Trade and Inequality in Developing Countries

- My research background:
  - Labor market responses to trade liberalization in developing countries

- Discussion of research on specific aspects of trade and inequality delegated to separate sessions
  - Trade, firms and employment
  - Trade and informality/job quality
  - Labor market adjustment to trade reform
  - Trade and Skill upgrading
Goal

• Trade and Inequality
  ○ Researchers have made big progress toward understanding the link between trade and wage inequality between educated and less educated workers in poor countries
  ○ Why? Some common features of recent research design
  ○ Identify areas for future research

• Trade and poverty
Big question: trade and increasing inequality

- Many developing countries liberalized international trade since 1980.

- The workhorse model of trade based on endowment differences across countries suggests that less educated workers in developing countries should benefit from reduction of trade barriers (Krueger et al: Trade and Employment in Developing Countries)
  - Lower poverty
  - Lower inequality

- Yet, wage inequality between educated and less educated (skill premium) increased in many poor countries since 1980s

- This “puzzling” fact instigated a large body of research

- Success toward resolving the puzzle
Research design

• Empirical work guided by theory
  ○ Static link between trade policy and inequality via changes in relative prices and wages (empirically tractable)
  ○ NOT dynamic link through growth
  ○ Focus on specific channels through which trade affects income

• Micro-level data for particular countries (firms, individuals, households)

• Direct measures of trade policy/trade costs to identify the effect
  ○ Reductions in trade barriers induced by large-scale trade liberalizations
  ○ Exchange rate shocks
  ○ Liberalization of Foreign Direct Investment/Trade in intermediate goods

• Consider the role of other reforms and cofounding factors
Explanations for increased wage inequality

- SBTC or trade-induced SBTC

- But trade based on relative endowment differences between rich and poor countries plays some role.
  - Not trade based on differences in the use of skilled labor across industries
    - Little reallocation of employment across industries.
    - Increase in the relative demand for educated within rather than across industries
  - Trade induces changes in relative demand for educated labor within industries
    - Factor proportions differences across stages of production Feenstra and Hanson (1997, 1999)
    - Factor proportions differences across firms within an industry Bernard and Jensen (1995, 1997)
Ongoing and Future Research: Residual wage inequality

- Most research focuses on wage differences between educated and less educated workers

- Large part of increased wage inequality attributed to inequality of wages of workers with same observable characteristics (i.e. residual wage inequality)

- Does trade contribute to changes in residual wage inequality?
  - Industry wage premium (trade matters, but magnitudes small)
  - Heterogeneity in wages across firms within an industry (session 2)
    - Driven by productivity differences across firms
  - Unobserved worker heterogeneity
Trade and Poverty

• Higher wage inequality does not necessarily imply higher poverty

• Difficult to draw conclusions about trade and poverty
  
  ○ Studies on trade and inequality often based on data that cover individuals employed in the “formal” sector living in urban areas
    
    ○ Poor: less educated worker in formal manufacturing sector

  ○ Don’t capture populations most vulnerable to poverty
    
    ○ Unemployed
    ○ Individuals working in “informal” sector, smaller firms
    ○ Individuals not working for wages
    ○ Individuals living in rural areas
Existing research on trade and poverty

- An emerging literature examines the direct effect of trade on poverty (Porto (2004), Goldberg and Pavcnik (2007), Topalova (2005), McCaig (2008), Mitra, et. al. (2007))

- Analysis relies on household level data that overcomes some of measurement challenges

- The effect of trade on poverty depend on
  - The nature of trade reform
  - Institutional context in which reform takes place
  - Mobility constraints on individuals
Ongoing and Future Research: Trade and Poverty

• Need to better understand the underlying mechanisms

• Examine how particular phenomena that are highly correlated with poverty are affected by recent trade liberalization episodes:
  ○ Absolute wages (as opposed to relative wages)
  ○ Unemployment
  ○ Employment in the informal sector, small firms
  ○ Compliance with labor standards (minimum wage in particular)
  ○ Relative prices of goods consumed primarily by the poor

• The role of mobility across geographic regions/industries/firms within a country
  ○ Trade associated with increases in poverty in areas with high concentration of previously protected industries (Topalova (2005)) or no effects on poverty (Goldberg and Pavcnik (2007), Mitra et. al. (2007))
  ○ Trade associated with declines in poverty in areas benefiting from export boom (McCaig (2008))
  ○ What inhibits people from moving toward new economic opportunities?
Ongoing and Future Research: Trade and Poverty

- So far, my comments focused on static effects of trade on poverty via changes in employment, wages and prices

- Dynamic effects of trade on poverty via growth