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Gains and losses from sectoral relocation: A review of theory and empirics☆

Frank Barry[a,*], Frank Walsh[b]

[a] *Trinity College Dublin, Dublin, Ireland*
[b] *University College Dublin, Dublin, Ireland*

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Abstract

This paper addresses the distributional consequences of international sectoral relocation. We begin by looking at the gains and losses for individual countries by reviewing the implications, and real-world relevance, of the various trade and growth models that address the issue. In each case, the role of FDI in the process is explored. The second part of the paper reviews the empirical evidence on what becomes of workers whose jobs are displaced by sectoral relocation. The ongoing policy debate on how to minimise the costs of displacement and the length of the adjustment period is also reviewed.
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1. Introduction

What causes sectoral production and employment to relocate across countries? Developments both within sectors (as emphasised by the product life-cycle model) and within countries (as with human capital accumulation) are clearly important. Ongoing liberalisation, exemplified by the integration of China, India and Central and Eastern Europe into the global market, is another driving force, as is the telecommunications revolution, which has made many formerly non-traded services internationally tradable. The growth of business process offshoring provides a dramatic example of the latter phenomenon. Foreign direct investment is an important component of all of these processes, and FDI has expanded even more rapidly than trade over recent decades.

The present paper is concerned with the distributional consequences of these global developments. One focus of analysis is on the distribution of the consequent gains and losses across countries. This has always been a contentious issue in public debate. Rich-country workers fear that they will be outcompeted by lower-wage workers from poorer countries, while firms from poorer countries fear that they will be unable to compete against stronger more established

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* Corresponding author.
E-mail address: frank.barry@tcd.ie (F. Barry).

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firms from richer countries. The other focus of analysis is on the distribution of gains and losses across factors of production such as low- and high-skill labour and owners of capital.

Different branches of the economics literature deal with various aspects of the issue. We consider the following four strands. (i) *Traditional trade theory* studies the consequences of the inter-industry adjustment to which trade liberalisation can give rise. Similar methods are used to study the consequences of liberalisation or expansion of foreign direct investment flows. (ii) *New trade theory*, which is based on imperfect competition and increasing returns (as is much of the recent FDI literature), focuses primarily on adjustments within rather than across industries, with the former typically assumed to be associated with lower adjustment costs. (iii) The "*new economic geography*" analyses the circumstances under which the world can be divided into a core and periphery, and assesses the consequences of falling trade costs for both areas, and (iv) *new growth theory* studies the cross-country distribution of the gains from innovation and technology diffusion.

Section 2 of the paper discusses the treatment afforded by each of these various literatures, while Section 3 surveys the state of knowledge on the consequences of sectoral relocation for displaced workers. It also considers the range of policy options that have been proposed to deal with the increased pace of sectoral relocation associated with globalisation.

2. Perspectives on the gains and losses from sectoral relocation

2.1. Traditional trade theory, FDI and offshoring

Our discussion will concentrate largely on the case of small economies which have little or no influence on world market prices.[1] The move from protectionism to free trade entails a movement away from self-sufficiency towards specialisation in export sectors in which each country has a comparative advantage. This allows each country to purchase from elsewhere the goods that it cannot produce efficiently, leading to a reduction in the prices it pays. The resources released from these declining sectors can then be transferred to other industries in which the country is relatively efficient, with the country gaining from the expansion of its relatively more efficient sectors.[2]

One obvious problem that can arise in the process is when distortions such as wage rigidities prevent the inter-sectoral reallocation of resources. In this case the jobs lost in declining industries may not be replaced by job gains elsewhere. The resulting increase in unemployment can mean that the country loses rather than gains from trade liberalisation. This is clearly an important real-world problem. The theory of optimal intervention shows that this issue is best tackled at source – by removing or overcoming these rigidities so that the country can reap the benefits of trade liberalisation – rather than by leaving protectionist policies in place. These issues are discussed at length later in the paper.

The period of time that displaced workers will spend out of work – and hence the overall speed of adjustment – will also depend on the prevailing stage of the business cycle. As Stiglitz (2002, p. 53) points out: "When trade liberalisation is done in the right way and at the right pace, so that new jobs are created as inefficient jobs are destroyed, there can be significant efficiency gains"; however (p. 84), "trade liberalisation *accompanied by high interest rates* is an almost certain recipe for job destruction and unemployment creation".

In the absence of such rigidities, what are the distributional implications of liberalisation? The Stolper-Samuelson theorem tells us that, in a two-factor world, one domestic factor will gain and the other will lose, with the overall gains outweighing the losses. To solidify the discussion, let us consider the cases of Austria and Hungary. Since the opening up of trade between the two countries means that the factor in scarce supply in Hungary (let us call it capital) is no longer effectively as scarce in that country (since capital-intensive goods can now be imported from abroad), Hungarian capital-owners lose while Hungarian labour gains. Austrian owners of capital meanwhile gain at the expense of Austrian labour.[3] These within-country redistributional effects underlie the study of "the political economy of protectionism".

[1] The "optimum tariff" argument suggests that large economies such as China may have an incentive to impose trade restrictions which shift world prices in their favour. The threat of countervailing actions by other large economies means however that such policies would frequently end up damaging the initiating countries; however, Krugman (1987).

[2] Since the gains from trade arise from the resulting changes in relative export and import prices, and since these changes will be largest for small economies, it is small economies that are predicted to gain most.

[3] The distributional consequences of the opening up of FDI between the two economies are the same, since this should see capital flow towards capital-poor Hungary.

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