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Economic theory suggests that greater openness to world trade in developing countries will reduce wage inequality. Trade liberalization raises the relative demand for unskilled workers and therefore reduces the wage gap between the skilled and the unskilled. The evidence for East Asia during the 1960s and 1970s supports this theory but the Latin American experience since the mid-1980s does not. This article examines this conflict of evidence. It asks whether these findings reflect a difference between the time periods .

Heckscher-Ohlin Theory

The dominant theory in the neo-classical economics of international trade is referred to as the Heckscher-Ohlin theory. This theory says that nations will choose to export goods that maximize the use of factors of production that are abundant within their borders. These exports will be exchanged for goods that use factors of production that are relatively scarce at home. The expansion of exports will raise the demand for abundant factors, while the growth of imports will reduce the demand for scarce ones. Thus, in the developing world where unskilled labor is a majority and skilled labor is scarce, increased trade tends to increase unskilled wages, lower skilled wages, and therefore reduce the gap between them.

The Heckscher-Ohlin theory holds both in simple situations that include only two goods, two factors, and two nations, and in more complex cases where there are many goods, and many countries. However, when considering multiple goods, countries and factors, the inclusion of nontraded goods or factors such as transportation and infrastructure can change the results, allowing trade to induce substitution between traded and nontraded goods as well as shifts within the realm of traded goods.

Overview of the Empirical Evidence

Some of empirical literature regarding the relationship between greater openness and relative wages in developing countries supports the conventional wisdom, as in the case of East Asia, some of it does not.

Almost all of the factor content studies in developing countries show that exports are less skill intensive than imports, thus supporting the view that greater openness benefits the unskilled. Factor content of trade studies calculate the amounts of skilled and unskilled labor used to produce a nation's exports and then compares these with the amounts of skilled and unskilled labor that would be used to produce at home the goods that the nation imports. When the ratio of skilled to unskilled labor is lower for exports than for imports then increased openness to trade should raise the demand for unskilled workers.

Time series studies tell a more varied story. They look at the changes in the relative supply of skilled and unskilled labor, and to changes in labor market institutions that increase or reduce wage flexibility. In this literature there is a conflict: in some countries and periods increased openness has caused a narrowing of the skill gap, but in others the opposite has occurred.

A good deal of the evidence for East Asia supports the conventional view that openness raises the demand for unskilled relative to skilled workers. During the decades in question, this was the case in the Republic of Korea, Singapore, and Taiwan. In Hong Kong the wage gap widened, but this could be do to a large increase in the supply of unskilled labor. Another possible reason for the narrowing of the wage gap in these nations is the expansion of post-basic education. Following export oriented industrialization in these nations, the expansion of higher education compressed wage differentials. However, in all three of the cases where differentials narrowed, the change in trade regime was at least partly responsible. For other countries in East Asia, such as Malaysia the evidence is not as clear.

Contrary to conventional wisdom, during periods of trade liberalization in Latin America, skill differentials in wages widened. In Argentina and Chile this occurred from the mid 1970s to the early 1980s; in Mexico after the mid-1980s; and between the mid 1980s and the mid 1990s in Columbia, Costa Rica, and Uruguay. In all of these cases, the number of skilled workers was rising.

In some of these cases changes in labor market institutions may help explain the widening of skill differentials. In Chile the widening of wage differentials in the late 1970s during the rise of the authoritarian Pinochet regime coincided with sever curtailment of union activity. Similarly, wage differentials widened in Argentina after a military coup and parallel declines in union activity during the late 1970

Differences Between East Asia and Latin America

Is the conflict of evidence due to regional differences between East Asia and Latin America in resource availability include trade liberalization policies?

East Asian and Latin American natural resources differ in several respects, but it is difficult to draw a causal connection between these differences and the difference in the impact of trade liberalization on wage inequality. Where Latin America is resource-rich and enjoys a comparative advantage in primary products, East Asia has few natural resources but is better endowed with manufactures such as footwear and clothing. However, primary exports tend to employ even more unskilled workers than manufactured exports. So one would expect the conventional effect to be stronger in Latin America than in East Asia. Perhaps the combination of nontraded sectors as well as natural resources could explain these differences in Latin America. If trade liberalization caused both nontraded and export sectors to expand the net effect might be an increase in the relative demand for skilled labor. While this may seem far fetched, it warrants further research. The policy mechanisms used in opening to trade in each region were also different. In East Asia, liberalization was achieve by increasing incentives for exporters and protecting selected sectors against imports. Latin America however, opened trade by reducing barriers to imports. Because neither subsidies nor barriers are the same across sectors, their effects on the skill composition of the demand for labor could be different. However, as in the case of natural resource endowments, the explanation of the widening gap in wages in Latin America can not be explained by the nuances of its changing trade regime.

Differences Between the 1960s-70s and the 1980s-90s

Changes in the make up of the world economy during the periods examined are the most convincing explanations of the Latin American challenge to conventional wisdom. Specifically, the entry of large low income countries into world markets in the 1980s and the shift in the skill content of technology, are the most plausible explanations.

The entry of nations such as China, and Indonesia into the world market for labor intensive manufactures in the 1980s shifted the comparative advantage of middle income nations into goods of more medium skill intensity. Thus, trade liberalization in middle income countries , so that middle income East Asian countries, liberalizing at that time, had a comparative advantage in unskilled labor. In contrast, trade liberalization in Latin America in the 1980s coincided with expanding exports. During this period, the world price of unskilled labor dropped relative to that of skilled labor.

Perhaps trade liberalization had different effects on wage inequality in the 1980s than in the 1960s because the content of technological change. Imports of new technology into Latin American countries could have been what raised the relative demand for skilled labor. This "skill-enhancing trade" explanation has considerable support in the literature, but certain doubts about it have been raised.

Conclusions

The conventional wisdom would postulate that increased trade liberalization in developing countries would increase the demand for unskilled relative to skilled labor and thus reduce wage inequality. The Latin American experience in the mid 1980s and 1990s challenges this wisdom. The Latin American exception is due to the entry of low income nations into the world economy and to skill biased technological change.