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I Z A
World of Labor
Evidence-based policy making

Trade, foreign investment, and wage inequality in developing countries

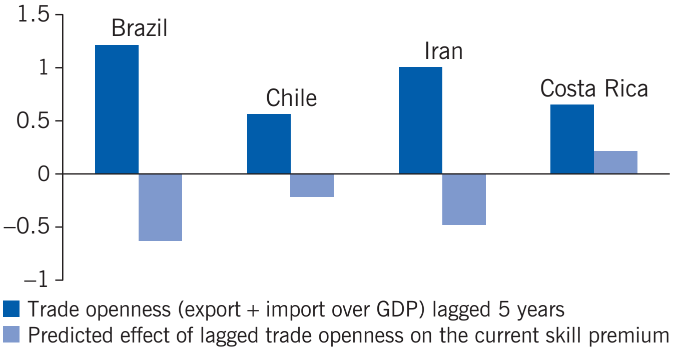
Exposure to foreign trade raises the skill premium in countries with a large stock of educated workers and reduces it in others

Keywords: trade openness, offshoring, skill endowments, skill premium

ELEVATOR PITCH

Liberalization of foreign trade and investment raises the domestic ratio of skilled to unskilled wages (skill premium) if the country has a sufficiently well-educated workforce, but lowers it otherwise. Wide wage inequality is undesirable on equity grounds, especially in poor countries where the bottom wage is close to the breadline; but it gives parents an incentive to invest in their children's education. The incentive will be ineffective, however, if parents cannot borrow for their child's education because of underdeveloped credit markets or because they are too poor to finance the investment from their own income and savings.

Trade reduces the skill premium if initial endowment of skilled labor is insufficient



Source: Based on Figure 1.

KEY FINDINGS

Pros

- In developing countries with a sufficient stock of skilled labor, liberalization boosts the skill premium and increases the incentive for parents to invest in their children's education, provided that liquidity constraints can be addressed.
- A fall in the skill premium redistributes income from the rich to the poor.
- Regardless of the initial stock of skilled labor or the effect on the skill premium, liberalization raises average income and reduces child labor (encourages investment in education).

Cons

- In developing countries with a sufficient stock of skilled labor, liberalization redistributes income from the (unskilled) poor to the (skilled) rich, making it harder for parents who are poor to invest in their children's education.
- If a country lacks enough educated people when it liberalizes, wage inequality will fall, but the incentive to invest in children's education will weaken.
- Foreign investment reduces the demand for skilled labor in countries where the supply is low.

AUTHOR'S MAIN MESSAGE

Although liberalization raises average income and reduces child labor, developing countries ought to delay opening to foreign trade and investment until they have accumulated a stock of educated workers large enough for foreign trade and investment to raise the skill premium. Countries that liberalized prematurely because of outside pressures prolonged their condition as low-skill producers, while development advanced in countries that waited. Even if the stock of educated workers is sufficiently large, government intervention may still be needed to counter the adverse consequences of trade-induced wage disparities on income distribution.

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