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Trade, wages, and the political economy of trade protection: evidence from the Colombian trade reforms

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Abstract

Worker industry affiliation plays a crucial role in how trade policy affects wages in many trade models. Yet, most research has focused on how trade policy affects wages by altering the economy-wide returns to a specific worker characteristic (i.e., skill or education) rather than through worker industry affiliation. This paper exploits drastic trade liberalizations in Colombia in the 1980s and 1990s to investigate the relationship between protection and industry wage premiums. We relate wage premiums to trade policy in an empirical framework that accounts for the political economy of trade protection. Accounting for time-invariant political economy factors is critical. When we do not control for unobserved time-invariant industry characteristics, we find that workers in protected sectors earn less than workers with similar observable characteristics in unprotected sectors. Allowing for industry fixed effects reverses the result: trade protection increases relative wages. This positive relationship persists when we instrument for tariff changes. Our results are in line with short- and medium-run models of trade where labor is immobile across sectors or, alternatively, with the existence of industry rents that are reduced by trade liberalization. In the context of the current debate on the rising income inequality in developing countries, our findings point to a source of disparity beyond the well-documented rise in the economy-wide skill premium: because tariff reductions were

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proportionately larger in sectors employing a high fraction of less-skilled workers, the decrease in the wage premiums in these sectors affected such workers disproportionately.

Keywords: Trade liberalization; Political economy; Industry wages; Colombia

JEL classification: F14; F16; J31

1. Introduction

The public debate on the merits and perils of trade liberalization often centers on the question of how trade reforms will affect labor markets. But despite the prominence of this question in public policy, empirical research to date has offered no conclusive evidence on the effects of trade liberalization on employment and wages. This state of affairs reflects two main difficulties associated with empirical work in the area. The first one is a measurement issue: in recent years, trade protection in developed countries has taken the form of nontariff barriers (NTBs) that are inherently hard, if not impossible, to measure.[1] Accordingly, while one might hope to use recent waves of trade liberalization as a testing ground to identify the effects of trade on wages, inference is limited by the lack of proper measures of this liberalization. The measures of international integration usually employed in the literature (imports, exports, import and export growth, import price indices, or product prices when available) are highly contentious, as they are associated with conceptual problems in their interpretation, while regressions employing them as explanatory variables suffer from simultaneity biases. These problems are particularly severe when quantity measures are used. As has been pointed out before, in general equilibrium trade models, trade affects wages through prices that are set on the margin, and not through quantities. The use of price data, on the other hand, raises other issues: prices are plagued by measurement problems and are simultaneously determined with wages. As Freeman (1995) points out, "perhaps the biggest problem with these studies is that they ignore potential determinants of sectoral prices. . .save for trade".[2] Similarly, Haskel and Slaughter (2001) argue that relying on product prices could be problematic since little is known about "how much domestic price variation is caused by international trade, such as changes in trade barriers".[3]

A second limitation is that the political economy of trade protection, while having made inroads in trade theory and empirical studies of import penetration, has remained a second-order concern in studies of the effects of trade reform on wages. Trade liberalization is usually treated as exogenous. Yet, both political economy theories of trade protection and casual empiricism suggest that trade policy is endogenous, both in the economic and

[1] The common wisdom in the field is that the agencies collecting NTB data take great care in making the data comparable across sectors and across countries in any given year, but are less concerned with consistency of the numbers across years. This makes the use of time series data on NTBs troublesome.

[2] Freeman (1995, p. 29).

[3] Haskel and Slaughter (2001, p. 164).