

Trade and Employment: Stylized Facts and Research Findings¹

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Preliminary

Introduction

This paper is a brief and selective survey of the impact of trade and trade reform on employment. It focuses mainly on empirical studies that have sought to establish the labor implications of greater trade and trade liberalisation. As is revealed by the long bibliography attached to this paper—which represents only a selection from the literature—a huge amount of research has been undertaken on the subject of the relationship between trade, wages and employment. A consequence of this state of affairs is that there are also numerous excellent literature surveys, many of which review underlying theory, empirical strategies, methodology, and techniques in some depth.² Thus we make no attempt to be comprehensive, and those seeking a more rigorous and detailed discussion of specific papers should refer to these surveys and the papers themselves. We also do not discuss labor economics-oriented literature on labor market institutions, regulation and distortions, the design and effectiveness of possible instruments to facilitate the movement of workers across sectors or employers within sectors, or issues related to the relationship between trade openness and income

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² Surveys include Baldwin (1995), Cline (1997), Slaughter (1998), Johnson and Stafford (1999), Gaston and Nelson (2001), Greenaway and Nelson (2001), Acemoglu (2002), Feenstra and Hanson (2004), and Goldberg and Pavcnik (2004).

distribution.³ Rather, our emphasis is limited to the stylized facts that emerge from the literature and possible research questions.

As noted in a recent survey by Goldberg and Pavcnik (2004), empirical research to date has offered no conclusive evidence on the effects of trade liberalisation on employment and wages. In part this is because it is hard to obtain a good measure of trade policy, even for OECD countries. While information on most-favored-nation tariffs is readily available, this is not the case for ad valorem equivalents of specific duties, nontariff barriers of different types, or the trade effects of product regulation (such as health and safety standards).⁴ The weakness in the openness measures that confound the literature on trade and growth are equally problematic here. More fundamentally, trade policy is endogenous—among other things labor market concerns are one determinant of trade policy, and the factors affecting the latter may affect the formation of wages. Moreover, it is increasingly recognized that trade is a channel for technology diffusion/adoption, both directly—e.g., through imports of capital goods—and indirectly, e.g., by creating pressure to innovate (Wood, 1994, 1995; Richardson, 1995; Thoenig and Verdier, 2003).⁵ Thus, there are numerous endogeneity and simultaneity problems.

1. Some Stylized Facts

What are the “core” stylized facts that have informed and emerged from the research agenda revolving around the impact of trade on workers (employment and wages)?⁶

- There has been a significant increase in the relative reward for skilled labor. This wage premium has been accompanied by increases in the ratio of skilled to unskilled employment in *all* sectors, not just those that use skilled labor intensively. Thus, unskilled labor has seen its relative remuneration fall generally.

³ Income distributional effects extend of course beyond wages/employment and include non-wage income, transfers, income from assets (non-labor endowments), etc.

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Moreover, the skill premium has risen in *both* developing and OECD countries—increasing inequality between the skilled and unskilled is a global phenomenon.⁷

- At the same time there has not been a large decline in the relative price of goods that use low-skilled labor relatively intensively. This is noteworthy from a trade

industry wages also concludes that these are generally small. Thus, despite the large trade liberalisations undertaken in many Latin American countries during the 1980s-90s, most of the research to date has not found evidence of large-scale reallocation of workers across sectors. Instead, the brunt of the impact appears to be concentrated within sectors. Studies using plant- or firm-level data conclude that major impacts of trade reforms are natural selection among firms and reductions in X-inefficiency: less efficient firms in a sector are forced to downsize, improve efficiency or exit, with more productive (efficient) firms expanding their market shares. Overall total factor productivity increases more in industries that liberalized more (Roberts and Tybout, 1997; Goldberg and Pavcnik, various).

- Correspondingly, the effects of trade reform on aggregate employment are muted. In the long run they are arguably zero, while in the short run Keynesian responses and/or adjustment strains are not generally very large relative to total employment.⁸

2. Trade and Labor—A (Very) Incomplete Survey

The literature on trade and labor markets (wages/employment) focuses on the implications for relative rewards to and employment of different “types” of labor, as differentiated by either skill (education, etc.) or by industry/sector of employment. The focus is on the incidence of greater trade or

facilitates the attribution of effects to trade, making the developing country-based literature more informative/robust in terms of its conclusions.

Aggregate Employment

Although the main impact of trade policy reforms and greater openness will generally be on the distribution of employment across sectors and the relative returns to different types of labor (factors), we start with the headline issue of total employment. In the long run, overall levels of employment and unemployment are determined by macroeconomic variables and labor market-related institutions rather than trade and trade policy. Thus trade policy reforms *per se*—policies aiming to increase integration—should not have a long term impact on employment levels although, of course, they may be accompanied by labor and other market reforms which should, as in Chile in the late 1970s. In the shorter run, the level of economic activity may be influenced by macroeconomic policy (money supply, interest rates, fiscal policy, etc.), and can also be affected temporarily by trade shocks or major changes in trade policy, but in the long run, the labor market will clear in the absence of distortions, with the equilibrium wage being determined by the intersection of demand and supply. The role of labor market institutions in determining this supply and demand is well established, a

complex models with complex and ambiguous results, but at least they admit the possibility that trade reform could have long-run consequences for employment. When we turn to the empirical evidence, however, there is no support for such a view. Marquez and Page (1998) suggest that firm-level declines in employment per unit of output (increased efficiency) are offset by increases in firm sizes or numbers. IADB (2003), in a review of ten countries' household data, suggest that trade liberalisation increased employment and left unemployment unchanged—i.e., increased participation.

The story is rather different when we turn to the short run or adjustment period following a trade liberalisation. The churning that reform induces could clearly reduce employment temporarily, as could conceivably a Keynesian shock emanating from increased import competition. In Chile, for instance, Edwards and Edwards (1996) find a positive association between the degree of liberalisation a sector experienced and the extent of layoffs; the sectors experiencing the greatest liberalisation were also the ones where the duration of unemployment was longest. (We return to sectoral evidence below.)

Overall, however, there is surprisingly little evidence on the nature and extent of transitional unemployment in developing countries, at least partly because of the difficulties of measuring or even defining the phenomenon in dualistic economies. A multi-country study of trade liberalisation before 1985 (Michaely et al., 1991) argued that experiences varied from case to case, but that, on the whole, transitional unemployment was quite small. In a survey of more than fifty studies of the adjustment costs of trade liberalisation in the manufacturing sector, Matusz and Tarr (1999) argue that the adjustment costs associated with transitional unemployment are not high and that unemployment durations generally quite short. Indeed, in some cases employment appears to increase more or less instantly – as, for example, Harrison and Revenga (1998) report for Costa Rica, Peru and Uruguay. In their (non-random) sample, developing

agriculture or services, or indeed anywhere outside the formal sector. This is a major shortcoming, at least as much conceptual as practical.

A further mystery is whether those laid off following trade liberalisation are disproportionately poor. In developed countries, Kletzer (2002, 2004) suggests 'yes,' but for developing countries we are far from sure. Enterprise surveys report the responses of firms to trade liberalisation, but typically give little information on the characteristics of their employees, while household surveys, which do provide this information, cannot easily be matched to enterprises. The latter do, however, generally suggest that, in many low income countries, very few of the poorest are employees in the formal manufacturing sector.

Evidence is available on the relationship between public sector job loss and poverty. Although this job loss is not a consequence of trade liberalisation, it does deal with transitional unemployment resulting from a shock to the formal sector, and so may inform us also about the effects of trade liberalisation. In fact, it probably offers an upper bound for the costs of the latter, because public sector employees are frequently the ones

The “standard” prediction from endowment based theories of comparative advantage (Heckscher-Ohlin) is that the distributional impacts of trade and trade liberalisation operate through the effect of changes in the relative price of tradable goods as a result of liberalisation or other changes that allow trade or expand it. The basic result (prediction) is that once labor adjustment across industries has occurred, wage impacts depend only on the change in product prices induced by gr

expenditures/ computerization and a rise in the relative return to skilled labor).¹⁰ Thus, despite different methodologies, the labor and trade literatures have been in substantial agreement on the effect of trade on wages (employment): SBTC dominates.¹¹

This does not mean trade can be completely ignored, however, as a source of wage inequality within developed or developing countries. Researchers focusing on the labor content of trade (so-called factor content studies) obtained so

Using French firm-level data, Gourinchas (1999) also finds that exchange rate appreciations reduce net employment growth, because of lower job creation and increased job destruction. Bentivogli and Pagano (1999) find for a number of European countries rather limited, but diverging effects of exchange rates changes on job flows. The latter may reflect differences in labor market institutions. Thus, Burgess and Knetter (1998) find in that in countries with the most rigid labor institutions, such as Germany and Japan, employment is not sensitive to exchange rates, while in other countries appreciations are associated with reductions in employment.

Work on developing countries has tended to be much more explicitly motivated by trade reforms. An early discussion of trade and employment was Krueger (1983), who argued

employment. Tariff reductions appeared to affect wages, however, because Revenga concludes, tariff liberalisation eroded rents and thus had no effect on employment and output decisions. Similarly small employment effects elsewhere in Latin America are reported by, for example, Marquez and Pages-Serra (1998) for Latin America and the Caribbean in general, Levinsohn (1999) for Chile and Moreira and Najberg (2000) for Brazil.

Milner and Wright (1998) explore industry level data on Mauritius and find a slightly more encouraging response to liberalisation. Af

data. Liberalisation episodes are followed by a *reduction* in the extent of intersectoral labor shifts at the economy-wide 1-digit level of disaggregation. Liberalisation has a weak positive effect at the 3-digit level, but it is small in magnitude and not robust. There is no evidence of trade-induced structural change at the more disaggregated 4-digit industry level. Wacziarg and Wallack note that other (complementary) policies will matter. Other reforms such as domestic deregulation and privatization are found to have greater effects on intersectoral labor movements than trade reform in isolation. But their bottom line is that claims that trade liberalisation generally leads to the absolute decline of entire sectors (broadly defined) are not supported by the data.

studies noted above established a presumption that labor markets outcomes are affected by international trade, although it is left unclear what the channels are through which this occurs (Greenaway and Nelson, 2001; Francois, 2004).¹³

Recent papers increasingly conclude that (the threat of) competition drives enterprises to improve productivity and that quality of output is likely to have an important role in determining labor market effects. The simple Heckscher-Ohlin prediction that trade results in a redistribution of employment away from the import substituting towards export-oriented production assumes a world of homogenous firms/products and inter-industry specialization/trade. In practice most trade is of the intra-industry type, reflecting the exchange of differentiated products between countries with very similar factor endowments, or trade in intermediates. The Heckscher-Ohlin prediction of inter-sectoral reallocation is partly driven by the assumption of homogeneity among producers within the same sector (Haltiwanger et al. 2004). In principle, given that much trade involves the intra-industry trade of differentiated products, one might expect that much of the job/wage impacts of trade will also be intra-industry in nature (Jansen and Turrini, 2004). Although comparative advantage forces are likely to continue to imply that increased imports (exports) are associated with employment reductions (increases), as noted by Greenaway et al. (1999) there are differences. First, output changes—positive or negative—occur within the same (similar) industry, so that the focus needs to be on establishing how trade impacts differentially across industries depending upon differences between them in the type of exposure they have to trade and the changes that have occurred. Firm heterogeneity will play an important role in driving job

¹³ Neary (2001) notes that it is not clear how compelling the SBTC finding is either in explaining the

while Pavcnik (2002) finds that market share reallocations contributed significantly to productivity growth following trade liberalisation in Chile.

Exports, intermediates, FDI and global production sharing:

Research that focuses on the differential role of exports as opposed to imports as a source of labor market effects concludes that exports tend to positively and imports negatively affect labor employed in the sectors concerned. Thus Davidson and Matusz (2003) find higher sectoral net exports to be associated with less job destruction and more job creation. Harrison and Hanson (1999), find that trade reforms result in employment expansion in export sectors/firms in Mexico, and Milner and Wright (1998) find the same for Mauritius. None of this is surprising of course, but it is important to bear in mind that greater imports have to be paid for, thus requiring and inducing output and employment in export sectors. More interesting is the relative effects on different types of labor.

Exporters in an industry tend to be more productive than other plants. This finding is by now very well established—e.g., Clerides *et al.* (1998), Bernard and Jensen (1999a) and Aw *et al.* (2000). One reason is that there are generally large sunk costs associated with contesting an export market (see Roberts and Tybout, 1997; Bernard and Jensen, 1999b). Hallward-Driemeier *et al.* (2002) find that in a sample of east Asian countries, both firms with foreign ownership and firms that export are significantly more productive, and the productivity gap is larger the less developed is the local market. Using a firm-level dataset to explore the sources of exporting firms' greater productivity, they argue that it is in aiming for export markets that firms make decisions that raise productivity. It is not simply that more-productive firms self-select into exporting, but that firms that explicitly target export markets consistently make different decisions regarding investment, training, technology and the selection of inputs, and thus raise their productivity. Thus, the “exporter selection” process is not necessarily driven by exogenous shocks such as trade reforms but reflects investments made by firms in anticipation of accessing foreign markets.

Feenstra and Hanson, among others, have analyzed the effects of FDI and outsourcing, recognizing that trade increasingly comprises slicing up the value chain. (The counterpart to outsourcing is often inward FDI in developing countries). Feenstra and Hanson (1997) focus on the effects of relocation of manufacturing activities to developing countries (US FDI into Mexico) on the demand for skilled (non-production) and unskilled labor in Mexico. For nine industries located across multiple regions in Mexico they find that the relative demand for skilled labor is positively correlated with the change in the number of foreign affiliate assembly plants, and that FDI increases the relative wage (share) of non-production workers relative to unskilled labor.

be a more relevant factor underlying the observed limited impacts of trade liberalisation on labor markets, citing Currie and Harrison (1997), who showed that many firms adjusted to trade reform by reducing profit margins and raising productivity rather than laying off workers.

Goldberg and Pavcnik (2005) focus on a short to medium run framework where the industry affiliation of workers is assumed to affect how trade policy affects wages—e.g., as is the case in the specific factors model of trade. This differs from the focus above, and in much of the earlier empirical research, where the investigation centers on how trade policy affects wages by altering the economy-wide returns to a specific worker characteristic (usually defined by skill level as measured by education). Goldberg and Pavcnik investigate the relationship between trade liberalisation (protection) in Colombia and industry wage premiums. Controlling for unobserved time-invariant industry characteristics through fixed effects (interpreted as reflecting the prevailing mix of political economy forces), workers in protected sectors earn more than workers with

A number of other papers have sought out the effect of trade liberalisation on industry wage premia. Pavcnik et al. (2004) suggest that for Brazil there is no relationship, despite a fairly major trade reform in the early 1990s. Feliciano (2001) also fails to find a significant relationship for Mexico, while, as noted above, Revenga (1997) finds a positive link. Likewise on India, while Mishra and Kumar (2005) suggest that premia are inversely related to tariffs—i.e., sectors with the greatest liberalisation have the largest increases in wages—Vasudeva-Dutta (2004), using different data, finds the opposite. The Mishra-Kumar result, which parallels Gaston and Trefler's (1994) on the USA, is said to spring from either a general Stolpher-Samuelson result whereby unskilled workers benefit from liberalisation and happen to have been most protected prior to liberalisation, or an exaggerated productivity response to liberalisation whereby sectors with larger tariff cuts make larger productivity imp

Pavcnik (2003) find that while the share of informal workers increased in Colombia in the aftermath of the trade reforms, the entire increase is accounted for by within-industry changes from the formal to the informal sector, rather than between industry shifts of informal workers. To summarize, it appears that trade liberalisation had a significant impact on relative wages in Colombia, but not on inter-sectoral reallocation of labor. Whether this impact reflects industry rents, constraints on labor mobility or other factors remains to be determined. Goldberg and Pavcnik consider both hypotheses to be plausible.

3. Research implications/questions

In writing this survey, we have been struck

- **Actual/potential impact of trade liberalization on wages.** The high levels of aggregation used in household surveys (2- or 3-digit ISIC) may not be fine enough to detect worker reallocation across firms within the same industry in response to trade liberalization. This leads Goldberg and Pavcnik to call for empirical firm/plant level studies that explore the income distributional effects of trade reforms by analyzing the impacts of reform on firms belonging to the same 3- or 4-digit ISIC sector, as reflected for example in the compositional changes of their output (quality upgrading or other forms of greater differentiation of their production). Information on relative (productivity-adjusted) labor costs would help identify sectors/firms that may be confronted with more serious adjustment costs post reforms. These exercises could also be augmented with information on additional operating costs related to the “quality” of the business environment, of the sort generated by the World Bank’s Investment Climate Research (World Bank, 2005) and *Doing Business* (World Bank, 2005b).
- **Inter-sectoral mobility, entry/exit across sectors.** Borjas and Ramey (1995) found that the effect of trade on the labor market depended on market structure of industries. Barriers to entry and exit will clearly have a bearing on labor market responses to further trade and investment liberalization. Capital/financial market distortions or inefficiencies will affect the ability of firms to expand/enter. These variables may be more important than the labor market. To a large extent such factors have already been studied, but perhaps not from a labor market adjustment perspective.
- **Beyond manufacturing.** The manufacturing sectors are the focus of the lion’s share of research on the effects of trade on employment/wages, in both developing and developed countries. However, most employment in both sets of countries is elsewhere. In OECD countries services account for 70+ percent of turnover and employment, whereas agriculture and the informal/public sectors account for most employment in developing countries, especially poorer ones. To a significant extent services have become “tradable”, be it through cross border exchange and telecom networks (internet etc.) or be it through international factor mobility (FDI, labor movement). Adjustment to agricultural price

shocks/competition may be quite different from the type of adjustment that occurs in manufacturing, giving rise to greater inter-sectoral reallocations of labor with associated differences in social costs/implications.

- **Formal vs. informal sector and responses to trade reform.** There is little

technological upgrading, not just directly, but also indirectly. Developing country liberalization episodes offer the best prospects of identifying trade effects as trade liberalization is discrete and often significant. The micro evidence to date does not point to large trade effects for wages/employment in that it does not do much to change the structure of the economy. More evidence points to trade liberalization reducing x -inefficiency and putting pressure on firms to improve produc

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