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► **To cite this version:**

Julien Gourdon. Trade and Wage Inequality in Developing Countries: South-South Trade Matter. 2011. halshs-00557113

**HAL Id: halshs-00557113**

**<https://shs.hal.science/halshs-00557113>**

Preprint submitted on 18 Jan 2011

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Document de travail de la série

***Études et Documents***

E 2007.10

**TRADE AND WAGE INEQUALITY IN DEVELOPING  
COUNTRIES: SOUTH-SOUTH TRADE MATTER**

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53 p.

*Abstract*

The relationship between trade liberalization and inequality has received considerable attention in recent years. The primary purpose of this paper is to present new results on the sources of wage inequalities in manufacturing taking into account South-South (S-S) trade. Globalization not only leads to increasing North-South (N-S) trade, but the direction and composition of trade has also changed. More trade is carried out between developing countries. We observe increasing wage inequality is more due to the South-South trade liberalization than to the classical trade liberalization with northern countries. The second purpose is to elucidate the link between the direction of trade and technological change, arguing that it might explain why we obtain different results for South-South trade and North-South trade on wage inequality. A part of this increasing wage inequality due to S-S trade comes from the development of N-S trade relationship in S-S trade which increases wage inequality in middle income developing countries. However the fact that S-S trade is more skill intensive sector oriented increase wage inequality for all developing countries.

JEL classification: F1, J3, O3

Keywords: International Trade, Wage Inequality, Skill-biased technical change

## 1 Introduction

The relationship between trade liberalization and inequality has received considerable attention in recent years. Integration with world markets bears the promise of prosperity in developing countries. Concerning inequality the predictions by economists would be that lower tariffs and transportation costs should push each country to specialize in the production of the goods for which it has a comparative advantage. Since unskilled labor is the abundant factor in the developing world and skilled labor the abundant factor in the developed world, globalization should therefore be associated with an increase in the relative demand for unskilled labor in poor countries, thereby resulting in a decrease in inequality. However, empirical evidence does not support this expected result. Studies on income distribution do not find clear cut results and studies on wages find mainly an increasing wage inequality during trade liberalization (often in Latin American countries). Faced with this unexpected result several studies provide explanations concerning wage inequalities during trade liberalization (Goldberg and Pavnick 2004). The main explanation used is the skilled biased technological change incorporated in trade liberalization which favors the wage of skilled workers in North and South countries.

In this paper, I propose another explanation: the direction of trade. A developing country might trade with another developing country. Hence the impact on wage inequality in this case may not correspond to the classical Stolper-Samuelson result. Then, taking into account South-South (S-S) trade, we come back to the effect of skill-biased technological change in considering a sector-biased technological change rather than a factor-biased technological change.

Pursuing this reasoning, globalization not only leads to increasing North-South (N-S) trade, but the direction and composition of trade has also changed. More trade is carried out between developing countries, and more developing countries are now exporting manufactures. Indeed South-South trade now accounts for around two fifths of all developing country merchandise trade and around 12 per cent of global merchandise trade. Trade liberalization has underpinned this development, with average tariff levels around one-third of their 1983 levels. As developing country markets become more important for other developing countries, and future trade liberalization will mainly concern South-South trade<sup>1</sup>, we need to examine closely their trade policies and their impact on inequality<sup>2</sup>.

First, in accounting for heterogeneity in the South we might discover that upper middle income countries are the “Northern” countries among low-income countries and this South-South trade will increase wage inequality in those middle-income countries while decreasing wage inequality in low-income countries. In this case, effects are only a transposition of classical North-South trade theory.

Second, trade liberalization with Northern or Southern countries could also bring inequality among workers if those who have the skills needed to adjust to the new technologies benefited from increased economic integration while the others were left behind. Here the question is how to link trade liberalization, technological change and wage inequality. Several

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<sup>1</sup> It is notable that around 70 per cent of tariffs faced by developing countries are levied by other developing countries

<sup>2</sup> Here we restrict globalization to trade liberalization, outsourcing, immigration and capital account openness, as they affect trade flows in goods. A measure which could do a distinction between trade liberalization with a northern partner and trade liberalization with a southern partner does not exist (the tariffs by partner’s country are available on TRAINS since 1989). So we mainly use a ratio of trade flows on output.

studies link them, using skill-biased technological change. However, Haskel and Slaughter (2002) showed recently that, concerning the USA and UK, it was sector-biased technological change and not skill-biased technological change which matters to explain wage inequality. Taking this perspective, we explore whether S-S trade and N-S impact differently on sector technological change since this may explain a difference in the impact of South-South trade on wage inequality.

Concerning inequality we only focus on wage inequality which is closest to the predictions of Stolper-Samuelson. Most previous studies on wage inequality concerned only country case studies (mainly Latin American countries) because of the lack of comparable wage data across countries. However developing countries are heterogeneous and it is difficult to obtain global results from country case studies. Studies on panels of developing countries used Gini coefficients which measure inequality in income and so include the revenue from capital and natural resources. Recently we have had access to a homogeneous dataset on inter industry wage inequality. So here we deal with wage inequality across industries and not between workers as usual in the literature on wage inequality.

More precisely, the primary purpose of this paper is to present new results on the sources of wage inequalities in manufacturing taking into account South-South trade. We use two trade ratios, the first one measures trade liberalization with developed countries and the second one measures trade liberalization with developing countries<sup>3</sup>. In including them successively and together in an estimation of wage inequality, we observe increasing wage inequality is more due to the South-South trade

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<sup>3</sup> In addition we replicate this test in using two indexes of trade policy openness for developing countries obtained from a gravity model of bilateral trade data,

liberalization than to the classical trade liberalization with northern countries.

The second purpose is to elucidate the link between the direction of trade and technological change, arguing that it might explain why we obtain different results for South-South trade and North-South trade on wage inequality. Studies that link trade liberalization and technological change assume that increasing imports of machines have increased wage inequality in developing countries in introducing skill-biased technological change (SBTC). Effectively using these machines requires skilled workers and increases the relative demand for skilled workers. However, it does not capture the effect of technological change on TFP which might also affect wage inequality, and in a different way. Hence if the technological change (even a SBTC) occurs in unskilled intensive sectors this may decrease wage inequality, by increasing demand for unskilled labor.

The remainder of the chapter is organized as follows. Section 2 presents a literature review on trade liberalization and wage inequality in developing countries. Section 3 presents the descriptive statistics on all aspects of S-S trade and N-S trade in our database which concerns 68 developing countries for 1976-2000 for 27 manufacturing industries and which is based on Nicita and Olareagga (2006). Section 4 presents the results concerning our assumption on the impact of S-S trade and N-S trade on wage inequalities. Section 5 concludes.

## 2 Review of the Empirical Literature

### 2.1 Basic Theory

The crucial feature of the “standard” theory (i.e. factor endowment based theory) on the determinants of wage inequality is the correspondence between product prices and factor prices. This implies that an increase in the relative price of a good results in an increase in the relative return of the factor used intensively to produce that good. An extension to the above analysis considers capital, skilled and unskilled labour as the relevant factors of production. Hence if unskilled labor is the abundant factor in the South, the prediction of the theory is that the returns to unskilled labour should increase following trade liberalisation.

### 2.2 Evidence for Developing Countries

The experience of the East Asian newly-industrialised economies was a reduction in wage inequality after openness was introduced in the 1960s and 1970s. This was therefore consistent with “standard” trade theory which predicts that trade liberalisation should benefit the locally abundant factor (Wood, 1994, 1997). However, the generality of this optimistic outcome has been challenged by a number of studies for countries that opened up to trade more recently, mostly for Latin America (see summary of results in table 1).

Robbins (1996), for example, examines the changes in the structure of wages after trade liberalisation in Chile and finds that, although the content of skilled labour in imports exceeds the content in exports, the returns to skilled labour grew following liberalisation. Cragg and Epelbaum (1996) find that the increase in the returns to education in Mexico contributed to



the rise of relative wages of skilled workers and that this effect is highest in traded sectors. Feenstra and Hanson (1997) show that the American 'maquiladoras' in the north of Mexico caused a significant increase in the relative demand for skilled workers in the border region with the US. Robbins and Gindling (1999) investigate the changes in relative wages and in the supply and demand for skilled labour in Costa Rica before and after trade liberalisation. They find that the skill premium rose after liberalisation as a result of changes in the structure of labour demand. Beyer *et al.* (1999) use a time series approach and find a long-term correlation between openness and wage inequality in Chile. Hanson and Harrison (1999) examine the changes in both wages and employment of skilled and unskilled workers after trade liberalisation in Mexico. They find little variation in employment levels, but a significant increase in skilled workers' relative wages. They also show that foreign companies and those heavily involved in export markets pay higher wages to skilled labour. Finally, for Brazil, Green *et al.* (2001) find an increase in the returns to college education following trade liberalisation. However, contrary to studies for other developing countries, there was no apparent change in overall wage inequality. Recently, Galiani and Sanguinetti (2003) find that import penetration explains a small part of wage premium in Argentina and Milanovic and Squire (2005) find that decreasing tariffs increase inequality both in inter industry wages and inter occupation wages in developing countries.

Thus, the evidence on trade liberalisations which have been implemented in the last two decades (mainly, but not exclusively, for Latin America), suggests a positive relationship between trade liberalisation and wage inequality. This finding is clearly contrary to the predictions of the traditional theory of international trade.

### *2.3 Alternative Explanations*

First authors have accounted for heterogeneity in developing countries in human capital, arguing that some developing countries did not present a comparative advantage in unskilled labor.

Thus, to explain the difference of liberalization in wage inequality between Latin American and Asian countries, Wood (1997) suggest that the timing of trade policy reform is important by making this point: when Latin American countries liberalized, they were no longer unskilled labor abundant, because India and China had already accessed international markets. Thus contrary to East Asian countries which liberalized earlier, at a time when they were unskilled labor abundant, Latin American countries were not relatively abundant in unskilled labor.

In the same vein, Davis (1996) presents a model in which the central hypothesis is that the availability of a country's factors of production should be assessed in relation to a group of countries with similar endowments, rather than in relation to the wider international economy. Thus, the availability of factors should be considered from a relative, and not from an absolute, perspective. What matters in the model is the relative position of the country amongst other countries within its own cone of diversification. Each cone comprises countries with similar, though not identical, factors endowments. This gives each country a different comparative advantage inside its cone, leading to a specialisation of production. In this framework, trade liberalisation can raise the demand for skilled labour in a developing country as long as among the countries of its cone, it has a relatively high supply of skilled labour.

Several studies on wage in Latin America (Harrisson and Hanson 1999) find that unskilled-labor intensive sectors were protected with the highest tariffs prior to trade reform. So those industries experienced the largest

tariff reductions during trade reform. This puzzling fact shows that “the increase in the skill premium” is exactly what SS predicts: since trade liberalization was concentrated in unskilled-labor intensive sectors, and so the economy-wide return to unskilled labor should decrease.

Second, trade liberalization benefits the unskilled labor intensive industry in developing countries but leads also to the shift of industry activities intensive in unskilled labour from North to the South which could increase inequalities (notably through FDI). Two effects could increase relatively demand for skilled labor in developing countries during trade liberalization: the industry effect and the occupation effect.

The industry effect deals with the shift of skill-intensive intermediate goods production from developed to developing countries. The idea is that the flow of FDI changes the structure of production and increases the stock of capital of developing countries. Feenstra and Hanson (1996) develop a model which assumes the production of a simple final good that requires a *continuum* of intermediate goods with varying proportions of skilled and unskilled labour. The model suggests that the stages of production which demand less skilled labour (by the measure of the advanced country) will be transferred to the less developed countries where unskilled labour is relatively cheaper. However, the kind of labour that is actually demanded is skilled when judged from the perspective of the developing countries.

The occupation effect deals with the fact that the rapid pace of change in the economy increased the demand for individuals that could enact change: managers and professionals, whatever the industry. Cragg and Epelbaum’s work (1996) on Mexico reports that the occupation effect seems more relevant than the industry effect to explain wage inequality.

The main alternative explanation to demand shifts is the inclusion of technological change which complicates seriously the prediction. The inclusion of differences in technology in the wage literature deals with biased technological change. An additional effect of trade liberalisation is a rapid inflow of foreign technology as a result of both FDI and increased imports. As different recent models show, a skill-biased technological change can be indirectly and partly induced by trade policy [see for example, Thoenig & Verdier (2003), Acemoglu (2003) or Aghion et al. (2003)].

A large part of the literature argues that trade liberalization can increase wage inequalities via the import of machines. Authors argue that those imports increase the demand for skilled labor to use with these machines and improve the productivity of skilled worker as it includes a skill biased technical change (Harrison Hanson 1999, Gindling Robbins 2001, Attanasio and al. 2004).

Zhu and Trefler (2005) showed that the technological catch up that they measure with labor productivity (without linking it to imports), does not increase directly wage inequality but allows developing countries to be specialized in more skill intensive products in their exports and hence to increase wage inequalities indirectly<sup>4</sup>.

Notwithstanding the studies reviewed above, there remain important questions as to how far the conjecture that trade liberalisation may enhance skill demands can be generalised to all developing countries. It is also of

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<sup>4</sup> A variation on this theme is the conjecture that, even if the technology to be transferred is neutral, the transitional process of transferring and installing new technologies may be skill-biased (Pissarides, 1997). In this case, the effect on the returns to human capital will be temporary and skilled workers benefit only during the transition period to the new, higher, technological level. Goldin and Katz (1998) reach a similar conclusion. They argue that the demand for skilled workers can follow a technological cycle. The demand rises when new technologies and machinery are introduced, but it declines once the other workers have learned to use the new equipment.

interest to examine the extent to which trade liberalisation leads to an increasing wage inequality, regarding the fact that South-South trade now accounts for around two fifths of all developing country merchandise trade. To address these issues, the following section presents some new evidence regarding the impact of trade liberalisation in a case of South-South trade relative to North-South trade.

**Tableau A: Summary of recent country studies**

| Studies  | Measure for wage inequality   | Measure for trade openness                           | Alternative explanations  | Main results   |
|--|---|--|---|--|
| <b>Feenstra &amp; Hanson 1997</b><br>Mexico<br>1975-1988             | Relative non production wage share  |  | FDI by number of Maquiladoras   | FDI increase non producer wages share so inequality  |
| <b>Cragg &amp; Epelbaum 1996</b><br>Mexico<br>1987-1993              | Industries dummies and occupation dummies in wage equation                                  | Comparison of traded sectors with non traded sectors |   | Occupation explains close to half of the wage inequality.. Economy became more skill-intensive and that this effect was larger for the traded sector |
| <b>Robins 1996</b><br>9 developing countries<br>1974-1989            | Wage skilled worker / wage unskilled worker   | Just analysis by period                              | Financial openness and Technical Change by machinery imports              | Trade liberalization sometimes rise wage inequality, both financial openness and skill biased technical change increase inequality                   |
| <b>Beyer, Rojas &amp; Vergara 1999</b><br>Chile<br>1960-1996         | Difference in return to education on wages  | Trade Liberalization by Trade to GDP                 |   | Trade Liberalization has increased inequality  |
| <b>Harrison &amp; Hanson 1999</b><br>Mexico<br>1984-1990             | Wage skilled worker / wage unskilled worker   | Trade Liberalization by Industry Tariffs rate        | Technology change by machinery imports, license Financial openness by FDI | Wage inequality rise after trade Liberalization, FDI and Technological change increase this effect.  |
| <b>Gindling &amp; Robbins 2001</b><br>Chile, Costa Rica<br>1974-1995 | Standard Deviation of log wages wage 90 <sup>th</sup> decile / wage 10 <sup>th</sup> decile | Trade Liberalization by Average Tariff rate          | Skilled biased technology change by machinery imports                     | Trade Liberalization and Technological change explains difference in inequality between 2 countries  |
| <b>Green, Dickerson &amp; Arbache 2001</b>                           | Mean log deviation of wages Return to   | Just analysis by period                              |   | Increase in education returns but no effect on wage inequality, no effect  |

|  |   |  |   |  |
|--|---|--|---|--|
| Brazil<br>1981-1999  | education   |  |   | of trade liberalization  |
| <b>Galiani &amp; Sanguinetti 2003</b><br>Argentina<br>1993-1997        | Difference in return to education on wages  | Trade Liberalization by M to VA and X to VA in each industry             |   | Import penetration explain wage premium but just a small part  |
| <b>Pavcnik 2003</b><br>Chile<br>1976-1986                              | Wage skilled worker / wage unskilled worker   |  | Capital deepening<br>Technology import                            | Capital deepening increase wage premium but adoption of foreign technology has no effect   |
| <b>Esquivel 2003</b><br>Mexico<br>1988-1994<br>1994-2000               | wage non production worker / wage production worker   | Trade Liberalization by product prices                                   | Technological Progress by labor productivity                      | Technological change rise wage inequalities and trade liberalization decrease wages inequalities in the first period.                                    |
| <b>Attanasio, Goldberg &amp; Pavcnik 2004</b><br>Columbia<br>1984-1998 | Std Deviation log wages<br>wage 90 <sup>th</sup> decile / wage 10 <sup>th</sup> decile<br>Industry dummies in wage equation | Trade Liberalization by M and X in each industry<br>And Industry Tariffs | Skilled biased technology change by proportion of skilled workers | Trade Liberalization increase inequality through technology, and through growing informal sector (pay less)  |
| <b>Goldberg &amp; Pavcnik 2005</b><br>Columbia<br>1984-1998            | Industry dummies in wage equation   | Trade Liberalization by Industry Tariffs                                 |   | Tariffs cuts decrease industry wage premium so unskilled wages since the most protected workers were unskilled   |
| <b>Mishra &amp; Kumar 2005</b><br>India<br>1983-2000                   | Industry dummies in wage equation   | Trade Liberalization by Industry Tariffs                                 |   | Tariffs reduction increase wage, since tariff reduction is highest in unskilled worker intensive industry so Trade Liberalization reduce wage inequality |

**Tableau B: Summary of recent cross-countries studies**

| Studies  | Measure for wage inequality                                 | Measure for trade openness                     | Alternative explanations  | Main results          |
|--|---|--|---------------------------|-----------------------|
| <b>Freeman &amp; Ostendorp 2001</b><br>83 countries<br>1983-1998 | wage 90 <sup>th</sup> decile / wage 10 <sup>th</sup> decile | Trade Liberalization by Trade to GDP           |                           | Weak positive results |
| <b>Rama 2003</b><br>103 countries<br>1983-1998                   | Standard Deviation of log wages<br>Return to education      | Trade Liberalization by Trade to GDP and Sachs | Financial openness by FDI | No significant effect |

|  |  |  |  |  |
|--|--|--|--|--|
| <b>Zhu &amp; Trefler 2005</b>                  | wage non production worker / wage production worker                                  | Warner index Trade Liberalization by the amount of exports | Technological catch up by the change in skill composition of exports | Trade Liberalization has no effect, technological catch up explains wage inequality only by changing composition exports |
| 20 developing countries 1985-1998 in 4 periods |  |  |  |  |
| <b>Milanovic &amp; Squire 2005</b>             | Inter industry wage dispersion from UTIP Inter occupational wage dispersion from OWW | Trade Liberalization by global Tariffs                     |  | Trade Liberalization increases wage inequality in developing countries   |
| 118 countries 1983-1999 90 countries 1975-1999 |  |  |  |  |

### 3 South-South trade and wage inequality

We explore three extensions relative to the existence of “South-South” trade on wage inequality in developing countries. The exploration takes place with the data used later or in relating to the econometric analysis of section 4. We use the database recently updated by Nicita and Olarreaga (2006). The database includes information on bilateral trade flows, production, labor, added value and wages in 101 countries over the period 1976 to 2004. The industry classification is the 3-digit level ISIC revision 2, which covers 28 manufacturing sectors.

First, similarly to Wood (1997), we argue that South-South trade might explain increasing wage inequality in middle-income countries as they do not present a comparative advantage in unskilled labor intensive sectors (this argument is also related to the wage industry premium explanation mentioned earlier and used in several studies on Latin American countries to explain wage inequality (Goldberg and Pavcnik (2004))).

Second, we explore if S-S trade and N-S trade have different impacts concerning sector-biased technological change. If S-S trade leads more to

increasing competition in skill-intensive goods than N-S trade, it might bring technological change more biased towards skill-intensive sectors than N-S trade.

Table 3.1 presents for three groups of developing countries (see Annex 1 for classification) the change between 1980 and 2000 in the direction of trade measured by total exports and total imports of manufactured products. We observe the expansion of South-South trade for all developing countries (roughly from 19-18% of exports and 9-12% of imports in 1980 to 35-50% of exports and 30-40% of imports in 2000). It seems that developing countries have really benefited from this expanded South-South trade, and it concerns mainly the Middle income countries which multiplied their share of S-S trade by five.

**Table 3.1: Expanding South-South trade by developing countries clusters**

| <i>Export</i> |                |               |            | <i>Import</i> |            |               |                |              |
|---------------|----------------|---------------|------------|---------------|------------|---------------|----------------|--------------|
| <b>North</b>  | <b>Mid. Up</b> | <b>Middle</b> | <b>Low</b> | <b>1980</b>   | <b>Low</b> | <b>Middle</b> | <b>Mid. Up</b> | <b>North</b> |
| 82.2          | 6.6            | 4.2           | 7.0        | <b>Middle</b> | 2.2        | 5.5           | 3.8            | 88.5         |
|               |                |               |            | <b>Up</b>     |            |               |                |              |
| 81.0          | 7.6            | 8.4           | 2.9        | <b>Middle</b> | 0.8        | 5.3           | 3.0            | 90.9         |
| 81.3          | 1.7            | 2.8           | 14.2       | <b>Low</b>    | 4.0        | 4.2           | 1.5            | 90.2         |
| <b>North</b>  | <b>Mid. Up</b> | <b>Middle</b> | <b>Low</b> | <b>2000</b>   | <b>Low</b> | <b>Middle</b> | <b>Mid. Up</b> | <b>North</b> |
| 64.4          | 12.0           | 20.0          | 3.6        | <b>Middle</b> | 1.3        | 17.8          | 10.9           | 70.0         |
|               |                |               |            | <b>Up</b>     |            |               |                |              |
| 58.6          | 9.1            | 26.3          | 6.0        | <b>Middle</b> | 2.5        | 23.0          | 7.5            | 67.0         |
| 50.0          | 3.2            | 26.7          | 20.1       | <b>Low</b>    | 4.8        | 30.8          | 5.3            | 59.1         |



### 3.1 Dissimilarity and Inter industry Specialization among developing countries

#### *North-South relation in South-South trade*

Table 3.2 presents the share of exports and imports according to three clusters of products classified by skill labor intensity (see Annex 2 for classification). We see that in 2000 the richest developing countries appear to export relatively more skilled intensive goods “HSL” (54% of total exports) and export fewer unskilled intensive goods “LSL” (30%) than low income countries (respectively 22% and 57%). This evidence seems to be consistent with the notion of a ladder of comparative advantage as defined by relative factor endowments.

**Table 3.2: Trade and Labor force by commodities clusters**

|              | Goods | Export | 1980<br>Import | Labor<br>force | Export | 2000<br>Import | Labor<br>force |
|--------------|-------|--------|----------------|----------------|--------|----------------|----------------|
| Middle<br>Up | LSL   | 38.1   | 24.5           | 51.8           | 29.6   | 19.1           | 52.2           |
|              | MSL   | 18.6   | 21.8           | 29.3           | 16.6   | 18.3           | 26.6           |
|              | HSL   | 43.3   | 53.7           | 21.3           | 53.8   | 62.6           | 23.0           |
| Middle       | LSL   | 50.1   | 21.6           | 53.4           | 38.3   | 22.5           | 48.7           |
|              | MSL   | 15.9   | 21.7           | 29.3           | 21.2   | 21.8           | 27.7           |
|              | HSL   | 34.0   | 56.7           | 18.7           | 40.5   | 55.7           | 25.4           |
| Low          | LSL   | 68.9   | 28.4           | 60.0           | 57.2   | 23.3           | 56.5           |
|              | MSL   | 17.2   | 19.3           | 26.7           | 20.4   | 25.7           | 29.2           |
|              | HSL   | 13.9   | 52.3           | 14.3           | 22.4   | 51.0           | 17.8           |

What emerges is that dissimilarity of supply conditions simultaneously generates South-North and South-South trade. Therefore, as Wood (1997) suggested, this helps explain increasing wage inequality in middle income countries since the opening of the low income half of the world is likely to have altered the comparative advantage of middle-income countries in unskilled-intensive sectors. This pattern has been reported for Columbia (Attanasio, Goldberg and Pavcnik (2004),

Mexico (Hanson and Harrison (1999), Robertson (2000)) and Brazil (Pavcnik, Blom, Goldberg and Schady (2004)).

#### *Industry wage premium*

Table 3.2 reveals that the distribution among sectors does not change a lot across countries and time, although middle-up income countries have less labor force in unskilled intensive sectors (52%) compared to low income countries (57%). And this lack of labor reallocation does not conform to traditional HO expectations where labor should reallocate from sectors with declining share to sectors with increasing share. This suggests that the adjustment of the labor market to trade liberalization occurred through relative wage adjustments and not through labor reallocation across sectors, thereby having an effect on the wage premium. In sum, if trade liberalization leads to declines in industry wage premiums, wage inequality between industries could increase if the industries with the largest tariff cuts are the ones employing a higher share of unskilled workers and if these industries had the lowest wage premiums prior to the reform.

Here evidence on how responsive industry wage premiums are to trade reforms is mixed. Some studies find no association between tariffs and industry wage premiums (Feliciano (2001) for Mexico, Pavcnik, Blom, Goldberg, and Schady (2004) for Brazil), while others find a positive association between tariff declines and industry wage premiums (Goldberg and Pavcnik (2004) for Colombia). Feliciano (2001) reports a positive association between declines in import licenses and industry wage premiums. Thus, in Colombia and Mexico, trade liberalization might have lead to increased wage inequality through the industry wage premium channel, especially since tariff cuts in these countries were the largest in unskilled-labor intensive industries and the sectors with the largest tariff

cuts had the lowest wage premiums prior to the reform (Attanasio, Goldberg and Pavcnik (2004)).

If N-S trade leads to tariff cut and increasing importation in the HSL-intensive sector and that S-S trade will lead mainly to tariff and increasing importation in the LSL-intensive sector this could explain why S-S trade could increase more inter industry wage inequality than N-S trade.

Havrylyshyn (1985) finds that factor content characteristics are relevant in the trade of developing countries but observes that these characteristics vary according to the direction of trade. He finds that developing countries export more skilled and capital intensive products to the South than to the North while they import more skilled and capital intensive products from the North than from the South. Nevertheless some of the observed differences are attributable to distortions caused by domestic and commercial policy.

Table 3.3 details the shares of each product cluster: high skill labor intensive (HSL), medium skill labor intensive (MSL) and low skill labor intensive (LSL), in the bilateral trade flow between groups of countries. As Havrylyshyn (1985), we observe that exports from Southern countries to other Southern countries are more intensive in high-skilled labor (HSL) than exports to Northern countries (44,8% versus 38,2%) and less intensive in unskilled labor (33,5% versus 44,9%). At the same time, imports from Southern countries are more intensive in unskilled labor than from Northern countries (26,4% versus 18,4%) and less intensive in skilled labor (46,2% versus 62,9%). The results hold when we decompose developing countries in three groups. Broadly speaking these ratios suggest that if South-South trade exports relatively less unskilled intensive products and imports relatively more unskilled intensive products, this may lead to increasing inequality relatively to North-South trade.

So we observe the existence of a N-S trade relationship among S-S trade due to heterogeneity between developing countries. This is consistent with increasing inter-industry wage inequality in middle income countries. However we observe also that S-S trade implies more imports of unskilled intensive products and fewer exports of unskilled intensive products than N-S trade for all sorts of developing countries (even low income). This could lead to increasing wage inequality for all developing countries.

**Table 3.3: factor content in South-South trade and in North-South trade**

| 2000         |     | Exportations |       |              |        |      | Importations |       |              |        |      |
|--------------|-----|--------------|-------|--------------|--------|------|--------------|-------|--------------|--------|------|
|              |     | North        | South | Middle<br>Up | Middle | Low  | North        | South | Middle<br>Up | Middle | Low  |
| <b>South</b> | LSL | 44.9         | 33.5  |              |        |      | 18.4         | 26.4  |              |        |      |
|              | MSL | 16.9         | 21.6  |              |        |      | 18.7         | 27.4  |              |        |      |
|              | HSL | 38.2         | 44.8  |              |        |      | 62.9         | 46.2  |              |        |      |
| Middle<br>Up | LSL | 35.9         |       | 23.2         | 28.2   | 34.2 | 15.3         |       | 25.2         | 23.5   | 52.0 |
|              | MSL | 15.3         |       | 20.2         | 18.2   | 19.2 | 16.1         |       | 25.0         | 22.2   | 14.8 |
|              | HSL | 48.9         |       | 56.6         | 53.6   | 46.6 | 68.6         |       | 49.8         | 54.3   | 33.3 |
| Middle       | LSL | 39.9         |       | 37.6         | 30.5   | 19.9 | 20.4         |       | 22.3         | 26.2   | 45.3 |
|              | MSL | 18.9         |       | 22.5         | 22.9   | 26.0 | 18.4         |       | 28.5         | 31.3   | 16.7 |
|              | HSL | 41.3         |       | 39.9         | 46.6   | 54.2 | 61.2         |       | 49.2         | 42.5   | 38.0 |
| Low          | LSL | 69.0         |       | 56.8         | 53.1   | 43.5 | 19.1         |       | 33.7         | 28.5   | 38.8 |
|              | MSL | 15.7         |       | 20.8         | 20.2   | 19.1 | 23.5         |       | 23.0         | 29.1   | 24.0 |
|              | HSL | 15.2         |       | 22.4         | 26.6   | 37.3 | 57.4         |       | 43.4         | 42.4   | 37.2 |

### 3.2 Sector biased technological change

Leamer (1998) has made the argument in several papers that it is sector-bias, and not factor bias that is relevant for the income distribution. Skilled-biased technological change that is concentrated in unskilled-intensive sectors would benefit unskilled workers in the general equilibrium, while skilled-biased technological change concentrated in skilled-intensive industries would benefit skilled workers. However,

Leamer's argument rests on the assumption of fixed product prices, which is unlikely to hold during trade liberalization.

Recently, Haskel and Slaughter (2002) have considered the 'sector bias' of technological change. They present a model where it is the sector bias of technological change rather than the factor bias that determines the effect on relative wages, even in case of flexible prices (contrary to Leamer who assumed fixed prices). Technical progress in a sector will potentially raise profitability. If technical change occurs in the skill-intensive sector, then skilled wages must rise so that relative profitability falls back to its original level. If it occurs in the unskilled-intensive sector, then unskilled wages must rise. Note that all technical change matters (not only SBTC) since any advances might raise sector profitability. They test their model on UK and USA and find that decreasing wage inequality in 70's was due to SBTC in unskilled-intensive sectors and increasing wage inequality in 80's was due to SBTC in skilled-intensive sectors.

This suggests that researchers should look at skilled, unskilled and neutral technical change to see if there is an impact on wages. The impact of sector bias can be summarized: if prices or TFP grow faster in the skill-intensive sectors, then skilled wages tend to rise relative to unskilled wages. But if prices or TFP grow faster in the unskilled-intensive sectors, then skilled wages tend to fall relative to unskilled wages. Thus, the appropriate empirical strategy is to examine whether price or TFP change is more concentrated in the skill- or unskilled-intensive sectors. This approach contrasts with studies that seek to document whether price or technical changes are occurring within sectors but not to compare across sectors. In our framework of S-S trade and N-S trade we could attempt for a difference in sector biased according to the direction of trade.

On the export side, trade openness potentially increases innovation, knowledge and productivity by encouraging firms to find new ways to compete. Since for a developing country, N-S trade leads to export unskilled labor intensive goods, this would lead the country to improve its labor productivity in this unskilled-intensive sector to be competitive relative to other developing countries on the northern market. On the contrary, in case of S-S trade where countries trade relatively more in skilled-intensive products this would lead to increasing competition and labor productivity in those more skilled intensive industries. To the extent that technological change is an endogenous response to intensified competition from abroad (see Acemoglu, 2003), one could argue that S-S trade was indirectly responsible for the increase in inter industry wage inequality<sup>5</sup>.

Table 3.7 shows the correlation between shares by different partners, in export and in import, with TFP in three different clusters of industry for developing countries. The coefficients are generally very low, however it seems that when the share of Northern partner in export and in import is highest the TFP in unskilled intensive sectors is also the highest, while when the share of middle income country is high (in exports or in imports) the TFP in unskilled intensive sectors is low. Moreover exportations to low income country are positively correlated to high TFP in skilled intensive sectors.

**Table 3.7: Direction of trade and TFP in sectors: correlation**

|              | Partners         | TFP LSL       | TFP MSL | TFP HSL |
|--------------|------------------|---------------|---------|---------|
| Exportations | <b>North</b>     | <b>0.143</b>  | -0.040  | -0.055  |
|              | <b>Middle Up</b> | -0.075        | 0.052   | -0.005  |
|              | <b>Middle</b>    | <b>-0.224</b> | -0.071  | -0.087  |

<sup>5</sup> This argument is also related to Wood (1995) and to the more recent paper by Thoenig and Verdier (2003). See also the survey by Acemoglu (2003).

|              |                  |               |              |              |
|--------------|------------------|---------------|--------------|--------------|
|              | <b>Low</b>       | 0.060         | 0.089        | <b>0.182</b> |
| Importations | <b>North</b>     | <b>0.174</b>  | 0.017        | 0.022        |
|              | <b>Middle Up</b> | -0.009        | <b>0.107</b> | <b>0.109</b> |
|              | <b>Middle</b>    | <b>-0.238</b> | -0.074       | -0.092       |
|              | <b>Low</b>       | -0.018        | -0.042       | -0.017       |

## 4 Econometric specification

### 4.1 Estimation Strategy

Now we test how South-South trade affects inter industry wage inequality in developing countries.

The basic regression equation to be estimated is the following:

$$Ineq_{ct} = \beta_1 Y_{ct} + \beta_2 FDI_{ct} + \beta_3 Educ_{ct} + \beta_4 \left( \frac{TradeS}{TradeN} \right)_{ct} + D_c + D_t + \varepsilon_{ct} \quad (1.1)$$

Where we expect that  $\beta_2 > 0$ ,  $\beta_3 < 0$  and  $\beta_4 > 0$

We measure inter industry wage inequality in country  $c$  in the period  $t$ ,  $Ineq_{ct}$ , using the standard deviation of the logarithm of wage by industry (alternatively using a Theil index in a robustness check). Explanatory variables include the supply of human capital in the economy ( $Educ_{ct}$ ) which might affect the relative factor price of skilled and unskilled labor, and so the relative price of labor in skilled intensive industry and in unskilled intensive industry. We expect that an increase in the supply for skill will decrease inter industry wage inequality. We include also foreign direct investment ( $FDI_{ct}$ ) which as Feenstra and Hanson (1997) showed could increase wages in industries intensive in skilled labor. FDI leads to a transfer of production from North to South which are skill intensive relatively to the South. Finally we add income per capita ( $Y_{ct}$ ) to control for macro economic development which might act on wage inequality. The

shares of trade to North ( $TradeN_{ct}$ ) and to South ( $TradeS_{ct}$ ) to total output in industries are respectively:

$$TradeN_{ct} = \frac{E_{ct}^N + I_{ct}^N}{Output_{ct}} \text{ and } TradeS_{ct} = \frac{E_{ct}^S + I_{ct}^S}{Output_{ct}}.$$

We use a within estimator in order to control for country specific heterogeneity  $D_c$  which might explain differences in wage inequality among countries. Moreover, in doing this, we are closer to a relationship in change rather than in level which is more suitable way of specification. We use three years averages period in order to control for serial correlations and we add dummies equal to 1 for the period after 1990  $D_t$ , we do this since Humberto Lopez (forthcoming in Economics Letters) shows that the relationship growth and income inequality suddenly changed in the 1990s. All the coefficients present robust standard with the White correction.

In the robustness check, we will use the country-industry dimension of the database to test the model above on wages in unskilled-labor intensive industries and in skilled intensive industries rather than on the index of wage inequality. We adopt quantile analyses where we estimate the initial econometric specification for the 25<sup>th</sup> quantile and 75<sup>th</sup> quantile in the distribution of wage by industry.

A way to test if the level of income in developing country is determining for the effect of S-S trade versus N-S trade is to test the equation (1.1) for different clusters of countries, low income, middle income and middle up income. Here we obtain the following specifications where we test the impact of trade flows (in imports and exports) with three sorts of groups of countries  $P$  (middle up, middle, low):



$$\begin{aligned}
Ineq_{c \in P, t} = & \beta_1 Y_{c \in P, t} + \beta_2 FDI_{c \in P, t} + \beta_3 Educ_{c \in P, t} + \beta_4 \left( \frac{TradeS}{TradeN} \right)_{c \in P, t} \\
& + D_{c \in P} + D_t + \varepsilon_{c \in P, t}
\end{aligned} \tag{1.2}$$

Where we expect that  $\beta_2 > 0$ ,  $\beta_3 < 0$ ,  $\beta_4 < 0$  if  $P = \text{low}$  and  $\beta_4 > 0$  if  $P = \text{middle up}$

We investigate now the potential effect of sector biased technological change. In a first specification, we measure the sector biased technological change using a ratio of labor productivity in unskilled intensive sector on labor productivity in skilled intensive sectors.

We proceed in two steps. First in equation 1.4, we observe the impact of S-S trade and N-S trade on the sector biased toward unskilled intensive industries,  $USBTC_{ct}$ , which is the ratio of Labor productivity in unskilled labor intensive sectors to labor productivity in skilled labor intensive sectors.

$$USBTC_{ct} = \alpha_1 Y_{ct} + \alpha_2 FDI_{ct} + \alpha_3 Educ_{ct} + \alpha_4 \left( \frac{TradeS}{TradeN} \right)_{ct} + D_c + D_t + \varepsilon_{ct} \tag{1.4}$$

In the robustness check we deal with technological change in using TFP index which is more appropriate than labor productivity which strongly correlated to wage. However this considerably reduces our panel of developing countries.

Then, in equation 1.5, we will test simultaneously the impact of S-S versus N-S trade and unskilled sector biased technological change on inter industry wage inequality.

$$\begin{aligned}
Ineq_{ct} = & \beta_1 Y_{ct} + \beta_2 FDI_{ct} + \beta_3 Educ_{ct} + \beta_4 \left( \frac{TradeS}{TradeN} \right)_{ct} + \beta_5 USBTC_{ct} \\
& + D_c + D_t + \varepsilon_{ct}
\end{aligned} \tag{1.5}$$

So we will get a direct effect of the direction of trade,  $\beta_4$ , and an indirect effect, through the sector biased technological change,  $\alpha_4 * \beta_5$ . In fact a proper test of the Haskel and Slaughter (2002) model should consist, in the second test, to use wage inequality among worker as interest variable, since it could appear obvious that increasing labor productivity in a sector relative to another increase relative wages in this sector. However we do not have the wage per worker but only the wage per industry.

In the robustness check we will use GMM system estimates to control for problem of endogeneity. The regression presented above poses some challenges for estimation. Most explanatory variables (trade openness and foreign direct investment) are likely to be jointly endogenous with wage inequality.

## 4.2 Data

We use the updated database of Nicita and Olarreaga (2006) which gives us data for bilateral trade, production and added value, and wages by industry. Data on wage inequality comes also from the database where we construct the standard deviation in the log of wages as in several studies (Gindling and Robbins 2001, Rama 2003, Attanasio and al. 2004).

Concerning trade openness we use two measures: a trade ratio on manufacture products (exports and imports of manufactured products on output in manufactured sectors). We also use, as robustness test, a constructed an adjusted trade ratio (closer to the notion of trade liberalization) for N-S and S-S trade, based on a gravity model (see Annex 7).

We used the data from WDI (2004) to measure foreign direct investment and the data on education come from Barro and Lee (2000). Our sample consists of an unbalanced panel dataset of 68 developing countries. For each, the dataset includes at most 8 observations (and at minimum 2), consisting of 3-year averages spanning the 1976-2002 period. Among the developing countries, 23 are from Sub-Saharan Africa, 12 from Asia, 11 from the Middle East and North Africa, and 22 from Latin America and the Caribbean. Annex 1 provides the full list of countries in the sample.

## 5 Results

### *5.1 South-South trade increases wage inequality for middle income countries*

The table 5.1 shows results when we adopt the specification of equation (1.2) in using the standard deviation in log of wages by industry. Columns 1 to 4 present results.

The foreign direct investment tends to increase wage inequality as suggested by Feenstra and Hanson (1997). This FDI occurs in sectors often more skill intensive than in the mean of sectors in developing countries. We observe that this concerns mainly upper middle income countries (column 2) where FDI are more important and where skilled labor is more present. An interesting result concerns the impact of education level. Several studies (Zhu and Treffer 2005) find that the education level increase wage inequality whereas it should increase the supply of educated workers and decrease relatively their remuneration. This result holds when we do not control for time period, but if we add dummies for periods, as in Table 5.1, this effect is no more significant or is conform to the theoretical prediction (significantly negative).

We see that trade with southern countries increase wage inequality relatively to trade with northern countries, an increase of 1% in the share of south trade relative to north trade increase inter industry wage inequality by 0.027%. **This means the importance of the purpose deals in this study since S-S trade has an inverse effect than N-S trade.**

**Table 5.1: S-S Trade versus N-S Trade according to income level of developing countries**

|                          | <b>1</b>                | <b>2</b>                | <b>3</b>                | <b>4</b>                |
|--------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
|                          | FE                      | FE                      | FE                      | FE                      |
| Sample                   | All                     | Upper<br>Middle         | Middle                  | Low                     |
| wage inequality          | SDLW                    | SDLW                    | SDLW                    | SDLW                    |
| GDP pc                   | -0.026<br>(0.67)        | -0.104a<br>(2.68)       | 0.068<br>(0.95)         | -0.094<br>(1.38)        |
| FDI                      | 0.480<br>(1.59)         | 1.016a<br>(2.99)        | 0.060<br>(0.12)         | 0.737<br>(0.69)         |
| Education                | -0.044b<br>(1.99)       | -0.038<br>(0.70)        | 0.005<br>(0.08)         | -0.107b<br>(2.08)       |
| TSS/TNS                  | 0.027a<br>(3.44)        | 0.023b<br>(2.24)        | 0.034a<br>(2.63)        | 0.028c<br>(1.77)        |
| Dummy period<br>Constant | Yes<br>0.674b<br>(2.54) | Yes<br>1.275a<br>(4.33) | Yes<br>-0.022<br>(0.05) | Yes<br>1.080a<br>(2.64) |
| Observations             | 421                     | 98                      | 179                     | 144                     |
| Number                   | 69                      | 14                      | 25                      | 30                      |
| R-squared                | 0.19                    | 0.51                    | 0.13                    | 0.25                    |

A first candidate explanation for this result would be the existence of a North-South trade relationship (e.g. inter industry specialization), among developing countries. Therefore South-South trade would be increasing wage inequality for middle income countries (like for the North in N-S trade) and decreasing inequality for low income countries. We observe that this effect is more significant for middle income countries (column 2, 3) than for low income countries (column 4) as we could expect since low

income countries present a comparative advantage in unskilled labor relatively to all the other southern countries.

## 5.2 Sector biased technological change matter

The table 5.2 shows us that trading with southern countries rather than with northern countries decrease the biased in technological change toward unskilled intensive sector, although this effect is not significant for middle income countries. This comforts our assumption concerning the fact that S-S trade increases competition and labor productivity in mildly skill (MSL) and high skill (HSL) industries whereas N-S trade increases competition and labor productivity in low skill intensive (LSL) industries. However the within R squared in our regression is low, except for middle up income countries (column 2) so those results must be taken with caution.

**Table 5.2: Effect of S-S and N-S trade on sector biased technical change**

|                  | 1                 | 2                 | 3                | 4                 |
|------------------|-------------------|-------------------|------------------|-------------------|
| Sample           | All               | Upper<br>Middle   | Middle           | Low               |
|                  | USBTC             | USBTC             | USBTC            | USBTC             |
| GDP pc           | -0.146<br>(0.73)  | 0.249<br>(0.89)   | -0.256<br>(0.81) | -0.079<br>(0.20)  |
| FDI              | -1.658<br>(0.71)  | -4.370<br>(1.40)  | -1.855<br>(0.41) | 4.936<br>(1.14)   |
| Education        | 0.248c<br>(1.82)  | -0.617<br>(1.25)  | 0.063<br>(0.18)  | 0.336c<br>(1.83)  |
| TSS/TNS          | -0.083b<br>(2.15) | -0.071c<br>(1.83) | -0.022<br>(0.28) | -0.175b<br>(2.13) |
| Dummy<br>country | Yes               | Yes               | Yes              | Yes               |
| Dummy<br>period  | Yes               | Yes               | Yes              | Yes               |
| Observations     | 414               | 96                | 179              | 139               |
| Number           | 67                | 13                | 25               | 29                |
| R-squared        | 0.09              | 0.32              | 0.08             | 0.10              |

Next we observe the impact of this sector biased technological change on wage inequality in table 5.3. As expected this sector biased technological change toward unskilled intensive sector decrease wage inequality across industries, for all group of countries. Once we account for the effect though sector biased technological change the results on S-S trade versus N-S trade holds for middle income countries. Here again there is not significant effect for low income countries meaning that for low income countries the increasing effect on wage inequality of S-S trade occurs only through the sector biased technological change, whereas for other groups of countries, they have both effect, direct and indirect.

**Table 5.3: Direct and Indirect effects of N-S and S-S trade on wage inequality**

|                          | 1                 | 2                 | 3                 | 4                 |
|--------------------------|-------------------|-------------------|-------------------|-------------------|
| Sample                   | All               | Upper<br>Middle   | Middle            | Low               |
| Index of wage inequality | SDLW              | SDLW              | SDLW              | SDLW              |
| GDP pc                   | -0.071c<br>(1.89) | -0.070b<br>(2.06) | 0.002<br>(0.03)   | -0.186a<br>(3.12) |
| FDI                      | 0.291<br>(1.08)   | 0.713b<br>(2.01)  | 0.019<br>(0.05)   | 0.883<br>(1.18)   |
| Education                | -0.043<br>(1.07)  | -0.024<br>(0.45)  | -0.032<br>(0.43)  | -0.059<br>(1.16)  |
| USBTC                    | -0.078a<br>(4.85) | -0.048b<br>(2.45) | -0.062a<br>(3.25) | -0.137a<br>(5.40) |
| TSS/TNS                  | 0.023a<br>(3.26)  | 0.020c<br>(1.82)  | 0.031b<br>(2.14)  | 0.014<br>(1.43)   |
| Dummy country            | Yes               | Yes               | Yes               | Yes               |
| Dummy period             | Yes               | Yes               | Yes               | Yes               |
| Observations             | 414               | 96                | 179               | 139               |
| Number                   | 67                | 13                | 25                | 29                |
| R-squared                | 0.30              | 0.55              | 0.18              | 0.52              |

The global effect (indirect and direct) of S-S trade relatively to N-S trade is given in Table 5.4 and is calculated in using standard error of TSS/TNS

multiplying by its coefficient in the first regression and by the coefficient in front of USBTC in the second (the indirect effect) and we add the standard error multiplied by its coefficient in the second regression as direct effect. For example, in the first column (all developing countries) with a standard error of 1.07 the indirect effect is  $1.07 * (-0.083) * (-0.078) = 0.007$  and the direct effect is  $1.07 * 0.023 = 0.025$  meaning a global effect of 0.032. Hence we observe that being oriented toward S-S trade rather than N-S trade affect mainly directly the middle income countries since they not present a comparative advantage in unskilled labor and have decreasing wage premium in their unskilled intensive industry following trade liberalization. The effect through the sector biased technological change toward skilled intensive sectors is mainly important for the low income countries. The indirect effect is more important in Low income countries (63% versus 37%) whereas in middle income countries the direct effect is the highest (around 90%).

**Table 5.4: Quantify the indirect and direct effect of S-S trade relative to N-S trade on wage inequality**

| Effect of SS/NS | All   | Upper<br>Middle | Middle       | Low          |
|-----------------|-------|-----------------|--------------|--------------|
| Indirect effect | 0.007 | 0.004           | <i>0.002</i> | 0.028        |
| Direct effect   | 0.025 | 0.022           | 0.037        | <i>0.017</i> |
| Total effect    | 0.032 | 0.026           | 0.039        | 0.045        |
| Share Indirect  | 22%   | 15%             | 4%           | 63%          |
| Share Direct    | 78%   | 85%             | 96%          | 37%          |

Value in italics means that it is not significant

## 6 Robustness check

### 6.1 GMM system

The regression presented above poses some challenges for estimation. The first is that most explanatory variables (trade openness and

foreign direct investment) are likely to be jointly endogenous with wage inequality, so we need to control for the biases resulting from simultaneous or reverse causation. We use the generalized method of moments (GMM) estimators developed for dynamic models of panel data that were introduced by Arellano and Bond (1991). Blundell and Bond (1997) show that when the explanatory variables are persistent over time, lagged levels of these variables are weak instruments for the regression equation in differences. And in our model education level or trade orientation for example are more persistent over time than usual explanatory variables. To reduce the potential biases and imprecision associated with the usual difference estimator, we also use the GMM system estimator that combines the regression in differences and the regression in levels into one system (developed in Arellano and Bover, 1995, and Blundell and Bond, 1997).

We consider FDI and Trade Openness as likely endogenous variables; Education and GDP per capita are pre-determined variables in our model. Using lagged variables necessitates having an important number of observations. That is why we use a yearly database rather than the three years averages period database for this GMM estimator. Otherwise we lose too many observations.

The columns 1 to 4 in Annex 4.1 present results with the GMM-system estimator on the yearly dataset. We see that trade with southern countries increase wage inequality relatively to trade with northern countries, an increase of 1% in the share of south trade relative to north trade increase inter industry wage inequality of 0.047%. This means the importance of the purpose deals in this study since S-S trade has an inverse effect than N-S trade. We observe that this effect is more significant for Upper middle income countries (column 2,) than for Lower middle income countries (column 3) or low income countries (column 4). The annex 4.2 show that, as in the previous results, trading with southern countries rather than with northern countries decrease the biased in technological change



toward unskilled intensive sector, and this effect is more important for low income countries. Annex 4.3 and 4.4 show here again that for low income countries the increasing effect on wage inequality of S-S trade occurs mainly through the sector biased technological change, whereas for other groups of countries, they have both effects, direct and indirect.

## 6.2 *Quantile estimations on industries*

We are also interested, as robustness test, in analyzing directly variation in wage by industry rather than through an index of wage inequality. Here we could use the mean wage for different clusters, as used for the descriptive statistics: unskilled labor intensive, mildly skilled labor intensive and high skilled labor intensive. However in doing this we lose information on changes among industries. That is why we adopt quantile analyses where we estimate the initial econometric specification for the 25<sup>th</sup> quantile and 75<sup>th</sup> quantile in the distribution of wage by industry. This allows us to test the impact on wage of both global -level orientation in trade and of sector-level orientation in trade. In this specification on wages by industry we use three years averages period in order to control for serial correlations and we also add dummies by industry and by period.

Those results on the industry database where we estimate quantile regression on wage by industry (Annex 5.1) confirm previous results. We show in columns 1 and 2 that South-South trade relatively to North-South trade decreases inequality for the 25<sup>th</sup> percentile of wage more than for the 75<sup>th</sup> percentile of wage (-0.063 versus -0.034) meaning that this increases wage inequality<sup>6</sup>. We observe the same impact on the different clusters of developing countries (columns 3 to 6°, except for the low income countries

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<sup>6</sup> An inter-quantile regression shows that a 1% increase in the share of south trade relative to north trade increases difference in wages between the 25<sup>th</sup> and 75<sup>th</sup> quantile of 0.029%.

(columns 7 and 8) where the impact is inverted<sup>7</sup>. As suggested in the previous part, low income countries present a comparative advantage in unskilled labor relatively to all the other southern countries<sup>8</sup>. The quantile estimations on Labor productivity (Annex 5.2) show, that South-South trade relatively to North-South trade increases more labor productivity in sectors where this labor productivity is already the highest and decreases labor productivity in low productivity sectors.

### ***6.3 TFP rather than Labor productivity***

In the previous part, we do not use a TFP index since this considerably reduces our panel of developing countries. Moreover we do not have the capital stock and measure this capital stock requires adopting the procedure of Keller (1997) for the perpetual inventory method which is very critizable. However if we deal with technological change, using TFP index is more appropriate than using labor productivity which strongly correlated to wage. Then we use the industry dimension of our database to apply our two steps strategy on the three clusters of industries (highly skill-intensive, medium skill-intensive and low skill-intensive) for 38 developing countries for which we have TFP in industries.

We observe in annex 6.1 that an increase in S-S trade relative to N-S trade increases more the TFP in the high skill-intensive sector than in the low skill-intensive sectors, and this effect is very huge for low income countries. Then when we include both TFP and trade in the second step (annex 6.2), we observe that the direct effect of S-S trade versus N-S trade is still important and for low income countries the indirect effect (through the

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<sup>7</sup> The interquantile regressions show that a 1% increase in the share of south trade relative to north trade increases difference in wages between the 25<sup>th</sup> and 75<sup>th</sup> quantile of 0.050% and 0.048% respectively.

<sup>8</sup> An inter-quantile regression shows that a 1% increase in the share of south trade relative to north trade decreases difference in wages between the 25<sup>th</sup> and 75<sup>th</sup> quantile of 0.047%.

TFP) is most important than for other group of countries. The measure of both impacts in annex 6.3 show that for upper middle income countries the direct effect represent 85% of total effect of S-S trade versus N-S trade whereas for low income countries the indirect effect represent roughly 40% of total effect.

#### **6.4 Other robustness check**

We also check the robustness of our results in using other dataset and measure for wage inequality and openness to trade in Annex 8. The Theil index on inter-industrial wage differences, created by James Galbraith and associates covers on average about 90 countries annually over the period 1975-99. We also construct a new measure of trade openness based on a gravity model (annex 7) as suggested by Hiscox and Kastner (2002).

In column 1 we present the trade ratio for South-South trade and for North-South trade in industry for all developing countries rather than the previous ratio (S-S trade/ N-S trade). As expected S-S trade increases wage inequality whereas N-S trade decreases wage inequality (but not significantly). Then, in column 2, we use the Theil index on wage from UTIP database as output variable and the previous ratio (S-S trade/ N-S trade), the result are conformed to the previous results (column 1 of table 3.1). The columns 3 and 4 show that trade openness, measured by our index of trade liberalization, decreases wage inequality in developing countries in case of trade liberalization with northern partners and increases wage inequality in case of trade liberalization with southern partners, whatever is the index of wage inequality, standard deviation in log of wages (column 3) or Theil index from UTIP database (column 4).

We have also tried to use another approach to measure N-S trade versus S-S trade for developing countries<sup>9</sup>. We could consider S-S trade as openness with a partner less endowed in human capital (measure by the average years of education from Barro and Lee 2000), and N-S trade as openness with a partner more endowed in human capital. Then each developing country faces different partners for South and for North. Unfortunately this approach gives no consistent results since the measure mainly captures the endowment of countries in human capital, e.g. country with low endowment in capital has mainly North partners so N-S trade.

## 7 Conclusions

Concerning the impact of trade liberalization on wage inequality in developing countries, the theory tells us that we must expect decreasing wage inequality during trade reforms. The initial tests did not conform to this theory: namely the wage skill gap often increased in developing countries when they liberalized their trade. Faced with this puzzling result, authors have improved their empirical assessment and their theoretical approach to studying the consequences of trade liberalization. They account notably for skill biased technological change during trade liberalization. Here we propose another explanation: the direction of trade. In a context where globalization does not only lead to an increase in North-South trade but also in South-South trade, it seems important to account for this change in the direction of trade when analyzing the impact on inequality. South-South trade account now 40% of merchandise trade in developing countries.

The primary purpose of this paper is to present the result of a new empirical investigation concerning the direction of trade. We look for a

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<sup>9</sup> Thanks to Marcelo Olarreaga and Mathias Thoenig for this comment

classical North-South trade relationship in the South-South trade since developing countries are heterogeneous.

The secondary purpose is to precise the link between direction of trade and technological change. Arguing that if South-South trade bring technological change more oriented toward skill intensive sector than North -South trade; it might explain why we could obtain different results for South-South trade and North-South trade on wage inequality.

Here we restrict globalization which traduces trade liberalization, outsourcing, immigration and capital account openness to only trade flows in goods since the measure of trade liberalization with the north and with the South is not obvious to obtain. Concerning inequality we will only focus on wage inequality which is closest to the initial trade theory of Stolper-Samuelson, and we use inter industry wage inequality.

In a first part we observe the characteristics of this S-S trade and explore from which channels this S-S trade could affect wage inequality. We observe a development of a North-South trade relationship between high middle income countries and low income countries. Since S-S trade increases competitiveness in skill intensive products, S-S trade appears to bring technological change more biased towards skill intensive sector than N-S trade.

In a second part we test econometrically the different channels from which S-S trade affect wage inequality. The results show that increasing share of S-S trade increases wage inequality whereas N-S trade tends to decrease inter industry wage inequality. A part of this increasing wage inequality due to S-S trade comes from the development of N-S trade relationship in S-S trade which increases wage inequality in middle income developing countries (which are the North in this S-S trade). The fact that S-S trade is

more skill intensive sector oriented increase wage inequality for all developing countries (included low income countries). Whereas for middle income country the impact of S-S trade on increasing wage inequality is mainly direct (through the fact that they are the North in this S-S trade) for 90%, for low income countries it is the indirect effect through the sector biased technological change which impact more on wage inequality.

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## APPENDICES

A.1: *List of countries included in the sample 1976-2000*

|                            | <b>Countries</b>   | <b>observations</b> |                      |                     |            |
|----------------------------|--------------------|---------------------|----------------------|---------------------|------------|
| Middle Up Income Countries | Argentina          | 6                   |                      |                     |            |
|                            | Barbados           | 7                   |                      |                     |            |
|                            | Chile              | 8                   |                      |                     |            |
|                            | Costa Rica         | 6                   |                      |                     |            |
|                            | Israel             | 5                   |                      |                     |            |
|                            | Korea, Rep.        | 7                   |                      |                     |            |
|                            | Malaysia           | 8                   |                      |                     |            |
|                            | Mauritius          | 7                   |                      |                     |            |
|                            | Mexico             | 8                   |                      |                     |            |
|                            | Panama             | 8                   |                      |                     |            |
|                            | Trinidad & Tobago  | 8                   |                      |                     |            |
|                            | Uruguay            | 8                   |                      |                     |            |
|                            | Venezuela, RB      | 8                   |                      |                     |            |
|                            | <b>Total</b>       | <b>13</b>           | <b>94</b>            |                     |            |
|                            | <b>Countries</b>   | <b>observations</b> |                      |                     |            |
| Middle Income Countries    | Algeria            | 7                   | Low Income Countries | Bangladesh          | 7          |
|                            | Bolivia            | 8                   |                      | Benin               | 2          |
|                            | Brazil             | 4                   |                      | Burundi             | 2          |
|                            | China              | 4                   |                      | Cameroon            | 7          |
|                            | Colombia           | 8                   |                      | Central African Rep | 6          |
|                            | Dominican Rep.     | 4                   |                      | Congo               | 4          |
|                            | Ecuador            | 8                   |                      | Ethiopia            | 3          |
|                            | Egypt, Arab Rep.   | 8                   |                      | Gambia, The         | 3          |
|                            | El Salvador        | 7                   |                      | Ghana               | 6          |
|                            | Fiji               | 6                   |                      | Haiti               | 3          |
|                            | Guatemala          | 8                   |                      | India               | 8          |
|                            | Guyana             | 2                   |                      | Ivory Coast         | 5          |
|                            | Honduras           | 6                   |                      | Kenya               | 8          |
|                            | Indonesia          | 8                   |                      | Liberia             | 2          |
|                            | Iran, Islamic Rep. | 8                   |                      | Madagascar          | 5          |
|                            | Jamaica            | 6                   |                      | Malawi              | 7          |
|                            | Jordan             | 8                   |                      | Nepal               | 5          |
|                            | Morocco            | 8                   |                      | Nicaragua           | 4          |
|                            | Peru               | 5                   |                      | Nigeria             | 6          |
|                            | Philippines        | 8                   |                      | Pakistan            | 7          |
| South Africa               | 8                  | Papua New Guinea    | 5                    |                     |            |
| Sri Lanka                  | 7                  | Rwanda              | 5                    |                     |            |
| Syria                      | 8                  | Senegal             | 7                    |                     |            |
| Thailand                   | 8                  | Sierra Leone        | 2                    |                     |            |
| Tunisia                    | 5                  | Tanzania            | 4                    |                     |            |
| Turkey                     | 6                  | Togo                | 5                    |                     |            |
|                            |                    |                     | Zambia               | 4                   |            |
|                            |                    |                     | Zimbabwe             | 7                   |            |
| <b>Total</b>               | <b>25</b>          | <b>173</b>          | <b>Total</b>         | <b>30</b>           | <b>139</b> |

**A.2:** *Classification of Isic Industry according to Skill Intensity*

| Label                                 | 3-digit ISIC                          | Content                                   |
|---------------------------------------|---------------------------------------|---|
| Low Skill Labor Intensive<br>(LSL)    | 311                                   | Food products                             |
|                                       | 321                                   | Textiles                                  |
|                                       | 322                                   | Wearing apparel, except footwear          |
|                                       | 323                                   | Leather products                          |
|                                       | 324                                   | Footwear, except rubber or plastic        |
|                                       | 331                                   | Wood products, except furniture           |
|                                       | 332                                   | Furniture, except metal                   |
| Medium Skill Labor Intensive<br>(MSL) | 356                                   | Plastic products                          |
|                                       | 313                                   | Beverages                                 |
|                                       | 314                                   | Tobacco                                   |
|                                       | 341                                   | Paper and products                        |
|                                       | 342                                   | Printing and publishing                   |
|                                       | 355                                   | Rubber products                           |
|                                       | 361                                   | Pottery, china, earthenware               |
|                                       | 362                                   | Glass and products                        |
|                                       | 369                                   | Other non-metallic mineral products       |
| 371                                   | Iron and steel                        |   |
| High Skill Labor Intensive<br>(HSL)   | 372                                   | Non-ferrous metals                        |
|                                       | 381                                   | Fabricated metal products                 |
|                                       | 351                                   | Industrial chemicals                      |
|                                       | 352                                   | Other chemicals                           |
|                                       | 353                                   | Petroleum refineries                      |
|                                       | 354                                   | Miscellaneous petroleum and coal products |
|                                       | 382                                   | Machinery, except electrical              |
|                                       | 383                                   | Machinery, electric                       |
| 384                                   | Transport equipment                   |   |
| 385                                   | Professional and scientific equipment |   |

A.3: *List of variables*

| Label                         | Content  | Sources   |
|-------------------------------|--|---|
| Theil                         | Theil index on inter industry wage inequality  | UTIP (2004)   |
| SDLW                          | Standard Deviation of log wages per Industry (measure inter industry wage inequality)  | Nicita and Olarreaga (2006)   |
| Wage                          | Wage by industry   | Nicita and Olarreaga (2006)   |
| FDI                           | Foreign Direct Investment  | WDI (2004)  |
| GDPpc                         | GDP per capita in power parity purchase (PPP)  | Pen WorldTables (2005)  |
| Capital                       | Capital per Worker   | Easterly and Levine (1999) & Kraay and al. (2000)                               |
| Arable Land                   | Land arable per labor force (Cereal-land; Crop-land; Forest-land)  | WDI (2004)  |
| Mining & Fuel                 | Index Isham and al. (2005) base on net exports   | Comtrade (2002)   |
| Education                     | Average years of schooling in the population over 15 years old   | Barro and Lee (2000)  |
| Infrastructure                | Principal component analysis on road per km <sup>2</sup> , telephone lines per workers, power Gigawatt per worker  | Caning (19996) and Calderon and Serven (2004)                                   |
| Density                       | Population on Surface  | WDI (2004)  |
| Tariffs                       | Import duties comprise all levies collected on goods at the point of entry into the country. In % of Imports   | WDI (2004)  |
| (X+M)/Gdp                     | Output trade ratio   | WDI (2004)  |
| Index South                   | Adjusted Trade ratio on bilateral trade with South Countries   | Calculate by author   |
| Index North                   | Adjusted Trade ratio on bilateral trade with North Countries   | Calculate by author   |
| Trade South (TSS)             | Imports from South and Export to South on Added Value in manufacturing industry  | Nicita and Olarreaga (2006)   |
| Trade North (TNS)             | Imports from North and Export to North on Added Value in manufacturing industry  | Nicita and Olarreaga (2006)   |
| TSS/TNS                       | Openness biased toward South   | Calculate by author from Nicita and Olarreaga (2006)                            |
| Labor productivity            | Added value per Labor  | Nicita and Olarreaga (2006)   |
| USBTC                         | Ratio of Labor productivity in Low Skill Labor intensive industry on Labor productivity in High Skill Labor intensive industry   | Calculate by author from Nicita and Olarreaga (2006)                            |
| Tot Factor Productivity (TFP) | The TFP is calculated un logs as the difference between output and factor use: $\log TFP = \log Y - a \log L - (1-a) \log K$ , with a equal to labor's share. The capital stocks are derived from investment series using the perpetual inventory model with a 9% depreciation rate. The labor share is equal to the wage bill divided by the value of output. | Calculate by author from Nicita and Olarreaga (2006) with Mathias Thoeng method |

## A.4: GMM

## A.4.1: S-S Trade versus N-S Trade

|                 | <b>1</b>         | <b>2</b>          | <b>3</b>         | <b>4</b>         |
|-----------------|------------------|-------------------|------------------|------------------|
|                 | GMM-SY           | GMM-SY            | GMM-SY           | GMM-SY           |
| Sample          | All              | Upper<br>Middle   | Middle           | Low              |
| wage inequality | SDLW             | SDLW              | SDLW             | SDLW             |
| GDP pc          | -0.017<br>(0.88) | 0.004<br>(0.30)   | 0.032<br>(1.63)  | -0.005<br>(0.14) |
| FDI             | 0.063<br>(1.18)  | 0.094a<br>(4.20)  | 0.133<br>(1.36)  | 0.174<br>(0.87)  |
| Education       | 0.002<br>(0.06)  | -0.088a<br>(3.52) | 0.058b<br>(2.02) | 0.053<br>(1.62)  |
| TSS/TNS         | 0.047a<br>(4.58) | 0.055a<br>(10.22) | 0.029c<br>(1.72) | 0.028c<br>(1.72) |
| Dummy period    | Yes              | Yes               | Yes              | Yes              |
| Constant        | 0.457a<br>(2.92) | 0.325b<br>(2.49)  | -0.199<br>(0.68) | 0.085<br>(0.16)  |
| Observations    | 1054             | 283               | 466              | 305              |
| Number          | 69               | 14                | 25               | 30               |
| Prob Sargan     | 0.77             | 0.74              | 0.53             | 0.13             |
| AR2             | 0.61             | 0.48              | 0.43             | 0.90             |

## A.4.2 Effect of S-S and N-S trade on sector biased technological change

|               | <b>1</b>          | <b>2</b>          | <b>3</b>          | <b>4</b>          |
|---------------|-------------------|-------------------|-------------------|-------------------|
| Sample        | All               | Upper<br>Middle   | Middle            | Low               |
|               | USBTC             | USBTC             | USBTC             | USBTC             |
| GDP pc        | -0.001<br>(0.01)  | 0.086<br>(0.26)   | -0.312<br>(1.30)  | 0.146<br>(0.57)   |
| FDI           | -0.225<br>(1.34)  | -0.338<br>(1.19)  | -0.625<br>(0.96)  | 0.513<br>(0.74)   |
| Education     | -0.410a<br>(3.03) | -0.152<br>(0.30)  | -0.610c<br>(1.81) | -0.586a<br>(4.89) |
| TSS/TNS       | -0.090c<br>(1.69) | -0.107c<br>(1.74) | -0.169b<br>(2.20) | -0.201b<br>(2.22) |
| Dummy country | Yes               | Yes               | Yes               | Yes               |
| Dummy period  | Yes               | Yes               | Yes               | Yes               |
| Observations  | 1036              | 280               | 466               | 290               |
| Number        | 61                | 13                | 24                | 24                |
| Prob Sargan   | 1.00              | 1.00              | 1.00              | 1.00              |
| AR2           | 0.54              | 0.67              | 0.82              | 0.40              |



## A.4.3 Direct and Indirect effects of N-S and S-S trade on wage inequality

|                          | 1                 | 2                | 3                 | 4                 |
|--------------------------|-------------------|------------------|-------------------|-------------------|
| Sample                   | All               | Upper<br>Middle  | Middle            | Low               |
| Index of wage inequality | SDLW              | SDLW             | SDLW              | SDLW              |
| GDP pc                   | -0.019<br>(0.98)  | 0.003<br>(0.12)  | 0.003<br>(0.10)   | -0.100a<br>(3.13) |
| FDI                      | 0.079c<br>(1.68)  | 0.091<br>(1.54)  | 0.099<br>(0.86)   | 0.454a<br>(3.18)  |
| Education                | -0.025<br>(0.91)  | -0.097<br>(1.18) | 0.002<br>(0.05)   | 0.027<br>(0.75)   |
| USBTC                    | -0.059b<br>(2.53) | -0.011<br>(1.62) | -0.088a<br>(3.55) | -0.049c<br>(1.85) |
| TSS/TNS                  | 0.041a<br>(4.47)  | 0.057a<br>(3.57) | 0.032c<br>(1.89)  | 0.010<br>(0.97)   |
| Dummy country            | Yes               | Yes              | Yes               | Yes               |
| Dummy period             | Yes               | Yes              | Yes               | Yes               |
| Observations             | 1036              | 280              | 466               | 290               |
| Number                   | 61                | 13               | 24                | 24                |
| Prob Sargan              | 1.00              | 1.00             | 1.00              | 1.00              |
| AR2                      | 0.53              | 0.62             | 0.46              | 0.67              |

## A.4.4 Quantify the indirect and direct effect of S-S trade relative to N-S trade on wage inequality

| Effect of SS/NS | All   | Upper<br>Middle | Middle | Low          |
|-----------------|-------|-----------------|--------|--------------|
| Indirect effect | 0.006 | <i>0.001</i>    | 0.015  | 0.013        |
| Direct effect   | 0.046 | 0.062           | 0.034  | <i>0.013</i> |
| Total effect    | 0.052 | 0.063           | 0.049  | 0.026        |
| Share Indirect  | 11%   | 2%              | 31%    | 50%          |
| Share Direct    | 89%   | 98%             | 69%    | 50%          |

Value in italic indicate that this is not significant

A.5: *Quantile Regressions*

## A.5.1: S-S Trade versus N-S Trade

|                | All                 |                     | Upper Middle        |                     | Middle              |                     | Low                 |                     |
|----------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
|                | 1<br>Wage<br>(25th) | 2<br>Wage<br>(75th) | 3<br>Wage<br>(25th) | 4<br>Wage<br>(75th) | 5<br>Wage<br>(25th) | 6<br>Wage<br>(75th) | 7<br>Wage<br>(25th) | 8<br>Wage<br>(75th) |
| GDP pc         | 0.7754a<br>(18.47)  | 0.6408a<br>(18.32)  | 1.1335a<br>(15.79)  | 0.9397a<br>(15.51)  | 0.5147a<br>(11.18)  | 0.4593a<br>(7.87)   | 0.7402a<br>(9.69)   | 0.4648a<br>(6.09)   |
| FDI            | -0.7924c<br>(1.84)  | -1.7228a<br>(4.93)  | -1.3815b<br>(2.58)  | -2.0310a<br>(3.90)  | 1.0674b<br>(2.07)   | -2.1947a<br>(3.62)  | -7.5166a<br>(7.36)  | -5.0562a<br>(5.67)  |
| Education      | 0.0628<br>(1.35)    | 0.1941a<br>(4.87)   | -0.0524<br>(0.49)   | -0.0317<br>(0.31)   | 0.1511a<br>(3.02)   | 0.4718a<br>(6.95)   | -0.0823<br>(1.25)   | -0.1682b<br>(2.45)  |
| TSS/TNS        | -0.0630a<br>(5.72)  | -0.0339a<br>(3.76)  | -0.0577a<br>(2.63)  | -0.0076<br>(0.42)   | -0.1551a<br>(12.48) | -0.1066a<br>(6.86)  | 0.0971a<br>(5.68)   | 0.0503a<br>(2.92)   |
| D industry     | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 |
| D country      | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 |
| D period       | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 | Yes                 |
| Constant       | -5.2705a<br>(20.98) | -3.6806a<br>(17.50) | -7.8395a<br>(12.76) | -5.6404a<br>(10.48) | -3.5532a<br>(9.95)  | -3.1540a<br>(6.79)  | -3.7993a<br>(10.81) | -2.4101a<br>(6.90)  |
| Observations   | 9181                | 9181                | 2295                | 2295                | 4102                | 4102                | 2784                | 2784                |
| R <sup>2</sup> | 0.56                | 0.56                | 0.54                | 0.54                | 0.57                | 0.57                | 0.56                | 0.56                |

## A.5.2: Effect of S-S and N-S trade on sector biased technological change

|                | Labor<br>Productivity<br>(25%) | Labor<br>Productivity<br>(75%) |
|----------------|--------------------------------|--------------------------------|
| GDP pc         | 0.758<br>(18.08)***            | 0.531<br>(10.05)***            |
| FDI            | -2.680<br>(6.05)***            | -1.600<br>(3.09)***            |
| Education      | 0.169<br>(3.48)***             | 0.252<br>(4.34)***             |
| TSS/TNS        | -0.018<br>(1.64)               | 0.032<br>(2.49)**              |
| Dummy industry | Yes                            | Yes                            |
| Dummy country  | Yes                            | Yes                            |
| Dummy period   | Yes                            | Yes                            |
| Constant       | -4.778<br>(12.72)***           | -2.497<br>(5.25)***            |
| Observations   | 9181                           | 9181                           |

**A.6: Total Factor Productivity (TFP)****A.6.1: Effect of S-S and N-S trade on sector biased technological change**

| Countries       | All                |                    |                    | Upper middle      |                    | Low                |                    |
|-----------------|--------------------|--------------------|--------------------|-------------------|--------------------|--------------------|--------------------|
| Skill intensive | LSL                | MSL                | HSL                | LSL               | HSL                | LSL                | HSL                |
|                 | <b>TFP</b>         | <b>TFP</b>         | <b>TFP</b>         | <b>TFP</b>        | <b>TFP</b>         | <b>TFP</b>         | <b>TFP</b>         |
| GDP pc          | 1.0849a<br>(12.57) | 1.1320a<br>(12.52) | 1.4076a<br>(11.71) | 0.7515a<br>(7.95) | 1.0878a<br>(6.09)  | 2.2330a<br>(7.38)  | 2.2267a<br>(6.22)  |
| Education       | -0.1116<br>(1.10)  | -0.2806a<br>(2.65) | -0.3316b<br>(2.36) | 0.0378<br>(0.24)  | -0.6868b<br>(2.46) | -1.1146a<br>(2.68) | 3.0431a<br>(5.43)  |
| FDI             | 0.1716b<br>(2.47)  | 0.1993a<br>(2.70)  | 0.1544<br>(1.54)   | 0.0171<br>(0.32)  | -0.2546b<br>(2.40) | -2.8683a<br>(2.91) | -2.5677b<br>(2.34) |
| TSS/TNS         | -0.0223<br>(0.98)  | 0.0589b<br>(2.47)  | 0.0883a<br>(2.77)  | 0.0391<br>(1.21)  | 0.1030<br>(1.58)   | 0.1041<br>(1.08)   | 0.3944a<br>(3.50)  |
| Dummy industry  | Yes                | Yes                | Yes                | Yes               | Yes                | Yes                | Yes                |
| Dummy country   | Yes                | Yes                | Yes                | Yes               | Yes                | Yes                | Yes                |
| Dummy period    | Yes                | Yes                | Yes                | Yes               | Yes                | Yes                | Yes                |
| Observations    | 4489               | 6003               | 4107               | 1334              | 1242               | 885                | 719                |
| Number          | 292                | 389                | 275                | 80                | 79                 | 71                 | 62                 |
| R-squared       | 0.17               | 0.21               | 0.23               | 0.39              | 0.32               | 0.23               | 0.35               |

**Annex 6.2: Direct and Indirect effects of N-S and S-S trade on wage inequality**

| Countries       | All                |                    |                    | Upper middle       |                    | Low               |                   |
|-----------------|--------------------|--------------------|--------------------|--------------------|--------------------|-------------------|-------------------|
| Skill intensive | LSL                | MSL                | HSL                | LSL                | HSL                | LSL               | HSL               |
|                 | <b>wage</b>        | <b>wage</b>        | <b>wage</b>        | <b>wage</b>        | <b>wage</b>        | <b>wage</b>       | <b>wage</b>       |
| GDP pc          | 0.6374a<br>(2.95)  | 0.5108a<br>(2.62)  | 0.5967a<br>(2.59)  | 0.9686a<br>(5.08)  | 0.7404a<br>(3.33)  | 0.2743<br>(1.42)  | 0.0859<br>(0.94)  |
| Education       | 0.0138<br>(0.34)   | -0.1214<br>(1.02)  | -0.1398a<br>(2.77) | 0.1143<br>(1.27)   | -0.1766c<br>(1.71) | 0.3972c<br>(1.93) | 0.4191a<br>(2.47) |
| FDI             | 0.0127<br>(0.45)   | 0.0219<br>(0.78)   | 0.0691c<br>(1.93)  | -0.1315a<br>(2.27) | -0.1023a<br>(2.61) | 0.0604<br>(0.22)  | 0.6560c<br>(1.95) |
| TSS/TNS         | -0.0784a<br>(2.88) | -0.0858a<br>(3.44) | -0.0596a<br>(2.93) | -0.1283a<br>(2.33) | -0.1071a<br>(1.97) | 0.0218<br>(0.75)  | 0.0345<br>(1.32)  |
| TFP             | 0.2275a<br>(3.74)  | 0.1332a<br>(3.59)  | 0.1129a<br>(4.47)  | 0.3395a<br>(4.48)  | 0.1329a<br>(2.85)  | 0.1231a<br>(3.32) | 0.0731a<br>(2.23) |
| Dummy industry  | Yes                | Yes                | Yes                | Yes                | Yes                | Yes               | Yes               |
| Dummy country   | Yes                | Yes                | Yes                | Yes                | Yes                | Yes               | Yes               |
| Dummy period    | Yes                | Yes                | Yes                | Yes                | Yes                | Yes               | Yes               |
| Observations    | 4489               | 6003               | 4107               | 1334               | 1242               | 885               | 719               |
| Number          | 292                | 389                | 275                | 80                 | 79                 | 71                | 62                |
| R-squared       | 0.42               | 0.36               | 0.36               | 0.58               | 0.54               | 0.39              | 0.47              |

**Annex 6.3 Quantify the indirect and direct effect Effect of 1% increase in the ratio S-S trade versus N-S trade on wages<sup>10</sup>**

|                 | LSL            | MSL     | HSL     | LSL           | HSL           | LSL           | HSL           |
|-----------------|----------------|---------|---------|---------------|---------------|---------------|---------------|
| <b>Direct</b>   | -0.0784        | -0.0858 | -0.0596 | -0.1283       | -0.1071       | <i>0.0218</i> | <i>0.0345</i> |
| <b>Indirect</b> | <i>-0.0051</i> | 0.0078  | 0.0100  | <i>0.0133</i> | <i>0.0137</i> | 0.0128        | 0.0288        |
| <b>Total</b>    | -0.0835        | -0.0780 | -0.0496 | -0.1150       | -0.0926       | 0.0346        | 0.0633        |

<sup>10</sup> value in italic indicates that it is not significant

### A.7: *Adjusted trade openness index*

The basic gravity model posits that the volume of trade between two nations is an increasing function of the incomes of those nations and a decreasing function of the distance between them. Although we include other variables, including whether the countries share a common border and/or a common language are often added to the model. Frankel and Romer (1999) use it to estimate the natural openness in a country. By implication, the model should also be able to help us in identifying abnormal or distorted patterns of trade and estimating the extent to which these are due to the trade policies of particular nations. The basic form of the gravity model can be expressed in log-linear form as

$$\ln \left( \frac{(M + X)_{ijt}}{Y_{it}} \right) = \alpha_{it} + \beta_1 \ln Y_{jt} + \beta_2 \ln(P_{it} * P_{jt}) + \beta_3 Dist_{ijt} \\ + \beta_4 \ln K_{ijt} + \beta_5 \ln N_{ijt} + \beta_6 \ln T_{ijt} + \beta_7 \ln H_{ijt} + \beta_8 \ln(R_{it} * R_{jt}) + \beta_9 Z_{ij} + \varepsilon_{it}$$

Where  $(M + X)_{ijt}$  represents total trade flow between country  $i$  and  $j$ ,  $Y_{it}$  and  $Y_{jt}$  denote national income,  $P_{it}$  and  $P_{jt}$  are total population,  $Dist_{ijt}$  is the distance between economic centers of each country.  $Z_{ij}$  represents dummies including whether the countries share a common border and/or a common language, are landlocked or exporter of oil. The Heckscher-Ohlin (HO) model of trade suggests that trade flows should vary with the character of each nation's factor endowments relative to trading partners. That is why we include variables that represent differences in factor endowments between countries.  $K_{ijt}$ ,  $N_{ijt}$ ,  $T_{ijt}$  and  $H_{ijt}$  are differences in factor endowments between countries  $i$  and  $j$  in physical capital per labor, mineral/fuel resources per labor, arable land per labor and human capital per labor. We include also the remoteness since a country's trade with any given partner is dependent on its average remoteness to the rest of the world (Anderson and Van Wincoop 2003). Let  $R_i$  and  $R_j$ , denote the remoteness of  $j$  and  $i$ , equal to GDP-weighted of distance.

In order to evaluate the distorting effects of each country's policies in each year we include a country year dummy  $\alpha_{it}$  for country  $i$  in year  $t$ . The country-year dummy variables stand in for the (unmeasured) relative openness of trade policy orientations. A similar approach has been used to gauge the effects of regional trade agreements on trade flows by using dummy variables for pairs of nations in the same regional bloc as

a proxy for regionally specific discriminatory policies. Here the set of estimated coefficient  $\alpha_{it}$  provides the amount of trade flows due to distorting effects of each country's policies in each year when compared to the mean for the entire sample.

The yearly data set is a panel of bilateral trade flows for 91 countries over the period 1975-1998. The data on trade flows come from Andrew Rose (2004) based on the CD Rom "Direction of Trade" from IMF. The measure of income is the real GDP in 1995 dollar from WDI (2004). The measure on distance comes from CEPII. Measure on capital per worker comes from Easterly and Levine (1999) and Kraay and al. (2000), the measure on arable land par person comes from WDI (2004) and the average years of schooling in the population over 15 years old comes from the Barro and Lee (2000) database. The measure for natural resources is the index from Isham and al. (2005) base on net exports share on fuels and minerals/

To check the robustness of our approach, we also estimate the previous model on imports to country  $i$  from  $j$ . So we have four estimations in OLS where columns 1 and 2 deal with total trade flows (imports and exports) with southern and northern countries respectively, column 3 and 4 deal with imports flows.

|                    | 1<br>S-S<br>(Xij+Mij)/GDPi |         | 2<br>S-N<br>(Xij+Mij)/GDPi |        | 3<br>S-S<br>Mij/GDPi |         | 4<br>S-N<br>Mij/GDPi |        |
|--------------------|----------------------------|---------|----------------------------|--------|----------------------|---------|----------------------|--------|
|                    |                            | t       |                            | t      |                      | t       |                      | t      |
| GDP j              | .8434706                   | 136.58  | 1.088825                   | 171.48 | .8407659             | 121.89  | 1.096644             | 177.21 |
| Distance ij        | -1.567697                  | -128.38 | -1.362507                  | -69.93 | -1.599144            | -124.18 | -1.269562            | -63.49 |
| Remoteness j       | 13.9901                    | 22.32   | -11.43796                  | -14.96 | 18.12565             | 23.98   | -13.30967            | -17.02 |
| Difference in K/L  | -.0504299                  | -4.23   | .5902252                   | 15.89  | -.050749             | -3.79   | .6914029             | 18.07  |
| Difference in AT/L | .2561743                   | 31.34   | .0847337                   | 8.54   | .2553133             | 29.18   | .0775922             | 7.76   |
| Difference in MF/L | .236932                    | 5.63    | -.1345675                  | -4.56  | .2708983             | 5.88    | -.0973902            | -3.16  |
| Difference in Ed/L | .2308808                   | 9.26    | .4954804                   | 11.30  | .2830758             | 7.70    | 1.143677             | 18.50  |
| GDPj/POPj          | .4689212                   | 36.31   | .0703882                   | 1.11   | .4851791             | 32.83   | .2897272             | 4.30   |
| Common border      | .1728211                   | 4.64    | -.8173135                  | -6.00  | .1034525             | 2.59    | -1.046493            | -8.60  |
| Colonial relation  | .1860693                   | 2.24    | .8976046                   | 29.58  | .2208701             | 2.64    | .7736648             | 24.96  |
| Common colons      | 1.076913                   | 32.42   | -.0895179                  | -1.44  | 1.140991             | 32.10   | -.2606428            | -4.37  |
| Common language    | .2126735                   | 9.65    | .4332245                   | 20.65  | .2323986             | 10.10   | .4174662             | 19.95  |
| Island             | -.1108155                  | -3.78   | .2906113                   | 9.56   | -.1338648            | -4.38   | .206694              | 6.60   |
| landlockness       | -.1997701                  | -6.50   | -.0450844                  | -2.21  | -.204416             | -5.54   | -.0849352            | -4.18  |
| R <sup>2</sup>     |                            |         |                            |        |                      |         |                      |        |
| Observations       |                            |         |                            |        |                      |         |                      |        |

A.8: *Alternative measures for wage inequality and trade openness*

|                          | 1                  | 2                  | 3                   | 4                   |
|--------------------------|--------------------|--------------------|---------------------|---------------------|
|                          | FE                 | FE                 | FE                  | FE                  |
| Sample                   | Developing         | Developing         | Developing          | Developing          |
| Index of wage inequality | SDLW               | Theil              | SDLW                | Theil               |
| GDP pc                   | -0.061<br>(1.39)   | -0.376<br>(2.23)** | -0.058<br>(1.28)    | -0.402<br>(1.84)*   |
| FDI                      | 0.509<br>(1.33)    | 4.174<br>(2.33)**  | 0.146<br>(0.40)     | 2.534<br>(1.54)     |
| Education                | -0.068<br>(2.02)** | 0.070<br>(0.44)    | -0.038<br>(0.76)    | 0.204<br>(1.05)     |
| Open SS                  |                    |                    | 0.023<br>(2.74)***  | 0.066<br>(2.34)**   |
| Open NS                  |                    |                    | -0.041<br>(3.83)*** | -0.121<br>(2.61)*** |
| Trade SS                 | 0.026<br>(3.11)*** |                    |                     |                     |
| Trade NS                 | -0.022<br>(1.57)   |                    |                     |                     |
| TSS/TNS                  |                    | 0.093<br>(2.43)**  |                     |                     |
| Dummy period             | Yes                | Yes                | Yes                 | Yes                 |
| Constant                 | 0.862<br>(3.32)*** | 4.184<br>(3.58)*** | 0.758<br>(2.77)***  | 3.703<br>(2.64)***  |
| Observations             | 406                | 388                | 329                 | 313                 |
| Number                   | 68                 | 68                 | 52                  | 52                  |
| R-squared                | 0.20               | 0.23               | 0.23                | 0.26                |