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Poverty, labor markets and trade liberalization in Indonesia

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ABSTRACT

We measure the effects of trade liberalization over the period of 1993–2002 on regional poverty levels in 259 Indonesian districts, and investigate the labor market mechanisms behind these effects. The identification strategy relies on combining information on initial regional labor and product market structure with the exogenous tariff reduction schedule over four three-year periods. We add to the literature on local labor market effects of trade policies by distinguishing between tariffs for output markets and for intermediate inputs, and finding that poverty reduced especially in districts with a greater sector exposure to input tariff liberalization. Among the potential channels behind this effect, we show that low-skilled work participation and middle-skilled wages were more responsive to reductions in import tariffs on intermediate goods than to reductions in import tariffs on final outputs. These results point towards increasing firm competitiveness as a driving factor behind the beneficial poverty effects.

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1. Introduction

Trade liberalization has been widely expected to contribute substantially to poverty reduction in developing countries (e.g., the Doha Ministerial Declaration, WTO, 2001). Under a more open trade regime, rising demand for unskilled labor could benefit poor workers by increasing workers' real wages (Stolper and Samuelson, 1941) as well as creating more jobs in the formal economy. However, the growing body of micro-empirical evidence on the welfare implications of trade liberalization is not unequivocal.¹ Short- to medium-run labor market effects of liberalized trade seem to be very much context specific and depend, among other things, on the previous structure of protection (Attanasio et al., 2004), regional market access (Chiquiar, 2008) as well as the degree of market flexibility. For example, overregulated local labor markets that inhibited the adjustment to structural change could explain the unfavorable regional poverty effects of trade reform in India (Topalova, 2010).² By contrast,

bilateral trade liberalization between the US and Vietnam led to clear reductions in Vietnamese rural poverty, potentially also due to higher labor market mobility (McCaig, 2011). In this latter case, poverty reduction resulted from large improvements in the access to the US market whereas the loss of import protection to local markets was negligible.

Studies focusing on labor market and wage effects of tariff reductions present indirect evidence on potential effects of trade liberalization on poverty, again with mixed results. Reductions in protection and increased foreign competition generally seem to have increased skill premia in Latin America (e.g., Attanasio et al., 2004; Galiani and Sanguinetti, 2003; Goldberg and Pavcnik, 2005), although with some exceptions (e.g., Gonzaga et al., 2006 for Brazil). While most of these studies focus on formal manufacturing employment, Goldberg and Pavcnik (2003) also document an increase in informality in the sectors most exposed to tariff cuts in Colombia. Gaddis and Pieters (2014) find negative effects of trade liberalization for low skill employment in Brazil, and re-allocation of high skill labor from the tradable to nontradable sectors. These empirical findings of increases in skill premia and informality in Latin America suggest that it is less likely that trade would have had strongly favorable poverty effects in the region. However, contrasting evidence is presented by Porto (2006) who finds pro-poor distributional effects of Mercosur in Argentina through price changes and wage responses.

Indonesia offers an interesting case to study the poverty effects of trade liberalization. It is considerably more abundant in unskilled labor than large Latin American countries such as Mexico or Brazil and

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¹ See e.g., Goldberg and Pavcnik (2007) and Winters et al. (2004) for surveys of the earlier literature.

² In a similar vein, tariff reductions in Brazil were associated with increases in urban poverty, which anecdotal evidence attributes to adjustment frictions and rising urban unemployment (Castilho et al., 2012).

hence has a more pronounced comparative advantage in unskilled-labor intensive goods. In the period that we will study in this paper, Indonesia also had relatively flexible labor markets that could potentially restrict the adverse effects of trade reforms on poverty. Moreover, its vast geographic and economic diversity yields potentially large regional variation in the effects of trade liberalization.

With the completion of the Uruguay round in 1994, Indonesia committed itself to substantially lower its remaining tariff barriers across all tradable goods over the following ten years. The tariff reductions were concentrated in the hitherto most protected sectors and resulted in an overall convergence of sectoral protection levels; average import tariff lines decreased from around 17.2% in 1993 to 6.6% in 2002 (see Fig. 1). During the same period, poverty rates also declined, although it is a priori unclear to what extent this decrease can be attributed to trade liberalization.

The existing empirical evidence suggests that trade liberalization could potentially explain a part of the reductions in Indonesian poverty during the nineties. Amiti and Cameron (2012) show that industrial skill premia (defined as the relative wage bill of nonproduction to production workers in manufacturing establishments with at least twenty employees) decreased as a response to tariff reductions. By distinguishing between tariffs on output and intermediate goods used by those firms they are also able to show that skill premia changed mostly because of improved firm competitiveness due to reductions in tariffs on intermediate goods. As a consequence, we would therefore also expect differential effects of tariff reduction through input and output markets on poverty.

Kis-Katos and Sparrow (2011) document that child labor decreased faster in districts that were relatively more exposed to trade liberalization, with indirect evidence that this was driven by positive income effects for the poor. Descriptive evidence also shows the presence of ongoing structural change and reductions in wage inequality (Suryahadi, 2003) as well as improvements in labor conditions (Robertson et al., 2009) over the same time period. However, this evidence, although suggestive, does not directly address the poverty effects of trade liberalization and the relative importance of the different channels for poverty reduction.

In this study we assess the causal effects of tariff reductions on poverty in Indonesian districts in the period of 1993 to 2002. Our study extends the literature on the poverty effects of trade liberalization by explicitly distinguishing tariffs for output markets and for intermediate inputs, and analyzing the effects of reducing these tariffs in a

geographically diverse Southeast-Asian country with large labor mobility. Using district pseudo-panel data, we find that especially reductions in tariffs on intermediate inputs tend to reduce the extent of poverty.

In addition, our analysis focuses on the channels of labor market dynamics, wages, job creation and displacement. With regard to wage effects and job creation, we investigate the regionally differential effects of tariffs on output and intermediate goods using firm level data and household and labor market surveys. We find that increased competitiveness of firms due to lower import tariffs on intermediate goods is weakly related to increases in manufacturing wages. However, we also find evidence of increased poverty due to reduction in output tariffs, presumably due to costly adjustment to trade. This contributes to the empirical evidence on the effects of trade liberalization on local labor markets, in particular highlighting the differences in the mechanisms of liberalization affecting intermediate and output goods.³

The next section describes the context and trends in tariff reductions and poverty and outlines our expectations with respect to the effects of trade liberalization. Section 3 presents the data sources for the pseudo-panel analysis and Section 4 outlines the identification strategy. The results follow in Section 5, while Section 6 investigates the possible confounding trends, discusses caveats and potentially remaining sources of bias. Section 7 concludes.

2. Trade liberalization in Indonesia and its expected effects

2.1. Descriptive trends

Indonesia started to liberalize its trade regime from the mid-1980s, involving a first reduction in tariff lines and a slow tariffication of non-tariff barriers (Basri and Hill, 1996). These reforms were accompanied by reforms of fiscal policy, tax reforms and financial deregulation. The second wave of trade liberalization started in the beginning of the 1990s. By the end of the Uruguay round, Indonesia entered formal multilateral agreements to apply binding tariff ceilings of maximum 40% on 95% of its products (up from 9% of binding tariff ceilings before) (WTO, 1998).

Fig. 1 shows the reduction in average unweighted effectively applied tariff lines across the 1990s: on average, tariff lines reduced from 17.2% in 1993 to 6.6% in 2002. The tariff reductions were not gradual but occurred more or less in two steps over the analyzed time period: the first large reduction of tariff barriers came about with Indonesia's WTO obligations preceding the formation of the WTO, while a second substantial wave of tariff reductions followed in the post monetary crisis period as part of the IMF conditionality package, starting with 1999. Table 1 shows the detailed evolution of the tariffs for the 20 major tradable sectors, which are defined according to a concordance of tariff information and census labor market data. Fig. 2 plots the average reductions in tariffs for these sectors over the entire time period. The high correlation between initial tariff levels and tariff reductions shows that tariff reductions occurred across the board and were the highest in those industries that started with the highest original tariff levels. Moreover, the pattern of tariff reductions across sectors shows that highly protected sectors were not favored by means of delaying exposure to tariff

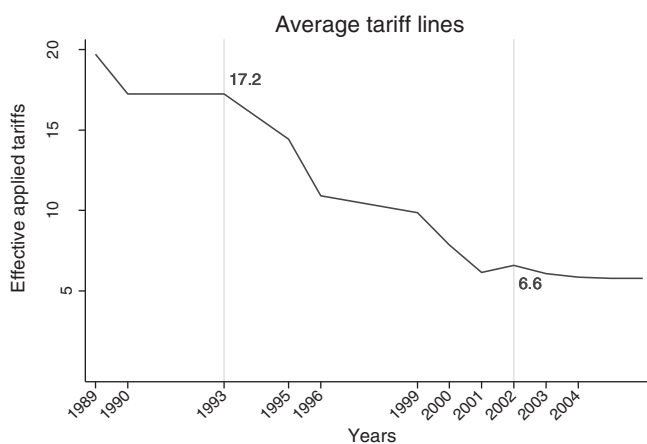


Fig. 1. Evolution of average tariff lines 1993–2002. Source: Kis-Katos and Sparrow (2011).

³ Goldberg and Pavcnik (2003) assess the effects of trade liberalization on the informal sector in Brazil and Colombia. Autor et al. (2013) look at job displacement in the US due to imports from China, while Iacovone et al. (2013) find displacement effects in Mexico as a result of increased competition from China for its exports on US markets.

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