

IMPACT OF TRADE LIBERALISATION ON EMPLOYMENT IN BANGLADESH

SUMMARY OF RESULTS AND POLICY IMPLICATIONS

[The following summary presents major findings of a study recently undertaken jointly by the Centre for Policy Dialogue (CPD) and International Labour Organization (ILO) to examine the employment consequences of trade liberalisation in Bangladesh. The findings of the study were presented at a dialogue jointly organised by CPD and ILO on 9 December 2007 at BRAC Centre Inn Auditorium.

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Introduction

Employment is a major concern in the context of trade liberalization. At one level, productive employment is a major route out of poverty, and hence, in a country such as Bangladesh, it should be of an issue of major concern. There is a vast body of literature which shows that trade is good for economic growth which in turn should be good for poverty reduction. However, it is to be noted here that there are a number of assumptions behind this line of causation which may not hold in reality. First, while high rate of economic growth is a necessary condition for poverty reduction, experience has shown that it is not sufficient. The pattern of growth, and in that context, the employment outcome of growth is an important element in determining the poverty reducing outcome of growth. Second, while trade may be good for growth, it does not necessarily imply that trade liberalization *per se* is good for growth. Indeed, trade liberalization, if pursued without due consideration to the strategic context of a given economy, can have a negative impact on growth itself. Third, the impact of trade liberalization on employment may not always be positive. And if that turns out to be the case in a country like Bangladesh, then one will need to closely examine the related issues.

The present study has examined the changes in the employment scenario of Bangladesh following the pursuance of the trade liberalisation strategy and the possible effects of further trade liberalisation. The study has first reviewed the tariff reforms pursued in Bangladesh and traced the dynamics of changes in the relevant correlates since the early 1980s. Based on an examination of the speed of change in the major trade liberalisation related correlates and indicators, four phases of reform process in Bangladesh were identified with a view to subsequently establishing the interface and impact of the trade liberalisation with the country's labour market dynamics. With this in mind the study reviewed the change in structure of employment in formal and informal sectors of Bangladesh during the pre and post-liberalisation period. A number of tools and techniques were used to establish the linkage and estimate the impact of trade liberalisation on employment. Firstly, data related correction was first undertaken for the data provided by the various LFSs to adjust for differences in definitional and age criteria. Secondly, consistency and validity of the CMI data, at disaggregated level, was checked and necessary corrections were made in this context. Given the poor quality of data, and the attendant lack of comparability, this task was of utmost importance from the perspective of undertaking an exercise of this nature. Subsequent analyses were carried out based on the corrected datasets. Thirdly, sectoral trade and tariff data were estimated, and these variables were used to measure the extent of trade liberalisation in Bangladesh. Fourthly, the trade liberalisation correlates were juxtaposed with aggregate employment dynamics to examine the nature of impact of the former on the later. Fifthly, econometric analyses (estimation of production function and labour demand function) were carried out using the 4-digit disaggregated industry-level data from successive CMI reports to provide more insightful results compared to those obtained by using the more aggregate level data. Finally, a CGE model for Bangladesh economy has been applied and some *ex ante* trade liberalisation policy scenarios have been simulated with a view to exploring the likely impact of these scenarios on sectoral labour demand in Bangladesh economy.

Key Findings of the Study

The major findings of the study are summarised below:

- There has been significant liberalisation of trade in Bangladesh, during the 1990's compared to the 1970's and 1980's. Simple average MFN applied tariff rate, import weighted average tariff rate, implicit nominal tariff rate and quantitative restrictions declined significantly during the 1990's. For example, simple MFN applied average tariff and import weighted average tariff rate came down to 19.50 and 13.80 percent respectively in 2000 from 88.60 and 42.10 percent in 1991. Also, in terms of trade-GDP ratio there has been remarkable rise during the last two decades; it crossed 40 percent in 2006 from 17 percent in 1991. Based on the pace of liberalisation, a number of distinctive phases were identified. The fastest pace of trade liberalisation in Bangladesh has taken place in phase-2 (1991-95).
- Overall, and in general, tariff liberalisation in Bangladesh has followed the classical sequence of higher protection for final goods and relatively lower protection for capital goods and intermediates. However, this was more prominent when nominal rates of protection were considered rather than when import weighted rates.
- Observing the sectoral and overall employment growth, it can be stated that during the second phase of trade liberalisation, employment, in general, has suffered. In particular, agriculture and manufacturing sector (particularly in industrial sector) have experienced average negative growth. On the other hand, recovering from the negative per annum growth in the first phase, service sector has experienced positive growth during the second and third phases.
- Throughout the period of analysis manufacturing employment has remained stagnant while service sector showed an increasing trend with a big jump in 1995-96 and agriculture has experienced a decrease in 1995-96 following which employment in this sector has again increased. The share of agriculture in GDP has been declining; however, this sector contributes almost half of the total employment in Bangladesh. Contribution of service sector to employment has experienced a decline in the late 80s but increased from mid-90s. However, the

share of manufacturing employment in total labour force shows an erratic pattern in first and second phases. From the beginning of the third phase, manufacturing employment indicates an increasing trend. It is to be pointed out that share of manufacturing sector in total employment is still very low and has not shown any increasing trend indicating the failure of manufacturing sector to absorb the growing labour force (in a Lewisian manner).

- Till 1999-2000, an increase in self employed category is observed at the cost of a reduction of employment in the unpaid family worker category. However, after 2000, there has been a drift back towards unpaid family workers. The share of other categories remained more or less unchanged for all the three phases.
- As revealed by the LFS data, there was an increase in total employment over the past years. On the other hand, the labour force was growing at a faster rate compared to the rate of creation of new job opportunities, resulting in a rise in unemployment rate. From the second phase of trade liberalisation the unemployment rate has been increasing more rapidly in all cross-sections of the population. It is interesting to note that while open unemployment has risen, the degree of underemployment (by time measure) has fallen. The underemployment rate is lower in urban areas as compared to rural areas.
- The overall female participation rate (FPR) is about 29 percent in Bangladesh in 2005-06. No conclusive evidence could be discerned with regard to the impact of trade liberalisation on female participation in the labour force. Some sectors have observed a rise in FPR (e.g. RMG) while some others have experienced a fall in FPR (e.g. small and cottage industries).
- According to the PRSP, the projected total employment for FY2006 was 51.69 million against a base of 44.03 million in FY2003 (from LFS 2003). That would imply a compound annual growth rate (CAGR) of 5.49 percent during this period. However, analysis of LFS data (2003 and 2006) reveals that the compound annual growth rate (CAGR) of actual overall employment from FY 03 to FY 06 was 2.28 percent, with the rural rate being 2.42 percent and the urban rate being 1.84

percent. The PRSP document has also set the target of total employment to be 58.08 million in FY08 against the base of FY03 implying a CAGR of 5.70 percent between FY2003 and FY2008. Given the present employment scenario as reported in LFS of FY06, to achieve this projected employment size in FY2008, overall employment has to be generated at the rate of 10.69 percent, with rural being by 8.59 percent and urban being by 17.16 percent annually over the next two years (if the actual employment figure for 2006 is taken into account). Given the current macroeconomic scenario and the recent employment and growth relationship experience, this will indeed be a Herculean task. Considering the recent trends of urbanization in the country and slow pace of employment creation in urban areas, achieving the PRSP employment targets will be an issue of critical importance from the perspective of policy making.

- As estimated from LFS data, labour productivity for overall and manufacturing sector shows significant and strong positive correlations with corresponding real wages. However, in case of agriculture no significant association between productivity and wages could be found. Lack of wage data restricts an examination of this relationship for the service sector. Considering the dominance of services in the overall economy, one could justifiably discern a positive alliance between wage and productivity in case of service sector as well.
- Although evidence is found favouring a linear association between real wage and productivity for the overall economy, as also for the manufacturing sector and service sectors, and this can be reasonably explained, the growth in real wages lagged behind that of productivity. It is clearly visible from the study that these two indices diverge over time for both overall and manufacturing sectors; the gap between these is highest in case of the manufacturing sector. These findings lead to the following plausible hypotheses which are, of course, subject to empirical verification. The sectoral real wage elasticities with respect to corresponding labour productivity would perhaps vary from sector to sector. In case of agriculture the relative movements in real wage and productivity would suggest inelastic behaviour of agricultural real wages with respect to productivity rise. If productivity in agricultural sector increases and if wage does not respond

positively to the increase in productivity, then it would imply that workers are not receiving enough gains from productivity rise. If the reverse happens, i.e. if wage remains sticky or increases when the productivity falls, it implies that the workers are getting protection against fall in productivity. In case of manufacturing sector the elasticity, although positive, would seem to be low compared to that of the overall economy. If wage remains sticky during the period of rising productivity in manufacturing sector, this would indicate that workers are not getting a share in the rising productivity through rising real wages. If the reverse happens in the manufacturing sector, i.e. if wage remains sticky or increases during the period of decreasing productivity, this may lead to a trade-off between real wage determination and fall in competitiveness.

- Data suggests that because of tariff liberalisation a number of import substituting industries, for example, sugar, yarn, edible oil, paper, pharmaceuticals, tobacco cigarette, cloth mill, chemical fertilizer, iron and steel, metal products, machinery and transport equipment industries have faced a decline in respective ERPs over the last two decades. However, not all import substituting industries have performed badly during this period. Sectors with negative growth were sugar, edible oil, paper, cloth mill and transport equipment industries whilst industries such as yarn, pharmaceuticals, cement, tobacco cigarette, chemical fertilizer, iron and steel and metal products experienced positive growth during that period.
- It was found from CMI data that export-oriented sectors were more protected than non-export oriented sectors, labour-intensive sectors were more protected than non-labour intensive sector. It was also found that growth of production workers in labour intensive sectors was higher than that of non-labour intensive sectors. For, export-oriented sectors, the growth rates tend to be higher, with exceptions in particular years.
- It is important to note that, one of the major difficulties to assess the impact of trade liberalisation is to separate its impact from other policies events or global market fluctuations whose impacts are likely to influence the impact of shocks originated from trade liberalisation. There are also a number of other policies and

issues which are not directly treated as trade reform policies, rather should be treated as accompanying policies to trade reform ones, that could have significant employment and wage implications of the country. Some of these effects could act in the same direction with trade liberalisation while others could act on opposite direction.

- Growth in employment of productive workers is observed for both export and non-export sectors, though the growth rate has been relatively higher in case of the export-oriented sectors. In general, during the liberalisation period labour-intensive sectors have expanded more rapidly than the non-labour intensive sectors.
- Production function of the manufacturing industries in Bangladesh was estimated by using panel econometric techniques. In this connection impact of trade liberalisation variables on the growth of output in the manufacturing sector was investigated. It appears that three trade liberalisation variables considered in this study, i.e., custom duty, tariff incidence, and sectoral export orientation, turn out to be statistically insignificant in the regression model. On the other hand, two trade liberalisation variables i.e. sectoral import penetration and sectoral trade orientation have significant and robust negative impacts on output growth. These results would suggest that during the 1990s, increased import penetration and increased trade orientation (primarily through increased import penetration) did not have a positive impact on the output growth in the manufacturing sector of Bangladesh.
- Panel econometric estimation results for the labour demand function reveals some interesting results. Significant positive direct employment impact of more restricted trade regime is found when custom duty is used as the trade liberalisation variable; however, using tariff incidence as globalisation variable no significant result is found. On the other hand, when trade variables are used alone, significant negative coefficients are found on labour demand in all cases. These results tend to suggest that increase in trade activities in Bangladesh have resulted

in a reduction in domestic employment. These results also corroborate findings of a number of cross country studies.

- Results of the different trade liberalisation simulation exercises using the CGE model for Bangladesh economy are also consistent with those found in the econometric estimation. The CGE modelling exercise shows that in terms of employment generation there will be many sectors that will lose out as a result of trade liberalisation; some sectors will win as well. It appears that trade liberalisation would lead to expansion of the export-oriented manufacturing industries, and as a result, these sectors would experience increase in employment under a more liberalised trade regime. However, in this context the performance of the non-export oriented sectors, especially those in the agriculture and service sectors, turn out to be unsatisfactory. The simulation exercise reveals that if further liberalisation is undertaken, the results are expected to be as those articulated above.

Based on the aforementioned analyses a number of policy implications could be suggested:

Analysis suggests that in general there has been a rather weak relationship between trade liberalisation and growth in the manufacturing industries in Bangladesh. Therefore, trade liberalisation may be a necessary condition for industrial growth but not a sufficient condition in the context of Bangladesh. In addition other factors such as the state of business support services, adequate supply of infrastructure, adequate supply of skilled labour, easy access to credit on reasonable terms, a conducive business environment, good governance and global business environment including market access situation are important in this context.

It is also seen that not all sectors are equally gainers or losers from opening up of the economy. Transferring of part of the gains from winners to the losers through redeployment of workers in expanding sectors from the contracting sectors is another important issue that needs to be considered from the policymaker's perspectives. As our empirical examination indicates, as far as trade liberalisation is concerned such

reform measures have not been able to increase labour demand for the manufacturing industries as a whole. Though it is true that the export-oriented sectors, and to some extent some non-export oriented sectors, have been able to generate employment opportunities during the liberalised trade regime, the fall in labour demand in other import-competing sectors has been large enough to result in a net negative effect. It is, therefore, important for the policy makers to design future trade liberalisation programme in such a way that it takes into account the need for employment generation in a large number of non-export oriented sector in the economy.

Because there are winners and losers as a consequence of trade reforms, policies will need to be designed for the losers. The findings of the study reinforces the argument for supportive actions favouring workers in the form of assistance to displaced workers and funds, skill upgradation, training for imparting new skills and various safety net programmes.

It is critically important to take into account the possible adverse social consequences of trade liberalization and adopt measures to minimize, or if possible, to avoid such adverse consequences. The first such issue is the impact on total employment in an economy and the "churning" that takes place in the labour market of a country as a result of trade liberalization. While there may be an adverse impact of trade liberalisation on employment as a whole, there may be differential effects on different segments of the labour market. A rise in the overall rate of unemployment is an example of the former type of effect. On the other hand, even when the overall unemployment situation does not deteriorate, some groups may lose out due to a decline of some industries while others benefit from new jobs that are created. In Bangladesh, we have examples of both (viz., the decline of traditional industries like jute and cotton textiles, matches, etc. and the rise of new industries like garments). In that kind of a situation, one cannot simply forget those who are losing out just because in an overall sense there has not been a drop in total employment. Appropriate measures would be needed to provide social protection and facilitate alternative sources of livelihood for those who might lose out in the process of adjustment.

Another social dimension is the type of skill and education that is required in the production structure that emerges after trade liberalization. Demand for higher

education and skill levels and new types of skills should be met by appropriate measures to impart such education and skills to the members of the labour force.

Employment and labour market implications of trade liberalization may also have a gender dimension. While some newly emerging industries (e.g., export-oriented industries like garments, electronics, toys, etc) may create demand for more women workers, decline in cottage and small scale industries, especially in rural areas (e.g., handlooms, food processing, etc.) may have an adverse effect on women's employment. Moreover, the quality of new employment that is generated for women is also an issue that needs to be addressed.

The above are only some of the possible social dimensions of trade liberalization that a country like Bangladesh should address. A good way to address these would be to put in place appropriate social safety nets and introduce active labour market policies that would combine unemployment benefits, training and re-training, and assistance in job search. Creation of a "social fund" could be a good vehicle for implementing such measures.

Indeed, some initiatives had been taken in Bangladesh to address the adverse employment implications of trade liberalisation over the past few years (training of retrenched workers; skill upgradation). However, instead of being proactive initiatives a large part of such initiatives were more of a reactive nature. There is no clear and long term strategy as to how training needs and people needing training are to be identified, how redeployment of the trained people is to be made and how safety nets during the search period is to be organised. The rural sector is the major source of the supply of surplus labour and urban sector is seen as the creator of demand for labour and employment opportunities. Addressing the best ways to bridge this labour demand and labour supply scenarios through appropriate incentives and initiatives continue to be a major challenge for Bangladesh. However, this social dimension and technical aspects of labour force absorption are often not given adequate importance in the employment policies.

It is important here to mention that, although liberalisation should encompass many factors affecting trade and business practices, in Bangladesh an overwhelming

attention has been given to trade related instruments only. In fact, policymakers are so inclined to measures related to tariffs and QRs that most of the time reform measures are used interchangeably with trade liberalisation measures. Reforms of the institutions have largely been overlooked in this context. Enforcing such trade reforms as tariff cuts and elimination of QRs, are relatively easy. However, significant growth and employment enhancing effects perhaps require reforms in other difficult areas. In this regard, there are suggestions that institutional reforms should be considered as the key to Bangladesh's growth and employment supporting strategies. It is important that trade policy reform as is considered as institutional reform, as has been argued strongly by Rodrik (2002). This is not to argue against any further trade liberalisation, but to emphasise the point that such measures should be seen as part of a comprehensive package that has employment considerations as an important element.

It is also important to recognise the difference between trade policy and policy of trade liberalisation. The distinction is important for protecting some policy space that is required to promote development priorities. An overall pro-liberalisation policy does not exclude the possibility of policy support for certain specific sectors. The strategic trade policy school has strongly argued in favour of such a nuanced approach. Across the board drastic tariff reduction may not only have revenue implication for the government, but this should also be seen in conjunction with the need to also provide strategic support to domestic industries with high growth, employment and poverty alleviation potentials. By adopting a pro-active and analytical policy regime effective support to the growth of small and informal sector activities with significant employment and poverty alleviation effects can be provided; however, to a large extent such opportunities appear to have been missed in Bangladesh in the absence of a clear-cut trade policy philosophy and lack of manoeuvrability and flexibility.