

Trade and Inequality

Adrian Wood, North-South Trade, Employment and Inequality: Changing Fortunes in a Skill-Driven World, Oxford University Press, New York, 1994

Reviewed by Jerome Fahrer

The impact of the expansion of trade between the industrialised countries (the 'North') and the developing countries (the 'South') on labour markets and the distribution of income in the North has been a big political issue for several years in the developed world. In the 1992 American Presidential election, Ross Perot's prediction that the NAFTA agreement would result in a 'giant sucking sound' of jobs flowing out of the high-wage United States and into low-wage Mexico. In Europe, the French in particular are calling for more trade protection against the low-wage threat.

The instinctive response of most commentators is to say that that this rhetoric betrays deep ignorance of elementary economics, since whereas free trade enhances the welfare of nations, protection is just a recipe for falling living standards: if not absolutely, then certainly in comparison with countries with an open trading regime. The threat from developing nations, they say, is a myth.

The problem with this response is that although free trade leads to increased incomes on average, it involves both winners and losers. This proposition is unarguable as a matter of theory; but, in terms of the effect of trade between the North and South, a number of practical questions need to be answered. These include who the winners and losers are from this trade; the size of the effect the trade has had on northern labour markets; and what other factors might have been at work.

Several economists — orthodox trade and labour economists as well as quasi-economists like Robert Reich — have turned their attention to these questions in recent years. Adrian Wood's book is the most comprehensive study of the subject to date. It is a very impressive piece of scholarship. Although aimed primarily at an academic readership, it is not technically demanding and is accessible to anyone willing to make the investment in understanding a complex and important set of issues. Wood's argument is essentially that trade with developing countries has been harmful to less skilled workers in the advanced industrialised countries, partly directly, and partly because such trade has accelerated the adoption of technologies that economise on the use of unskilled labour. Skilled workers, on the other hand (those who work with computers, for instance), have been the winners. The precise effect on the unskilled varies from country to country but essentially depends on the degree of labour-market flexibility (for which read whether the wages of the unskilled can fall). In Europe, institutions tend to stop wages falling. As a result, unemployment among the unskilled is high, but income inequality has increased relatively little. In the United States, where unions have always been weak and were made even weaker in the 1980s, wages can and do fall. As a result, unemployment

among the unskilled is relatively low, but inequality of incomes has greatly increased.

The book begins with the theoretical framework, which is a fairly standard neo-classical trade model in which the factors of production include skilled and unskilled labour. Somewhat unusually, capital is excluded. But Wood argues persuasively that, because capital is these days extremely mobile across countries, profit rates will tend to be equalised throughout the world and so capital cannot be an enduring source of comparative advantage. On the other hand, most labour is not mobile internationally, and so relative shares of skilled and unskilled labour will be important in determining the pattern of world trade, and therefore who the winners and losers from that trade are likely to be.

The remainder of the book is in three parts. Part A, 'Patterns and Magnitudes', presents evidence from previous studies and Wood's own analysis of the factor content of trade. Part B, 'Causes and Consequences', identifies the origins of the increase in North-South trade (the lowering of trade barriers in the North), and the effect of this trade on Northern manufacturing, wages and employment. In Part C, 'Prospects and Policies', Wood outlines his vision of what is likely to happen in the future (more trade liberalisation throughout the world), and some thoughts of how policy-makers should respond to these developments.

One policy response is to liberalise labour markets in order to minimise the unemployment problem; but this might lead to ever increasing inequalities of income. If this is regarded as a problem, what should be done about it? Wood argues forcefully that restricting imports is not the answer, as the efficiency losses would far outweigh any equity gains. His favourite solution is more education for unskilled workers, but, as he acknowledges, this would be expensive and difficult to implement. Should this education be general or vocational? Nobody knows. One interesting idea is a differential payroll tax to restore the market-clearing relative wage between skilled and unskilled labour, but it would be difficult to set this tax at the right level. (Besides, this kind of thing has been tried before — the Selective Employment Tax in the UK comes to mind — but without success.) Another idea, which has been floated many times before, is a negative income tax for low-wage workers. This might avoid the incentive problems associated with welfare payments as it would be payable only to those in employment. It would, however, be difficult to sell politically.

The lessons from Wood's book are applicable to Australia, which has liberalised its international trade as much as, if not more than, any other developed nation, and the pressures correspondingly to liberalise the labour market are growing.

Over half Australia's footwear imports, for example, now come from China, compared with just over 10 per cent at the beginning of the 1980s, while employment in the clothing and footwear industries has fallen markedly. Similar trends are apparent for many other manufactured goods. While the formal evidence suggests that unskilled labour-saving technologies have a greater impact than trade on Australia's labour markets (Fahrer & Pease, 1994), the two forces do not operate independently and the policy issues overlap.

Wood's policy recommendations are all worth considering, but they do have a motherhood (more education) or band-aid (a better welfare system) flavour. Although Wood characterises himself as a cautious optimist, his message is slightly pessimistic: these are difficult problems, and whereas we know what won't fix them, we don't know what will.

Perhaps we should take a closer look at the example of one country, Hong Kong, and how it has responded to exactly the same set of challenges. Over the past five years or so, nearly half of Hong Kong's manufacturing jobs have disappeared as its manufacturers have moved their operations to southern China, where the wages are much lower, and where the pool of workers available to work at these low wages is essentially infinite. Does Hong Kong have either massive unemployment or falling wages as a result? Not at all. Unemployment is virtually non-existent, and wages have been increasing rapidly as workers have moved from relatively poorly paid manufacturing jobs to much better paid jobs in the service sector.

A close look at Hong Kong's experience is clearly in order. In the meantime, Adrian Wood's book is essential reading for anyone interested in these issues.

Reference

- Fahrer, J. & A. Pease (1994), 'International Trade and the Australian Labour Market', in P. Lowe & J. Dwyer (eds), *International Integration of the Australian Economy*, Reserve Bank of Australia, Sydney.

Jerome Fahrer is a Senior Associate of the Allen Consulting Group.