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Long-run costs of piecemeal reform: Wage inequality and returns to education in Vietnam

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ABSTRACT

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In this paper, we examine changes in wage structure and wage premia during Vietnam's transition from command to market economy. Relative to other work in this literature, our paper is unique in that we identify the policies that lead to such changes. By examining skill premium trends along the two dimensions of particular importance to the transition—state or non-state firms, and traded or non-traded industries—we are able to separate the contribution of external liberalization to wage growth and rising skill premia from that of domestic labor market reforms, and to examine potential interactions between the two types of reform. The results point to the high cost of incomplete reform in Vietnam. Capital market segmentation creates a two-track market for skills, in which state sector workers earn high salaries while non-state workers face lower demand and lower compensation. Growth is reduced directly by diminished allocative efficiency and reduced incentives to acquire education, and indirectly by higher wage inequality and rents for workers with access to state jobs. *Journal of Comparative Economics* **41** (4) (2013) 1106–1122. Department of Economics, Beloit College, United States; Department of Agricultural and Applied Economics, University of Wisconsin–Madison, United States.

1. Introduction

The skill premium – the ratio of wages for skilled or relatively highly educated workers to those of workers with low skills or education – is an important and widely used indicator of progress in economic development. It provides information about the distribution of income, at least among wage earners. It also signals incentives for individuals to acquire education or skills, the accumulation of which (in the aggregate) is essential to long-run economic growth. Further, trends in the skill premium reveal, indirectly, some of the consequences of changes in production structure and employment associated with economic growth or globalization.

The idea of a single, economy-wide skill premium presumes the existence of a unified market for human capital. In some developing and transition economies, however, this assumption may not be justified. If the labor market is segmented by policies or market failures, then equilibrium skill premia can differ among workers even if they are alike in other respects such as gender and ethnicity, and both wages and returns to skills can in principle evolve independently. In this case skill

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premium data can yield more information than listed above. They provide circumstantial evidence of the nature and extent of imperfections in the wage labor market. This in turn makes it possible to ask new normative questions about economic efficiency, and about the distribution of income and opportunity among workers.

In this paper we explore trends in wages and returns to education in the wage labor market of a transitional developing country, Vietnam. That country's transition to "market socialism" since about 1990 has been marked both by extensive domestic policy reforms and by a huge increase in exposure to global markets. *A priori*, each process has momentous impacts in the labor market. Our data cover almost two decades of the transition, during which time average wages rose in real terms and average returns to education also increased. Both of these trends are widely observed in the course of economic growth and the transition to a market economy, as we discuss in more detail below. But the Vietnamese data also reveal two unusual patterns.

First, the most important trends have not been linear – nor even monotonic – over the entire transition period. In particular, while average real wages rose from 1993 to 2008, most of this increase took place during the 1990s; in the 2000s there was a clear slowdown in wage growth. Likewise, skill premia rose sharply during the 1990s but leveled off and even declined somewhat in the 2000s.

Second, we find persistent differences in both levels and growth rates of wages and skill premia across some subsectors of the labor market, even after controlling for ethnicity, gender, location and other characteristics. These differences can be seen between state and non-state employers. Prior to the mid-1990s state sector wages offered no premium for education; this "wage grid" system was dismantled only after a major reform in the early 1990s. Another dimension over which we find variation is that of traded and non-traded industries. Vietnam's move from near-autarky to more integration with the global economy has been promoted by measures—notably exchange rate unification and depreciation, trade policy relaxation, and domestic commercial policy reform—which increase the domestic terms of trade between traded and non-traded industries.

If internal policy reforms, especially the relaxation of wage controls in the state sector, and external (trade and FDI policy) reforms have been so extensive, why is it that intersectoral gaps in wages and skill premium persist? We hypothesize that this is due to incomplete transition, specifically, the persistence of interventions in capital and labor markets, even as extensive external liberalization was taking place. The government's policy of giving state firms preferential access to capital creates segmentation in the capital market, and this spills over to the market for skills because of capital-skill complementarity. Consequently, a program of economic policy reform that is both gradual and incomplete may impose substantial costs in the form of inefficient allocation of both capital and skilled labor. This in turn might give rise to persistent inequality of income and opportunity.

There is a large microeconomic literature devoted to estimating the determinants of wages and returns to education for individuals. We review a Vietnam-specific subset of these in the next section. But our work also connects to two areas of macroeconomic research, on transition economies and on globalization.

In Eastern Europe and the former Soviet Union (EE/FSU), the collapse of communism around 1990 caused deep and sustained recessions and dramatic reductions in state sector output and employment. The recovery of employment during this transition was led by private (and newly privatized) firms. Workers with skills specific to state-owned firms suffered relative wage declines (Brainerd, 1998); there was positive selection of skilled and ambitious workers into private sector enterprises unconstrained by the state sector wage grid (Adamchik and Bedi, 2000), and overall there was a rise in average returns to skills, led by growth of skill-intensive private sector firms (Flanagan, 1995; Orazem and Vodopivec, 1997; Adamchik and Bedi, 2000; Munich et al., 2005). The evidence from EE/FSU transitions seems to support the contention that smaller, privately held firms are in general more open to new ideas and technologies. This is also the contention in recent work on China, another economy undergoing a slow and as yet highly incomplete transition (Lin, 2011; World Bank/DRC, 2012).

The global trend toward more open trade and capital market policies also dates from around 1990. It too has stimulated a lot of research, much of it evaluating the effects of trade policy reforms and globalization on wages and skill premia. Many studies of low-income economies undergoing trade liberalization have found that skill premia have risen rather than falling as predicted by the Heckscher–Ohlin/Stolper–Samuelson model. In Latin America and Asia, skill premia and wage inequality have increased along with integration into the global market (Wood, 1997; Arbache et al., 2004; Knight and Song, 2003). These trends may still be consistent with Heckscher–Ohlin in that the rise of China and India to global prominence has caused a sharp rise in the global endowment of unskilled labor. Other analyses, however, have identified Ricardian technology-based comparative advantage as playing a leading role, especially in the more dynamically growing developing and transitional economies (Feenstra and Hanson, 1997; Zhu and Trefler, 2005). If market-driven growth of skill-intensive industries is the main cause of rising wage inequality, then there is no cause for concern on welfare grounds. However, these studies' findings are for *average* skill premia. At least one more recent study finds (in the case of China) that the averages mask differential rates of skill premium growth within a segmented labor market (Li and Coxhead, 2011).

Vietnam's transition is superficially similar to those in EE/FSU in that there was a great deal of new private sector activity and rising skill premia. By contrast with EE/FSU, however, economic growth in Vietnam remained positive throughout the transition. Moreover, state-owned enterprises (SOEs), while contracting in relative terms, by no means became irrelevant or marginalized. Rather, their privileged access to capital and other resources meant that they were well placed to take advantage of opportunities created by closer global integration. In this paper we explore how such differences in transition experiences might explain the observed trends in Vietnam's wage labor market, in particular the rise in average wages and skill premium, as well as the persistence of inter-sectional wage and skill premium gaps.