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Labor market distortions and China's WTO accession package: an applied general equilibrium assessment

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The economic implications of China's accession to the World Trade Organization have been analyzed using applied general equilibrium techniques. We explore the consequences of trade reform in the presence of labor market distortions. A formal model of imperfect labor mobility is incorporated into a large-scale, stochastic applied general equilibrium framework with which the consequences of China's trade reform for net welfare are considered. The simulations suggest that distortions in China's labor market, including imperfect labor mobility, rural-urban migration, dual urban markets and surplus rural labor, have significant effects on trade liberalization outcomes and in some cases produce unexpected second-best results. *Journal of Comparative Economics* **31** (4) (2003) 774–794. Utah State University, 3530 Old Main Hill, Logan, UT 84322-3530, USA; IMPACT Center, Washington State University, Pullman, WA 99164-6210, USA.

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1. Introduction

The long-awaited formal return of China to the international trading system occurred in 2001. Under the terms of its World Trade Organization (WTO) accession agreement, China has committed to extensive trade reform, which reinforces an ongoing trade and domestic

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reform agenda that began in earnest with the open door policy of 1978. Several economic policy issues emerged from the domestic reform process. Among the most noteworthy are the transformations that have occurred in the labor market, in particular the growth of surplus rural labor, the gradual erosion of labor mobility restrictions, the emergence of migration from rural to urban areas, and the development of informal urban labor markets. Since the outcomes of trade reform processes are connected intimately to domestic labor market structure, the effect of these labor market imperfections on the outcomes of trade liberalization under China's WTO accession agreement is of considerable interest.

Although a substantial literature exists on the labor market in China and recent papers can be found on quantitative modeling of Chinese trade reform using applied general equilibrium (AGE) techniques, e.g., Gilbert and Wahl (2002), no significant integration of these two branches of analysis has occurred. When labor market distortions have been introduced into the numerical simulations, the results are striking. Xu (1994) calculates much larger gains from trade reform by the introduction of surplus rural labor to a three-sector model. In contrast, Zhai and Li (2000) introduce imperfect labor mobility to a neoclassical model and show that the estimated net welfare effects of reform are lower than in other comparable studies. Other labor market distortions, and potential interactions among these distortions, remain unexplored. In this paper, we consider the effects of trade reform using both formal modeling and numerical simulation with the latest GTAP5 database in a highly disaggregate, i.e., 57 sector, model of the Chinese economy. We explore systematically the implications of Chinese labor market distortions, including wage gaps, migration, imperfect mobility, informality, and surplus labor, using a comparative simulation approach and extensive sensitivity analysis.

The paper is organized as follows. In Section 2, we review briefly the relevant labor market imperfections. In Section 3, we use a formal general equilibrium model to illustrate some of the consequences for trade policy of a subset of these imperfections. This model highlights the underlying structure of a larger and more realistic numerical general equilibrium model that we describe in Section 4, along with our systematic sensitivity analysis procedures. In Section 5, we present the results of a series of simulations quantifying the potential effects of WTO accession in China in the presence of labor market distortions and discuss the policy implications. Our work is not an analysis of the role of Chinese labor markets in economic development. Rather, it is an analysis of the consequences of trade liberalization in a second-best environment. Our objective is to understand the interactions of existing labor market distortions with the trade reform process. Accounting for labor market distortions is shown to have substantial effects on the estimated outcomes of WTO accession. Section 6 contains concluding comments.

2. Labor markets in China

In the past, development of Chinese heavy industry was supported by means of a cheap food policy and urban household subsidies, which were maintained by introducing a household registration system (*hukou*) that limited the number of subsidized urban residents (Carter, 1997). State-owned work units limited access to jobs. Rural workers

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