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INTEGRATION: A POLITICAL
ECONOMY PERSPECTIVE**

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ABSTRACT

Socially Responsible Trade Integration: A Political Economy Perspective*

Economists tend to agree that international trade liberalization brings significant gains from trade to countries engaging in such a process. At the same time however, public opinion is much less optimistic and there is a widespread concern that the current sharing of the gains from trade is 'unfair' and unevenly distributed across and within countries. This Paper emphasizes that in order to understand the position of globalization skeptics and respond adequately to their complaints, one should move beyond the existence of the gains from trade (static and/or dynamic) and one should pay more attention to the 'pains from trade' and, more generally, the distributive dimensions of trade integration. In particular, a critical dimension that needs to be addressed is the issue of the redistribution (or non-redistribution) of the gains from trade and the interactions between trade openness and domestic redistributive policy. After reviewing briefly what we know about the distributive impacts of trade openness, the paper considers the political economy feedbacks of trade integration on domestic redistribution and identifies the economic and political feasibility constraints of a 'trade regime with redistribution'. Taking then a normative perspective, it explores the conditions for the existence of a 'socially responsible' open trade regime and discusses some of the policy tradeoffs associated with its implementation.

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“There is enough in the world for everybody’s need, but there cannot be enough for everybody’s greed.” (Mahatma Gandhi)

I. Introduction

When asked by a physicist colleague to provide a proposition in Economics which is “*both true and not trivial*”, Paul Samuelson, Nobel prize in Economics, responded: “*Specialization according to Comparative Advantage*”. Interestingly, this idea is also at the heart of one of the few recommendations on which most mainstream economists tend to agree: namely the desirability of trade between nations. As the story goes, international trade is beneficial to countries because specialization according to comparative advantage (and its associated division of labor) leads to a more efficient allocation of resources across sectors and regions, induces bigger output, productivity gains and economic growth. These gains from trade are then expected to contribute to higher social welfare, general development and poverty reduction.

While openness brings gains from trade, it brings however also “pains from trade”²: trade liberalization inevitably creates "gainers" and "losers" within nations. The strong presumption however, is that losers can be compensated with the use of appropriate redistributive mechanisms (lump sum transfers) without exhausting the benefits of the gainers. Trade related efficiency considerations can be safely analyzed separately from their associated direct distributive implications. It is therefore no surprise that much of the international trade literature has concentrated on showing the extent and importance of the gains from trade (or alternatively the welfare costs of protectionism), just mentioning in a last paragraph or so, the fact that the use of appropriate transfers is necessary to make everybody better off after the opening of the border to foreign goods.

It is striking to see however how little this consensus in mainstream economics resonates in public opinion. Figure 1 reproduces data from Mayda and Rodrik (2002) and gives a sense of what the “man in the street” thinks when asked about his views on trade. The data were collected by the International Social Survey Programme (ISSP) on a cross national basis and covering information at the individual level on some 28 456 respondents from 23 countries. The question asked was: “How much do you agree or disagree with the following statements : (Respondent’s country) should limit the imports of foreign products in order to protect its national economy : 1. Agree strongly, 2. Agree, 3. Neither Agree nor Disagree, 4. Disagree, 5. Disagree Strongly “

[Figure 1 about here]

² This terminology is borrowed from Sapir (2000)

Typically, more than half the respondents agree with the proposition that trade should be restricted (mention 1. or 2.), while less than 25% disagree (mention 4. or 5.). While there is always a concern that survey responses are highly sensitive to framing, there is ample other evidence from the United States, suggesting that the precise phrasing of the question on imports does not greatly affect the average responses provided (Scheve and Slaughter (2001)).

In any case, these opinions are consistent with the views articulated in the last decade or so by various elements of civil society who feel that the current sharing of the gains from trade is "unfair" and unevenly distributed across and within countries.

For instance, for a recent ILO report entitled "*A Fair Globalization: Creating Opportunities for All*" (2004), The World Commission on the Social Dimension of Globalization, launched a wide-ranging programme of dialogues and consultations at national, regional and global levels, including over 2000 decision-makers and social actors involved in globalization issues. A common feature expressed by many participants is the fact that the current process of globalization (and trade integration in particular) has not produced beneficial, legitimate and fair outcomes for all in the world economy. While people tended largely to favor more openness and interconnections between societies, they were much less positive when asked about the impact on their jobs and incomes. In the consultations, frequent references were made to the difficulties faced by the small and the poor left at the margins of globalization, the loss of jobs and the downward pressures on work conditions implied by competitive global markets. There was also a widespread perception that the logic of the current international trade regime (multilateral or bilateral) was getting more intrusive into the functioning of domestic political institutions and domestic policies and was generating outcomes biased in favour of the rich and powerful.

The gap between the views shared by mainstream economists and those expressed by public opinion is worrying because it is the ferment of a political backlash in many countries, threatening the dynamics of worldwide trade integration with, in the long term, detrimental effects for developing countries.

In a celebrated paper, "Crises and the Poor: Socially Responsible Macroeconomics", Nora Lustig discussed the effects of macroeconomic crises on poverty and inequality in Latin American countries. She argued that, beyond macro stabilization aspects, one should get concerned about the distributive impacts of these episodes and use adequate safety nets and the composition of fiscal instruments to protect the income of the poor during the process of macroeconomic adjustment.

In a similar vein, a central theme of the present paper is to emphasize that in order to understand the concerns of globalization skeptics and respond adequately to their complaints, one should move beyond the existence of the (potential) gains from trade (static and/ dynamic) and pay more attention to the "pains from trade" and, more generally the distributive dimensions of trade integration.

Trade policy is certainly more intended to be about income distribution than macro policy and, as noticed already, trade economists have been quick to acknowledge the distributive dimension of the gains and pains from trade. Still, one dimension has not received the attention it deserves in the economic literature and nevertheless seems to be critical in understanding the concerns of public opinion about globalization. This is

the issue of the redistribution of the gains from trade and the interactions between trade openness and domestic redistributive and social policy .³

Typically, trade economists often tend to view the distributive impacts of trade policy separately from other re-distributive tools in society. As both are actually ways to affect the distribution of resources across individuals, there is a priori no reason why we should view them independently from each other. In particular, trade integration may be expected to impact the re-distributive capacity of governments in several ways. From an economic perspective, it may change the structural parameters of the economy ⁴, rendering domestic redistribution more or less difficult. From a political perspective, trade integration may affect the pattern of political power and coalitions, preventing or promoting compensation and the redistribution of resources inside the economy. The capacity and willingness for domestic redistribution and compensation cannot therefore be analyzed separately from the decision to open the country to trade and foreign direct investment flows.

When discussing redistribution and trade integration, two important dimensions have to be distinguished conceptually. On the positive side, one needs to focus on the economic, administrative and politically feasibility of a particular trade regime with redistribution and compensation. In particular, an important question to be addressed is which kind of coalitions and circumstances tend to induce the emergence of a “trade with compensation regime” in which gainers accept to compensate losers in exchange for support for a liberal trade policy?

From a normative perspective, the issue rather concerns the kind of trade regime with redistribution which should be favored from a given ethical and social justice point of view. Of course, in order to discuss this aspect, one needs to express one’s set of ethical and social values in order to derive a particular social welfare point of view from which one evaluates the different possibilities.

Consistent with Lustig (2001), ILO ((2004) and Sen (2002), the normative perspective taken here will be that trade integration with redistribution is defined as “socially responsible” if: a) it helps the people at the bottom of the income distribution to maintain adequate levels of living of standard and economic security, b) provides real benefits and equal opportunities to an increasing number of individuals and c) reduces disparities which impair economic and social development. While certainly leaving apart many other environmental, social, cultural and political aspects associated with globalization⁵, this definition seems to be

³ While many trade economists take for granted the argument that the gains from trade are always large enough to compensate the losers, this does not fit well with the record of compensation policies and programs. For instance, the well known Trade Adjustment Assistance (TAA) programme in the United States implemented to help workers displaced by imports competition, has not brought any sense of adequate compensation nor any enhanced capacity for finding a new job (Kletzer (2003)).

⁴ Typically price elasticities and elasticities of the tax base.

⁵ For instance, many discussions on globalization turn around its impacts on cultural dimensions, environmental issues, democratic values, national security and international political relations. Globalization here is viewed in the more restricted economic sense of increased integration of goods and factor markets and the criteria defining social responsibility are accordingly restricted to an individual socio-economic welfare perspective.

a good starting point to encapsulate normative elements one would reasonably define as “pro-poor” and “socially fair”.

Armed with such a normative perspective, a set of natural questions comes to mind : what are the conditions promoting the emergence of a “socially responsible” trade regime with compensation which is also politically feasible? What can be the elements and tradeoffs of such deals? Which kind of policy implications can be derived to promote such conditions? This paper starts to explore some of these dimensions, with the belief that it will stimulate more research in these areas and help us provide responses to the current public demands for a better sharing of the gains from trade in a way which is socially responsible, politically credible and, yet compatible with trade adjustment.

To organize our discussion in a simplified way, consider for instance the real disposable income of a given individual i in a country. This income can typically be written as: $Y(i) = s(i)Y + T(i)$ where Y is the average real income in the economy, $s(i)$ is the share of that income accruing to our individual and $T(i)$ the net transfer/benefit (positive or negative) received by him after “fiscal redistribution” by the government. $s(i)Y$ reflects therefore the “market” income of our individual before any government intervention. It depends on a variety of elements among which, relative prices (commodity prices, wages, factor returns) and the quantity of assets the individual owns (labor, skills, capital, land, financial assets).

Trade integration is likely to affect the real disposable income of our individual through three channels. First, international trade is going to change Y (the average real income of the country). Trade economists have spent a good deal of effort showing that the effect on Y is likely to be positive (the gains from trade at the level of the economy). Then, trade by changing relative prices and factor returns and employment, is also likely to affect the income of our individual through a change of $s(i)$, the market share of income. This is the “*first round*” *distributive impact* of trade integration. Finally, trade openness may also affect the last term $T(i)$. This is the “*second round*” *distributive impact* of trade, affecting the level of net transfers that our agent receives after government’s intervention: the “re-distributive” impact of trade integration.

In order to concentrate on the distributive and re-distributive issues related to trade, we will take for granted the widely shared view in mainstream economics that international trade is a source of economic gains. This may not appear as obvious or true to everybody and in every instance. Indeed, a classical result from trade theory is that unilateral free trade is not an optimal trade regime for a country big enough to affect its terms of trade with the rest of the world. Also, in the presence of global or domestic markets imperfections, second best theory suggest that trade integration may not be all the way efficient. Taking such a perspective however seems natural for at least two reasons. First, there is ample evidence that openness brings (at least to some extent) aggregate gains and increases in average real income (see Irwin (2002) chapter 2, for a good non technical discussion on this aspect). Second, this view seems to be the minimal one to start a meaningful discussion about “socially responsible” trade liberalization. If trade, to begin with, is perceived as productively inefficient, then there is no point to discuss how to make it actually “socially responsible”.

With this in mind, what is the road map of the paper? The two next sections consider the “first round” distributive impacts of trade integration. In section II, we briefly review the conceptual tools economists use to analyze the distributive impacts of trade liberalization. Section III then quickly summarizes what we know empirically about the distributive effects of trade openness. As it turns out, the consensus one can draw from the economic literature is that trade openness is thought to be socially benign. It generates benefits for poverty reduction (though not in every instance) and does not seem to be systematically biased towards inequality. Section IV contrasts this rather optimistic or neutral view of mainstream economists to the pessimistic perspective of globalization critics. Two aspects in particular will be noted: a) The role of economic insecurity linked to global production and trade openness, b) the importance of fairness and perceptions of polarization in the distribution of the gains from trade.

Section V presents then the core dimension of the paper: the domestic redistributive implications of trade openness. It discusses the political economy feedbacks of trade integration on domestic redistribution and the positive aspects of a “trade regime with redistribution”. Building on the economic theory of optimal taxation and the political science literature on small Corporatist States, it argues that trade policy and domestic redistribution should be viewed jointly in terms of their political determination inside a country. It emphasizes that a crucial aspect of the political feasibility of trade liberalization with redistribution hinges on how to build a credible coalition between pro-trade interests and a big enough number of actual or potential losers.

Taking then a normative perspective, we explore in section VI the conditions for the existence of a “socially responsible” trade integration regime with redistribution and we discuss some of the tradeoffs involved with the political feasibility constraints identified in section V. The paper finally concludes that an important policy element to address the current opposition to trade integration and to prevent a political backlash in civil society, is to promote the development of “commitment mechanisms” and political institutions allowing the credibility and political sustainability of a social contract associating trade reforms to internal redistribution.

At the outset, two precisions should be made before getting into the main part of the paper. The first one is that the discussion is mainly focusing on redistributive and compensation issues occurring *within* countries. From a political economy point of view this is justified by the fact that, despite the alleged demise of the Nation-State, most policy decisions that affect redistribution are still taken at the national level. This does not deny however the policy relevance of redistribution and transfers between countries. On the contrary, for many poor developing economies, this issue is a very salient one. While the policy section tangentially touches the topic, a proper discussion of this dimension is clearly beyond the scope of the present paper and is best left to future work.

The second precision is the fact that globalization is a multi-facet phenomenon touching various dimensions of social development. The paper considers trade integration in the restricted economic sense of a

move towards further integration of international markets for goods and services⁶. Given the strong complementary between multinationalization, trade in intermediate inputs and FDI, this will also include FDI flows and firms' mobility, leaving however aside labor flows (except in the conclusion) and financial portfolio flows.

II. The Distributive impact of trade integration: old and new tools

There are traditionally two ways through which economists analyze the distributive consequences of international trade. The first approach, based on the so-called Stolper Samuelson Theorem, takes a long term view. It assumes factors of production to be perfectly mobile across sectors and emphasizes distributive issues across factorial incomes. The second perspective takes a shorter time horizon in which factors of production remain sector specific and focuses on industry specific distributive conflicts. Let us briefly discuss both in turn.

The Stolper Samuelson Theorem

The Stolper Samuelson Theorem (SST thereafter) elegantly links trade induced changes in commodity prices to changes in domestic factor returns. In its simplest form, it says that an increase in the price of a good using intensively one factor of production (say unskilled labor) raises the real return of that factor while it reduces the real return to the other factor (say skilled labor) used less intensively in production of that good.⁷ The distributive implications of the SST results can best be described in a North-South trade context. The North has a comparative advantage in the production of a skilled labor intensive commodity while the South has a comparative advantage in an unskilled labor intensive good. The North exports the skilled intensive good while the South exports the unskilled labor intensive commodity. With trade integration between the two regions, the relative price of the skill intensive commodity increases in the North and falls in the South. According to the SST, in the North skilled workers gain and unskilled workers lose while the opposite conclusion holds in the South. By the same token, wage inequality increases in the North and goes down in the South.

⁶ This terminology of trade integration at an individual country level has to be differentiated from the notion of "deep integration", including additionally an international convergence and coordination of domestic social and regulatory policies.

⁷ The formal mechanism of the Stolper Samuelson theorem can be described as follows: as the price of the unskilled labor intensive good rises, production of that good increases, drawing factors of production away from the other, skilled intensive sector. Since the unskilled labor intensive sector uses more unskilled labor per unit of skilled labor than the skilled intensive sector releases, this reallocation process increases the demand for and the relative price of unskilled labor to skilled labor. This change causes both industries to switch to less unskilled labor intensive production methods. This in turn raises the marginal productivity of unskilled labor in both sectors. In competitive labor markets, as wages equal marginal productivities, unskilled labor receives a higher wage in terms of each good and so a higher real return regardless of consumption patterns. A similar reasoning shows that the real wage of skilled labor goes down.

How useful is the SST to understand the distributive impacts of trade in an economy? First, it should be noticed that the SST is a result on the *functional* distribution of income and not on the *personal* distribution of income. As the functional distribution is not necessarily identical to the personal distribution of income, the SST results have to be viewed as only indicative of a channel through which trade flows influence the income distribution within an economy. Second, as any theory, the SST and its associated framework (the Heckscher-Ohlin model of trade) is built on a set of specific assumptions⁸ (Winters 2000) and it is well known that some of its predictions SST are weakened (or may be even reversed) when one or more of these assumptions are relaxed.

The specific factor model of trade

An assumption traditionally reconsidered by trade analysts is the fact that factors of production are perfectly mobile across sectors. In the short run, this is quite unlikely and some factors may remain sector specific. In such a context, an increase in the price of a particular good is likely to increase the incentive to produce that good. This, in turn, raises the real return of the factors specific to the production of that good (sector specific skills, fixed capital, land). To this extent that production is expanding, such a price movement is also likely to affect the return of non specific and mobile factors which are complementary to the fixed factors (Jones 1971). The return to one factor at least goes up, while the return to at least another one goes down. According to this view of the world, what matters for the distributive impact of international trade is how much a factor of production is “stuck” in a given industry. Factors specific to the expanding export sectors are gainers while factors specific to contracting import competing sectors are losers.

The preceding approaches (and the SST in particular) generate four important implications. First, the distributive impacts on factor prices have to come from changes in commodities’ prices induced by international trade. The larger the change in commodity prices, the larger the impact on relative factor returns. Second, the impact of trade on factor markets is accompanied by a reallocation of resources *across* sectors. Mobile factors move from the contracting import competing sector to the expanding export sector. Third, *within* sectors, there is a shift in production methods away from the factor of production becoming relatively more expensive.⁹ Finally, SST effects predict an asymmetric change in wage inequality in developed and developing countries.¹⁰

While useful, the STT and associated factor specific approaches tend however to overlook three important dimensions of the current process of globalization. First, there is now increasing global production sharing,

⁸Formally, the assumptions are: a) perfect competitive markets, b) perfect mobility of factors across sectors in the economy, c) countries do not specialize in production after trade integration, d) goods are homogenous in the same industry, e) technologies are with constant returns to scale, f) there are no non traded goods countries have access to the same exogenous technologies.

⁹ In other words, in our previous simple North-South example, if trade integration induces the wage of skilled workers to increase relative to the wage of unskilled workers in the North, then both the import competing and the export sectors should switch to less skilled labor intensive production methods, substituting away the expensive factor for the relatively cheaper one. The reverse result should hold for the South

¹⁰ This last prediction however may not be valid in more sophisticated versions of the SST with many countries and many goods (see in particular Davis 1996).

and production matching across the world. This trend is accompanied with increasing trade in intermediate inputs and complementarity with Foreign Direct Investment. Second, the distinction between trade and technology is somewhat blurred; trade and technological change may just be the two facets of a same phenomenon: increased global competition. Third, global production reorganization affects workers and firms not only through a *shift* of the relative demands for factors but also through a change in the *elasticity* of these demand functions. This in turn has significant implications in the presence of non competitive rent sharing between firms and workers.

Each of these dimensions has appeared as being partly relevant to the debate on the distributive impacts of trade in developed and developing countries. Accordingly, economists have supplemented the traditional SST approach with new conceptual tools taking into account these dimensions.

Production Sharing and Fragmentation

In a series of influential papers, Feenstra and Hanson (1996, 1997, 1999) have presented an alternative framework suggesting that trade flows combined with FDI could be a significant contributing factor to the dynamics of income inequality. The starting point is the recognition that trade flows in the last decades have increasingly involved trade in middle products due to production sharing and fragmentation across countries (Feenstra 1998), Arndt and Kierkowsky (2001) and Hummels, Ishii and Yi (2001)).

Consistent with this fact, rather than focusing on final goods industries of various skill intensities, Feenstra and Hanson (1996) emphasize the role of intermediate activities with different factor intensities *within* each industry. These activities are modelled as intermediate inputs that are traded between countries and combined into a final commodity. In the two regions North-South framework of above, the South produces and exports the range of inputs using unskilled labor relatively more intensively, while the North specializes into the remaining inputs (like R&D and Marketing) which are more intensive in skilled labor. Foreign Direct Investment complementary to the intermediate activities and flowing from North to South, induces a shift of localization of activities across regions. Indeed, activities transferred from the North to the South are more skilled-labor intensive than those formerly produced in the South, but less skilled-labor intensive than those now produced in the North. This shift of activities increases the relative demand for skilled labor in *both* countries, leading to a larger wage premium and increasing inequality in *both* regions. Changes in production methods occur *within* sectors (along the production chain of the final good sector). Hence, as outsourcing increases the demand for skilled labor in both countries, it may be perceived from the outside as a kind of “endogenous technical change” biased in favor of skilled workers.^{11 12}

¹¹ It should be noticed that while unskilled workers loose relatively to skilled workers in the North, they need not be worse off in real terms as outsourcing of some activities to the South lowers the prices of goods available through trade, which may be enough to offset the wage reduction.

¹² Trefler and Zhu (2003) consider also a version of the Feenstra and Hanson (1996a) model without FDI but with technology catch-up of the South, generating similar results of increased wage inequality in both regions.

Also consistent with the view of global production sharing and fragmentation, Kremer and Maskin (2003) proposed recently a stylized framework of trade integration based on matching and joint production between workers across the world¹³. The North (rich) country is populated by high skilled and skilled workers. The South (poor) country is populated by workers with intermediate skills and very low skilled workers. Output is obtained by matching workers together. As long as the difference in skills between workers is not too large, production is assumed to be more efficient if there is cross-matching between a higher-skill worker and a lower-skill worker than if there is self-matching. In autarky, workers can only match within their own country. Trade integration means that workers from different countries can work together in the same firm. This opens up therefore increased possibilities of matching for some skilled workers but not necessarily for all of them. More specifically, when the difference in average skills between the rich and the poor country is large enough, there is no possibility of cross-matching between a very low skilled worker in the South and a higher skilled worker in the North. Very low skilled workers in the South therefore remain at the margin of globalization. Interestingly, the model is compatible with a trend of reduced global inequality and increased inequality within both rich and poor regions.

The distinction between trade and technology is somewhat blurred

In order to explain the increase of the skill premium in the US during the 70-80s, the so-called empirical literature on “trade and wages” has traditionally opposed a STT trade based explanation to one based on technological change. Two main stylised facts induced several authors to argue that both the shift away from unskilled workers and their reduced relative wage was inconsistent with the trade explanation (Lawrence and Slaughter (1993), favoring another cause, of which biased technological change and computerization seemed most likely. First, there was much more *within* sector labor movements than *between* sector labor reallocation in the US during that period (Bernard and Jensen (1997)). Second, the wage and employment pattern was characterized by a decreasing relative intensity of unskilled labor *within* industries (Bound and Johnson (1992), Berman, Bound and Griliches (1994)).

While much of this literature treated changes in technology as exogenous to international trade, Wood (1994, 1995, 1997) noted that the distinction between trade and technology could be rather blurred, as the former may well have been a driving force behind the latter. Indeed, in a skilled-labor rich country (the North), trade could induce firms in the import competing sectors to save on unskilled labor by adopting skilled labor biased technologies as a “defensive innovation” strategy. In an unskilled-labor rich economy, trade may also be skill-enhancing when domestic firms gain greater access to imported superior technologies (by importing

¹³ Tang and Wood (2000) provides also a related model with three types of labor: high skilled (so called “knowledge”) workers, skilled workers and unskilled workers in which production is based on cooperation between “knowledge” workers and other types of labor. Trade integration is assimilated to falling costs of moving “know-how” around the world and allows high skilled workers in the North to match more easily with unskilled workers in the South.

skilled labor biased technologies embodied into better quality capital goods or by “learning by exporting” and exposing to foreign markets, Robbins (1995)).

A difficulty with this original arguments however was the fact that there was no explanation why trade-induced technological change needed to be skill-biased. Recent work however by, among others, Acemoglu (2002) and Thoenig and Verdier (2003) has reconsidered this issue more precisely, allowing the bias of technological change to be endogenous to the decisions taken by economic agents.¹⁴

In Acemoglu (2002) for instance, two types of technologies can be discovered. Some are complementary to skilled labor while others are complementary to unskilled labor. Whether R&D activity (and consequently the direction of technical change) is directed towards one type of technologies or the other depends on two effects. First, there is a price effect : technologies producing more expensive goods will be upgraded faster. Second, there is a market size effect: a larger size of potential users of the technology leads to more innovation. Within a North-South context in which innovations can only be made in North with protected intellectual property rights, international trade tends to increase the relative price of the skilled labor intensive good in the North. Through this price effect, innovation is stimulated towards skilled labor and trade induces skill-biased technical change.

Thoenig and Verdier (2003) investigates a different mechanism leading also to trade induced skill biased technological change. The starting point is that intellectual property rights protection is never perfect and that firms can change and influence the rate of diffusion of specific knowledge embodied in their production process. To reduce informational leakages and lessen the threat of imitation and technological leapfrogging, firms have incentives to increase the share of tacit knowledge and non-codified knowhow embedded in their production process. They do so at the cost of a larger share of skilled labor in their workforce. In this context, trade openness, by intensifying international technological competition, triggers a race to imitation and innovation. As a consequence, firms tend to develop innovations of a new kind, less imitable and endogenously more skill intensive.

Interestingly, the interaction between trade flows and technological change generates predictions different from the standard SST results. Wage inequality may increase in both skilled-labor rich and skilled-labor poor regions. Also, these analyses are consistent with *within* sectors methods of production shifting towards skilled labor. Finally, trade may have distributive impacts without significant changes in relative prices between skilled-labor intensive and unskilled-labor intensive goods, a feature consistently noticed by several observers in the empirical “trade and wage” literature

Own-Price Elasticity of labor demand and rent sharing

The last “non traditional” channel through which trade flows may have distributive impacts on labor markets is the elasticity of labor demand (Rodrik (1998)). More precisely, a firm’s own price labor-demand

¹⁴ See also Epifani and Ganica (2002), Xu (2001), Yeaple (2003) for recent additional analytical work on the “trade induced technical change” paradigm.

elasticity is defined as the percentage fall in the quantity of labor demanded by that firm in response to a one percent increase in the price of labor. This elasticity consists in two parts. The first one is the “substitution effect”. It indicates, for a given level of output, by how much the firm substitutes away from labor towards other factors of production when wages rise. The second part is the “scale effect”, namely the extent with which labor demand changes thanks to the change in the output level. When the wage rate increases, both effects tend to reduce the amount of labor demanded.

International trade and FDI/ outsourcing by multinationals is likely to make labor demands more elastic through both the “substitution” and the “scale” effect. Consider first the substitution channel and take a firm that is vertically integrated with a number of production stages. Trade integration gives the firm access to foreign factors of production directly (through FDI and outsourcing) or indirectly (through trade in intermediate inputs) as well as domestic factors of production. When domestic wages increase, this new access clearly expands possibilities for the firm to substitute away from domestic labor beyond just domestic non-labor factors. Trade raises therefore the sensitivity of labor demands to domestic wages.

The “scale effect” channel works in a similar way. To the extent that trade integration generates “ pro-competitive” effects on market structures, a given increase in wages (and thus costs of production) translates into a larger decline in output and therefore a larger fall of demand for all factors. Again, this implies a rise of the elasticity of a firm’s labor demand competing in that market.

As noticed by Rodrik (1998), three main implications can be derived for the distributive impact of trade on labor markets. First, higher elasticities shift the wage and employment incidence of non-wage labor costs (ie. payroll taxes, labor standards) towards labor and away from firms. Second, higher elasticities induce more volatile wage and/or employment responses to exogenous shocks on the labor demand. Finally, to the extent that markets are not perfectly competitive and that there is rent sharing between workers and the firm, higher elasticities may shift the bargaining power over rent distribution from workers towards firms. Related to the last aspect of rent sharing, the increased possibilities for outsourcing and FDI also affect the outside options of the firm at the expense of immobile workers, affecting again the pattern of profit sharing between the two parties.

III. What do we know about the distributive impacts of trade integration?

But what do we know now about the distributive impacts of trade integration across and within countries and how do the preceding approaches help us understand these impacts, if any? A starting point may be to consider the evolution of global inequality and poverty in the world and then ask how much of this evolution is related to trade integration.

The evolution of global inequality and poverty

In the recent years, a fast growing literature has emerged in order to understand the evolution of the income distribution and poverty in the world economy (Bhalla (2002), Sala-I-Martin (2002), Bourguignon

and Morrisson (2003), Chen and Ravallion (2002)). As mentioned by Deaton (2004), much effort has been done in terms of collection and treatment of income distribution data. Still, the literature is characterized by a bulk of contradicting claims and controversies. For instance concentrating on poverty, according to some observers, the proportion of people living in extreme poverty in the developing world (ie. the number of people living below the 1\$/day poverty line as defined by the World Bank) has fallen sharply (Bhalla (2002), Sala-I-Martin (2002)). Others suggest more modest gains (Chen and Ravallion (2001)). Still, other analysts question further the validity of the international poverty measures (Reddy and Pogge (2002), Wade (2002)) or even claim that poverty has actually increased (International Forum on Globalization, (2001)). Similar contradictory claims have been made for the trend of global income inequality. For some, inequality has increased (Galbraith (2002), Wade (2002)), others claim that it has been falling (Bhalla (2002), Sala-I- Martin (2002)) though not continuously.

Efforts have been done to clarify the sources of the differences between the conflicting assessments (Ravaillon (2003), Deaton (2004), Aisbett (2003)). The variety of concepts used to describe poverty and inequality measures (Ravallion (2003)), the intrinsic difficulties to define time consistent and cross country consistent measures of standard of living (Reddy and Pogges (2002), Wade (2002), Ravallion (2003)), methodologies to estimate the incomes of different groups within the same country (national accounts versus household-level survey data estimates, Bhalla (2002), Sala-I-Martin (2002), Deaton (2004) and Ravaillon (2003)), all these features create scope for margins of errors and disagreement on the best assessment of the evolution of the global income distribution.

Taking these limitations into consideration, the bottom line of a reasonable consensus is illustrated in figures 2, 3 and 4:

[Figures 2, 3, 4 about here]

- As illustrated in figure 2, global poverty has declined in absolute and relative terms during the 1990s. (Bhalla (2002), Bourguignon and Morrisson (2002), The impact across continents is quite diverse though.

- The picture for global inequality trends is more ambiguous. Total inequality between people in the world can be thought of as having two components: the amount of inequality between countries and the amount within countries. Controlling for population size (ie. weighting by population), there is evidence that the “between” country component has tended to fall (Schultz (1998), Bhalla (2002)) due mainly to the good performance of the two largest countries China and India. This is well illustrated by figure 2 showing the contrasting pattern of Gini coefficients of GDP per capita across countries whether one controls for population size or not.

- At the same time however, as is depicted in figure 3, inequality has tended to rise in many countries, including China and India (Cornia and Kiiski (2001), Ravallion (2001), Milanovic (2003)). Putting all this together, there are no convincing evidence that overall inequality has risen or has fallen in the last two decades.

- Finally, *on average*, there is no systematic relationship between growth of income and within country inequality change. Amongst growing economies, inequality tends to fall about as often as it rises (Ravallion 2001).

Trade integration and its distributive impacts

How much of these trends in global income distribution is related to globalization and, more specifically to international trade flows? This issue has been even more ragingly debated in academic and public circles. Sceptics consider the competition of international trade and foreign direct investment as a major source of the damage caused to jobs, wages and income of the poor, or are much concerned about the unequalizing effects of trade integration on domestic economies. Many trade economists, on the contrary, welcome trade flows as an important source of gains contributing strongly to the improvement of a vast majority of people in the world economy.

A popular way to assess the distributive impact of trade liberalization has been cross-country regression analyses, relating levels of measured inequality or changes over time in measured inequality and/or poverty to data on trade openness and other control variables. Dollar and Kraay (2001, 2002a) 2002b), find that increased international trade integration has no systematic impact on inequality. As trade openness is also shown to be positively associated to growth (Frankel and Romer (2001)), the effect of trade integration are concluded to be the same across all income groups (in the sense that each decile's gain is proportional to its initial income). As a conclusion, the poor tend to benefit from trade openness in the same proportion as the rich (Berg and Krueger 2003). Other panel data analyses however have found trade liberalization to be positively associated with inequality at least for poor countries (Lundberg and Squire (1999), Barro (2000), Ravallion (2001) and Milanovic (2003)).

Cross-country regressions on the nexus "trade-growth-poverty" have been heavily criticized (Rodriguez and Rodrik (2001), Baldwin (2003), Baghwati and Srinivasan (2003), Bardhan (2003), Ravallion (2003)). Beyond the obvious concerns about cross country comparability of data and methods on inequality measures (Aktinkson and Brandolini (2002)), intrinsic problems exist on how to measure empirically trade integration. Which variable is used to capture the impact of trade liberalization (trade instrument or trade flows) matters a lot for the significance of the correlations. Also difficulties arise in teasing out, at the cross country level, the causality links running from genuine trade policy variables and growth performances. More fundamentally, aggregate inequality or poverty measures may not change with trade liberalization even though there are both losers and gainers from trade integration at all income levels. A given trade policy change may help some people to escape poverty while forcing others to get into poverty, even though the aggregate poverty rate may not have changed significantly. Looking only at aggregate levels can be quite misleading to understand the distributive impact of trade flows.

Given the limitations of the cross country evidence, analysts have turned to detailed analysis of country case episodes of trade liberalization and micro-economic studies of specific channels through which trade integration can have distributive impacts¹⁵.

Bhagwati and Srinivasan (1999) and Panagariya (2002) have argued that we are more likely to uncover the effects of trade liberalization in country case studies than in cross country econometric analyses. Country case studies provide useful information on particular experiences and allow a rich institutional description of the trade liberalization episode one wants to analyze. They are however also subject to limitations. First, there are *many* countries and *many* liberalizing cases, with *many* different contexts. Drawing general relationships from one country or one given time period may be difficult and even, hazardous, as one can never completely control for the specific factors of the case study. Second, several other aspects often occur at the same time as trade policy changes in a given country. Ascribing causality through a case approach requires great care and contextual knowledge, some of which again difficult to formalize and therefore always subject to some degree of interpretation varying from one analyst to the other.¹⁶

What then do micro studies teach us about the linkages between trade and inequality and/or poverty? Because labor earnings are a major component of income, unsurprisingly much of that literature has concentrated on the impact of trade flows and trade reforms on labor markets and wage dispersion between skilled and unskilled workers.

In the case of developed economies, this has given rise to the huge “trade-and-wage” literature investigating the cause of the rising wage inequality experienced in the United States and related employment phenomena in other countries¹⁷. Using a variety of approaches (product price-wages effects, factor content computations, cross industry and time series analyses) and despite unresolved methodological issues, many researchers have demonstrated that international trade accounts for no more than 20-30% of the rise in the wage premium experienced by the United States (Feenstra and Hanson 1996a), Borgas et al. (1997), Baldwin and Cain (2000)). The bottom line therefore is that international trade explains a positive and significant, yet

¹⁵ Two alternative methods also widely used to analyse the distributive impacts of trade liberalization are Computable General Equilibrium Models (CGE) and more recently Micro-Macro syntheses. CGE models are based on disaggregated economy-wide social accounting Matrices. Integrating the interactions between markets they account for commodity, terms of trade and factor market effects on various “representative” classes of agents in the economy (See Reimer (2002) for a thoughtful review of these methods to the impact of trade liberalization on poverty). Micro-Macro syntheses involve general equilibrium analysis coupled with some form of post simulation analysis based on household survey data (see Bourguignon and Spadaro (2004) for a recent introduction).

¹⁶ The fact that the same country can be subject to different interpretations by different analysts is well illustrated for the case of China and Korea. Trade liberalization proponents have emphasized China and Korea’s growth in the recent decades as the result of liberalization of their economies (see for example Panagariya (2002)). Globalization sceptics however have argued that these same countries have been able to take on the opportunities afforded by trade liberalization because of extensive or selective government intervention both now and in the past (Wade (1990) and Rodrik 1995a))

¹⁷ In the US, the wage gap between college education and high school education has increased by about 20 % in the 1980s (G. Borjas and V. Ramey (1994)). In addition, employment of unskilled workers has declined in favor of skilled workers and, in several continental European countries, increased unemployment for the less skilled has been widely observed (OECD 1993).

relatively small share of the increase in wage inequality and/or unemployment witnessed in the developed countries in recent decades (Slaughter (1998), Dewatripont, Sapir and Sekkat (1999)). A caveat of that literature is the fact that it has been mainly framed within the context of North-South trade, while increased competition between Northern countries, with intra-industrial trade, intra-firm trade and trade-related technological change are probably the most significant distributive drivers (Francois and Nelson (2000)).

While there is no dispute about the sign of the effect of trade flows on labor markets in the North, the empirical evidence in developing countries is more contrasted. Rama (2003) provides a useful survey of the literature. The bottom line is the following. First, there is evidence that wages tend to grow faster in economies that do integrate with the rest of the world. While, trade may have a negative impact in the short run, the effect becomes positive within a few years. Conversely, the impact of FDI is highly positive even in the short run.

Second, the benefits from trade integration are not evenly distributed across workers though. A variety of studies uncover an increase in the wage premium to skills, in particular in Latin American countries.¹⁸ Interestingly, the increase in this wage gap seems to be associated to skilled biased technological change triggered in part by increased foreign competition (ie. trade-induced technical change) (Attanasios, Goldberg and Pavnick (2003) for Columbia, Pavcnik, Blom, Goldberg and Schady (2002) for Brazil, and Sanchez-Paramo and Schady (2004) for a comparative study of five Latin American countries). Overall however, these effects cannot explain fully the increase in wage inequality observed over the period, suggesting that the impact of trade liberalization on the labor market may not be very sizable.

Third, there seems to be a “continental divide”. Controlling explicitly for changes in domestic factor supply, Robbins (1995, 1996) finds that greater openness has led to decreasing inequality between skilled and unskilled workers in the majority of the East Asian countries in his sample, while on the contrary, for the five Latin America countries studied, there is evidence that trade liberalization has been associated with increased wage inequality. This was explained by Wood (1997), arguing for a difference of timing between the two liberalization experiences: 60-70s for East Asia countries and 80-90s for Latin America. The entry of large low income countries into world markets (like China) coinciding with Latin American liberalisation could then explain the difference of outcomes along the conventional SST lines.

Finally, a noticeable element found in many micro-studies is the fact that trade liberalization has far smaller effects on intersectoral reallocation than is predicted by the conventional mechanism of the STT¹⁹. In a recent paper, considering a set of 25 trade liberalization experiences in developing countries, using internationally comparable sectoral labor data, Seddon and Wacziarg (2002) conclude that trade liberalization has little sectoral reallocation across sectors (even at the 3-digit level within manufacturing). Similarly, Ghose (2000), looking at the re-allocation of labor from import competing sectors to export-oriented sectors in newly

¹⁸ For Mexico see Cragg and Epelbaum (1996), Revenga (1997), Hanson and Harrison (1999), Feenstra and Hanson (1997)). For Chile, see Beyer et al. (1999). For Columbia, see Goldberg and Pavnick (2003) and Attanasios, Goldberg and Pavnick (2003). For Brazil see Pavcnik, Blom, Goldberg and Schady (2002).

¹⁹ See for instance Goldberg and Pavnick (2003) and Attanasios, Goldberg and Pavnick (2003) for Colombia, Pavcnik, Blom, Goldberg and Schady (2002) for Brazil, Levinsohn (1999) for Chile.

industrializing countries in the 1980s and 1990s²⁰ finds evidence that trade liberalization accelerated employment growth in *both* export and import competing sectors for most of the countries in the sample.

The micro-studies have attributed this intersectoral “sluggishness” of the labor market to broad market rigidities (Seddon and Wacziarg (2002), labor regulations or to various adjustment processes by firms which can reduce margins and/or increase productivity rather than laying off workers (Currie and Harrison (1997)). This pattern of adjustment to trade liberalization by firms through productivity gains is indeed confirmed by Erdem and Tybout (2003) which summarizes work that uses micro enterprise or firm data to examine the effects of five trade liberalizing experiences in developing countries²¹. Virtually all of the studies find productivity rises in import competing sectors. These were attributed sometimes to exit of less efficient producers, or to firms investing in capital and new technologies, or reducing inefficiencies out of their production process.

Significant effort has also been undertaken to assess the impact of trade liberalization on the bottom of the income distribution, namely the link between trade and poverty. McKay, Winters and Kedir (2000) and Bannister and Thugge (2001) provide recent surveys of the literature. The bottom line of the literature is to recognize that there are many links through which trade liberalization can affect poverty. While there is a general presumption that trade reforms enhance the static and dynamic opportunities of the poor and does so in a number of cases (China and India for instance), the impact of trade integration on poverty is very country specific and depends much on the initial local conditions before liberalization. No broad statement can be easily made, but it seems reasonable to emphasize the following aspects associated with pro-poor liberalization: a) the role of agriculture: trade liberalization which promotes agriculture is more likely to reduce poverty, b) the existence of efficient distribution channels to make sure that the poor receive the benefits of increased incentives and access to imported inputs, c) the importance of access by the poor to assets (capital, human and social) to enable effective supply responses, d) the need for safety nets to shelter the agents who may be inevitably become losers and pushed into poverty after trade liberalization.

What to conclude on the distributive impacts of trade integration?

What can we conclude from all this on the distributive impacts of trade integration in the recent decades? Though each approach has its own limitations, put together they point to the following set of reasonable statements on the effects of trade flows on poverty and inequality :

a) Absolute global poverty has decreased and this is certainly related to the growth in some big poor countries. As there is a positive correlation between growth and trade openness, trade does not seem to be systematically biased against the poor, though the local impact of trade on poverty is very country specific.

b) There is mixed evidence on the relationship between trade integration and within-country inequality. While North-South trade integration contributed for a significant but small part of the increase in wage

²⁰ The six developing countries are China, India, Indonesia, Malaysia, the Philippines and Taiwan.

²¹ Brazil (1991-94), Mexico (1984-89), India (1991), Cote d’Ivoire (1985-87), Chile (1973-79).

inequality in the developed countries, the impact of trade liberalization in developing countries is mixed, depending on the continent, the timing and the pattern of specialization of the country.

c) The channels through which trade integration impacts the income distribution have less to do with the conventional SST logic than is conventionally assumed. Some channels have to do more with changes in rent-sharing arrangements between workers and firms, trade induced technological change or technology or technology catch-up, and increased internationalisation of production and outsourcing.

III. Perceptions and the potential for a political backlash against globalization

Given the previous conclusions, many economists and policy makers would think that trade integration is rather a socially benign phenomenon. Some economists, like Freeman (2003), would even think of international trade flows as having such a small global impact on labor markets that one would wonder why there is so “much ado about nothing” .

These rather positive, or at least neutral positions, are however quite at odds with the perceptions shared by demonstrators in the streets and critics of the process of globalization. As shown by Mayda and Rodrik (2002), Scheve and Slaughter (2001), or O’Rourke and Sinnott (2001), public opinion is generally more sceptical about the benign impacts of trade flows than most trade economists are. Given the intensity of the debate (and the noisy demonstrations in the streets), substantial research effort has been devoted recently to assess and understand these alternative positions (Deardorff (2003), Aisbett (2003), Bardhan (2003), Elliot, Kar and Richardson (2003)).

Different perspectives on the distributive dimensions of trade integration.

A first issue has to do with the way people in the streets and civil society conceive the distributive impacts of trade flows. Their conceptions do not necessarily share much with the way professional economists tend to discuss the same distributive issues. Kanbur (2001) emphasizes four dimensions on which conceptions tend to vary: level of aggregation, time horizon, monetary versus multidimensional measures and finally relative versus absolute measures,.

Concerning the level of aggregation, the standard economic approach tends to consider measures at the national, regional or world level, focusing on average impact effects. On the contrary, critics of trade integration will be more sensitive to individual and local trajectories. For instance, while economists might be content with a situation in which the total number of poor has decreased, critics may not be satisfied by such an evaluation if some of the remaining poor are made poorer. As argued by Aisbett (2003) economists tend implicitly to assume a utilitarian social welfare function with which trade-offs across individual destinies are possible. On the contrary, the alternative approach may be viewed as applying more some sort of Rawlsian social criterion by which the position of any already poor should be improved.

Implicit differences in time horizon also matter to explain differences in perceptions. Economic analyses tend to take a medium term perspective by which markets have time to adjust to changes in the environment. Hence, the view for instance that after a trade shock, export sectors will expand, creating new job opportunities and allowing a smooth reallocation of resources from import competing sectors. A shorter term view however would rather emphasize the immediate loss of income and adjustment costs of displaced workers due to more intense foreign competition. Related also to the time horizon issue, there is a concern about time irreversibility effects and the associated incapacity for mobility. Some losers from trade integration may remain permanent losers when their specific skills are rendered obsolete by the trade shock and their ability for retraining are limited (due to age or geographic immobility).

A third issue is whether measures for poverty should be reduced to monetary dimensions. There is by now a large consensus among analysts that dimensions like health and education have to be integrated in policy assessments on poverty outcomes (Kanbur 2001). Other dimensions like empowerment, participation and vulnerability to shocks are also gaining acceptance as important aspects of poverty. These dimensions are however harder to quantify and despite the growing consensus about the appropriateness of using multidimensional poverty measures, there is a complete lack of application of them in empirical analyses of trade integration and poverty (Kanji and Barrientos (2002)).

Finally, a particular source of discrepancy has to do with the type of measures one considers as appropriate to analyse the distribution of the gains of trade. Economists tend to favor measures invariant to scale (ie. *relative* measures). Hence the insistence on the *incidence of poverty* (percentage of people considered as poor in the population), or the use of *Gini coefficients* to describe a summary of the income distribution. Critics tend on the other hand to emphasize *absolute* measures of poverty or inequality (like for instance the total number of poor or absolute differences incomes)²².

Differences in perceptions may be due to differences of emphasis on what inequality or poverty means. The opposition against free trade may also reveal more fundamental cleavages in terms of the distribution of the gains and costs from trade.²³ Three issues seem in particular to be somehow overlooked by many

²² Ravallion (2003) illustrates well the case with a simple example. Consider two individuals: a rich one (individual A) with an endowment of 5 \$ and a poor one (individual B) with 1\$. Assume that both gain a 100% increase in their income because of trade liberalization. The after liberalization endowments are therefore 10\$ for the rich and 2\$ for the poor. As they both gain in same proportion, a relative inequality measure would remain invariant to the trade shock. However, an absolute measure of inequality like the difference of incomes does not remain invariant. It is $10 - 2 = 8$ \$ after the trade shock while it was only 4 \$ before. Globalization critics have an eye focused on this last fact: the absolute difference increased by 100% !!

²³ A first concern by critics of the current trade regime is not an objection per se to international trade but rather a critical position of the current *biases* of the trade liberalization process between developed countries and developing economies (See for example the Oxfam report on "Rigged Rules and Double Standards"). The current international trade regime is viewed as facilitating market access of developing economies to developed countries while preventing symmetric beneficial outcomes to southern countries in sectors of particular importance to their comparative advantage (agriculture, textile and apparel, labor intensive manufacturing sectors), or the system is viewed as imposing restrictions on vital technology and knowledge transfer for development and growth of developing economies (TRIPS agreements). This position is in fact consistent with mainstream trade theory and finds sympathy and consensus among academic economists (See for instance Bardhan (2003) and Deardoff (2003)).

economists in their analyses of the distributive impacts of trade integration. The first one is the perceived feeling of insecurity and stress generated by trade liberalization. The second one is the fact that people do care about social status, relative income positions and fairness in the distribution of income. Finally, the third issue is the fact that many concerns have to do with the domestic political economy feedbacks of trade liberalization and the implied consequences for *re*-distribution by national governments. Let us first consider quickly the first two dimensions. The third aspect will be discussed more thoroughly in the next section of the paper.

Feeling of insecurity, workers' anxiety and trade integration.

The link between economic integration and worker's insecurity contributes in an essential manner the public opposition to policies aimed at liberalizing international trade and FDI flows. Indeed, beyond the impact of trade integration on average income levels, individuals care also about markets risks and the implied volatility for their income. Trade openness may increase the economic risk born by economic agents in several ways. First, exposure to international trade may generate greater economic volatility in domestic prices (Rodrik 1997). Second, trade may also induce increased specialization in productive activities away from optimal diversification. As was described in part I, trade integration may also increase the elasticity of labor demand to its own price and render workers more vulnerable to other shocks in the economy. Importantly, these effects may be felt by workers without any actual observed change in prices or trade flows.

The nature of trade may also affect the perceptions about economic insecurity. It is generally thought that intra-industry trade flows based on economies of scale generate less distributive conflicts than inter-industry trade flows based on endowment differences. In the first case, both scarce and abundant factors tend to gain (Helpman and Krugman (1985)) while the usual SST conclusions imply that scarce factors automatically loose. Also, the adjustment process is thought to be more costly when resources have to move across sectors than when they have to be shifted across firms within the same sector. One aspect somehow overlooked though, is the fact that with intra-industry trade, there is also an increased ex-ante uncertainty about the identity of who is going to bear the adjustment cost. From an individual point of view, anybody can be hit within a particular sector and the identity of losers is not as well defined as when trade is based on endowment differences. The extent of people who might be potentially affected (even temporarily) by trade openness is increased, which in turn may lead to an enhanced feeling of insecurity.²⁴

There is mixed empirical evidence on the impact of international trade flows on economic insecurity. Rodrik (1997) for instance argues positively by showing evidence that exposure to external risk from trade, as

²⁴ This aspect is also well illustrated by the reactions in industrialized countries to the fast growing cross border trade in business and electronic services and outsourcing of back office operations in low wage exporting countries, like India or China. Though the phenomenon is still quantitatively small, white collar workers who previously felt sheltered from external competition, tend now to join their blue collar fellows in the fear of "job outflows" caused by globalization. Reflecting these fears, in the US legislative action has already been initiated to create restrictions on outsourcing of services for government procurement markets (Mattoo and Wunsch (2004)).

measured by the standard deviation of a country's term of trade interacted by its degree of trade openness is positively related to growth volatility. Iversen and Cusack (2000) on the other hand, present evidence, at least for developed countries, suggesting no correlation between trade openness and volatility in output or employment.

There is also mild empirical support on a trade-increasing effect on the elasticity of labor demand (see Slaughter (1999) for the US and Fajnzylber, Maloney and Ribeiro (2001) for developing countries). Results however are more conclusive with FDI and the globalization of production by multinational firms (Fabbri, Haskel and Slaughter (2003)). Consistent with this finding, Scheve and Slaughter (2003) also present evidence, based on analysis of individual-level panel data from the UK over 1991-1999 that FDI activity in the industries in which individuals work is positively correlated with these individual perceptions of economic insecurity.

Importantly, to understand how this dimension may generate a discrepancy between public opinions and the views shared by many professional economists, it should be recognized that these vulnerability effects may have strong effects at the individual level without being actually detected at a more aggregate level in income distribution measures. Aggregate inequality measures like the Gini coefficient, which are static snapshots of countries' income distributions, mask a great deal of movement up and down the income ladder. Also, although micro studies point to the fact that trade liberalization does not induce major labor reallocation effects across sectors, this does not prevent churning to occur across firms and plants within sectors (Seddon and Wacziarg (2002), Levinsohn (1999)).

Relative losers and Fairness in the distribution of the gains of trade

It is by now well established that, after a certain level of absolute income, individuals' satisfaction is partly determined by how they compare themselves to others in their reference group and by concerns for fairness and reciprocity (Fehr and Schmidt 2000)). Given this, it is well known that situations which would appear as "win-win" from the point of view of standard economic analysis, may not look so anymore when individuals share a concern for relative position and fairness in the distribution of the gains for trade (Aisbett 2003).

Indeed, the fact that the gains from trade are distributed unevenly may enter negatively into someone's preferences. People, even if they get something positive in absolute terms, may be concerned that they get much less than others. First, when they have a concern per se for social status and relative positions, they may suffer from the new situation if that occurs within their reference group. This aspect is illustrated by Graham (2001) who argues that top-driven inequality in the distribution of the gains of trade may be an important element explaining the negative perceptions of globalization among the poor and lower middle class in developing countries. By providing an ever-higher benchmark for comparison, top driven inequality induce people to under estimate their own positive gains.²⁵

²⁵ Indeed, from repeated household surveys in Peru during a 10-year period of market reforms, Graham and Pettinato (2001) report that, of the respondents with the most upward mobility (more than 30% gains in income),

Second, when the gains are perceived as an identified windfall, a too unequal distribution is perceived as unfair. This has been shown repeatedly in the experimental and behavioral economic literature (as illustrated for instance by the “divide-the dollar” game (Fehr and Schmidt (2000))). The distribution of the gains from trade may well be perceived as being very much independent from one’s own efforts. It can be just viewed as the result of having the chance to be in the right (or wrong) sector, in the right (or wrong) firm and with the right or (wrong) timing when trade liberalization occurs. In that case, the gains and costs will be largely considered as windfalls and to be shared equally among people.²⁶

V. Trade integration and the redistribution of the gains from trade

Many concerns about trade integration, in the end, are however related to the capacity and the willingness of governments to affect their redistribution of income and resources domestically.

This is first manifested in a fear of decreased capacity or autonomy of national governments and therefore a perceived loss of democratic process associated with it. The competitiveness constraints imposed by external competition on domestic firms and workers, are perceived as reducing the ability of governments to manage their domestic redistributive policies and/or regulations though the latter may reflect legitimate national preferences (on cultural and social cohesion, environment, health, ethical goods,...). This is reinforced by the feeling of an increased influence of international trading rules through the WTO on the determination of these policies.

A well cited variant of this position is the idea that trade and the international organization of production by multinationals generate outcomes naturally biased towards the interests of mobile economic factors (capital, skilled labor) and prevents governments to exercise domestic redistribution in favor of the immobile or less mobile factors (land and unskilled labor).

An important and key aspect is finally derived from political economy considerations and the link between economic resources and political power. The more polarized is the distribution of the gains from trade across domestic residents, the more concentrated is political power and influence inside the economy. This, in turn, is expected to feedback on the nature of the domestic equilibrium of redistribution (Bardhan 2003) and to induce the implementation of policies further biased towards narrow political interests.

Political feedback effects need not be limited to redistribution *within* countries, though. When agents have multinational activities and can successfully pressure their own governments to get concessions from a foreign government, this induces further distributive consequences *between* countries. For instance, Deardoff

44 % reported that they were worse off. They were mostly urban, average income people and older than non frustrated upwardly mobile respondents. While poorer respondents tended to respond that their economic conditions was the same as it had been before the reform, those in the middle class were more likely to report that it got worse.

²⁶ There is a clear concern among critics of globalization about the current polarization of the gains from trade between firms and workers. This position is particularly well articulated by the fear of “Corporate globalization” of all economic and social activities (as for instance exemplified in the best-selling books “When Corporations Rule the World” by David Korten or “No Logo” by Naomi Klein).

(2003) and Aisbett (2003) present a good case of the influence of “big business” at the WTO in the design of the TRIPS agreement or in the design of NAFTA with its notorious chapter 11 giving foreign direct investors a private right of action against host country governments

All these views clearly differ from the broad consensus among trade economists that trade openness is not systematically biased against the poor and that a relevant redistribution from the gainers to the losers can make, in the end, everybody better off. On the contrary, public opposition is fed by the fear that the relevant redistributive arrangements will not realize and further, that trade integration is actually affecting the capacity and/or willingness of governments to provide these compensation mechanisms.

Does this fear make sense? What do we know about the economic and political feasibility of an open trade regime with compensation? In order to explore these positive dimensions, this section starts with some conceptual considerations in the economic literature on the capacity for a government to make redistribution in an economy open to international trade. Then we will turn to political economy feedbacks of trade integration and review briefly what we know about the relationship between trade integration and the political willingness and ability of governments to operate domestic redistribution.

This discussion will then pave the way for the last part of the paper which takes a more normative stance and considers the likelihood of a “trade policy regime with compensation“ which is socially responsible in the sense depicted in the introduction.

Economic feasibility: Why is it difficult to re-distribute the gains from trade?

A first obvious reason why it might be difficult to redistribute the gains from trade is simply the lack of resources available for this purpose. Raising up taxes necessitates a minimum of fiscal infrastructure, implies administrative costs and paying wages to public servants. Even without corruption and a fully efficient system, there are non negligible collection costs to be disbursed. Some instruments may involve less resources than others. A classical argument is that trade taxes are less costly to administer than other instruments like VAT or income taxes. Clearly, for poor economies where tariff revenues amount for a sizable fraction of their fiscal revenues, trade liberalization may render redistribution and compensation difficult or impossible. It should be noticed however that the initial tariff structure can be on the wrong side of the Laffer curve. In such a case, a trade reform rationalizing the country’s tariff structure may actually increase the size of the tax base and thereby provide more rather than less tariff revenues (Ebrill, Stotsky and Gropp (2002)).

More fundamentally, the “technical” assumption underlying the idea that the gains from trade can be redistributed without problems inside an economy is the existence of non distortionary (lump-sum) transfers which can be freely used by governments to tax gainers and compensate losers. The difficulty however is that, in reality, there is no such thing like lump-sum taxes. Still, the consensus in the optimal taxation literature is that, if the government has enough tax instruments to redistribute income across individuals, then it is optimal to keep production efficient, implying that the government should not use either tariffs, nor production subsidies or taxes in a small open economy context. There is therefore in such a case, complete separation

between production efficiency (what trade economists are often most concerned with) and domestic redistribution.

In the international trade literature for instance, Dixit and Norman (1980) were among the first to show that a free trade regime could be made superior to autarky for anybody in society, even without lump-sum transfers. The gains from trade could be redistributed by using appropriate commodity taxes and taxes contingent on the various factors of production. Similarly, in the public finance literature, the Diamond and Mirrlees (1971) result that, for a government using commodity taxes and perfect contingent factor taxes, production efficiency is optimal, generates similar implications, even when the government is concerned with optimal income redistribution. Hence, in the case of a small open economy, the production efficiency result implies that domestic production prices have to be equal to international prices, precluding the use therefore of trade taxes or restrictions.

The problem however with the Dixit and Norman and Diamond and Mirrlees taxation schemes is the fact that they require relatively strong informational assumptions on what the government needs to know about the characteristics of the agents. For instance, if production involves different types of workers differentiated by skills, then taxes contingent on factors require that the government implements different tax rates for all the different skill levels. Since, however the government cannot have full information and verify and differentiate the skill levels of workers because of asymmetric information problems, these factor taxes would not be feasible in reality.²⁷

When weaker informational requirements are made on the corrective or redistributive instruments available to the government, it is likely that one cannot separate anymore production efficiency and redistributive\equity aspects. It is also likely that trade liberalization has implications for the capacity of the government to redistribute resources, in particular the gains from trade generated by openness. Recent papers (Guesnerie (1998), Naito (1998), Spector (2001)) surveyed in Guesnerie (2001) have started to explore this issue more systematically²⁸.

To understand the basic forces through which trade integration may affect the redistributive capacity of the government, consider the initial situation of an economy with skilled workers and unskilled workers producing different goods. This economy is initially closed to the rest of the world. The government has a distributive objective of transferring income from skilled workers to unskilled workers. However, it does not have information on individual skills and only makes redistribution based on observable income levels.

²⁷ There is a well established literature in international trade theory which has investigated the pattern of optimal trade policy in the second best context of a small open economy subject to domestic distortions (Bhagwati (1971)). The general conclusion of this literature is that, while trade instruments may improve welfare in some circumstances, they are generally not the best instruments to correct for the domestic distortions. Hence again, the conclusion that trade instruments are dominated. This literature however does not take explicitly into account the informational constraints that can be imposed on the domestic instruments and/or their redistributive consequences in the economy

²⁸ see also Feenstra and Lewis (1991) and Feenstra, Lewis and Mc Millan (1991) for a very first discussion in partial equilibrium of the constraints that asymmetric information can impose on the capacity to redistribute the gains of trade between gainers and losers.

Because of this lack of information on individual characteristics, the amount of possible redistribution is constrained by incentive compatibility conditions related to the labor supply decisions of agents. In order to relax these constraints on income redistribution, it is optimal for the government to use as many instruments as he can. Therefore it is also part of the optimal solution to affect also factor prices and to directly reduce the wage gap between skilled and unskilled workers (manipulating therefore production prices). When our economy becomes open to international trade, the demand elasticity for its goods, and therefore for the different types of labor tends to increase. In the extreme case of free trade in a small economy with homogenous commodities, domestic production prices are pinned down by international prices and wages are also fixed. It is no more possible for the government to affect domestic wages and one of the two redistributive tools available in the closed economy context becomes ineffective. Two things follow from this conclusion. First, if the government has the possibility to differentiate domestic production prices from international prices through the use of a tariff, it will be welfare improving to do so (Naito (1998)). Second, if this is prevented by the respect of international agreements or by fear of capture by protectionist interests, there are limitations on the capacity to redistribute income domestically. When the gains from trade are not big enough, one cannot fully compensate the losers from free trade, even if one wishes to do so (Spector (2001), Guesnerie (1988)).

While expressed in a very stylised framework, this line of research emphasizes a force underlying the concerns expressed by critics of trade liberalization. Trade openness may reduce the capacity of governments to undertake the domestic redistribution they wish because the tools available for domestic redistribution are not powerful enough. There is no way one can separate the issue of internal redistribution from the issue of opening up the economy to trade flows²⁹.

Let us note also, in passing, that this central idea that governments are impeded to redistribute domestic income after openness because factor prices are *less* sensitive to local interactions, is also underlying the usual argument that openness tends to bias redistribution in favor of mobile agents and factors of production and at the expense of immobile agents or factors (Rodrik 1997). When one factor of production can move across borders without significant cost, its price is fixed by the international market conditions. When domestic taxation is imposed on that factor, the adjustment process tends to occur through the mobile factor moving outside the country, in order to get the same domestic after tax return as the international return. Remaining immobile factors inside the economy have then to bear the full burden of the tax induced adjustment and again there is no capacity to redistribute income from the mobile factor towards the immobile ones. This effect is underlying all the literature on tax competition with capital mobility, FDI and firms' delocalisations.

²⁹ The issue is more general than simply for internal redistribution. When, because of asymmetry of information, there are also endogenously imperfect tools of regulation to correct for local market distortions, free trade may also be dominated by a restricted trade regime (Martimort and Verdier 2004).

Political feasibility I: the political economy feedbacks of trade integration on redistribution

The preceding arguments help us to understand why the “*capacity*” of national governments for domestic redistribution may be affected by trade liberalization. Several observers have also pointed out that trade openness can interact with the “*willingness*” of governments to provide domestic redistribution and fiscal policy. In other words, international trade may affect the domestic political equilibrium of internal redistribution (Bardhan (2003), Boix (2001)) and induces various types of political economy feedbacks, affecting positively or negatively the redistribution of resources inside the economy.³⁰

In this respect, there is indeed a well established tradition in political sciences studying how trade openness shapes the structure of the economy in a way which facilitates the formation of organizations and interest imposing high redistributive demands on the State (Cameron (1978), Katzenstein (1985)).

Cameron (1978) for instance, argues that small open economies are characterized by a high degree of industrial concentration with a small number of large firms holding a large share of production and employment. Because of small domestic markets and external competition, these countries specialize in a small number of sectors. The high domestic level of industrial concentration and the little fragmentation of the labor force, facilitate the emergence of employers’ associations and strong centralized labor unions. Two elements promotes the implementation of intensive domestic redistribution through an expansion of the public sector. First, unions contribute to the formation of strong social democratic and labor parties, pursuing intensive redistributive agenda. Second, there is centralized wage bargaining at the national level, leading to nationwide corporatists arrangements. These “social pacts” offer wage moderation to maintain external competitiveness, in exchange for expansion of public expenditures, in areas like unemployment benefits, health, pensions and education.

Katzenstein (1985) expands this view in his analysis of small corporatist European States, by acknowledging the fact that small open economies are considerably dependent on external economic fluctuations. This, in turn, implies a public demand for social insurance which policy makers satisfy through extensive arrangements with unions and employers. Wage moderation and flexible procedures are accepted by workers to allow for adaptations to fluctuations in the world demand, in exchange of which losers are compensated through generous unemployment coverage. Full fledged public programmes in education and physical capital formation, are also undertaken by the state to secure the competitiveness of the economy. Rodrik (1998) presents a formal illustration of Katzenstein’s argument. In his model, trade openness tends to increase the extent of domestic redistribution in small open countries in order to satisfy the domestic demand for social insurance associated with the risks faced in the international economy.

Trade openness may have positive political economy feedbacks on the domestic demand for insurance and redistribution. As expressed by some critical views on globalization, trade integration may also trigger negative feedbacks on the domestic political equilibrium of redistribution.

³⁰For formalizations of political economy feedbacks of trade integration on redistribution, see Bourguignon and Verdier (2002) and Przeworski and Meseguer Yebra (2002).

One channel in particular is related to the “first round” *distributive* impact of trade integration in the economy and the possible *redistributive* responses of the political system to this impact. To see this, consider for instance that trade liberalization induces an increase in income inequality in a given country. If the country is a perfect democracy in which domestic redistribution is decided by majority voting, this increased inequality is likely to induce a larger social demand for redistribution by the lower middle class. As these people are politically decisive, their demands will be satisfied by political parties competing for votes³¹. If however, political competition is far from perfect and/or that political outcomes are mostly determined by influence and money, then an increase in inequality may render the rich relatively more politically influential than the lower classes. Consequently, the resulting political equilibrium may well end up with less income redistribution. Polarization in the distribution of the gains from trade then would induce polarization also in domestic political power, which in turn, would feed back into further income or welfare polarization after government intervention. This view is quite consistent with the concern that polarization of the gains from trade, may lead in countries with weak political governance structures to regressive outcomes in domestic redistribution.

What does the empirical evidence tell us about the redistributive impacts of trade integration? Several cross countries analyses in the last decades have shown that higher levels of trade are systematically associated to a larger public sector both for developed economies and developing countries. For instance, Cameron (1978) looking at OECD countries in the period 1960-75, observed that the best predictor of an increase on the size of the public sector as a share of GDP was the degree of trade openness as measured by the sum of exports plus imports over GDP. Rodrik (1998) has extended the result of a positive association between government consumption and trade openness to a larger set of countries including developing economies. Other recent empirical research by political scientists tend to confirm the robustness of the relationship, (Garrett and Nickerson (2001), Adserà and Boix (2001)) with the added twist that the positive relationship is more likely to hold for democracies than non democratic governments.

As we know, cross countries analyses have their usual limitations and their conclusions should be taken with caution. In particular, the macro variables used as proxies of government redistribution may hide different aspects in different countries with different ways and modes of redistribution. Mahler (2001) tries to compensate these aspects by employing measures of post-government disposable incomes and market incomes that have been calculated for OECD countries from household-level income surveys available in the Luxembourg Income Study (LSI). The advantage of the LSI is that it provides information comparable across countries and covering at the household level comprehensive dimensions of sources of income. By comparing the Gini of the market income distribution to that of the post-tax and transfers income distribution, a country measure of direct fiscal redistribution can be constructed. The evidence presented by Mahler suggests that

³¹ Formally, the politically determined level of income redistribution is the one wished by the median voter in the country (Metzler and Richards (1981) which is negatively related to his relative position compared to the mean income. When trade integration lead to increased income inequality in the first place, it is likely that the relative position of that median agent deteriorates and therefore that he wishes more redistribution.

trade openness is negatively associated with his measure of fiscal redistribution while the contrary holds for outbound FDI. These results offer therefore only mixed support to the preceding cross countries analyses. In any case, this may partly be reconciled with the political sciences literature on small open corporatists countries by recognizing the fact that part of the redistributive dimensions negotiated within these economies may not be well captured by direct fiscal redistribution. For instance, public education, active labor market policies, various regulations and provision of public goods may also have important indirect distributive consequences.³²

Political feasibility II: trade with compensation or protectionism ? That is the question.

An important element of the literature discussed above is the fact that the level of trade exposure is considered as exogenous to the political decisions of domestic actors. Still, to understand the potential for a political backlash against trade integration and to draw from this some policy implications, it is also important to take into account the fact that the decision to open up the economy to foreign goods is determined by domestic political forces. As noticed by Adselà and Boix (2001), scholars trying to explain trade policy with political economy considerations, too often tend to disconnect the choice of trade policy from the choice of other redistributive instruments. However, as both trade policy and fiscal policy are means to redistribute income across economic agents, it is important to have in mind a framework in which both types of instruments can be jointly determined by the political process. Such a framework could then provide insights on when protectionism without other forms of compensation is likely to occur, and when trade and compensation emerges as a political equilibrium.³³

Several reasons have been provided in the literature to explain the use of trade policy rather than some other domestic instrument, as a way to redistribute income in a country. A first type of answer has to do with the fact the total excess burden of trade policy may be lower than alternative more economically efficient instruments, once the resource costs involved in the political process (like those generated by competition for political influence) are also taken into account.

Another set of reasons has to do with the existence of incomplete or asymmetric information. As we already discussed in the public finance literature, when the power of fiscal instruments for income redistribution is weak because of asymmetric information problems and incentive reasons, it may be optimal for the government to introduce trade restrictions. A more political dimension concerns the existence of asymmetric information between voters and politicians. In such a context, choosing a less transparent instrument (like for instance a tariff or a Rule of Origin), even at the cost of economic efficiency, may help policy-makers to disguise their reputation as redistributive politicians to specific groups, something which in turn might be penalized by electors if they had the information (Coate and Morris (1995)). Finally, when there

³² Also it should be recognized that these results are limited to OECD countries.

³³ There is a huge literature on the political economy of trade policy with a number of good surveys (see for instance Hillman 1989, Magee, Brock and Young (1989), Rodrik (1995), Adselà and Boix (2001)).

is uncertainty about who will enjoy the gains from trade after liberalization, there is a status-quo bias against reforms, even when welfare is known to increase ex-post for a majority of individuals (Fernandez and Rodrik (1991)).

An important dimension, useful to understand the emergence of protectionism versus trade with fiscal compensation is emphasized by Adselà and Boix (2001): the capacity for winners to compensate fully the losers, once the reform is done. Take for instance, the case where winners are well identified but a minority. Suppose, also that trade integration generates global gains but also increases the capacity of the winners to escape domestic taxation (because openness increases their trading or productive opportunities and/or their mobility). Then, if these winners could commit ex ante to redistribute part of the gains of trade to the losers, trade integration with compensation is possible. If however, such commitment is not available or not credible, then the majority is likely to oppose resistance to trade openness³⁴. An interesting insight of such a line of reasoning is the fact that protectionism is less likely to occur in countries that have a good political commitment technology: like strong parties and well functioning institutions through which politicians can be bound by their promises.

The time inconsistency issue discussed above is also useful to explain why protectionist policies are preferred by losers to trade liberalization with efficient income compensation. Once protection like a tariff is granted, losers have no incentive to change occupation and relocate into expanding export led sectors. This policy-induced persistence of their sector, and therefore their political capacity to get compensation by the government, may actually be viewed as a political commitment technology against the previously discussed problems of time inconsistency about compensation.³⁵

A vivid example of this kind of situation in Europe is the case of the policy of price support to Farmers. Getting tariff protection and price support mechanisms is for them a much better way to get compensation against competition from developing countries, than accepting a free trade regime associated with a transfer in the form of lump-sum compensation and retraining subsidies (to help them move into other sectors). Even if they could be exactly compensated and indifferent in terms of economic welfare between the two options, they are more likely to prefer the first one. With the lump sum compensation and retraining subsidies, farmers will progressively leave their farm, get involved into other activities and lose their size and their identity as part of a specific sector. Their political base and capacity to organize politically gets progressively eroded as well as their ability to sustain compensatory policies. At some point in time eventually, the government may implement a free trade regime with no compensation at little political cost. Getting a tariff or a price support which allows the persistence of the sector is a much better way to ensure that compensations will be paid over time.

³⁴ Evidently, this reasoning holds also when all winners are not ex ante identified but still are known to be a majority ex post (Fernandez and Rodrik (1991)).

³⁵ This argument of economically inefficient but politically consistent mode of redistribution has been formalized recently by Acemoglu and Robinson (2001).

As is suggested by the above discussion, a crucial issue to be considered to make an open trade regime politically viable in the long run, is really how to ensure that losers get adequately compensated after the change of policy. In other words, under which circumstances can we be sure that an open trade regime with compensation is likely to be a politically sustainable? Which kind of mechanism can make gainers commit to redistribute the gains to the losers (absolute and relative) under the constraint that the losers do not prevent economic restructuring associated with trade integration? Is this possible?

Boix (2002) presents an instructive discussion of a set of historical examples to uncover the circumstances under which a free trade regime with compensation may emerge. He contrasts the trade policy regime adopted by the two self governing colonies of Victoria and New South Wales in the end of the XIX century (1890-1900) before the formation of the Australian Commonwealth. The two regions represent a kind of “laboratory” experiment in the sense that they did share similar structures in terms of population size, living conditions and economic structures, endowments and political institutions (both were parliamentary democracies with a two chamber parliament, the upper house representing the propertied interests, the lower house being elected through male universal suffrage). In New South Wales a free trade regime was supported by a coalition between free trade interests and the lower middle class and urban working class by which low tariffs were sustained in exchange for the introduction of land taxes, progressive income taxes and generous public expenditures. By contrast, in the Victoria region, protection was imposed by a coalition of the protectionist interests and labor in which workers supported high tariffs in exchange for wage legislations/regulations, ensuring that part of the gains of protection were directly passed to workers through high wages.

That a free-trade policy regime can emerge as a politically sustainable outcome when sufficient fiscal redistribution is imposed domestically is also illustrated by the case of Britain at the beginning of the XX century. The Liberal party won the 1906 elections with a vigorous position on state intervention, in order to defend Britain’s commitment to free trade. In particular, in response to the economic downturn of 1907-1908 and stagnant real wages creating protectionist popular pressures, the liberal government reacted by the creation of a old-age pension program, a raise in land taxes and the introduction in 1911 of trade boards establishing national insurance for sickness, invalidity and unemployment. This combination of free trade and broad compensation schemes actually pushed Conservatives on the protectionist side, even those who were initially opposed to tariff protection (Blewett. 1972).

In a similar vein, other authors (Cameron (1978), Katzenstein (1985), Baldwin (1990)) have also described how a trade openness strategy was possible in small open economies like Scandinavian countries when it was associated with fiscal redistribution and universalist compensatory policies.

An interesting aspect suggested by these historical examples is the importance of the nature of the instrument politically credible to redistribute income to workers. This appeared as a crucial determinant of the contrasting trade policy outcomes. When export interests had the capacity to organize a coalition based on domestic fiscal redistribution, an open trade regime was sustainable. When income redistribution to workers

was obtained by manipulations of factor prices linking the level of wages to domestic commodities' prices, that forged a political alliance between labor and protectionist sectors.

What determines the political credibility of one type of redistribution rather than the other is not obviously clear from the examples discussed by Boix (2002). Certainly, idiosyncratic circumstances about the feasibility of particular political coalitions did matter. Building on our previous conceptual discussion of the redistribution of the gains from trade, these observations may still help us suggest some structural factors promoting one outcome rather than the other.

First, when the government in place has powerful enough fiscal instruments, the need for making redistribution through wages and prices is reduced. This is likely to promote the credibility of an open trade regime with compensation. The efficiency of the fiscal instruments in turn depends on two aspects. One obvious dimension is related to the elasticity of the tax base, this being determined by informational and mobility characteristics of the factors to be taxed. The second aspect relates to the political capacity of these factors to oppose redistribution through taxation. The less elastic and the less politically influent is the targeted tax base, the more likely a free trade and compensation regime.

Second, engineering a political commitment for trade gainers to compensate losers is facilitated by the existence of political institutions able to sustain credible intertemporal political deals. As mentioned by various political scientists (Cameron, Katzenstein and others), a low degree of political fragmentation and the existence of centralized economic associations reflecting trade and labor interests promote the capacity for politicians to concoct such political arrangements.

Third, trade with compensation is also more politically sustainable, the broader the type of compensation proposed in the deal. First, in order to capture fully the gains from trade openness, it is important that compensation should not prevent the adjustment and reallocation of resources across sectors and regions. Compensation therefore should be made on dimensions which facilitates (or at least appear as neutral) to this process of adjustment. Second, public expenditures and redistribution on broader areas like education, health and social insurance help exploit the potential for multidimensional political tradeoffs. As they touch a broad set of individuals, rather than already identified minority losers, they are more difficult to reverse politically. Potential losers may accept the risks to be hurt by trade integration if they get in exchange other dimensions of compensation like insurance and social benefits. Trade interests and identified gainers may be less reluctant to pay for compensation when redistribution improves at the same time, their ex-post efficiency (like for example with training increasing the skill pool of workers they may need to employ) and promote social peace and a stable investment climate. In other words, redistribution giving to losers access to social assets complementary to the interests of the trade oriented sectors, is likely to facilitate a open trade regime with compensation in a politically credible way.

Fourth, it is worth noting that the virtue of economic transparency on redistributive instruments may, to some extent enter into conflict with the political credibility and sustainability of compensation mechanisms. This case is particularly acute when losers have veto power on the decision to open the economy to trade but are not politically decisive on decision-making for less distortive compensation schemes. Too much

transparency on the last instruments weakens the commitment capacity for compensation after openness, making the current losers reluctant to abandon their veto power on trade liberalization. A delicate trade-off may be faced under such circumstances.

VI. “Socially responsible” trade integration with compensation

In the preceding section, we discussed the economic and political feasibility constraints of an open trade regime with compensation. Consider now the normative perspective as described earlier on in the introduction. Trade integration is “socially responsible” if it is “pro-poor” in the sense that it helps those at the bottom (or nearly so) of the income distribution to maintain adequate levels of living of standard and economic security, provides real benefits and equal opportunities to an increasing number of people and reduces disparities impairing economic and social development. What are then the conditions promoting the emergence of a trade regime with compensation which is “socially responsible”? Figure 5 depicts in a very stylized way a two-by-two matrix useful to organize the discussion.

[Figure 5 about here]

The horizontal dimension shows the two basic economic outcomes where the poor wins or loses from trade liberalization (the “first round” distributive impacts of trade integration). The vertical dimension depicts whether the poor is able or not to affect politically the redistribution of the gains from trade (the “second round” distributive effects of trade integration). In other words, whether the poor is a politically decisive agent or not in the country.

Whether the poor wins or loses from trade liberalization depends obviously on several economic factors, some of which being directly related to the nature of trade and FID flows (inter- industry trade versus intra- industry trade, outsourcing and global production networks) and the structure of technologies and factor endowments of the country. Typically, STT results suggest that the poor are likely to win in low income countries having a comparative advantage in agriculture or unskilled labor intensive sectors. In developed economies, conversely we may rather expect poor unskilled workers to lose from trade integration.

It should be noted that the situation may also be more complex than this stylized dichotomy. First, some poor may be winners while other poor may be losers. For instance, in some poor and middle income economies, trade liberalization may help rural poor peasants, while other poor urban unskilled workers may lose. Second, the identity of who is a winner or who is a loser among the poor (or nearly so) may not be known ex ante and there can be significant uncertainty on the column in the matrix the poor gets located at after trade integration. As was mentioned before, multinationalization and global production sharing may be a source of increased individual uncertainty, affecting negatively the welfare of relatively poor unskilled workers.

Concerning the vertical dimension, whether or not the poor (or the relatively poor) is a politically decisive agent able to affect redistribution depends also on a host of factors (political institutions and coalitions, patterns and culture of political participation, information structure, rent seeking and access to political resources, organization of civil society...). Normally, one may expect the poor to express more voice in a democratic than in an authoritarian regime. Often though, the poor and the disadvantaged is unlikely to have real access to political power. A vibrant and well organized civil society may sometimes compensate for this. Access to information and transparency on policy outcomes may also be particularly important. Often, the reason why the poor are not politically influent is because they are ill informed or do not perceive exactly the consequences of policy measures and who really wins or loses. This may be particularly acute in the domain of trade policy often characterized by the lack of transparency.

The combination of the two dimensions expanded on figure 5 generates four stylized outcomes, reflecting different trade offs in terms of political feasibility and social responsibility of a trade regime.

A first regime in cell A depicts the “globalization dream” situation with no tradeoff between political feasibility and social responsibility: the poor win directly from trade liberalization and furthermore are politically decisive for redistribution. In that case, losers (rich or nearly so) need not be compensated to implement an open trade regime which by definition is also socially responsible. Given the current public complaints against globalization and trade liberalization, this outcome does not seem yet to be part of a general picture of the real world.

The second possible situation (in cell B) is one where the poor (or nearly so) tend to directly loose from trade liberalization and are politically decisive. In this situation, the final outcome is going crucially to depend on the economic and political “capacity “ to redistribute the gains from trade. Our previous section suggests two possible outcomes. If there are powerful enough redistributive instruments (ie. not distorting too much relative prices) and if openness does not destroy the political credibility of redistribution, then a “socially responsible trade integration with compensation” is likely to be the outcome. If however, non distortive redistributive instruments cannot be implemented and/or trade openness decreases significantly the political capacity of losers to be compensated, then those at the bottom of the income distribution will oppose trade liberalization. One is likely to get a restricted trade regime preventing bad redistributive outcomes to the disadvantaged. This outcome is called “social protectionism”.

The third possibility is cell C where the poor wins directly from trade openness but is not politically effective at influencing the domestic pattern of redistribution. In such a case conversely, the losers from trade liberalization are likely to be “fat cats”, a relatively privileged Elite enjoying economic and political rents from a trade restrictive regime.³⁶ Again, the outcome is going to depend on the capacity for compensation within the country. If the “fat cats” can capture part of the gains from trade through redistribution from the poor and further, that openness does not threaten their future political power, an open trade regime with

³⁶ This situation may happen for instance in a country enjoying a comparative advantage in agriculture. After trade liberalization, cash food prices might go up inside the country. If poor peasants sell these goods, they are better off, but urban elites and middle upper income workers may be affected negatively by this price shift.

compensation is possible. Clearly however, such an open trade regime with compensation may not be perceived as “socially responsible”, as it is accompanied by regressive transfers from the poor to the rich. It is a “Socially regressive trade integration with compensation” and social responsibility and political feasibility considerations get to some extent into conflict.³⁷ In the alternative case where compensation is not possible, the Elite will oppose trade liberalization and there is what we call “fat cat protectionism”.

The final possible outcome is the one described by cell D: the poor loose from trade integration and have no political power on redistribution. The likely outcome is trade liberalization with no compensation. This regime is clearly not socially responsible and can be described as the “ liberal order nightmare” of all those opposed to “wild“ globalization.

Two features should be mentioned about this sketchy framework First, as already noticed, the dichotomy between winners versus losers for the poor may be oversimplified. For a given pattern of trade liberalization, some poor might loose while other poor might win. Also there might be ex ante uncertainty about who at the bottom of the income distribution (for the same identifiable individual characteristics) is going to be a winner or a loser. From this, one needs to keep in mind that redistribution need not mean only pure ex-post compensation but also insurance schemes and adjustment facilitating mechanisms (training, education) transforming losers eventually into gainers .

Second, the two dimensions of the matrix (winners versus losers, politically decisive or not) have to be considered within a dynamic perspective, taking into account the impact of .trade openness and redistribution on economic growth and political change. Economic change (growth) and political evolution (institutional change, empowerment) may reduce or strengthen the capacity for compensation in a socially responsible way and implies additional inter-temporal economic and political tradeoffs.³⁸

A clear issue from a policy point of view, is how to move from a regime which is “social protectionism”, “Socially regressive trade integration”, “fat cat protectionism” or “liberal order nightmare” towards the “globalization dream “ regime or more realistically, to the “socially responsible trade integration” regime ? In other words, what can we do to promote a socially sensitive, credible and broad based pro-trade coalition and avoid political backlash against globalization?

³⁷ If the ex-post level of consumption of the poor after trade openness with regressive compensation is higher than before trade openness, one may still argue that the trade regime is socially responsible on that account. However, regressive compensation may also increase disparities inside the country which, in turn may impair economic and social development. Taking a more procedural point of view about social responsibility, one may also simply argue that regressive transfers in such conditions are morally questionable.

³⁸ For instance, trade openness with redistribution to the poor may imply in the short run a loss to the Elite but, may stimulate growth, which in turn can be beneficial to all in the economy. At the same time, this may imply a dynamic shift of power towards the poor. See Bourguignon and Verdier (2003) for a formal analysis of this in the case of openness and education.

From “Social Protectionism” towards “socially responsible trade integration”

Start first with “social protectionism”. Moving towards a “socially responsible open trade” regime involves improving the economic capacity and/or political credibility of the redistribution of the gains from trade. The discussion of section V suggests simple policy implications in that direction.

a) When opposition to openness comes from the public perception of insecurity and anxiety generated by trade integration in all its forms (trade, FDI, outsourcing), one should think not only to compensate identified losers but also to provide insurance mechanisms to people who view themselves as potential losers along various dimensions. This can shift the balance towards an open trade regime appearing as socially fair to a majority of people.³⁹

b) The mechanisms should be broad based in order to be difficult to reverse politically and to increase the set of dimensions on which mutually beneficial pro trade deals can be exploited.⁴⁰

c) Redistribution by a manipulation of relative factor prices and goods prices should be minimized. First, from an economic point of view, it is important that, in order to allow the gains from trade liberalization to be realized, compensation should not prevent trade adjustment and the associated reallocation of resources to proceed. Second, from a political economy perspective, avoiding the link between compensation and changes in producers prices, reduces the capacity for building up a protectionist coalition.

d) Asset-based redistribution or access to social assets delivered by the government is better than redistribution through transfers and income flows, in terms of political credibility. In the same spirit, the mechanism should also try to tie up the interests of some losers to those of the gainers from trade integration. Obvious examples include educational and training programmes and various types of public investments enhancing the productivity of unskilled workers, and thereby the profitability, of trade oriented sectors. These policies may also transform dynamically actual (and potential) poor unskilled losers into gainers.

Another more speculative avenue, but may still worth exploring, could be the distribution of shares from sectors typically gaining from trade liberalization (where the economy has a clear comparative advantage). The shares could be given to and administered by a public fund agency with an appropriate governance structure involving unions, employers’ associations and the state, with the purpose of being used to finance social benefits/training to displaced lower income workers. In this way, their interests could be made partly congruent to those of trade oriented sectors. This in turn might be a fair price to pay by these sectors to obtain support for an open trade regime with social stability.

e) Needless to say, a necessary condition (but by no means sufficient) for arrangements of this sort within a given country is the existence of strong enough political institutions of conflict management (Rodrik 1998) and encompassing social associations. For the emergence of credible inter-temporal political deals and

³⁹ The fact that people have intrinsic concerns about their relative positions in their reference group or about fairness, suggests that attention should also be given to the polarization of the gains from trade. This may necessitate compensation to lower income individuals who are relative losers rather than only absolute losers.

⁴⁰ A typical targeted compensation programme directly related to trade is the Trade Adjustment Programme in the United States and there is a widespread consensus that its results are mixed in terms of compensation and retraining (Kletzer 2003)

coalitions, pro-trade interests and potential gainers should be able to commit and internalize politically the return they get from investing into the human or social assets of present (or potential) poor losers. While such an institutional setting is likely to exist in developed democracies, already equipped with welfare state institutions, the question remains on how to design and develop such mechanisms when the institutional context is weak or polarized, as is often the case in some developing economies.

In such a context, a purely “within country” arrangement of the sort described above is unlikely to emerge. One possible (albeit partial) way to explore a solution to this problem is the use of foreign aid as a commitment device provided by an external institution. Consider for example the following situation of a country with weak political institutions and polarized social groups. Pro-trade and openness interests have no way to commit to broad based compensation schemes and cannot either implement a regime of free trade without compensation. What the external institution can do to help sustain a socially responsible “trade regime with compensation” in the local economy is to commit to give foreign aid to the country conditional on the two following conditions: 1) trade liberalization is implemented, 2) the transfer is used to finance a compensation system targeting a large enough base of poor (potential) losers. What that system does is effectively is to make foreign aid an asset to the poor losers in exchange for a support for trade openness. For the mechanism to work, two conditions need to be satisfied. First, the leverage of the external institution should be large enough to make sure that the deal is worth to the coalition of the (potential) losers. Second, the external institution should have a higher capacity of political commitment than local interests. The first condition depends on the amount of aid that the external institution is ready to give, its the monitoring capacity and the structure of the coalition necessary to sustain trade liberalization. The second condition depends on the institutional setting in which the external institution is operating and the willingness of developed economies having at their disposal the right institutions of commitment.⁴¹

Starting from “fat cat protectionism” or “Socially regressive trade liberalization”

The basic problem of these situations is the fact that those at the bottom of the income distribution do not influence the pattern of redistribution (fiscal and trade policy) in the country, though they would be net gainers from trade liberalization. Conceptually, the crucial issue therefore is to try to move them towards the “globalization dream” regime by giving them opportunities to get empowered.

a) In a democratic regime, the problem is often related to effective political participation and the information structure available to voters. Disadvantaged individuals may not perceive that they are actual net gainers and/or do not get well organized politically. Increasing transparency about policy outcomes may then transform the degree of political participation and shift the political equilibrium towards the disadvantaged and more generally towards those that loose from the current situation.

⁴¹ In this respect, for some poor developing economies, the Poverty Reduction Strategy Paper (PRSP) process could be framed as an available commitment instrument for a “trade with compensation” strategy by the country entering in such a process.

b) In non democratic regimes, a purely “within country” socially responsible arrangement is again unlikely to emerge. External intervention providing adequate compensation to the Elite in place may shift the outcome from “fat cat protectionism” towards a “socially regressive trade integration” outcome. The drawback of such intervention is that it is not socially responsible, at least in the short run. In the long run however, trade liberalization by providing additional resources, may trigger a force of political empowerment of the poor. Domestic growth (and in particular pro-poor growth) may have the same effects and may transform a zero-sum distributive problem between the Elite and the poor into a “win-win” situation dynamically. While international institutions should press for the implementation of pro-poor growth policies, depending on the degree of forward looking-ness of the Elite, a socially regressive compensation may be however the price to be paid to satisfy the domestic political feasibility constraints of the initial situation.

Starting from the “liberal order nightmare”

For the globalization skeptic, this last case seems to be the most difficult to get at a “socially responsible” open trade regime. It requires both empowering the poor and providing feasible and credible compensation or opportunities to them. For the globalization proponent, this may be only a short term difficulty. Indeed, as in the preceding case, growth may be viewed as the solution to the problem. Indeed, if trade liberalization favors growth and if growth trickles down to the poor, then in the medium-long run, the poor has access to more resources, and progressively gets transformed into a net economic and political gainer, moving the economy from cell D to eventually cell A. While a priori possible, this rosy scenario may take time to realize and provides cold comfort to someone who is currently socially and politically disenfranchised. Moreover, as the Elite also gets access to more resources and that power is a relative concept, there is no guarantee that the Elite is going to loose its initial political ability to influence the pattern of redistribution overtime.

a) In a democratic society in which formal mechanisms can be activated to provide a voice to the losing poor, the situation again may be improved by appealing to increased information and political participation, inducing eventually a shift from cell D to cell B⁴². Then, enlarging the set of policy options available for compensation, social insurance and the provision of social assets in the way described earlier may facilitate a move towards a “socially responsible” open trade regime.

b) In non democratic countries, the rosy growth dynamics (if any) need to be supplemented by external intervention. In a context in which the state apparatus is controlled by the local Elite, external policies generating gains and opportunities accruing directly to the poor should be promoted. Initiatives favoring direct access to markets for the poor and decentralized economic activities is important as the associated gains are more difficult to capture by the Elite. To the extent that the Elite can only appropriate part of these gains through internal redistribution, one may expect the poor to be economically better off and, eventually with the resulting resources, to become politically more effective. NGOs and the international community more generally, have also an important role to play to stimulate the emergence of a vibrant and

⁴² Note that the shift from cell D to cell B may also occur spontaneously in a democratic society if an increasing number of politically active individuals feel more and more insecure with respect to trade openness.

locally organized civil society able to reverse the pattern of political power and help the poor to claim a fair share of the gains from trade.

VII. Conclusion

As has been discussed in this paper, a large discrepancy exists between the optimistic view about trade flows of most mainstream economists and critics of globalization, who perceive the current international trade regime as generating an unfair distribution of the gains from trade and inducing a reduced capacity by national government to achieve their domestic distributive objectives. Even if one accept the fact that trade is likely to generate global gains, the distributive and redistributive dimensions of trade integration are to be seriously taken into account if one wants to ensure the political viability of the process. Simply looking at the growth induced by trade openness and the implied beneficial aspects for some part of the population (even a majority *ex post*) is not going to be enough to make trade acceptable to the eyes of critics of trade integration. One needs to think about a set of social compensatory arrangements that make the deal politically acceptable. This involves finding ways to create “pro-trade coalitions with sensible compensation”.

Clearly, the existence of welfare state institutions allowing multidimensional compensation schemes helps promote the conditions for such arrangements. The current questioning about the financing and long run sustainability of these institutions in rich or middle income democratic countries, however presents a salient trade-off with the capacity to sustain an open trade regime accepted by a large fraction of public society. Two considerations may be worth mentioning in this respect.

First, the *form* of support inside the welfare state may matter as much as the *size*. Policy support may have to be increasingly “worker-owned” – less and less attached to a worker’s current employer, industry, or community. Worker empowerment might entail mobility and educational objectives that are rewarded in an increasingly globalized world (e.g., job-search enhancement, portability of health and pension benefits, language and cultural training). “Opportunity nets” may be a more accurate conception of the redistributive policies to be implemented than simply “safety nets.”

Second, the political feasibility of a “socially responsible” open trade regime interacts with the policy context with respect to the two other economic dimensions of globalization: labor and capital mobility. For instance, policies affecting capital and skilled labor flows interact with the credibility of domestic redistributive mechanisms, by impacting on the domestic tax base. The impact can be positive or negative depending on the net inflows being positive or negative. Similarly, a liberal migration policy attracting poor foreign workers may be felt as undermining in the short run the generosity of rich countries’ welfare state systems. On the other hand, when fertility rates of these immigrants are above the national average, such policy may be useful to improve the long run fiscal sustainability of the system of social benefits. These observations suggest therefore that factor mobility regulatory policies may act as complements or substitutes

to the establishment of a “socially responsible” open trade regime and that their interactions are worth investigating in more details when thinking about these issues.

While this piece of work has been mainly concerned with trade related redistributive problems within countries, the issue of redistribution between countries is of course of paramount importance. A full discussion of this dimension is beyond the scope of the current paper but two quick points may be just emphasized.

First, with trade integration occurring at the regional level, one may also think about credible broad compensation or adjustment facilitating mechanisms engineered at that regional level. The typical example is the regional trade liberalization experience of the European Union (Sapir 2000). Beyond the redistributive capacities of national welfare states, the Treaty of Rome clearly recognized that the abolition between member states of obstacles to freedom of movement for goods, services and factors of production, should be accompanied by an adapted regional social policy. That included the establishment of a European Social Fund (ESF) designed to ease workers’ adaptation to economic changes. This mechanism, used regardless of whether the cause is trade liberalization or technological change, can be viewed as a broad element which has facilitated the political acceptability of (intra or extra EU) trade integration. Whether that experience can be reproduced in other contexts remains to be seen and worth exploring.

Second, in poor developing countries lacking strong social and political institutions, a necessary condition to enjoy the gains from trade rests on world market access in sectors where they have a comparative advantage. In this respect, the emergence of a “socially responsible open trade regime” in the rich countries is clearly crucial. Such a regime will prevent a political backlash against trade liberalization and will ensure market access to the developing countries. In order to grasp the full gains from trade that can be generated, these poor economies will need also to undertake some trade reforms. The political sustainability and “social responsibility” of these reforms however will crucially depend on the help of foreign aid and grants supplementing their own few resources. Hence, consistent with the view of the recent ILO report (ILO 2004), domestic social responsibility will need to be complemented for these countries by a sense of “global social responsibility” of the international trade and development regime.

Economists have been, for a long time fascinated by the provision of static and dynamic gains from trade because of the logic of *specialization according to comparative advantage*. They should perhaps now spend more time and effort investigating how to make the distribution and redistribution of these gains from trade socially acceptable to a majority of people. Trade integration needs to be socially responsible, or it takes the risk to be the political victim of its own economic success.

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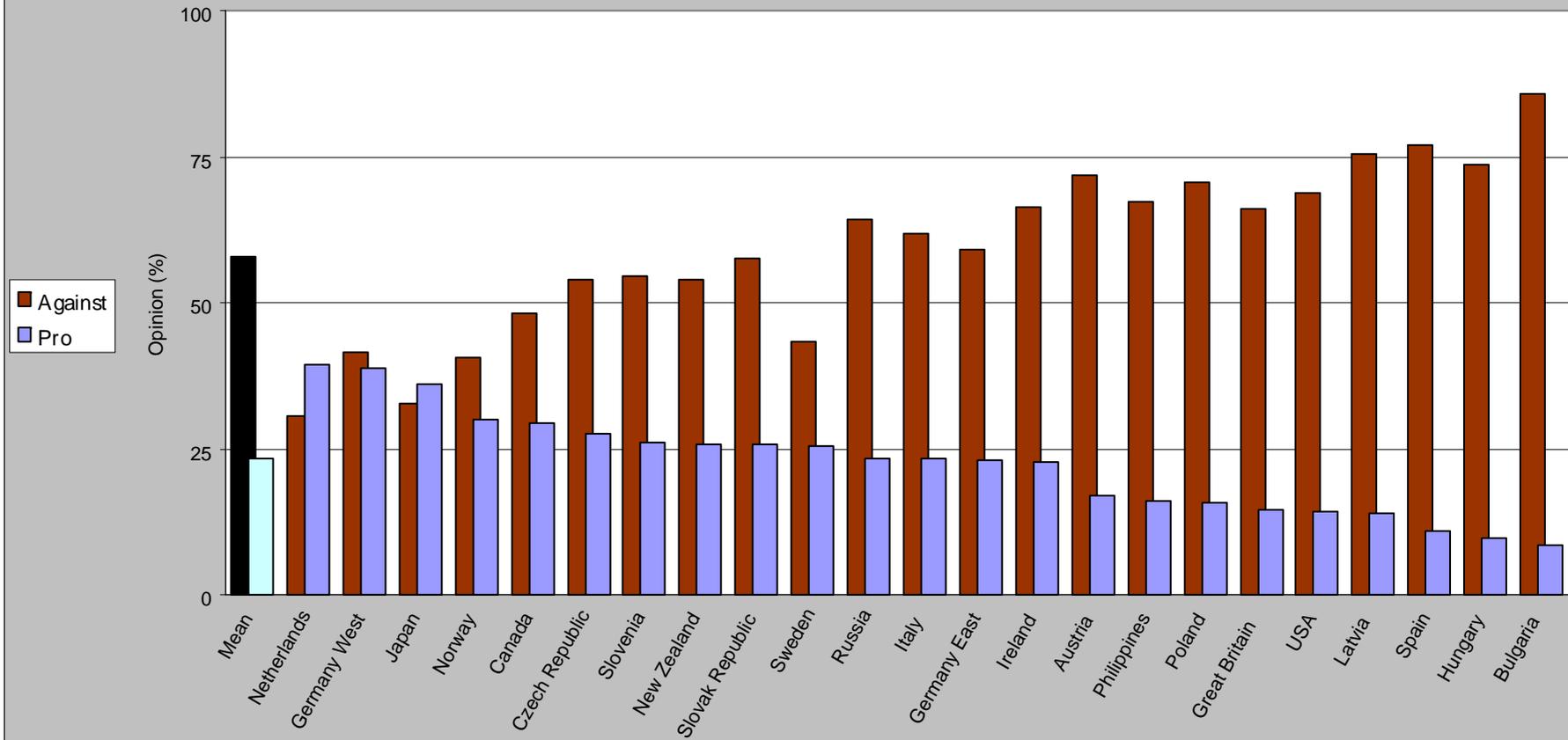
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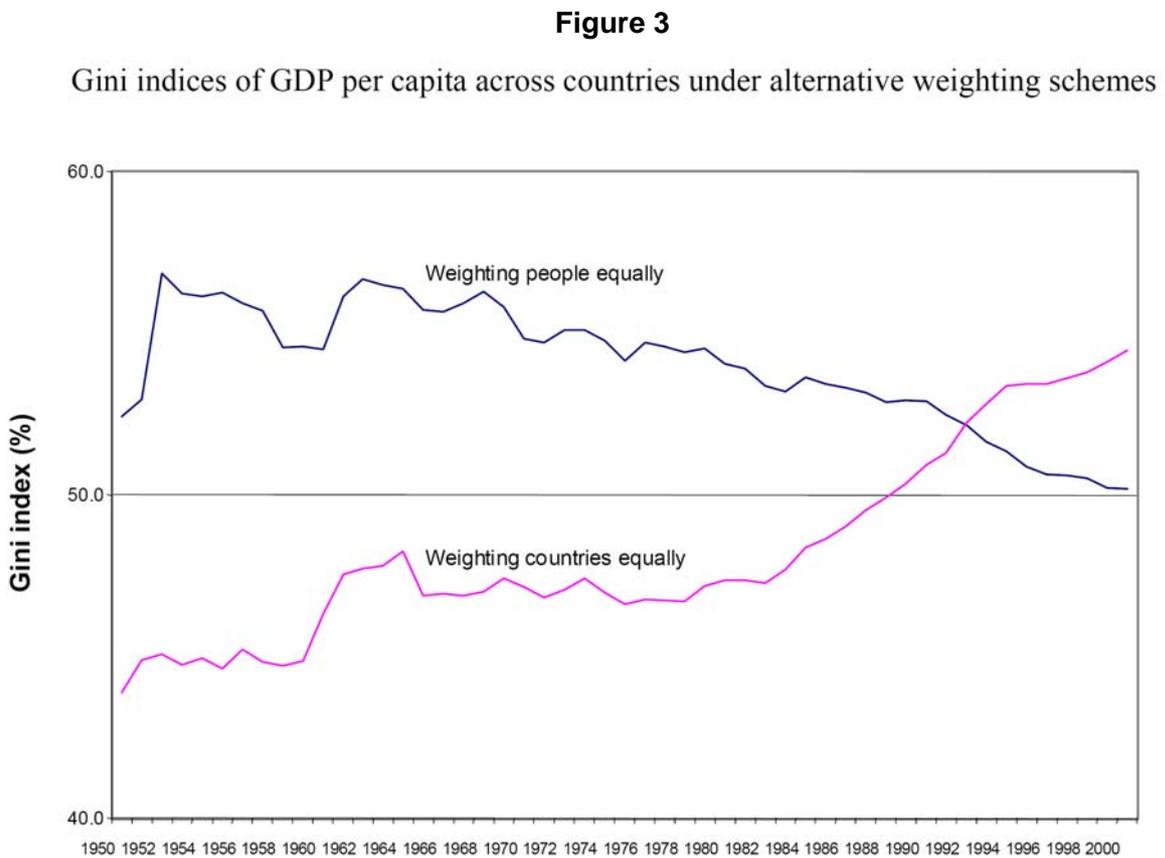
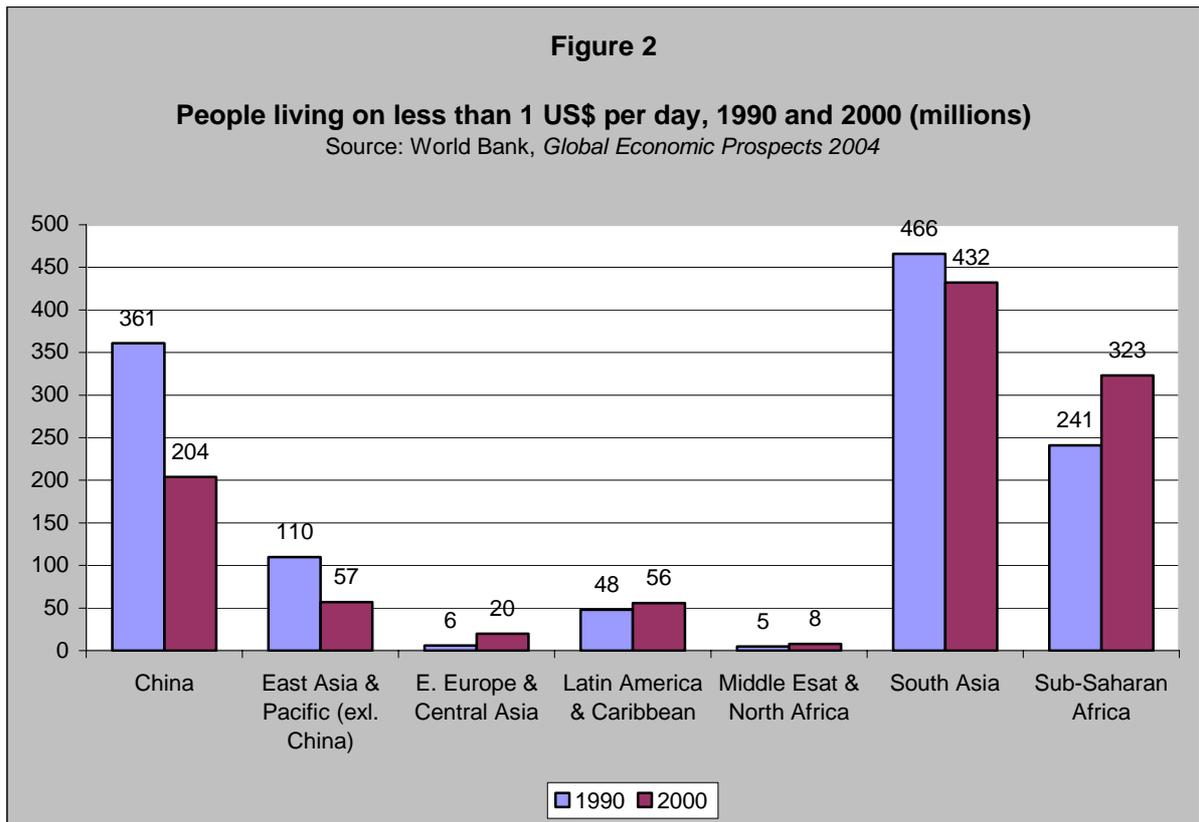
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Figure 1
Trade: Pro and Against



Source: data from 1995 ISSP National Identity, in Mayda & Rodrik (2002)



Source: Milanovic (2004), cited in Ravallion (2004)

Figure 4

Income inequality in 73 countries, 1960s to 1990s

Source: Cornia & Kiiski, 2001

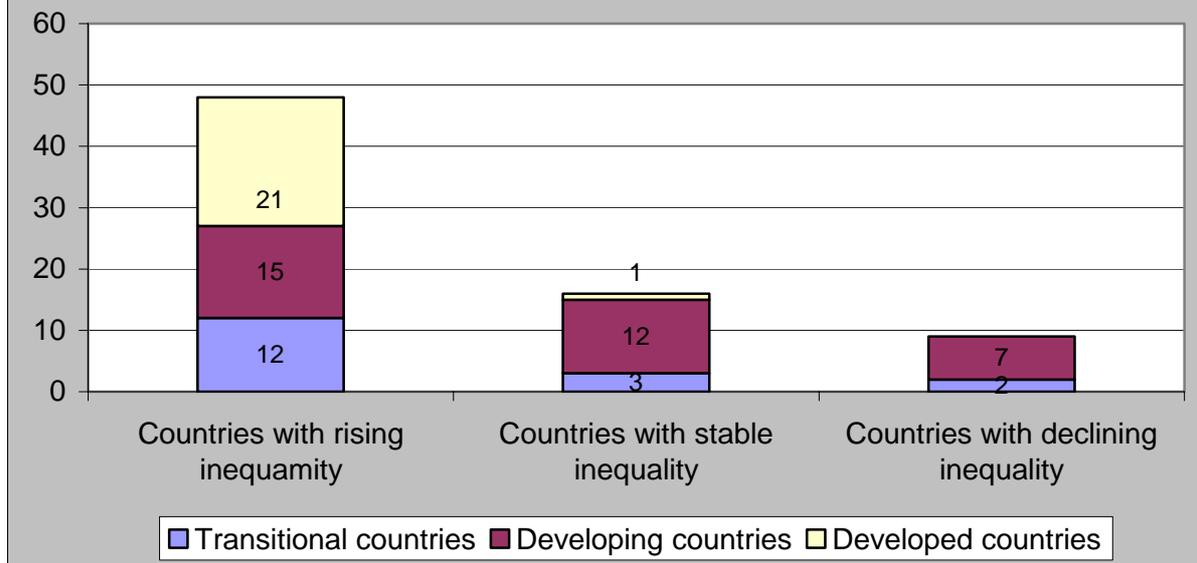


Figure 5

Political Feasibility and Social Responsibility of a trade regime

The Poor	Winner of trade liberalization	Loser of trade liberalization
Politically Decisive	<p style="text-align: center;">A</p> <p style="text-align: center;">“ Globalization Dream “</p>	<p style="text-align: center;">B</p> <ul style="list-style-type: none"> • “Socially Responsible” Open Trade Regime • “Social Protectionism”
Not Politically Decisive	<p style="text-align: center;">C</p> <ul style="list-style-type: none"> • “Socially Regressive “ Open Trade Regime • « Fat Cat » Protectionism 	<p style="text-align: center;">D</p> <p style="text-align: center;">“ Liberal Order Nighmare “</p>