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Developing Country Labor Market Adjustments to Trade Reform:

Briefing on a New Overview and Resource Guide

Background: With free trade agreements proliferating, and WTO talks in the news, trade liberalization's impact on developing economies has attracted much attention. A USAID report released a few months ago examines the issue. It focuses on trade liberalization's impact on labor, the most significant asset of most developing country households. The report, *Developing Country Labor Market Adjustments to Trade Reform,* was produced by Nathan Associates under a SEGIR task order and released in June 2006. It discusses a conceptual framework for, and empirical evidence relating to, trade reform -induced labor market adjustments, reviews relevant literature, evaluates donor initiatives, and makes a number of recommendations. The third chapter highlights two case studies, one on trade liberalization and the garment industry in Zambia, and the other, on agricultural labor and employment in Mexico before and after the advent of NAFTA, which may prove to be especially useful examples for USAID EG officers participating in policy dialogue with host governments.

Trade Liberalization's Labor Market Effects, Conceptual Framework: The report's three-stage conceptual framework analyzes how labor markets adjust to trade reforms. (1) First, when trade is liberalized, a trade "shock" occurs on both the supply and demand sides of commodity and service markets. Some groups benefit: e.g., users of imported products and exporters. Others experience net income losses and face costs of adjustment, e.g., producers of locally-sold products that compete with imports. (2) Next, the effects of the trade shock reach the labor market as changes in producers' demand for labor due to the changes in final demand for the goods and services that have occurred. Adjustments may occur in employment levels, wages, workplace conditions, and/or job security. (3) Finally, longer run adjustments take place as longer term impacts work themselves through, further affecting both labor demand and supply. Losers from reform are almost always more visible than winners, as benefits are distributed over the population more diffusely than losses are. Political factors may inhibit needed adjustments. Institutional and structural factors help shape outcomes.

The report emphasizes two important points. (1) "Dualistic" labor markets are found in many developing countries: an informal sector employing the majority of the working population at low wages coexists with a smaller formal sector employing a smaller percentage of the population at much higher wages. (2) Deep pools of low-and unemployed and underemployed unskilled labor, rapidly increasing in supply as more young people enter the labor force, help explain why trade liberalization in poor countries tends to increase employment levels but not necessarily wages.

State of Empirical Evidence: The report examines the general limitations of the labor data available for developing countries. A general lack of labor data for many developing countries prevents broad analysis: most data are drawn from the formal sector in which only a minority of the work force is employed. Additionally, trade liberalization's effects on labor markets are difficult to isolate from those of other determinants. The report finds trade liberalization's effects on labor markets to be generally quite small relative to those of the many other factors that also influence labor market outcomes. The report emphasizes that on occasion trade liberalization may adversely affect the poor, making it important to identify and implement potential public sector mitigations that help minimize

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the social and economic costs to poor individuals and households.

Findings: Having pointed out the difficulties of empirical research, the report examines to what extent, according to evidence in a wide array of published empirical studies, trade liberalization appears to cause changes in wages and employment levels, the distribution of jobs, and wage inequality. On the basis of the evidence, few simple generalizations can be made. Most studies' findings are limited largely to the formal sector. Depending on country conditions, formal sector employment levels and/or formal sector real wages are reported to increase, decrease, or remain unchanged, but only by small amounts. Limited evidence suggests that trade liberalization generally causes very little reallocation of labor across industries/sectors. Adjustments in hiring and firing generally occur *within* industries/sectors as operations are restructured and workers move from less to more competitive firms; however, in some cases, large and persistent reallocation of labor does occur across sectors. Finally, empirical evidence strongly suggests that trade liberalization increases wage inequality in many developing countries, by increasing the "wage premium for skills." However, as the report stresses, rises in wage inequality do not mean unskilled workers are worse off. In fact, much evidence suggests that trade liberalization contributes to increasing wages for unskilled workers, as for example additional opportunities in the formal sector may cause them to move up. The report emphasizes, however, that on occasion trade liberalization may adversely affect the poor. As they lack the resources to mitigate the impact themselves, it is particularly important to manage the transition and identify potential public sector mitigations that help minimize the social and economic costs to poor individuals and households.

Donor Initiatives in Trade-Related Labor Adjustment Assistance: Trade-related labor adjustment assistance has two primary objectives: (1) to help an economy to create replacement jobs faster and (2) help workers find and shift to new jobs more quickly. Few donor activities explicitly make trade-related labor adjustment assistance a primary goal. But the report identifies several programs and many program components addressing trade-related labor adjustment assistance objectives. Donors and recipient countries have already done much to enhance the "business-enabling" environment, which removes obstacles to entering the formal sector, reduces labor market rigidities and lowers overall unemployment. USAID has done programs of this kind in all regions of the world but relatively few of them in Africa. EGAT/EG staff believe that in most situations business enabling environment work remains the highest priority. Other assistance programs directly address needs for job training, career counseling, and job searching.

Recommendations: The paper's key recommendations include suggestions that USAID should:

1) Help fill gaps in understanding of trade liberalization and labor adjustment by helping professionals develop and regularly provide standard data on labor market conditions to policymakers;

2) Explicitly include labor adjustment support in its trade capacity building (TCB) assistance to help pro- trade reform leaders win domestic support by easing adjustment costs of trade reform;

3) Support additional assessments analyzing its programs' long-term impacts on developing country labor markets and worker adjustment paths;

4) Improve information organization and availability about USAID programs to facilitate dialogue; and

5) Build a multi-donor "community of practice" to provide access to emerging research, bring together professionals interested in trade liberalization and its labor market effects, and provide USAID with a forum for public leadership on this issue.

Full report: http://www.nathaninc.com/publications/index.asp?bid=751422