Trade Liberalization and Employment

by
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Introduction

Trade liberalization, loosely defined as a move towards freer trade through the reduction of tariff and other barriers, is generally perceived as the major driving force behind globalization. Rapidly increasing flows of goods and services across national borders have been the most visible aspect of the increasing integration of the global economy in recent decades. However, this has also been one of the most contentious aspects of globalization. Critics of trade liberalization have blamed it for a host of ills such as rising unemployment and wage inequality in the advanced countries, increased exploitation of workers in developing countries and a "race to the bottom" with respect to employment conditions and labour standards, the de-industrialization and marginalization of low-income countries, increasing poverty and global inequality, and degradation of the environment. These views have spread in spite of the fact that the benefits of freer trade, in terms of improved allocation of resources and consequent gains in productive efficiency and economic growth, is a basic tenet of mainstream economic analysis.

In this context the impact of trade liberalization on employment is of particular significance. The level of employment is a key determinant of overall economic welfare, especially in developing countries where systems of social protection are weak. In particular, the impact of trade liberalization on the level and structure of employment determines, to a large extent, its impact on poverty, wage and income distribution, and the quality of employment. These latter variables are clearly among the central points of contention

standing infant industry argument for the granting of initial protection to potentially competitive industries to enable them to overcome barriers to start up and hence to learn by doing.

More recent developments in growth and trade theory have also provided additional arguments for protection. Endogenous growth theories suggest that "trade restrictions may also be associated with higher rate of growth of output whenever the restrictions promote technologically more dynamic sectors over others".[3] Apart from reaping the benefits of economies of scale there may be also positive externalities generated by an increase in the stock of knowledge through these means. This is similar to the older arguments for import substitution based on the view that increasing returns and cross-firm externalities are ubiquitous in manufacturing and that protection to promote industrialization is justified on these grounds. This is often accompanied by the argument that prior industrialization is a necessary condition for later export success. From this perspective, trade liberalization is often deplored on the grounds that it sometimes leads to de-industrialization. "New trade theory" also makes the case that strategic trade policies can raise welfare under some circumstances. By supporting its firms to gain entry into sectors of production where world demand can support only a few oligopolistic firms (e.g., aircraft production) a country can capture significant benefits for the national economy.

It has also been pointed out that standard trade theory also assumes that resources (including labour) are always fully employed and that trade will always be balanced.[4] These assumptions rarely apply in the real world (vide the high levels of unemployment prevailing in many countries). In these circumstances, in contrast to the comfortable predictions of smooth and costless adjustment in standard theory, trade liberalization can impose heavy adjustment costs in the form of a contraction in output, high unemployment and wide trade deficits. Another stand of the literature also argues that adjustment costs may be high where there is monopolistic or imperfect competition, factor immobility and wage and price rigidity.

Trade Liberalization and its Measurement

Before proceeding to examine the empirical evidence, it is necessary to review a few issues relating to the concept of trade liberalization and its measurement. Conceptually, trade liberalization is often defined in terms of the bias in the incentive structure between exports and imports.[5] The free trade position is one where incentives are neutral between exports and imports. Trade liberalization could thus be achieved either by the reduction of tariffs or of any anti-export bias through other means (e.g., introducing or raising export subsid

the intended effects of the announced policy changes. A second measure is based on a direct estimate of the change in the bias in trade regime as reflected in changes in relative prices. This, however, often runs into problems of weighting and aggregating price changes. A third measure is to use multiple criteria such as tariff changes and changes in relative prices but this too faces the same problems of weighting and aggregation.

It is also important to briefly note a few methodological problems that are commonly encountered in studies of trade liberalization. A particularly challenging problem is that of separating out the effects of trade liberalization from those of other policy shifts, macroeconomic crises, and other externally-generated shocks that may occur at the same time. Another is that of the counterfactual (or the alternative scenario that it is assumed would have prevailed in the absence of trade liberalization) that is used to establish the effects of trade liberalization. This counterfactual is often assumed to be a situation where pre-existing policies would have prevailed. This may not be appropriate since trade liberalization often occurs after an economic crisis and, in these circumstances, pre-existing polices are no longer viable.

Empirical Evidence on Trade Liberalization and Employment

There has been considerable liberalization of trade in the post Second World War era. This has been particularly pronounced since the 1980s. Over 100 countries across the world have adopted some measure of trade liberalization such as the reduction of tariffs, quantitative restrictions, and other non-tariff barriers to trade. As a result, average levels of tariffs and other barriers to trade have fallen significantly in a majority of countries in the world. These trade liberalization measures have often been accompanied by the liberalization of policies towards foreign direct investment as well as wider liberalization measures such as the removal of controls over domestic investment, deregulation of domestic product and labour markets, privatization and both internal and external financial liberalization.

This latter characteristic of trade liberalization in this period is significant because the methodological problem raised above is highly relevant in practice. It is often difficult to disentangle the effects of trade policies per se from those of other measures of liberalization that occurred contemporaneously. It is also important to note that there were important differences among countries in the initial degree of protection from which liberalization occurred, in the macroeconomic circumstances that surrounded the initiation and the implementation of trade liberalization programmes, in the extent of liberalization that was undertaken, in the pace and sequencing of trade liberalization measures, and in the relationship between trade and other liberalization measures. This makes it inherently difficult to arrive at general conclusions about the effects of trade liberalization.

It is, thus, difficult to draw any firm conclusions on the impact of trade liberalization simply on the basis of associations between changes in trade on the one hand and growth and employment performance on the other. The first problem is one of establishing causality between trade liberalization and growth and employment performance. An increaset9.51xternal financia

growth and the two are strongly correlated. Yet, as we shall see below, this has not deterred various proponents of trade liberalization from using such an approach to establishing their case.

(i) *Multi-country studies*

A prominent case in point are two studies, Dollar[6] and Sachs and Warner,[7] that have been highly influential in forming the widely accepted view that countries with lower policy-induced barriers to trade experience faster growth, once other relevant country characteristics are controlled for. Both these studies are based on a cross-section analysis for a large number of countries on the relationship between an index of "openness" of the economy and growth performance. The Dollar study claimed to show that for a sample of 95 countries over the period between 1976 and 1985, growth was negatively correlated with each of the two indices of openness used. The first index was a measure of real exchange rate distortion while the other was an index of real exchange rate variability. The rationale for the use of these indices was that the more open an economy the lower would be the extent of exchange rate distortion and the less the variability in the exchange rate. The Sachs and Warner study arrives at a similar conclusion on the relationship between the degree of openness and growth. The study is a cross-section analysis of a large sample, of 70 countries. Countries were classified as either "open" or "closed" based on five criteria – the level of average tariffs, the coverage of non-tariff barriers, whether or not it had a socialist economic system, whether or not it had a state monopoly of major exports, and the level of the black market premium.

The findings of both these studies have been seriously questioned by a convincing critique[8] which centres on the fact that the indicators of "openness" used are seriously flawed. They are not reliable measures of trade barriers and are also highly correlated with other sources of poor economic performance. As such the proposition that trade liberalization by itself leads to higher growth remains unproven.

Another recent attempt to revive the issue is the recent paper by Dollar and Kraay (2001)[9]. The paper identifies a group of countries, the "post-1980 globalizers" that have seen large increases in trade and significant declines in tariffs over the past 20 years and claims that "their growth rates have accelerated from the 1970s to the 1980s to the 1990s, even as growth in the rich countries and the rest of the developing world has declined". The paper also claims that "since there is little systematic evidence of a relationship between changes in trade volumes (or any other globalization measure we consider) and changes in the income share of the poorest, the increase in growth rates that accompanies expanded trade leads to 0.of in 01 Tciet

a policy measure (tariff averages) with an outcome (import/GDP) measure in selecting countries. This is conceptually inappropriate, as policy makers do not directly control the level of trade … the tools at the disposal of governments are tariff and non-tariff barriers, not import or export levels." This is significant because the countries in the sample which implemented the deepest trade liberalization, as opposed to those who experienced the greatest trade expansion, did not perform well in terms of the rate of economic growth achieved. Similarly, it was inappropriate to attribute the higher growth in India and China to trade liberalization. In these countries "the main trade reforms took place about a decade after the onset of higher growth. Moreover, these countries' trade restrictions remain among the highest in the world."

A recent review of the empirical evidence on the effects of trade liberalization[11] also comes to a more nuanced conclusion than the earlier Dollar or Sachs and Warner studies. This review concludes that trade liberalization has resulted in both an increase and a decline in the growth rate depending on country circumstances. Many countries were observed to have experienced an investment slump after trade liberalization, suggesting th

A recent World Bank study on globalization [16] takes a less sanguine view of the employment effects of trade liberalization than some of its earlier studies. 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,

This view is supported by the divergent results that are revealed by recent country studies that examine the relationship between trade liberalization and employment. A study on Mexico[18] found that in the period between 1984 and 1990 a 10 per cent reduction in tariff levels was associated with a 2 to 3 per cent reduction in employment. The wage differential between skilled and unskilled workers also widened. The study also argues that the absence of large aggregate employment effects was due to wage flexibility; wages declined significantly throughout the adjustment period. A study of Brazil[19] found that the trade liberalization at the beginning of the 1990s had a slight negative short-term impact on employment. It found that between 1990 and 1997 there was a 32.4 per cent drop in employment in capital-intensive industries and a 13.3 per cent decline in the labour-intensive industries. Not all this decline in employment could be attributed to trade liberalization since the trade reforms were carried out in a macroeconomic environment that was marked by high inflation and recessionary conditions. Among the explanations that it offers for the decline in employment are a sharp increase in productivity in the capital-intensive industries and poor export performance in the labour-intensive industries. In Chile,[20] the trade liberalization of the 1970s coincided with severe macroeconomic shocks. The effects of these on employment far outweighed that of the trade liberalization. The combined effect of these two factors resulted in an 8 per cent decline in net manufacturing employment

employment in the industries producing importables. The latter was due to an increase in the supply of female labour (which eased the labour supply constraint) and strong overall growth in

Interest in the issue of the impact of trade liberalization on wage inequality has also been very pronounced. A special issue of the *Journal of International Economics* [25] 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".[26] 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", [27] but this requires tax coordination at the international level since tax competition becomes a greater problem with higher capital mobility.

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 established.[28] 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.[29] A related argument in that skill-biased technological change occurring in the industrialized countries is being transmitted to developing countries through increasing trade and foreign direct investment flows. There is some fragmentary evidence that this may actually be occurring.[30]

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

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[25] *Journal of International Economics*, Vol. 54, 2001.

[26] Robert C. Feenstra: Introduction, *Journal of International Economics*, op. cit., p. 1.

[27] Dani Rodrik and Tanguy van Ypersele: "Capital mobility, distributive conflict and international tax coordination", in *Journal of International Economics*, op. cit., p. 58.

[28] 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.

[29] 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.

[30] Eli Berman and Stephen Machin "Globalization, Skill-biased Technological Change and Labour Demand" in Eddy Lee and Marco Vivarelli (eds) Understanding Globalization, Employment and Poverty Reduction (Palgrave Macmillan, 2004)

more skill-intensive machinery, hence pushing up the demand for skills.[31] However, there has been very little empirical testing of this hypothesis so far.

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.

Policy Issues

Nothing in the foregoing negates the proposition that there are gains from trade and that there are costs associated with protectionism. The issue is not whether countries should try to benefit from freer trade but how this should be achieved. What the preceding discussion has tried to suggest is that there is no basis for a blanket prescription of "big bang" trade liberalization that is applicable to all countries. The relationship between trade liberalization and growth and employment is likely to be "a contingent one, dependent on a host of countries and external characteristics".[32] Differences in countrneqmircuastaces i8T4is to what20.94 -140.0005c-62a

be widely replicable even if underlying economic circumstances make it potentially feasible. Nonetheless, even without opting for a more interventionist strategy, countries can still choose to exercise more discretion over the timing of trade liberalization measures, the initial extent of the liberalization, the pace of implementation, and whether or not other liberalization measures should be implemented simultaneously. For example, on the latter point, some observers have pointed out the dangers inherent in implementing trade and capital account liberalization simultaneously. More generally, trade liberalization needs to be embedded within a coherent set of macroeconomic and structural policies in order to be successful.

The efforts of developing countries to benefit from the liberalization of world trade requires essential support from the right national economic and social policies and institutions. Without this the potential gains from trade liberalization and other economic reforms will be thwarted by obstacles such as barriers to entry into newly competitive activities, market failures and other limitations on factor mobility. In addition, the gains that are realized are also likely to be unevenly distributed because of the lack of an even playing field for all economic agents. A particular challenge is that of equipping poor producers and workers in the rural and urban informal sectors with the means to share in the benefits of trade liberalization.

An obvious priority is in the area of education and training policies. Low levels of education and skills in the labour force are a basic barrier to industrial development, even in many labour-intensive industries. Greater effort to achieve universal primary education and skill-development programmes that are responsive to changes in labour demand are therefore required in the least developed countries. Similarly, in the emerging market economies the expansion of secondary and tertiary education with an emphasis on meeting the demand for new technical skills will be an important instrument to counteract the tendency towards a widening of wage differentials between skilled and unskilled workers in the aftermath of trade liberalization that has been observed in several countries.

Another important area for action is to increase the employment intensity of growth. Since the majority of the labour force in low-income countries is still employed in agriculture, measures to stimulate agricultural exports will obviously be important. This will comprise measures to remove any policy discrimination against the agricultural sector as well as programmes to provide small agricultural producers will the necessary credit, extension services and marketing assistance to enable them to take advantage of new export opportunities. Such measures are also likely to have a positive impact on the reduction of poverty. Policies and programmes to develop a dynamic small enterprise sector that is linked to export markets are also likely to raise employment growth and improve