The Impact on Allocation and Return to Labor and Capital of a Reduction of Customs Duties in the Developed Countries in their Trade with Less Developed Countries

By

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I. Introduction

Considerable attention has, in the literature, been paid to the importance of the foreign trade sector in growth and development in the less developed countries. There has, however, been much less serious discussion of the effects on allocation and return to the factors of production in the developed countries of freer trade with the less developed countries. It is the purpose of this paper to discuss some of the latter problems.

In this paper we will assume that the textile and footwear industries in the less developed countries have a comparative advantage, while the same two industries in the developed countries have a comparative

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Remark: This paper was written while on leave at the Center for Research on Economic Development, The University of Michigan, Ann Arbor. Financial support for the research was provided in part by the Norwegian School of Economics and Business Administration and in part by the Norwegian Research Council for Science and the Humanities.

disadvantage, and that exports from these industries in the less developed countries therefore should be encouraged. The comparative advantage in these industries in the less developed countries may be due to the low capital/labor ratio employed as well as the low requirement of technical skills in production as compared to production of other manufactures. Other manufactures in the less developed countries may, however, be equally qualified for production and exports. I believe, nevertheless, that this paper will illustrate the procedure that may be followed in analysing the problems in the developed countries for any other commodity, which the less developed countries might want to export.

This paper is confined to analyse the problems in the Norwegian economy of freer trade with the less developed countries. It may seem peculiar to select such a small and uninfluential country for this purpose. The main reason for this choice, however, is that the National Account figures in Norway, which will be used as a base for this study, are probably among the best developed and most reliable in the world. It will be pointed out at the end of the paper that the results arrived at for Norway probably may be true also for other developed countries.

In discussing the likely impact on allocation and return to labor and capital of freer trade with the less developed countries, we will assume initially a situation as observed in 1965, as well as a situation where the allocation of labor and capital between sectors is technically efficient.

The main reason for the latter assumption is that the industries in this case are ranked equally with regard to the marginal return to each of the two factors of production, and that allows us to discuss whether freer trade with less developed countries is likely to create an allocation of labor and capital between industries which is not technically efficient.

Since this paper is confined to study the impact of freer trade with the less developed countries in some manufacturing products, we will confine ourselves to discuss the impact on allocation and return to labor and capital in the manufacturing and construction sectors because the effects on other sectors are assumed to be quite insignificant.

II. The Return to Labor and Capital in 1965, as well as the Return to these Factors of Production in a Technically Efficient Situation

In order to estimate the marginal return to labor and capital in a technically efficient situation in the 17 industries in Table 1, we use the following equations:

Number of equations

16 $$\frac{\frac{\partial X_1}{\partial L_1}}{\frac{\partial X_1}{\partial K_1}} = \frac{\frac{\partial X_2}{\partial L_2}}{\frac{\partial X_2}{\partial K_2}} = \ldots\ldots = \frac{\frac{\partial X_{17}}{\partial L_{17}}}{\frac{\partial X_{17}}{\partial K_{17}}} \qquad (1)$$

16 $$X_2^o = X_2 (K_2, L_2), \quad X_3^o = X_3 (K_3, L_3), \ldots,$$
$$X_{17}^o = X_{17} (K_{17}, L_{17}) \qquad (2)$$

2 $$K_1 + K_2 + \ldots + K_{17} = K_o \text{ and}$$
$$L_1 + L_2 + \ldots + L_{17} = L_o \qquad (3)$$

where X_i, K_i and L_i are production, capital and labor, respectively, in sector i. $X_2^o \ldots X_{17}^o$ are production in the sectors 2 ... 17, and K_o and L_o total capital and labor, respectively, in 1965.

In the system above, we have 34 equations and 34 unknowns viz. $L_1 \ldots L_{17}$ and $K_1 \ldots K_{17}$ and the system is determined. Moreover, since labor and capital in all sectors have been determined from the equations above, production in sector 1 can be estimated by means of the production function for this sector (not shown in equation 2 above). The system above implies that the production in sector 1 is maximized subject to given production in the other sectors and total labor and capital in 1965[1]. Moreover, the marginal return to labor and capital, respectively, can easily be estimated as

$$w_i = P_i^* \cdot \frac{\partial X_i}{\partial L_i} \text{ and } r_i = P_i^* \cdot \frac{\partial X_i}{\partial K_i} \qquad (4)$$

[1] For more details and results on these and related problems, see Gunnar Fløystad, *Allocation Problems in a Distorted Economy*, The Norwegian School of Economics and Business Administration, Bergen, 1972, mimeogr., and *idem*, "Real Wage, Factor Prices and Gain From International Trade", *International Economic Review*, Publ. jointly by the Wharton School of Finance and Commerce, University of Pennsylvania, and the Osaka University of Social and Economic Research Association, 1972, No. 13, pp. 65 sqq., where the allocation of labor and capital in a technically efficient situation is shown as a result of the procedure described above. The production function in the different industries were assumed to be alternatively a CES and a Cobb-Douglas production function implying that the computations were run for alternative magnitudes of the elasticity of substitution between labor and capital. The production functions were assumed to show constant returns to scale.

where w_i and r_i are the marginal return to labor and capital, respectively, and P_i^* is the "net price" or the factor income per unit of production in sector i defined as:

$$P_i^* = P_i - \sum_{j=1}^{n} a_{ji} P_j - \mu_i P_{oi} - s_i - \delta_i \qquad (5)$$

where:

P_i = level of domestic seller's prices of goods from sector i

a_{ji} = input-output coefficient for deliveries from sector j to sector i

P_{oi} = price level of imported goods used in sector i

μ_i = input-output coefficient for deliveries from abroad to sector i

s_i = indirect taxes minus subsidies per unit of output in sector i

δ_i = depreciation of capital stock per unit of production in sector i

The coefficients a_{ji}, μ_i, s_i and δ_i are assumed to be constant[1].

In making the computations for the Norwegian manufacturing industries and the construction sector, we relied on both a CES production function and a Cobb-Douglas production function. As is well known, the Cobb-Douglas production function implicitly assumes that the elasticity of substitution between labor and capital is 1, while the CES production function allows for alternative magnitudes of the elasticity of substitution different from 1. Estimations of the elasticity of substitution between labor and capital have, however, been rather inconclusive[2]. I have therefore chosen to run the computations for alternative magnitudes of this elasticity assumed equal in all industries.

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[1] In making the computations as described later on, these coefficients were estimated from an Input-Output Table for Norway in 1965 obtained directly from the Central Bureau of Statistics, Oslo.

[2] For estimates of the elasticity of substitution between labor and capital on American material, see Zvi Griliches, "Production Functions in Manufacturing, Some Preliminary Results", in: *The Theory and Empirical Analysis of Production*, National Bureau of Economic Research, Conference on Research in Income and Wealth, Studies in Income and Wealth, Vol. XXXI, New York, 1967, pp. 275 sqq. — Also Marc Nerlove, "Recent Empirical Studies in the CES and Related Production Functions", *ibid.*, pp. 55 sqq. — For estimates on Norwegian material, see Gunnar Fløystad, "A Note on Estimating the Elasticity of Substitution between Labor and Capital", *The Swedish Journal of Economics*, Vol. LXXV, Stockholm, 1973, forthcoming. — Z. Griliches, V. Ringstad, *Economies of Scale and the Form of the Production Function: An Econometric Study of Norwegian Manufacturing Establishment Data*, Contributions to Economic Analysis, 72, Amsterdam, London, 1971. — Vidar Ringstad, *Estimating Production Functions and Technical Change from Micro Data, An Exploratory Study of Individual Establishment Time-Series from Norwegian Mining and Manufacturing*, 1959—1967, Central Bureau of Statistics of Norway, Samfunnsøkonomiske Studier, Nr. 21, Oslo, 1971.

Table 1 below shows the observed return to labor and capital in 1965, as well as the marginal return to labor and capital in a technically efficient or optimal situation when production in the chemicals and products of chemicals etc. industry is maximized subject to the production in the other 16 industries and the total labor and capital in all industries as observed in 1965[1]. The maximization of production in the chemicals and products of chemicals etc. industry was run for alternative magnitudes of the elasticity of substitution between labor and capital σ assumed equal in all industries.

As seen from Table 1, the return to labor and capital in a technically efficient situation is quite independent of the magnitude of the elasticity of substitution between labor and capital. Moreover, both the observed and technically efficient return to labor and capital differ quite a lot from industry to industry, which indicates that we have not perfect competition in the factor market in the sense that the factors of production in one sector immediately respond to higher income opportunities in another sector and therefore get equal return in all occupations[2].

From equations (4) and (5), and Table 1, we will estimate the impact on the return to labor and capital from freer trade with the less developed countries in textile and footwear commodities. From equation (5), the impact on "net prices" from an abolition of customs duties on the textile and footwear commodities can be estimated. Equation (4) implies that if labor and capital in the different industries remain unchanged and are paid according to their marginal productivities, the percentage change in the return to labor and capital will be equal to the change in the "net price." However, if the wage rate in the textile and footwear industries is negotiated to be more equal to that in other industries than implied by equation (5) after abolishment of customs duties on textile and footwear commodities, freer trade with less developed countries may have quite significant immediate impacts on employment in the textile and footwear industries. This follows if the employers adjust their use of labor in accordance with the rules of perfect competition, while the capital stock is considered to be fixed, at least in the short run, which may be quite true for Norway[3]. With these reservations in mind, I will estimate

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[1] This corresponds to the case where the chemicals and products of chemicals etc. industry in the system above is considered as industry 1. — For more detailed information of the procedure used and the results, see Fløystad, *Allocation Problems in a Distorted Economy*, *op. cit.* — Also *idem*, "Real Wage, Factor Prices", *op. cit.*

[2] For a more detailed discussion of these problems, see *idem*, "Real Wage, Factor Prices *op. cit.*

[3] For a more detailed discussion of these assumptions, see *ibid.*

Table 1 — *Wages and Return on Capital in 1965* (Wages and Return on Capital Computed from the Production Function Using 1965 Data of Labor and Capital, and Wages and Return on Capital in the Optimal Situation for Alternative Magnitudes of the Elasticity of Substitution between Labor and Capital; Production in the "Chemicals and Products of Chemicals, Petroleum and Coal" Industry is Maximed)

Industry	Return on capital 1965	Computed return on capital	Return on capital in the optimal situation, σ = 0.5	σ = 0.8	σ = 1.0	σ = 1.25	Wages 1965	Computed wages	Wages in the optimal situation, σ = 0.5	σ = 0.8	σ = 1.0	σ = 1.25
	per one N.kr. of the value of the capital equipment						per man-year in N.kr.					
Sheltered industries												
1. Food	0.107	0.107	0.098	0.099	0.100	0.101	18 736	18 725	19 598	19 446	19 355	19 251
2. Beverages	0.108	0.108	0.110	0.112	0.113	0.114	22 500	22 437	22 124	21 889	21 754	21 608
3. Wood and cork products, furniture and fixtures	0.118	0.118	0.104	0.106	0.107	0.108	20 000	20 000	20 765	20 668	20 608	20 539
4. Printing, publishing and allied industries	0.205	0.205	0.108	0.112	0.115	0.118	17 554	17 560	21 597	21 897	22 103	22 367
5. Leather- and rubber products	0.119	0.119	0.106	0.108	0.110	0.111	20 556	20 516	21 310	21 192	21 120	21 038
6. Non-metallic mineral products	0.119	0.119	0.114	0.116	0.117	0.118	22 419	22 404	22 921	22 705	22 577	22 435
7. Construction	0.149	0.149	0.126	0.129	0.131	0.133	25 046	25 046	25 309	25 278	25 259	25 236
Import-competing industries												
8. Tobacco	0.000	0.000	0.102	0.105	0.107	0.108	20 556	20 556	20 528	20 554	20 555	20 556
9. Textiles	0.088	0.088	0.087	0.088	0.089	0.090	17 293	17 287	17 349	17 248	17 188	17 123
10. Footwear, other wearing apparels and made-up textile goods	0.150	0.150	0.091	0.093	0.095	0.097	16 638	16 630	18 178	18 232	18 268	18 313
11. Iron-, metalware- and machine industries	0.129	0.129	0.118	0.120	0.121	0.123	23 014	23 017	23 581	23 470	23 402	23 326
12. Electrical machinery etc.	0.161	0.161	0.131	0.134	0.136	0.137	24 294	24 311	26 312	26 195	26 121	26 034
13. Transport equipment and repairing	0.151	0.151	0.123	0.126	0.128	0.129	23 453	23 453	24 724	24 636	24 581	24 516
14. Miscellaneous manufactures	0.143	0.143	0.112	0.115	0.116	0.118	21 053	21 097	22 527	22 460	22 416	22 366
Export industries												
15. Basic metal industries	0.116	0.116	0.119	0.121	0.122	0.123	24 508	24 508	23 881	23 609	23 454	23 288
16. Paper and paper products	0.023	0.023	0.077	0.083	0.087	0.092	21 628	21 622	15 457	16 310	16 846	17 459
17. Chemicals and products of chemicals, petroleum and coal	0.114	0.114	0.118	0.120	0.121	0.122	24 473	24 473	23 703	23 425	23 268	23 099

Source for base year: Central Bureau of Statistics of Norway, *National Accounts 1950—1966*, Norges Offisielle Statistikk, A 220, Oslo, 1968, Tables 11 and 12, and capital, employee and employer figures obtained directly from Central Bureau of Statistics, Oslo.

the impact on the return to labor and capital of abolishing the customs duties on textile and footwear commodities, assuming marginal return to labor and capital and an allocation of labor and capital both technically efficient and as observed in 1965. The possible allocation effects of freer trade with the less developed countries will then be discussed.

In the case we assume initially a technically efficient situation, we will confine ourselves to the alternative where the elasticity of substitution is assumed to be equal to 1. Since, however, the marginal return to labor and capital in a technically efficient situation is quite insensitive to alternative magnitudes of the elasticity of substitution between labor and capital, other alternatives of this elasticity would have given quite similar results.

III. The Impact on Allocation and Return to Labor and Capital of Abolishing the Customs Duties on Textile and Footwear Goods

To start with, we assume that abolition of protection of the textile and footwear industries has no allocation effects. Thus, the only thing that will happen is that the abolition of protection of these two industries will have impact on "net prices," defined as above, which in turn will affect the return to labor and capital.

In Table 1 above, the prices of the products in the sheltered industries are not supposed to be determined in the world market, but by internal demand and supply. The prices of the products in the import-competing and export industries are, however, assumed to be determined by the world market. One faces serious problems in distinguishing between the industries which have their prices determined in the world market and the industries which are not affected by international prices. In this paper, I have not offered explicit criteria for the grouping of industries in the main three categories in Table 1, but have just accepted, with some minor modifications, the same sector-specification as in the model used to evaluate the consequences of an income settlement in Norway[1].

Table 2 shows the impact on "net prices" as well as on the return to labor and capital both in the actual and technically efficient situation after abolishment of customs duties on textiles competing with the textile and footwear industries and on imported raw materials to these sectors. In estimating the change in "net prices" in Table 2, the prices of the products in the textile and footwear industries were reduced equivalent

[1] See e. g. Odd Aukrust, "Prim I, A Model of the Price and Income Distribution Mechanism of an Open Economy", *The Review of Income and Wealth*, Series 16, New Haven, Conn., 1970, pp. 51 sqq.

Table 2 — *The Norwegian Customs Duties, the Change of "Net Price" Due to Abolishment of Customs Duties on Final Products and Imported Raw Materials in the Textile Sectors and Observed for 1965 and Optimal Return to Labor and Capital at Domestic Prices and at Prices after Abolishment of Customs Duties on Textile Goods*

	Norwegian customs duties	Changes of "net price" due to the abolishment of customs duties on textile goods	Wages				Return on Capital			
			observed		optimal		observed		optimal	
			at domestic prices	after abolishment of customs duties on textile goods	at domestic prices	after abolishment of customs duties on textile goods	at domestic prices	after abolishment of customs duties on textile goods	at domestic prices	after abolishment of customs duties on textile goods
	%		per man-year in N.kr.				per one N.kr. of the value of the capital equipment			
Import-competing industries										
1. Tobacco	20	—	20 556	20 556	20 555	20 555	—	—	0.107	0.107
2. Textiles	20	— 26.7	17 293	12 676	17 188	12 599	0.088	0.065	0.089	0.065
3. Footwear, other wearing apparels and made-up textile goods . . .	20	— 26.3	16 638	12 262	18 268	13 464	0.150	0.111	0.095	0.070
4. Iron-, metalware- and machine industries . .	20	—	23 014	23 014	23 402	23 402	0.129	0.129	0.121	0.121
5. Electrical machinery etc.	20	—	24 294	24 294	26 121	26 121	0.161	0.161	0.136	0.136
6. Transport equipment and repairing	20	—	23 453	23 453	24 581	24 581	0.151	0.151	0.128	0.128
7. Miscellaneous manufactures	20	0.4	21 053	21 137	22 416	22 506	0.143	0.144	0.116	0.116
Export industries										
8. Paper and paper products	—	—	21 628	21 628	16 846	16 846	0.023	0.023	0.087	0.087
9. Chemicals and products of chemicals, petroleum and coal	—	—	24 473	24 473	23 268	23 268	0.114	0.114	0.121	0.121
10. Basic metal industries	—	—	24 508	24 508	23 454	23 454	0.116	0.116	0.122	0.122

Source: The Norwegian Customs Duties, 1965, Halden, 1964. — Table 1.

to customs duties of 20 per cent, and the prices of imported raw materials equivalent to customs duties of 10 per cent on these commodities[1].

As seen from Table 2, the decline of "net prices" in the textile and footwear industries is going to be 26—27 per cent. The changes of "net prices" in the other industries are negligible and are due to the inputs these industries receive from the textile and footwear industries.

In Table 2 above, we have also computed the change in the return to labor and capital assuming both an actual and technically efficient allocation of labor and capital. From equation (4) above, it follows that this change is equal to the change of "net prices." As shown, the abolishment of customs duties is going to have a quite dramatic impact on the return to labor and capital in the textile and footwear industries. This, of course, may in turn be expected to lead to a transfer of labor and capital from these industries to some other industries where the return to labor and capital in a technically efficient situation may be twice that of the textile and footwear industries.

The return to labor as observed in 1965 is quite close to the return to labor in a technically efficient situation, while this is not to the same extent true for the return to capital. An abolishment of the protection of the textile and footwear goods is, however, likely to create a greater discrepancy between actual and technically efficient return to labor and capital in the industries producing these commodities. Thus, because the trade unions are likely to negotiate wage settlements which will make wages higher than the one in the textile and footwear industries for the non tariff situation in Table 2 above, the return to capital is likely to be even less than shown in this Table.

If the employers consider the capital stock to be quite immobile, at least in the short run, while they adjust the use of labor in accordance with the rules of perfect competition, which may be quite true for Norway[2], this will result in a reduction of labor employed in the textile

[1] For information of customs duties in Norway, see *The Norwegian Customs Duties*, 1965. — The textile and footwear industries export 16 and 4 per cent, respectively, of their production. However, only the prices of production for domestic uses are going to be affected by a reduction of customs duties. For this reason the changes of prices in the textile and footwear industries, due to a reduction of customs duties, were multiplied by the share of total production used domestically in estimating the effect on "net price." — Note that a reduction of prices on the commodities produced by the textile and footwear industries of 16.7 per cent is equivalent to abolishing customs duties of 20 per cent on these products, and that a reduction of prices on imported raw materials etc. of 9.1 per cent is equivalent to abolishing customs duties of 10 per cent on these commodities. The price reductions of 16.7 per cent and 9.1 per cent on final commodities and imported inputs, respectively, were therefore used in the computations.

[2] See Fløystad, "Real Wage, Factor Prices", *op. cit.*, for a more detailed discussion of these problems.

and footwear industries. This may in turn cause a more technically inefficient allocation of labor and capital between industries. However, this may very well be outweighed, at least in the longer run, by a greater tendency of labor and capital to go to other industries, where Norway has a greater comparative advantage in international trade[1].

The results arrived at for Norway may be very similar to those we would have arrived at for other developed countries. Thus, the return to labor and capital in the textile and footwear industries is less than in almost any other industry in almost all developed countries[2]. Moreover, the nominal and effective protection of these industries in most other developed countries is at least at the level of that of Norway[3].

IV. Conclusion

As shown in this paper, the abolishment of tariff protection of the textile and footwear industries is going to result in a decline of the return to labor and capital of 26—27 per cent. This, of course, will stimulate a transfer of labor and capital form these industries to other industries where Norway has a comparative advantage in international trade.

The impact on the economy of other developed countries from a similar trade policy may be more or less the same as in Norway because the protection and return to labor and capital in the textile and footwear industries as compared to other industries is quite similar to that of Norway.

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Zusammenfassung: Die Wirkung einer Zollsenkung in entwickelten Ländern in ihrem Handel mit weniger entwickelten Ländern auf die Allokation und die Erträge von Arbeit und Kapital. — Die vorliegende Abhandlung geht von der Annahme aus, daß die Textil- und Schuhindustrien in den weniger entwickelten Ländern einen komparativen Vorteil haben, während die gleichen beiden Industrien in den entwickelten Ländern einen komparativen Nachteil aufweisen, und daß daher die Exporte dieser Industrien aus den weniger entwickelten Ländern gefördert werden sollten. Die Auswirkungen einer Abschaffung der Zölle auf Textilien auf die Erträge von Arbeit und Kapital in diesen Industrien wird für Norwegen geschätzt. Die Untersuchung ergibt, daß die Abschaffung der Zölle die Erträge von Arbeit und

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[1] See Fløystad, "Real Wage, Factor Prices", *op cit.*

[2] See e. g. Bagicha S. Minhas, *An International Comparison of Factor Costs and Factor Use*, Amsterdam, 1963. — I.L.O., *Yearbook of Labour Statistics*, Geneva, 1968.

[3] See e. g. Bela Balassa, "Tariff Protection in Industrial Countries, An Evaluation", *The Journal of Political Economy*, Vol. LXXIII, Chicago, Ill., 1965, pp. 573 sqq.

Kapital in den Textil- und Schuhindustrien um 26—27 vH verringern wird. Dies scheinen auch annähernd die Wirkungen auf die Erträge von Arbeit und Kapital in den meisten anderen entwickelten Ländern zu sein.

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Résumé: L'effet qu'exerce sur le rendement du travail et du capital une baisse du tarif douanier dans les pays développés en ce qui concerne leur commerce avec des pays moins développés. — Cet article suppose que les industries textiles et des chaussures dans les pays moins développés en ont un avantage comparatif, tandis que les mêmes industries dans les pays développés ont un désavantage comparatif, et que, par conséquent, il faudrait encourager à l'exportation ces deux industries dans les pays moins développés. Ensuite, est estimé pour la Norvège l'effet qu'exercerait sur le rendement du travail et du capital une abolition des tarifs de douane sur les textiles. On arrive à la conclusion qu'une telle abolition ferait baisser de 26 à 27 pour cent le rendement du travail et du capital dans les industries textiles et des chaussures. Il paraît que le même effet se produirait dans la plupart des autres pays développés.

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Resumen: El impacto de una reducción arancelaria en países desarrollados en su comercio con países menos desarrollados sobre la alocación y los rendimientos del trabajo y del capital. — El presente estudio parte del supuesto, que las industrias textiles y del calzado tienen ventajas comparativas en países menos desarrollados y desventajas comparativas en países desarrollados, y que por lo tanto deberíanse fomentar las exportaciones de estas industrias de los países menos desarrollados. El autor presenta una estimación para Noruega sobre el efecto que tendría la abolición del arancel de productos textiles y del calzado sobre los rendimientos de trabajo y capital. El resultado es que dichos rendimientos se reducirían en un 26 a 27 por 100. Esto equivale más o menos al impacto que cabría esperar en la mayoría de los demás países desarrollados.

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Riassunto: L'effetto di un abbassamento dei dazi in Paesi sviluppati nel loro commercio con Paesi meno sviluppati sull'allocazione e sui proventi di lavoro e capitale. — Il presente articolo parte dall'ipotesi che le industrie tessili e calzaturiere nei Paesi poco sviluppati hanno un comparativo vantaggio, mentre queste due stesse industrie presentano un comparativo svantaggio nei Paesi sviluppati e che perciò le esportazioni di queste industrie dovrebbero essere favorite dai Paesi poco sviluppati. Le ripercussioni di un'abolizione dei dazi su tessili sui proventi di lavoro e capitale in queste industrie vengono valutate per la Norvegia. L'indagine dà come risultato che l'abolizione dei dazi ridurrà del 26—27% i proventi di lavoro e capitale nelle industrie tessili e calzaturiere. Questi sembrano anche essere approssimativamente gli effetti sui proventi di lavoro e capitale nella maggior parte degli altri Paesi sviluppati.