization has contributed significantly to augmenting South Africa’s long-run growth potential via its impact on TFP (total factor productivity) growth”.<sup>19</sup> In arriving at this conclusion it examined and rejected the possibility that the rise in productivity was due to the continuous decline in employment in South Africa in the 1990s. If the industries that experienced larger tariff cuts also showed a greater decline in employment, then the rise in productivity would simply reflect the fact that less productive workers were being fired as tariffs were reduced. However, the paper finds no evidence for this. “If anything,

<sup>15</sup> David Hummels, Jun Ishii and Kei-Mu Yi: “The nature and growth of vertical specialization in world trade”, in *Journal of International Economics*, op. cit. See also Robert C. Feenstra and Gordon H. Hanson: “Global production sharing and rising wage inequality. A survey of trade and wages” (NBER Working Paper No. 8372, July 2001), which argues that taking outsourcing into account would significantly increase the role that is attributable to trade in the explanation of rising wage inequality in the advanced countries.

<sup>16</sup> See R.C. Feenstra and G.H. Hanson: “Foreign direct investment and relative wages: Evidence from Mexico’s maquiladoras”, in *Journal of International Economics* (1997) Vol. 42, pp. 371-393. This study presents evidence that the sharp increase in foreign investment in Mexico’s northern border region contributed significantly to the rising demand for skill and hence the rise in wage inequality.

<sup>17</sup> Feenstra, op. cit.

<sup>18</sup> Gunnar Jonnson and Arvind Subramanian: “Dynamic gains from trade: Evidence for South Africa”, IMF Staff Papers, Vol. 48, No. 1, Dec. 2001.

<sup>19</sup> *ibid.*, p. 219.

employment has fallen less in the sectors where tariffs have been reduced more aggressively.”<sup>20</sup>

11. It is of interest to note that the above study begins with the observation that “the pendulum of academic research on the positive relationship between trade and economic growth appears to be swinging from near universal to more qualified acceptance”, and that the dissatisfaction with the cross-country approach “argues for a research strategy that focuses on exploring more contingent or situation-specific relationships”. This is consistent with the stance taken in the ILO paper to the Working Party last November. It is also worth noting that two other papers published since the completion of that paper provide further support for this stance. A new paper by Greenaway et al. provides further elaboration of the point that trade liberalization has produced differing results depending on country circumstances.<sup>21</sup> Finally, a recent review article on international trade theory provides a useful elaboration of the points made in paragraph 18 of the ILO paper of last November on the reservations to the standard theoretical framework on international trade that need to be taken into account in policy formulation.<sup>22</sup>

Geneva, 28 January 2002.

*Submitted for information.*

<sup>20</sup> *ibid.* p. 213.

<sup>21</sup> D. Greenaway, W. Morgan and P. Wright: “Trade liberalization in developing countries”, in *Journal of Development Economics*, Vol. 67, No. 1, Feb. 2002.

<sup>22</sup> Sonali Deraniyagala and Ben Fine: “New trade theory versus old trade policy: A continuing enigma”, in *Cambridge Journal of Economics*, Vol. 25, No. 6, Nov. 2001.