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### How Trade Liberalization and Labor Development Could Coincide in the Philippines

Aeneas DR Hernandez

Brendan Emmanuel A. Miranda

Martin William P. Regulano

Andrae Jamal Tecson

Martin William P. Regulano

*See next page for additional authors*

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**Authors**

Aeneas DR Hernandez, Brendan Emmanuel A. Miranda, Martin William P. Regulano, Andrae Jamal Tecson, Martin William P. Regulano, Ma. Ella Oplas, Tereso S. Tullao Jr, and Winfred M. Villamil

# POLICY BRIEF

YOUNG ECONOMISTS' PERSPECTIVE

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Written by:

Aeneas Hernandez  
Brendan Emmanuel Miranda  
Martin William Regulano  
Andrae Jamal Tecson  
Myrna Austria  
Ma. Ella Oplas  
Tereso Tullao, Jr.  
Winfred Villamil

*School of Economics, De La Salle University*

**DLSU - Angelo King Institute  
for Economic and Business Studies**



Room 223, St. La Salle Hall  
2401 Taft Avenue, Manila, 0922, Philippines

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## How Trade Liberalization and Labor Development Could Coincide in the Philippines

Aeneas Hernandez,<sup>1</sup> Brendan Emmanuel Miranda,<sup>2</sup> Martin William Regulano<sup>3</sup>  
Andrae Jamal Tecson,<sup>4</sup> Myrna Austria,<sup>5</sup> Ma. Ella Oplas,<sup>6</sup> Tereso Tullao, Jr.,<sup>7</sup> Winfred Villamil<sup>8</sup>

### INTRODUCTION

As the world adapts to the rapid pace of globalization in the 21st century, countries ease trade restrictions by gradually removing tariffs and non-tariff barriers to incentivize the free flow of goods across nations. This prevalence of trade liberalization policies propelled policymakers and economists to investigate the relationship between trade reforms and economic outcomes including wage inequality around the world. They found that trade liberalization, on average, has had a positive impact on economic growth, but prior studies that examine the effects of trade liberalization on wage inequality in developing countries have found mixed results. Recently, Murakami (2021) examined the impact of trade liberalization on wage inequality in Chile through the reduction in effective tariffs brought about by the regional trade agreements of the country. Following his empirical strategy, we examine the impact of trade liberalization on wage inequality in the Philippines. In this policy brief, we provide insights on our findings and policy recommendations that the Philippines can undertake.

<sup>1</sup>[aeneas\\_hernandez@dlsu.edu.ph](mailto:aeneas_hernandez@dlsu.edu.ph), <sup>2</sup>[brendan\\_emmanuel\\_miranda@dlsu.edu.ph](mailto:brendan_emmanuel_miranda@dlsu.edu.ph)

<sup>3</sup>[martin\\_william\\_regulano@dlsu.edu.ph](mailto:martin_william_regulano@dlsu.edu.ph), <sup>4</sup>[andrae\\_tecson@dlsu.edu.ph](mailto:andrae_tecson@dlsu.edu.ph), <sup>5</sup>[myrna.austria@dlsu.edu.ph](mailto:myrna.austria@dlsu.edu.ph)

<sup>6</sup>[ma.ella.oplas@dlsu.edu.ph](mailto:ma.ella.oplas@dlsu.edu.ph) <sup>7</sup>[tereso.tullao@dlsu.edu.ph](mailto:tereso.tullao@dlsu.edu.ph), <sup>8</sup>[winfred.villamil@dlsu.edu.ph](mailto:winfred.villamil@dlsu.edu.ph)

## POLICY RECOMMENDATIONS

In line with the findings of our study, we provide the following policy recommendations: (1) to conduct thorough studies on the impact of trade agreements on labor markets, (2) to push for structural transformation in the manufacturing sector, and (3) to reform education and skills training in the country.

1. **Studies on Free Trade Agreements** – The government should conduct thorough and careful studies on the implications of each agreement on the labor market to mitigate possible negative welfare effects. This is amidst the increasing participation of the country in FTAs and other bilateral and multilateral agreements. Currently, the Philippines stands at a historic crossroad as it deliberates on the ratification of the Regional Comprehensive Economic Partnership, the largest free trade agreement in the world. With many partner countries already participating in the deal and with other stakeholders calling for its ratification, the Philippine government must carefully study the impact of the agreement amid concerns from different stakeholders.
2. **Structural Transformation in the Manufacturing Sector** – There needs to be a stronger push to structural transform the manufacturing sector so that we could compete with the global export market and increase wages. Related to the products that it is trading, deliberate measures should be taken for a structural transformation which would mean (1) increasing exports in terms of volume and complexity so that the wages of unskilled workers also rise up, (2) depending less on the importation of intermediate goods that may embody a technology that is biased towards skilled labors, and (3) producing high-value-added technology-intensive products Austria (2002) suggested that governments need to employ a comprehensive foreign direct investment policy and technology upgrading.
3. **Investment in Human Capital**– There should be higher premiums placed on education and skills training. First, the government should remove policies that disincentivize firms from investing in the training of its workers, such as contractualization laws (Villamil & Hernandez, 2009). In addition to this, the government could subsidize unemployed and

underemployed workers to enroll in the programs brought by TESDA, which is tasked with preparing workers for specific industries through rigorous training and skills tests, mainly unskilled workers. Second, long-term education reforms could gear the young populace toward jobs that produce high wage rates and highly complex technology-intensive products (e.g., STEM-related jobs). The government could financially incentivize students through increasing financial grants and STEM-related scholarships. They can also expand the number of state-run Science High Schools as studies have also shown that students who come from such educational institutions are more likely to choose STEM-related courses in college (Daway-Ducanes, Pernia, & Ramos, 2022).

## **ANALYSIS**

### Empirical Methodology

Our study used a unique dataset that combines pooled cross-sectional labor force data and panel data on industry-level characteristics to examine the impact of tariff reductions on wage inequality between skilled and unskilled workers in the Philippines. The empirical strategy that we employ follows Murakami (2021), who based his strategy on the specifications proposed by Galiani and Porto (2010). Data on the demographic and socio-economic characteristics of individual workers for 2009, 2012, and 2015 are obtained from the Labor Force Survey (LFS), a household survey conducted quarterly by the Philippine Statistics Authority. Specifically, we use the October round of the LFS and pool the individual cross-section data across years. To capture the effect of trade liberalization on wage inequality, we use effective tariff rates as a measure of trade liberalization. Specifically, we obtain our tariff data for the years 2009, 2012, and 2015 from the database of UNCTAD's Trade Analysis and Information System (TRAINS) through the World Integrated Trade Solution (WITS). We obtain other industry-level data from the Industrial Demand-Supply Balance Database (IDSB) of the United Nations Industrial Development Organization (UNIDO). We make use of import and export data from IDSB in conjunction with total trade values from the International Trade Statistics Database of the United Nations to arrive at variables such as import ratios and export ratios.

## Findings

1. **Trade liberalization indirectly impacts wage inequality through trade flows.** - While we find no evidence to suggest that tariff reductions impact wage inequality, we establish that trade liberalization has an indirect impact on wage inequality with trade flows as channels as reflected in the significant relationship between the trade variables and the industry skill premium. From this, we have derived the recommendation of conducting thorough and careful studies on the implications of each agreement on the labor market, and for the Philippines to undergo structural transformation.
2. **Patterns show that the import penetration is high in the Philippines.** - Trade patterns show that the Philippines has high import penetration, which implies that the domestic market is filled with imported goods and there must be a structural transformation that would realign the resources of domestic producers. From this, we have derived the recommendation for the Philippines to structurally transform, which means a stronger push towards increasing the exports of industries and lessening dependence on skilled-biased imports.
3. **College graduates are a small portion of the labor force.** - Our descriptive results show that while the percentage of college graduates has been increasing over the years, college graduates still account for a relatively small portion of the labor force. In the study, educational attainment is used as a basis for classifying whether a worker is skilled or unskilled, and these descriptive results related to the percentage of college graduates also translate to the percentage of skilled and unskilled workers that the Philippines has. From this, we have derived the recommendation of investing in human capital by improving education systems and skills training frameworks.

## **CONCLUSION**

In this paper, we conclude that trade liberalization has no direct impact on wage inequality. However, we also establish that trade liberalization has an indirect impact on wage inequality with trade flows as channels as reflected in the significant relationship between the trade variables and

the industry skill premium. Higher import penetration is associated with higher industry skill premium, implying widened wage inequality. The mechanism behind this is when imports are high, domestic producers would cut costs to remain competitive, and one of the costs often cut is labor cost, ergo lower wages for unskilled workers and higher wage inequality. On the other hand, higher export exposure is associated with lower industry skill premium, implying lower wage inequality. These suggest that industries with a higher share in exports require relatively less skilled labor while industries with a higher share in imports require relatively more skilled labor. This confirms the theoretical prediction of Heckscher-Ohlin for developing countries such as the Philippines where its exports in manufacturing are labor-intensive, requiring relatively less skilled workers, while its imports are relatively capital-intensive, requiring relatively high skilled workers.



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