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How Labor Standards Can Be Good for Growth

by Eric Verhoogen

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Last May, President Obama chose Nike headquarters in Oregon for a major speech on the Trans-Pacific Partnership trade deal — emphasizing its "strong, enforceable provisions" on labor standards — and was roundly criticized. On one hand, many noted that in the 1990s, following scandals in Indonesia and Vietnam, the shoe giant's name had become, in the words of the company's co-founder and former CEO Phil Knight, "synonymous with slave wages, forced overtime, and arbitrary abuse." On the other, critics argued that labor standards in trade agreements are a form of protectionism in disguise, favoring U.S. workers over those in poorer countries.

But in a recent study, my colleagues and I stumbled across evidence that both the choice of venue and the message were surprisingly apt. Nike is a leading example of how both anti-sweatshop campaigns and labor standards in trade agreements can be good for innovation and growth in developing countries.

The story begins in 2011, when our research team — David Atkin of MIT, Azam Chaudhry and Shamyla Chaudry of the Lahore School of Economics, and Amit Khandelwal and me of Columbia — set out to examine how new technologies spread in a cluster of factories in Sialkot, Pakistan, a major source of the world's soccer balls, including those used in the 2014 World Cup. The standard ball design combines hexagons and pentagons, cut from rectangular sheets of artificial leather called rexine, which is by far the most expensive material in the process. Poking around online, I came across a pentagon layout in a Chinese factory that was more efficient than the one in use in Sialkot. Inspired by this pattern, my wife, Annalisa

Guzzini, an architect, and I developed a new cutting die that reduces total costs by 1% — a modest reduction, but not negligible in an industry with average profit rates of 8%. (To better understand how the balls are manufactured, see this video.)

In May 2012, as part of our research, we gave out the new dies randomly to 35 of the 135 producers in Sialkot and sat back to watch. The first surprise was that few firms adopted the new die, despite indications that it was yielding more pentagons per sheet. We asked owners why not. Their number one answer: employee resistance. The vast majority of cutters in Sialkot are paid piece rates (usually per ball), and our new die was slowing them down, at least initially. Without changes to this scheme, the cutters bore the increased labor cost and saw none of the much larger benefits of reducing waste of material. Figuring that their earnings would decline, the cutters were trying to block adoption, in part by misinforming owners about the benefits of the technology.

The second surprise was an exception to this general rule. One large firm adopted the die early on, even though it was not in the initial group of recipients. Silver Star, the second-largest soccer ball production firm in town, with over 2,000 employees, learned about the die almost immediately, and by March 2014 was using it for all of its pentagon cutting. What is unusual about this company? It is one of the few in town that does not pay a pure piece rate, and the only one we came across that guarantees workers at least the national minimum wage, regardless of how much they produce in a day. (Enforcement of minimum wage law in Sialkot is not robust.)

Silver Star's unusual payment scheme can be traced directly to the anti-sweatshop campaign against its main customer, Nike. In 2005, after years of negative publicity, Nike published its list of suppliers and toughened its compliance policy, requiring subcontractors to comply with the Atlanta Agreement on child labor, international conventions on freedom to unionize, and local labor laws. In late 2006, Nike broke off relations with its existing supplier in Sialkot amid concerns over labor issues.

To attract Nike's business, Silver Star created a new set of human-resource policies, including the minimum-wage guarantee, health and old-age benefits, and an implicit promise to continue employing workers made redundant because of technological changes. The company moved stitching in-house, so that it could monitor working conditions. By the company's own estimate, total labor costs rose 20-30%. Nike began contracting with Silver Star in 2007.

Silver Star's management says that the new policies are key to gaining workers' cooperation. "With what we are paying them, we are getting their input and feedback as well," said Belal Jahangir, director of global marketing and son (and heir apparent) of the CEO. With the minimum-wage guarantee, workers had little reason to fear the new dies and helped in the process of implementing them.

Intrigued by this unexpected turn in our research, we conducted a follow-up experiment. In half of our original treatment group, we offered cutters a guarantee of a typical month's salary, compensating them for earnings they would have lost during the initial learning phase, on the condition that they show us (and their employers) that they could cut more pentagons per sheet, at speed, with the new dies. About half of the firms that accepted this offer adopted the technology in the next six months. Among firms where we didn't make the offer, there were no new adopters over the same period.

The message is that workers need to expect to share in the gains from new technologies - or at least not suffer losses - for adoption to be successful.

At this point, an economist's instinct is to ask: Why is outside intervention necessary? If practices like Silver Star's really are good for productivity and innovation, won't companies adopt them on their own? Not necessarily. It seems clear that without the anti-sweatshop campaign Nike would not have been so insistent about employment reforms in Sialkot. And if not for the incentive of gaining business from Nike, it is not clear that Silver Star would have had a sufficient reason to adopt the new, more productive practices. (Our new dies, although they save more in material than they require in labor time from cutters, aren't enough on their own to offset the 20-30% increase in total labor costs that Silver Star implemented to attract Nike's business.)

At the same time, Silver Star is generating benefits for other companies in Sialkot that don't show up on the company's own bottom line - what economists would call a positive externality. A number of other companies have already adopted the new dies because they saw them being used at Silver Star. In such cases, there is a clear economic rationale for interventions to encourage the activity that generates the positive externalities. The anti-sweatshop campaign against Nike appears to have played that role, though that was never its intention. One would expect labor standards in trade agreements - if they are enforced - to have a similar effect, on a broader set of companies.

In theory, anti-sweatshop pressure can have other, more negative unintended consequences, too. For instance, it could discourage companies from outsourcing to places like Sialkot. But recent research in Indonesia by Ann Harrison and Jason Scorse finds little evidence for such effects. And in Sialkot, the unintended *positive* consequences seem to be at least as important. More research is needed to see whether the experience of Silver Star is typical of other companies, in other industries and countries. But it is striking that the positive effects of anti-sweatshop pressure showed up in the one case where we happened to be watching carefully.

On the day of President Obama's speech, Nike put out a statement that it "fully supports the inclusion of strong labor provisions" in the TPP because they "create economic growth that benefits everyone." This is not a common view among trade economists or policy-makers. But the news from Sialkot shows that the argument makes a lot of economic sense.

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