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Must improved labor standards hurt accumulation in the targeted sector? Stylized analysis of a developing economy

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A R T I C L E I N F O

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A B S T R A C T

This paper analyzes a stylized small open economy that consists of two tradable output-producing sectors: a manufacturing sector and a (mainly tourism-related) services sector. Assuming sectoral differences based on stylized facts, we explore the impact of higher labor standards in the manufacturing sector on the long-term prospects of the economy using comparative dynamic exercises to analyze changes in relative prices, foreign capital flows, and the sectoral distribution of investment and output. We find, in particular, that imposing higher standards across the manufacturing sector could, under certain conditions, shift the structure of the domestic economy in *favor* of that sector. This result is driven by changes in relative profitability in the presence of learning-by-exporting.

1. Introduction and motivation

Debates surrounding the issue of labor standards have acquired a prominent place in economics literature in recent years. The analysis typically focuses on issues of trade, external competitiveness, and short-run effects on foreign direct investment. This paper analyzes a stylized small open economy to explore labor standards-related issues from the perspective of long-run accumulation. In doing so, we follow the structuralist tradition in making assumptions about different sectors based on stylized facts.[1]

Existing literature has devoted substantial attention to trade–labor standard linkages, especially in the context of small open economies (a term that applies essentially to most developing economies barring perhaps a few oil and primary commodity producers).[2] Issues surrounding the role of foreign direct investment and transnational corporations in promoting or undermining labor standards have also generated much energetic debate.[3] Although labor standards impact exports in our model, our main contribution is to analyze the issue of labor standards in a stylized *macroeconomic* framework from the perspective of long-run accumulation, inter-sectoral distribution, and structural change. Moreover, we incorporate the likely distributional consequences of learning-by-exporting in a developing economy with widespread open and hidden unemployment. In doing so, we do not attempt to provide an in-depth analysis of the impact of labor standards

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[1] See, for example, Blecker (1996).

[2] See, for example, Martin and Maskus (2001) and Maskus (1997). Brown (2000) and Singh (2003) provide comprehensive surveys of related literature.

[3] See, for example, Busse (2002).

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in terms of social welfare but focus narrowly instead on the structural evolution of the economy. In particular, we analyze the consequences of higher labor standards in terms of possible effects on the share of foreign-versus domestically-owned capital stocks and of the composition of the domestic capital stock in terms of manufactures versus services.

Although this paper is theoretical in nature, the structure of the model and some of the stylized assumptions are broadly inspired by the Cambodian economy. Cambodia is currently part of a pioneering effort called the "Better Factories Program" managed by the International Labor Organization (ILO) in collaboration with other organizations. Under this program, Cambodian apparel exporters are provided an incentive to improve working conditions by facilitating access to international buyers – who make sourcing decisions – in return for improvements. What are the likely effects of such a program in the small developing economy context? The answer depends on, among other things, what happens to the rest of the economy such as the services sector, where a similar program would likely be much harder to implement given organizational and monitoring barriers. Insofar as one or the other sector is associated with greater scope for technological progress, the resulting consequences for the composition of accumulation between manufacturing and services may determine the path of output and productivity growth over the long-run.

Ever since its recovery began in the post-Khmer Rouge period, the Cambodian economy has undergone major structural changes. To take a few indicators, trade has increased as a proportion of GDP from 69 percent in 1996 to 139 percent in 2006. Manufactured exports are now almost 98 percent of total merchandise exports. Moreover, of these, textiles and garments constitute almost three-fourths. Much of the manufactured exports originate from import-intensive, vertically integrated international supply chains where profit margins are thin and most of the value addition takes place outside Cambodia. Moreover, the merchandise exported (e.g., labor-intensive apparel) has close substitutes that are easily available from international markets. Trade in services has grown rapidly to a point where it now constitutes almost 30 percent of GDP. International tourism exports alone account for a quarter of total exports of goods and services. Of these, travel and transportation constitute almost 90 percent, according to World Trade Organization (2008).

Cambodia has also experienced a remarkable surge in inflows of foreign direct investment (FDI). Initially a significant proportion of this FDI went into the tourism-related services sector but the manufacturing sector has experienced the lion's share over the past few years. Cuyvers et al. (2008) report that over 1994–2004, 43 percent of realized FDI occurred in the manufacturing sector. The garment sector attracted more than half of this FDI. In recent years the sectoral composition has become more lop-sided in favor of manufacturing, mainly garments. For example, according to Asian Development Bank (2006), the manufacturing share of approved FDI projects was 60 percent in 2005. This FDI has more than offset current account deficits in recent years. For example, according to our calculations based on the World Bank's *World Development Indicators* database, the average net FDI to current account ratio was 1.1 over the period 2000–2007. The portfolio balance (debt and securities) to current account ratio, on the other hand, was only about 0.04.

These features, along with the presence of a highly dollarized urban segment co-existing with a traditional sector that mainly produces agricultural products and non-tradables, makes Cambodia an interesting economy to analyze in the sense that it encourages us to introduce structural nuances into the traditional small open economy models. Given the main objective of our analysis, we focus on the tradable goods sector, which, since it competes internationally, is often seen as the one where the consequences of labor standards hit the hardest.[4] Specifically, we consider a two sector economy in which both sectors produce output that is tradable, although different in crucial respects (see Section 2.1). We then explore the implications of raising labor standards.

To state our main result succinctly, higher manufacturing labor standards in our framework cause foreign capital outflows. This has two effects: (1) a real depreciation, and (2) a decline in exports and hence in learning-induced labor productivity. While the former shifts relative profitability in favor of the manufacturing sector, the latter has the opposite effect. In the presence of weak learning-by-exporting, therefore, the aggregate effect could be to shift production in favor of manufacturing. In other words, contrary to the fears expressed by some, higher labor standards need not impact negatively the *overall* stock of capital in the targeted sector. By reducing the stock of foreign capital, however, it may affect prospects for technological spillovers. Moreover, if a decrease in the foreign capital stock does not induce an adequately strong real depreciation, the dynamics following higher labor standards could end with a collapse in the foreign-owned capital stock before a steady state is achieved.

A significant strand of development literature has emphasized the "special" nature of the manufacturing sector as a greater source of learning, scale economies, and dynamic gains from trade.[5] Moreover, recent work

[4] Moreover, the manufacturing sector is where the labor standards are currently being monitored in Cambodia. Another reason for emphasizing the traded sectors is that the "warm glow" effect (Gibson, 2005) for consumers in the industrialized world is an important driver behind world-wide efforts to monitor labor standards. Non-traded goods, by definition, do not make an appearance in the consumption baskets of these consumers.

[5] See, for example, Cypher and Dietz (2008) for a discussion of the domestic technological learning capacity that arises from exporting manufactures. See also Lall (1998) and Lall (2000) for insightful discussions of the manufacturing export-development nexus in developing countries. In a recent study, Rodrik (2008) hypothesizes that tradable goods (especially manufacturing) suffer disproportionately from the market failures that constitute a binding constraint on low-income country growth. In an econometric study of nine African countries, Van Biesebroeck (2005) finds evidence of manufactured exports resulting in productivity growth. The study shows that the presence of scale economies plays an important role in this regard. Credit constraints and contract enforcement issues prevent firms that only produce for the domestic market from fully exploiting this channel. These problems are likely to be more relevant for developing countries, as are the potential gains from imitation. It is not