

**FOR DEBATE AND GUIDANCE**

FIRST ITEM ON THE AGENDA

**Trade and employment: Panel discussion
on issues arising from the joint ILO/WTO
Secretariat study on challenges for policy
research****I. Introduction**

1. The Working Party last discussed trade and employment issues at its March 2002 session. On that occasion, a panel of speakers from the secretariats of the WTO, UNCTAD and the ILO introduced papers analysing the relationship between trade liberalization and employment. In responding to the contributions of members of the Working Party, the speakers highlighted the need for further research and the potential for fruitful collaboration on further studies and analysis.¹ This suggestion was recalled by the Director-General of the WTO, Mr Pascal Lamy, and the ILO Director-General, Mr Juan Somavia, who requested their respective staff to prepare a joint study that was subsequently undertaken during 2006 and published in February 2007.²
2. Following consultations with the Officers of the Working Party on the agenda for the current session of the Working Party, it was agreed that the study should be discussed at its March session in the format of an exchange between a panel of speakers and the Working Party members, with a short ILO note to draw out issues for debate. The panel discussion will be led by Mr Lamy and Mr Somavia and the present paper serves to highlight some issues that the Working Party may wish to address.
3. The research collaboration with the WTO is part of the Office's approach to engage other organizations of the multilateral system on the topic of growth, investment and employment.³ In past debates, constituents have endorsed this strategy and, in particular,

¹ GB.283/15.

² International Labour Office and Secretariat of the WTO, *Trade and employment: Challenges for policy research*, a joint ILO/WTO Secretariat study, Geneva, Feb. 2007. This publication may also be consulted for full references to the academic literature. Copies of the study and an executive summary are available on request. www.ilo.org/public/english/support/publ/textem.htm#5511.

³ GB.292/15(Rev.), para. 8; GB.294/14.

welcomed closer links with the international financial institutions and the WTO on issues relevant to their respective mandates.⁴ This takes the form of the Policy Coherence Initiative (PCI) on which another paper before the Working Party reports.⁵ The Office's approach is also bearing fruit in the form of a closer alignment of research agendas and, as evident from the present paper, joint research.

4. As a joint undertaking by the WTO Secretariat and the Office, the study on "Trade and employment: Challenges for policy research" aims to provide an impartial view of what can be said, and with what degree of confidence, on the relationship between trade and employment. It provides a thorough and objective review of the academic literature, both theoretical and empirical, and distinguishes itself from existing surveys by its focus on the link between trade policies on the one hand, and labour market and social policies on the other. The present paper provides a digest of the main findings in Parts II and III below by drawing on the executive summary of the study, and then offers some points for debate in Part IV.⁶
5. As previous debates in this Working Party have emphasized, trade policies have a significant impact on the level and structure of employment, on wages and wage differentials, and on labour market institutions and policies.⁷ At the same time, labour and social policies influence the outcomes of trade policies in terms of the growth of output and employment and the distribution of income. Examining these links could serve as a useful input to the policy-making process in both domains. It may also act as a stimulus towards greater policy coherence between trade policies and social and labour market policies, that may ultimately contribute to increasing the economic and social benefits of trade liberalization and expansion.

II. Trade flows and employment: The current context

6. The employment impact of global trade flows, as well as their repercussion on wages and incomes, has become an increasingly important concern for policy-makers, the media and the general public. In mainstream economic theory it is presumed that greater trade openness will, in spite of possible problems of adjustment inherent in the process, eventually yield net benefits in terms of employment and incomes in the global economy. In contrast, discussions of the issue in the media often focus on negative effects such as job losses resulting from increased import competition and the displacement of local firms by foreign direct investment (FDI); the relocation of jobs from high- to low-wage economies; and claims that increasing globalization has triggered a "race to the bottom" in terms of wages and the quality of employment.

⁴ GB.292/15(Rev.); GB.294/14, para. 7.

⁵ GB.298/WP/SDG/2.

⁶ This Working Party paper is the sole responsibility of the Office.

⁷ See e.g. GB.282/WP/SDG/2.

Trade and the dynamics of job destruction and job creation

7. Economists have long recognized that trade would lead to a division of labour advantageous to everybody involved. Indeed, by reshuffling resources in accordance with the principles of comparative advantage, they can be used more appropriately and effectively for production, thus creating the so-called gains from trade. Highly productive producers will be able to expand as they start selling their goods or services abroad. Producers and consumers will be able to take advantage of cheaper imports and of a larger product and quality choice. The latter, however, implies that some domestic production will be replaced by imports.
8. In other words, trade liberalization is expected to trigger a restructuring of economic activity that takes the form of company closures and job losses in some parts of the economy and start-ups of new firms, investment in increased production and vacancy announcements in other parts of the economy. Trade liberalization is therefore associated with both job destruction and job creation. In the short run the resulting net employment effects may be positive or negative depending on country-specific factors like the functioning of the labour and product markets. In the long run, however, the efficiency gains caused by trade liberalization are expected to lead to positive overall employment effects, in terms of quantity of jobs, wages earned or a combination of both. Average wage increases may, however, hide distributional changes that affect some workers negatively.
9. Where trade liberalization affects parts of the labour force negatively, labour and social policies are required in order to redistribute some of the gains from trade from winners to losers. The joint study identifies some situations in which such government intervention may be helpful, and individuals and groups that should be targeted. It also discusses the possible effects of different types of labour and social policies in the relevant situations. In this discussion it is pointed out that labour and social policies may have unintended efficiency effects. Indeed, to the extent that such policies may have a negative effect on the abovementioned “reshuffling” process that is necessary in order to reap the benefits from trade, policy-makers may in such situations be confronted with a trade-off, although not necessarily a very steep one.

Recent developments: Effects of trade on labour demand and wage inequality

10. Traditionally, economists expected that the reshuffling process triggered by trade liberalization would take place across sectors. Roughly speaking, it was expected that labour-intensive industries would shrink in developed countries, while skill and/or capital-intensive industries would expand. The opposite phenomenon was expected to happen in developing countries. In developed countries jobs would therefore be destroyed in labour-intensive industries and capital employed in those industries would have to be re-employed. The long-term distributional consequences of trade would imply increased inequality between capital and labour or between skilled and unskilled labour in the developed world. In contrast, inequality was expected to decrease in the developing world.
11. Empirical evidence initially appeared to confirm these predictions. In particular, decreases in inequality were observed in a number of East-Asian economies that liberalized trade. At the same time, increases in the wage differential between high-skilled and low-skilled labour – the so-called skill premium – were observed in a number of developed countries. In other developed countries where labour market policies, like minimum wages, limited the extent of wage adjustments, increases in low-skilled unemployment were observed.

12. But three important phenomena emerged that were not in line with traditional trade theory, and a large body of theoretical and empirical literature has tried to respond to this discrepancy between traditional predictions and observed realities.

Impact on labour demand in industrialized countries

13. First, most industrialized countries trade above all with other industrialized countries. Traditional trade theory was only of very limited use in predicting employment effects resulting from this type of trade. Recent contributions to the theoretical trade literature have therefore looked at the question of whether trade among similar countries, i.e. intra-industry trade, may have an impact on the demand for high-skilled and low-skilled labour and some of these studies have combined trade with technological change. This literature comes to the conclusion that trade among similar countries can raise wage inequality within countries and also within sectors.
14. Another branch of literature has examined the relationship between openness and the sensitivity of labour demand to wage changes. In this context it has been argued that in an open economy employers would be more likely to threaten to lay off workers when they demand higher wages than in a closed economy, for instance, because they face stiffer price competition than before. Economists refer to this increased sensitiveness as an increase in the price elasticity of labour demand. This line of argumentation has two important implications. First, trade between industrialized and developing countries will affect the price elasticity of labour demand, but the same is true for trade among industrialized countries. Second, the price elasticity of labour demand can be affected by the mere possibility of trade. For instance, the mere threat of sourcing inputs from another country or of delocalization may weaken workers' resistance to wage reductions. This structural shift in bargaining power can have repercussions for the functional distribution of income between capital and labour, tilting it towards the former. It also increases the vulnerability of individual workers, making it pivotal to maintain or build functioning structures for collective bargaining.
15. These arguments may explain why surveys in industrialized countries have revealed that workers in very different types of industries report greater perceived job insecurity as countries liberalize. The theoretical literature confirms that trade, in particular if combined with FDI, has the potential to increase volatility in labour markets. Surprisingly, though, statistics on labour market reallocation do not reveal a systematic pattern of increased labour market volatility. Work on how to reconcile the conflicting evidence on workers' perceptions of insecurity on the one hand, and labour market statistics on the other, is ongoing in the research community. Parallel to this, social dialogue has in many countries been instrumental in finding practical solutions to provide employment security in the context of greater volatility. It further underlines the importance of an effective organization of both workers and employers that forms the basis for mutually beneficial outcomes.

Increasing wage inequality in developing countries

16. Second, in contrast to expectations, increases in the skill premium were also observed in developing economies during periods of trade liberalization, notably in a number of Latin American economies. A large body of empirical literature has tried to explain this phenomenon and finds that the timing of trade liberalization, the tariff schedules in place before liberalization, and technological change are some of the elements that explain why certain developing countries have experienced increases in the skill premium after trade liberalization. The relevant theoretical literature has focused on the interaction between trade, FDI and technological change in order to explain changes in wage inequality in developing countries, and discussed its gender implications. The distributional dynamics

observed in developing countries also contributed to renewed interest in the evolution of capital and labour shares and a more general emphasis on income inequality.

Reshuffling of employment within sectors

17. Third, a lot of employment reshuffling was observed to take place within sectors rather than across sectors as traditional trade theory would predict. In response, a new generation of trade models was developed that describes mechanisms according to which trade liberalization encourages the expansion of the most productive suppliers in all sectors, i.e. in sectors in which countries are net exporters and in sectors in which they are net importers. As a result, these models predict that in all sectors jobs are created by those suppliers who are able to compete internationally and destroyed by those suppliers who are unable to compete. For policy-makers this may be good news, as it is generally expected that it is easier for workers to change firms within the same sector than to find work in a different sector. Within-sector reallocation may, for instance, imply lower retraining costs for workers and shorter search periods. On the other hand, these new trade models imply that jobs are at risk in all sectors. While traditional trade models would suggest that policy-makers who wish to assist workers should focus on import-competing sectors, more recent research suggests that such targeted intervention is not justified. Indeed, recent literature emphasizes that it will be increasingly difficult for policy-makers to predict which will be the jobs at risk and which will be the jobs in demand in the near future.
18. A rich empirical literature has emerged from the analysis of these different phenomena. One major difficulty that empirical studies on the impact of trade on employment face is in distinguishing the different possible causes of employment changes. Some of these causes have a global character, like technological change, others are country-specific. Labour market policies, macroeconomic policies or movements along the business cycle are only a few examples of country-specific factors that may affect an economy's employment level and structure. They may also affect the reaction of the labour market to changes in trade policy. Not surprisingly, therefore, one of the general conclusions that can be drawn from the literature is that the employment effects of trade have differed significantly across countries.

III. Implications for policy

19. The above findings invite a discussion of a number of possible policy responses from three different angles: their potential to affect the link between trade, growth and employment either positively or negatively, their effect on redistribution, and their potential to provide security and insurance against major adverse events in working life.

Freedom of association and social dialogue

20. There is an international consensus on the importance of respecting fundamental principles and rights at work, including freedom of association and the right to bargain collectively. Nevertheless, there has been a debate on their economic effects in developing countries. Some developing countries have expressed concerns that the full exercise of these rights could have a negative impact on their competitiveness and could hamper FDI inflows and export growth. This concern derives from the view that a high level of unionization and collective bargaining could lead to an excessive rise in labour costs that erodes their comparative advantage of low wages, as well as lead to labour market rigidities that retard required adjustments in the structure of employment. There has been little empirical support for this view in the economic literature.

21. It is also important to point out that the focus on the economic effects of fundamental worker rights in the context of trade competitiveness overlooks other important dimensions of these rights. Apart from being a part of universally recognized human rights, they have clearly positive effects through enabling social dialogue between workers, employers and governments. This can facilitate the development of practical solutions to the challenges posed by trade reform, and is invaluable to promote broad social support for economic reforms and to advance a more equitable distribution of the burdens and benefits from trade liberalization.

Policies facilitating the transition between jobs

22. Workers who lose their job following trade reform have to look for a new job and potentially have to go through a period of unemployment. They may be expected to relocate or to undergo retraining. Two types of labour market policies targeting this situation can be distinguished: passive income support during periods of unemployment and so-called active labour market policies that attempt to facilitate re-employment. Most industrialized countries have more or less generous social protection systems in place and make broad use of active labour market policies. The latter are increasingly being seen as a preferable alternative to passive income support for the unemployed; some industrialized countries even provide specific trade adjustment assistance to workers.
23. Whereas some middle-income countries have begun to strengthen social protection systems and increasingly make use of active labour market policies, this is not the case in many low-income countries, mainly due to resource constraints. The possibility of introducing them for a limited duration, and specifically targeting those negatively affected by trade reform, has been discussed in the literature and has recently been raised in the context of the “aid for trade” debate. Strengthening the capacity of developing countries to design and implement such programmes could, indeed, enable them to cope better with the social impact of economic reforms as well as help to increase popular support for the reforms themselves. There is, however, room for more research in order to improve our understanding of how to design such programmes, including on aspects such as their gender-sensitivity and the involvement of social partners.

Policies to provide security and insurance against adverse events

24. The policies for facilitating transition discussed above are part of the general problem of providing security and insurance against adverse events. Economists tend to agree that modern economies need to constantly reallocate resources, including labour, from old to new products, from inefficient to efficient firms. At the same time, workers value security and insurance against major adverse professional events, job loss in particular. In response to this demand for insurance, economies have used different tools, like unemployment benefits and job security legislation, to provide a buffer against the most negative consequences of job loss. Given that retrenchments often affect men and women differently, such provisions also have an important gender dimension. While there are reasons to believe that a trade-off exists between efficiency and insurance, this trade-off does not need to be very steep if insurance policies are designed appropriately. Getting the policy mix right is a pressing issue. This is above all the case in developing countries that face the additional challenge of channelling important numbers of workers from the agricultural sector and the informal economy as smoothly as possible into formal activities.

Redistribution policies to address inequality

25. It is also increasingly recognized that it is important for policy-makers to ensure that the benefits of global economic integration are sufficiently widely shared in order to maintain or obtain public support for trade opening. However, the literature on redistribution policies in open economies has so far reached no agreement on how to design appropriate redistribution policies in a globalizing world. The difficulty in designing an effective redistribution policy arises from the fact that such policies are likely to affect not only the distribution of income but also incentives in the productive system. Redistributive transfers may affect the incentives faced by those who receive them as well by those who pay for them through, for instance, income or consumption taxes. An additional complication may arise if the ability of governments to redistribute is affected by the fact that some production factors are more mobile at the global level than others.
26. Independent of their causes, increases in the skill premium or income inequality represent a particularly serious challenge for developing countries with limited experience in the design of redistribution policies. Finding satisfactory answers does not appear to be straightforward and will be particularly challenging for developing countries that often lack any significant experience in this domain, and the necessary financial and administrative capacities. Yet, there are indications that the trade-off between equity and efficiency need not be great and that win-win strategies exist where policies that are good for equity are also good for growth.

Education and training policies for pro-poor growth

27. Policies that provide wider access to education have been identified in the literature as good pro-poor policies, as they stimulate growth and reduce inequality at the same time. The literature also emphasizes the increasingly important role of education policies in determining how well countries cope with economic and technological change. Education levels, for instance, determine countries' absorptive capacity, i.e. their capacity to adopt new technologies and maybe develop them further. Education affects individuals' capacity to deal with change, an important aspect in a globalized world that expects individuals to adapt constantly to new situations. At the same time it becomes increasingly hard to predict the set of skills needed for future employment, and education systems will therefore need to be sufficiently flexible in order to respond to economic changes. This also underscores the need for comprehensive vocational training systems and for continued on-the-job training to promote individual employability and overall economic efficiency.

Other policies and aid for trade

28. How successful developing economies are in the creation of more and/or better jobs, with attendant implications for poverty, depends above all on the supply response of the economy to trade liberalization. There appears to be a common understanding of the possible bottlenecks for supply response in developing countries. They include inadequate finance, physical infrastructure, telecommunication, information and human capital. It has also been argued that the pace of trade reform may affect countries' supply response. There appears to be an increasing awareness of the role the international community can play in helping developing countries to overcome supply constraints that is reflected in the debate on aid for trade. In this context it could be useful to improve understanding of how to effectively use aid for trade in order to optimize developing countries' supply response.

IV. Main conclusion and points for debate

- 29.** The single main conclusion that emerges from this study is that trade policies and labour and social policies do interact and that greater policy coherence in the two domains can help to ensure that trade reforms have significantly positive effects on both growth and employment. From this perspective, research directed at supporting the formulation of more effective and coherent policies would clearly have a high pay-off to the international community. The challenges are three fold.
- 30.** First, to improve the availability and timeliness of labour market information. Analysing the impact of trade, and other policies, on employment and working conditions is hampered by the paucity of up to date statistics. Looking to the future and the importance of being in a position to undertake policy impact assessments before policy changes are implemented it is vital that comprehensive information is available on past trends as a starting point for looking at possible future effects on opportunities for decent work.
- 31.** Second, to design and implement trade reforms in a manner that takes account of adjustment problems in the labour market. This should be done with the aim to make trade reform not only economically beneficial, but also to ensure that the benefits are widely shared by workers. The joint study is careful to avoid generalizations, and argues that the impact of trade on employment and wages will vary with country-specific characteristics. What follows from this is that countries will have to adapt steps towards greater trade openness to their specific situation, e.g. through appropriate sequencing and timing, to maximize the long-term benefits from free trade and to avoid adverse, unintended social consequences. This is of particular importance for countries at early stages of development that generally lack adequate social protection mechanisms. This implies that the international system should take into account the need both for accompanying policy measures to mitigate possible adverse effects and support efforts to realize the potential benefits of market opening and also for flexibility in the pace, depth and sequencing of trade liberalization commitments.
- 32.** Third, countries that have well-designed social and labour market policies in place when undergoing trade liberalization will be in a better position to reap its benefits, and to cope with possible adverse effects. These policies should include the provision of adequate social protection for displaced workers, but go beyond this and include dynamic elements. The dual purpose of these policies should be to create social equity and to improve economic efficiency. While there can be a trade-off between the two objectives, this need not be a steep one, and there is scope for win-win situations. For example, facilitating the transfer of labour between and within sectors will be in the interest of workers and reduce inequality, but it will also contribute to efficient resource allocation – as can education and vocational training. Likewise, the full exercise of the fundamental right to freedom of association can be equity-enhancing by improving the bargaining power of workers, but functioning social dialogue can also increase efficiency by identifying ways to improve productivity, maintaining social stability and by facilitating negotiated solutions that are in the interest of both workers and employers.
- 33.** The Working Party is invited to discuss the findings of the joint study and its implications for the future work of the Office, including:
- (i) work with the WTO and other multilateral agencies on the trade and employment relationship, for instance, within the framework of the Policy Coherence Initiative on growth, investment and employment;

- (ii) facilitating the exchange of information and experience amongst constituents regarding the social effects of trade reform and the interaction between trade and social and labour policies; and
- (iii) reviewing how ILO policies across the different dimensions of the Decent Work Agenda contribute to social equity and economic efficiency, and thereby assist member States to manage the social effects of trade reform and other aspects of globalization.

Geneva, 19 February 2007.

Submitted for debate and guidance.