# "Socially Responsible" Trade Integration: A Political Economy Perspective

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*Most economists believe that the liberalization of international trade produces significant gains. Public opinion is much less optimistic, concerned that the current division of the gains from trade is unfair, unevenly distributed both across and within countries. To understand the position of globalization skeptics and respond to their complaints, economists and policymakers need to move beyond the fact that trade produces static and dynamic gains. They need to pay more attention to the "pains from trade," the distributive dimensions of trade integration, and the interactions between trade openness and domestic redistributive policies. After briefly reviewing what is known about the distributive impacts of trade openness, this paper examines 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 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 implementing such a regime.*

There is enough in the world for everybody's need, but there cannot be enough for everybody's greed.

—Mahatma Gandhi

When asked by a physicist colleague to provide a proposition in economics that is both true and not trivial, Nobel laureate Paul Samuelson cited the fact that gains accrue from specialization based on comparative advantage. This idea is at the heart of one of the few ideas on which most mainstream economists agree, namely, that of trade between nations is desirable. Economic theory posits that 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, generating a higher level of output, larger productivity gains, and more rapid economic growth. These gains from trade are then expected to contribute to social welfare, general development, and poverty reduction.

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While openness brings gains from trade, it also brings "pains from trade" (the term is borrowed from Sapir 2000): trade liberalization inevitably creates winners and losers within nations. The strong presumption, however, is that losers can be compensated through the use of appropriate redistributive mechanisms (lump-sum transfers) and that trade-related efficiency considerations can therefore be analyzed separately from their associated direct distributive implications. It is 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), briefly mentioning in a last paragraph 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 how little this consensus in mainstream economics resonates with the public. To get a sense of what the man in the street thinks about trade, Mayda and Rodrik (2002) analyzed data from 28,456 respondents from 23 countries collected by the International Social Survey Programme. The question asked was "How much do you agree or disagree with the following statement? [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."

In most countries more than half of respondents agreed with the proposition that trade should be restricted, while less than 25 percent disagreed (figure 1). While survey responses are highly sensitive to framing, ample evidence from the United States suggests that the phrasing of the question on imports does not greatly affect the responses provided (Scheve and Slaughter 2001b).

These opinions are consistent with some of the views articulated in the past decades by various segments of civil society, which believe that the current sharing of the gains from trade is "unfair," unevenly distributed across and within countries. For a recent report published by the International Labour Organization, *A Fair Globalization: Creating Opportunities for All* (2004), the World Commission on the Social Dimension of Globalization launched a wide-ranging program of dialogues and consultations at the global, national, and regional levels. These consultations canvassed more than 2000 decisionmakers 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, or fair outcomes. While most people tended to favor more openness and interconnections between societies, they were much less positive about the impact on their jobs and incomes. Many cited 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 increasingly

intruding into the functioning of domestic political institutions and domestic policies and generating outcomes biased in favor of the rich and powerful.

The gap between the views expounded by mainstream economists and those expressed by public opinion is worrisome. It indicates the potential for political backlash in many countries, threatening the dynamics of worldwide trade integration. In the long term, the effects could be detrimental for developing countries.

In a celebrated paper, "Crises and the Poor: 'Socially Responsible' Macroeconomics," Nora Lustig (2000) discusses the effects of macroeconomic crises on poverty and inequality in Latin America. She argues that policymakers need to be concerned not just with macroeconomic stabilization but also with the distributive impacts of macroeconomic adjustment, creating adequate safety nets and fiscal instruments to protect the incomes of the poor during the process.

In a similar vein, this paper emphasizes 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) static and dynamic gains from trade to pay more attention to the "pains from trade" and the distributive dimensions of trade integration.

Trade economists have been quick to acknowledge the distributive dimension of the gains and pains from trade. But the *redistribution* of the gains from trade and the interactions between trade openness and domestic redistributive and social policy have not received the attention they deserve.[1] These issues seem to be critical in understanding the concerns of public opinion about globalization.

Trade economists often tend to view the distributive impacts of trade policy separately from other redistributive tools in society. As both are ways to affect the distribution of resources across individuals, there is a priori no reason why they should be viewed independently from each other. Trade integration can be expected to affect the redistributive capacity of governments in several ways. From an economic perspective, it may change the structural parameters of the economy (typically elasticities of prices and the tax base), 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.

[1] Many trade economists take for granted the argument that the gains from trade are always large enough to compensate the losers. But the record suggests that in practice workers are not compensated adequately. The Trade Adjustment Assistance program in the United States, for example, implemented to help workers displaced by imports competition has not provided adequate compensation or enhanced workers' capacity to find new jobs (Kletzer 2003).

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 political feasibility of a particular trade regime with redistribution and compensation. Which kind of coalitions and circumstances tend to induce the emergence of a trade with compensation regime in which winners accept compensating losers in exchange for support for a liberal trade policy?

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

Consistent with Lustig (2001), ILO (2004), and Sen (2002), the normative perspective taken here is that trade integration with redistribution is "socially responsible" if it helps the people at the bottom of the income distribution maintain adequate levels of living standards and economic security, provides real benefits and equal opportunities to an increasing number of individuals, and reduces disparities that impair economic and social development. While ignoring many environmental, social, cultural, and political aspects of globalization, this definition seems to be a good starting point from which to identify normative elements that can be reasonably defined as "pro-poor" and "socially fair."[2]

From such a normative perspective, a set of questions comes to mind: What conditions promote the emergence of a "socially responsible" trade regime with compensation that is also politically feasible? What are the elements and tradeoffs of such deals? How can policy promote such conditions? This paper explores some of these dimensions, in the belief that it will stimulate more research in these areas and help provide responses to public demands for a more equitable sharing of the gains from trade in a way that is socially responsible, politically credible, and compatible with trade adjustment.

Consider the real disposable income of individual $i$ in a country. This income can 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 individual $i$, and $T(i)$ is the net transfer or benefit (positive or negative) received by individual $i$ after "fiscal redistribution" by the government. The $s(i)Y$ term reflects the "market" income of individual $i$ before any government intervention. It depends on a variety of elements,

[2] Many discussions of globalization turn on 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. Accordingly, the criteria defining social responsibility are restricted to an individual socioeconomic welfare perspective.

including 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 individual *i* through three channels. First, international trade changes *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. Second, by changing relative prices, factor returns, and employment, trade is also likely to affect the income of individual *i* by changing *s*(*i*), the market share of income. This is the "first-round" distributive impact of trade integration. Finally, trade openness may affect, *T*(*i*). This is the "second-round" distributive impact of trade, reflecting the net transfers individual *i* receives after the government's intervention.

To concentrate on the distributive and redistributive issues related to trade, take for granted the widely shared view in mainstream economics that international trade is a source of economic gains. This may not appear obvious or true in every instance. Indeed, a classical result from trade theory is that unilateral free trade is not an optimal trade regime for a country large enough to affect its terms of trade with the rest of the world. Moreover, in the presence of global or domestic market imperfections, second-best theory suggests that trade integration may not be completely efficient. Assuming that the gains from trade are positive, however, seems natural for at least two reasons. First, there is ample evidence that openness brings at least some aggregate gains and increases in average real income (see Irwin 2002) for a good nontechnical discussion of this issue). Second, this view seems to be the minimal one for starting a meaningful discussion about "socially responsible" trade liberalization , since if trade is perceived as productively inefficient, there is no point in discussing how to make it socially responsible.

The next two sections consider the first-round distributive impacts of trade integration. The first briefly reviews the conceptual tools economists use to analyze the distributive impacts of trade liberalization. The second summarizes what is known empirically about the distributive effects of trade openness. The consensus one can draw from the economic literature is that trade openness is thought to be socially benign: trade openness reduces reducing poverty (though not in every instance), and it is not systematically biased toward inequality.

The third section of the paper contrasts this view of mainstream with the pessimistic perspective of globalization critics. It examines the role of economic insecurity linked to global production and trade openness and the importance of fairness and perceptions of polarization in the distribution of the gains from trade.

The fourth section, the core of the paper, examines 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 large enough number of actual or potential losers.

Taking a normative perspective, the fifth section explores the conditions for the existence of a "socially responsible" trade integration regime with redistribution and discusses some of the tradeoffs the political feasibility constraints identified in the previous section require. The paper concludes that an important policy element for addressing the current opposition to trade integration and preventing a political backlash in civil society is promoting the development of commitment mechanisms and political institutions allowing the credibility and political sustainability of a social contract associating trade reforms with internal redistribution.

Two caveats about the paper are warranted. First, the discussion focuses mainly 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 made at the national level. This does not deny the policy relevance of redistribution or transfers between countries. On the contrary, for many poor developing economies, this issue is a very salient one. While the policy section tangentially touches on this topic, proper discussion of this dimension is beyond the scope of this paper and is best left to future work.

Second, globalization is a multifaceted phenomenon that affects various dimensions of social development. This paper considers trade integration in the restricted economic sense of a move toward further integration of international markets for goods and services; it does not address "deep integration," which involves international convergence and coordination of domestic social and regulatory policies. Given the strong complementarity between multinationalization, trade in intermediate inputs, and foreign direct investment, trade integration will include foreign direct investment flows and firm mobility but leave aside labor flows (except in the conclusion) and financial portfolio flows.

## The Distributive Impact of Trade Integration: Old and New Tools

Economists traditionally analyze the distributive consequences of international trade in two ways. The first approach, based on the so-called Samuelson-Stolper 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. It keeps factors of production sector specific and focuses on sector-specific distributive conflicts.

*The Samuelson-Stolper Theorem*

The Samuelson-Stolper Theorem 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 and reduces the real return to the factor (say, skilled labor) used less intensively in production of the good.[3] The distributive implications of the Samuelson-Stolper Theorem 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 labor–intensive good, while the South exports the unskilled labor–intensive commodity. With trade integration between the two regions, the relative price of the skilled labor–intensive commodity increases in the North and falls in the South. According to the Samuelson-Stolper Theorem, in the North skilled workers gain and unskilled workers lose, while the opposite occurs in the South. Wage inequality increases in the North and declines in the South.

How useful is the Samuelson-Stolper Theorem for understanding the distributive impacts of trade in an economy? First, the Samuelson-Stolper Theorem applies to the functional distribution of income, not the personal distribution of income. As the two are not necessarily identical, the Samuelson-Stolper Theorem results have to be viewed as only indicative of a channel through which trade flows influence income distribution within an economy. Second, like any theory, the Samuelson-Stolper Theorem and its associated framework (the Hecksher-Ohlin model of trade) is built on a set of specific assumptions (Winters 2000).[4] Some of its predictions are weakened (or even reversed) when one or more of these assumptions is relaxed.

[3] 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 skilled labor–intensive sector. Since the unskilled labor–intensive sector uses more unskilled labor per unit of skilled labor than the skilled labor–intensive sector releases, this reallocation process increases the demand for and relative price of unskilled labor. This change causes both industries to switch to less unskilled labor–intensive production methods, raising the marginal productivity of unskilled labor in both sectors. In competitive labor markets, where the wage equals marginal productivity, unskilled labor receives a higher wage for each good and therefore a higher real return regardless of consumption patterns. Similar reasoning shows that the real wage of skilled labor declines.

[4]The assumptions include the following: markets are perfectly competitive, factors are perfectly mobile across sectors in the economy, countries do not specialize in production after trade integration, goods are homogenous in the same industry, technologies are with constant returns to scale, there are no nontraded goods, and countries have access to the same exogenous technologies.

*The Specific Factor Model of Trade*

Trade analysts often question the assumption that factors of production are perfectly mobile across sectors. In the short run this is unlikely, and some factors may remain sector specific. In such a context, an increase in the price of a good is likely to increase the incentive to produce it. This, in turn, raises the real return of the factors specific to the production of the good (sector-specific skills, fixed capital, land). To the extent that production is expanding, this price movement is likely to affect the return to nonspecific and mobile factors that are complementary to the fixed factors (Jones 1979). The return to at least one factor rises, while the return to at least one other factor declines. 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 gain, while factors specific to contracting import-competing sectors lose.

*Implications of the Approaches to the Distributive Consequences of International Trade*

The two approaches (particularly the Samuelson-Stolper Theorem) generate four important implications:

- The distributive impacts on factor prices have to come from changes in commodity prices induced by international trade. The larger the change in commodity prices, the larger the impact on relative factor returns.
- 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.
- Within sectors there is a shift in production methods away from the factor of production that becomes relatively more expensive.[5]
- Samuelson-Stolper Theorem effects predict an asymmetric change in wage inequality in developed and developing countries.[6]

While useful, the Samuelson-Stolper Theorem and specific factor approaches tend to overlook three important dimensions of the current process of globalization. First, global production-sharing and production-matching have increased. This trend has been accompanied by increasing trade in

[5] In other words, if trade integration induces the wage of skilled workers to increase relative to the wage of unskilled workers in the North, both the import-competing and the export sectors should switch to less skilled labor–intensive production methods. The reverse should hold for the South

[6] This prediction may not be valid in more sophisticated versions of the Samuelson-Stolper Theorem with many countries and many goods (see Davis 1996) .

intermediate inputs and complementarity with foreign direct investment. Second, the distinction between trade and technology is somewhat blurred; trade and technological change may simply be two facets of increased global competition. Third, the reorganization of global production affects workers and firms not only through a shift in the relative demands for factors but also through a change in the elasticity of these demand functions. This has significant implications in the presence of noncompetitive rent-sharing between firms and workers.

Each of these dimensions appears to be relevant to the debate on the distributive impacts of trade in developed and developing countries. Accordingly, economists have supplemented the traditional Samuelson-Stolper Theorem approach with new conceptual tools that take these dimensions into account.

*Production sharing and fragmentation* In a series of influential papers, Feenstra and Hanson (1996a, 1996b, 1997) present an alternative framework. They suggest that trade flows combined with foreign direct investment could contribute significantly to the dynamics of income inequality. The starting point is the recognition that in the past few decades trade flows have increasingly involved trade in intermediate products, due to production-sharing and fragmentation across countries (Feenstra 1998; Arndt and Kierkowsky 2001; Hummels, Ishii, and Yi 2001). Rather than focusing on final goods industries of various skill intensities, Feenstra and Hanson (1996a, 1996b) therefore emphasize the role of intermediate activities with different factor intensities within each industry. These activities are modeled as intermediate inputs that are traded between countries and combined into a final commodity. In the North-South framework, the South produces and exports a range of inputs using unskilled labor relatively more intensively, while the North specializes in skilled labor–intensive inputs (research and development, marketing). Foreign direct investment that is complementary to the intermediate activities and flows from the North to the South induces a shift of the location 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, increasing both the wage premium and 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. [7, 8]

Consistent with the view of global production sharing and fragmentation, Kremer and Maskin (2003) propose a stylized framework of trade integration based on matching and joint production by workers across the world.[9] The North (rich) country is populated by highly skilled and skilled workers. The South (poor) country is populated by workers with intermediate skills and very low skills. Output is obtained by matching workers. 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 match only within their own country. Trade integration means that workers from different countries can work together in the same firm. This opens up 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, 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. The model is compatible with the trend of reduced global inequality and increased inequality within both rich and poor regions.

*The Blurred Distinction between Trade and Technology*

In order to explain the increase in the skill premium in the United States during the 1970s and 1980s, the so-called empirical literature on trade and wages has traditionally opposed a Samuelson-Stolper Theorem trade-based explanation to one based on technological change. Two main stylized facts induced several researchers 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) and suggested a different cause, among which biased technological change and computerization

[7] While unskilled workers lose relative 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.

[8] Trefler and Zhu (2003) consider a version of the Feenstra and Hanson (1996a) model without foreign direct investment but with technology catch-up by the South. They generate similar results (increased wage inequality in both regions).

[9] Tang and Wood (2000) provide a related model with three types of labor: unskilled workers, skilled workers, and high skilled (so-called "knowledge") workers. Production is based on cooperation between knowledge workers and other types of labor. Trade integration is associated with the declining 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.

seemed most likely. First, there was much more within-sector than between-sector labor reallocation in the United States 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 treats changes in technology as exogenous to international trade, Wood (1994, 1995, 1997) notes that the distinction between trade and technology can be blurred, as trade may well have been a driving force behind technology. 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 skilled labor–biased technologies embodied into better-quality capital goods or by "learning by exporting" (Robbins 1995).

A difficulty with this argument was the fact that it did not explain why trade-induced technological change needed to be skill biased. Recent work by, among others, Acemoglu (2002) and Thoenig and Verdier (2003) has reconsidered this issue, allowing the bias of technological change to be endogenous to the decisions made by economic agents.[10]

In Acemoglu (2002) two types of technologies can be discovered. Some are complementary to skilled labor, others are complementary to unskilled labor. Whether research and development (and consequently the direction of technical change) is directed toward one type of technology or the other depends on two effects, the price effect and the market size effect. Technologies producing more expensive goods will be upgraded faster; a larger potential market leads to more innovation. Within a North-South context in which innovations can be made only in the 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 toward skilled labor and trade induces skill-biased technical change.

Thoenig and Verdier (2003) investigate a different mechanism that also leads to trade-induced skill-biased technological change. The starting point is that protection of intellectual property rights 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 the threat of imitation and technological leapfrogging, firms increase the share of tacit knowledge and noncodified know-how embedded in their production process. They do so at the cost of a larger share of skilled labor

[10] See also Epifani and Ganica (2002), Xu (2001), and Yeaple (2003) for recent analytical work on the trade-induced technical change paradigm.

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 less imitable and endogenously more skill-intensive innovations.

The interaction between trade flows and technological change generates predictions that differ from the standard Samuelson-Stolper Theorem results. Wage inequality may increase in both skilled-labor rich and skilled-labor poor regions. Within sectors methods of production may shift toward skilled labor. Trade may have distributive impacts without significant changes in relative prices between skilled labor–intensive and unskilled labor–intensive goods, a feature noted in the empirical "trade and wage" literature.

*Own-Price Elasticity of Labor Demand and Rent-Sharing*

The last "nontraditional" channel through which trade flows may have distributive impacts on labor markets is the elasticity of labor demand (Rodrik 1998). The price elasticity of a firm's demand for labor is defined as the percentage decline in the quantity of labor demanded in response to a 1 percent increase in the price of labor. This elasticity consists of two parts. The first is the substitution effect—how much the firm substitutes away from labor toward other factors of production when wages rise. The second part is the scale effect—the extent to which labor demand changes as a result of changes in the level of output. When the wage rate increases, both effects tend to reduce the amount of labor demanded.

International trade, foreign direct investment, and outsourcing by multinationals are likely to make labor demands more elastic, through both substitution and scale effects. Consider first the substitution channel for a firm that is vertically integrated across several production stages. Trade integration gives the firm access to foreign factors of production directly (through foreign direct investment and outsourcing) and indirectly (through trade in intermediate inputs). When domestic wages increase, this new access expands possibilities for the firm to substitute away from domestic labor beyond just domestic nonlabor factors. Trade therefore raises the sensitivity of labor demands to domestic wages.

The scale effect channel works in a similar way. To the extent that trade integration makes market structures more competitive, an increase in wages (and thus the cost of production) translates into a larger decline in output and therefore a larger fall in demand for all factors, implying a rise in the elasticity of labor demand by a firm competing in that market. As Rodrik (1998) notes, three main implications can be derived about the distributive impact of trade on labor markets. First, higher elasticities shift the wage and employment incidence of nonwage labor costs (payroll taxes, labor standards) toward labor and away from firms. Second, higher elasticities increase the volatility

of wages or employment responses to exogenous shocks on labor demand. Third, to the extent that markets are not perfectly competitive and there is rent- sharing between workers and the firm, higher elasticities may shift the bargaining power over rent distribution from workers toward firms. The increased possibilities for outsourcing and foreign direct investment also affect the outside options of the firm at the expense of immobile workers, affecting the pattern of profit-sharing between the two groups.

## What Do We Know about the Distributive Impact of Trade Integration?

What do we know now about the distributive impact of trade integration across and within countries? How do the approaches described above help us understand any impacts that may occur? 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 recent years a growing literature has emerged on the evolution of income distribution and poverty in the world economy (Bhalla 2003; Sala-I-Martin 2002; Bourguignon and Morrisson 2003; Chen and Ravallion 2002). Much effort has gone into the collection and analysis of income distribution data (Deaton 2004). Still, the literature is characterized by contradicting claims and controversies. According to some observers, for example, the proportion of people living in extreme poverty in the developing world (that is, the number of people living below the $1 a day poverty line, as defined by the World Bank) has fallen sharply (Bhalla 2003; Sala-I-Martin 2002). Others suggest more modest improvements (Chen and Ravallion 2002); question the validity of international poverty measures (Reddy and Pogge 2002; Wade 2002); or claim that poverty has actually increased (International Forum on Globalization 2001).

Contradictory claims have also been made for the trend in global income inequality. Some (Galbraith 2002; Wade 2002) claim that inequality has increased; others claim that it has been falling (Bhalla 2003; Sala-I- Martin 2002), though not continuously.

Researchers have tried to identify the sources of the differences between the conflicting assessments (Aisbett 2003). The variety of concepts used to describe poverty and inequality measures (Ravallion 2003); the intrinsic difficulties in defining time-consistent and cross-country consistent measures of standard of living (Reddy and Pogges 2002; Wade 2002; Ravallion 2003); the different methodologies used to estimate the incomes of different groups within the same country (national accounts versus household-level survey data estimates (Bhalla 2003; Sala-I-Martin

2002; Deaton 2004; Ravaillon 2003)—all these features create scope for disagreement on the best assessment of the evolution of the global income distribution.

Taking these limitations into consideration, figures 2, 3, and 4 present a reasonable consensus. Global poverty declined in absolute and relative terms during the 1990s. (Bhalla 2003; Bourguignon and Morrisson 2002) (figure 2). The impact varies across continents, however.

The picture for global inequality is more ambiguous. Total inequality can be thought of as having two components: inequality between countries and inequality within countries. Controlling for population size (that is, weighting by population), there is evidence that between-country inequality has fallen (Schultz 1998; Bhalla 2003), due mainly to the strong performance of the two largest countries, China and India (figure 2). At the same time, inequality has risen within many countries, including China and India (Cornia and Kiiski 2001; Ravallion 2001; Milanovic 2003a). Putting the two components together, there is no convincing evidence that overall inequality has risen or has fallen in the past two decades.

On average there is no systematic relationship between changes in income and within-country inequality. Among growing economies, inequality tends to fall about as often as it rises (Ravallion 2001).

*Trade Integration and Its Distributive Impact*

How much of these trends in global income distribution is related to globalization and, more specifically, to international trade flows? This issue has been fiercely debated in academic and public circles. Skeptics consider the competition of international trade and foreign direct investment as a major source of the loss of jobs, wages, and income of the poor or are concerned about the unequalizing effects of trade integration on domestic economies. In contrast, many trade economists welcome trade flows as an important source of the gains that contribute to improving conditions for the vast majority of people in the world.

A popular way to assess the distributive impact of trade liberalization has been cross-country regression analyses, which relate levels of measured inequality or changes over time in measured inequality 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 with growth (Frankel and Romer 1999), the effect of trade integration is concluded to be the same across all income groups (in the sense that each decile's gain is proportional to its initial income) (Berg and Krueger 2003). Other panel data analyses 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 2003b).

Cross-country regressions on the trade-growth-poverty nexus have been heavily criticized (Rodriguez and Rodrik 2000; Baldwin 2003; Bhaghwati and Srinivasan 2002; Bardhan 2003; Ravallion 2003). Beyond the obvious concerns about cross-country comparability of data and methods on inequality measures (Aktinkson and Brandolini 2001) are questions about how to measure 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. And difficulties arise in teasing out the causality links running from genuine trade policy variables and growth performances at the cross-country level. More fundamentally, aggregate inequality or poverty measures may not change with trade liberalization, even though there are both losers and winners from trade integration at all income levels. A given change in trade policy may help some people escape poverty while forcing others into poverty, even though the aggregate poverty rate may not change significantly. Looking only at aggregate levels can thus conceal 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 microeconomic studies of specific channels through which trade integration can have distributive impacts.[11] Bhagwati and Srinivasan (2002) and Panagariya (2002) have argued that country case studies are more likely to reveal the effects of trade liberalization than cross-country econometric analyses. Country case studies provide useful information on particular experiences and provide a rich institutional description of the trade liberalization episode. They are, however, subject to limitations. First, there are many countries, many liberalizing cases, and many different contexts. Drawing general relationships based on one country or one 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. Ascribing causality through a case approach requires great care

[11]Two alternative methods widely used to analyse the distributive impacts of trade liberalization are Computable General Equilibrium models (CGE) and micro-macro syntheses. CGE models are based on disaggregated economywide 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 for analyzing the impact of trade liberalization on poverty.) Micro-macro syntheses involve general equilibrium analysis coupled with some form of postsimulation analysis based on household survey data (see Bourguignon and Spadaro 2004 for a recent introduction).

and contextual knowledge, some of which is difficult to formalize and therefore always subject to some degree of interpretation.[12]

What, then, do micro-studies teach us about the linkages between trade and inequality or poverty? Because labor earnings are a major component of income, not surprisingly much of the 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, which investigates the cause of rising wage inequality in the United States and related employment phenomena in other countries.[13] Although some methodological issues remain unresolved, researchers using a variety of approaches (product price-wages effects, factor content computations, cross-industry and time series analyses) have demonstrated that international trade accounts for no more than 20–30 percent of the rise in the wage premium in the United States (Feenstra and Hanson 1996a; Borgas, Freeman, and Katz 1997; Baldwin and Cain 2000). The bottom line, therefore, is that international trade explains a positive and significant but relatively small share of the increase in wage inequality or unemployment witnessed in developed countries in recent decades (Slaughter 1998; Dewatripont, Sapir, and Sekkat 1999). A caveat about this literature is that it has been framed mainly within the context of North-South trade. The findings therefore fail to take account of intraindustrial trade, intrafirm trade, and trade-related technological change, probably the most significant drivers of changes in distribution (Francois and Nelson 2000).

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 less clear. Rama (2003) provides a useful survey of the literature. First, there is evidence that wages tend to grow faster in economies that 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. The impact of foreign direct investment is highly positive even in the short run.

[12] The cases of China and the Republic of Korea illustrate how different analysts can draw different conclusions about the same countries. Proponents of trade liberalization attribute growth in these countries to the liberalization of their economies (see, for example, Panagariya 2002). Globalization skeptics have argued that these countries have been able to take advantage of the opportunities afforded by trade liberalization because of extensive or selective government intervention, both now and in the past (Wade 1990; Rodrik 1995a).

[13] In the United States the wage gap between college education and high school education increased by about 20 percent in the 1980s (Borjas and 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).

Second, the benefits from trade integration are not evenly distributed across workers. A variety of studies reveals an increase in the wage premium to skills, particularly in Latin America.[14] The increase in this wage gap seems to be associated with skilled-biased technological change triggered in part by increased foreign competition (that is, trade-induced technical change) (see Attanasios, Goldberg, and Pavnick 2003 for Columbia; Pavnick and others 2002 for Brazil; and Sanchez-Paramo and Schady 2003 for a comparative study of five Latin American countries). Overall, however, these effects cannot fully explain 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 for changes in domestic factor supply, Robbins (1995, 1996) finds that greater openness has lead to decreasing inequality between skilled and unskilled workers in most of the East Asian countries in his sample. In contrast, in the five Latin America countries studied, trade liberalization has been associated with increased wage inequality. Wood (1997) argues that the difference stems from the difference in timing between the two liberalization experiences: East Asian countries liberalized in the 1960s–1970s, whereas Latin American countries did so in the 1980–1990s. The entry of large low-income countries (like China) into world markets coinciding with Latin American liberalization could explain the difference of outcomes along conventional Samuelson-Stolper Theorem lines.

Finally, many micro-studies reveal that trade liberalization has far smaller effects on intersectoral reallocation than predicted by the conventional mechanism of the Samuelson-Stolper Theorem.[15] In a recent article that examines 25 trade liberalization experiences in developing countries using internationally comparable sectoral labor data, Seddon and Wacziarg (2003) conclude that trade liberalization has little sectoral reallocation across sectors, even at the three-digit level within manufacturing. Looking at the reallocation of labor from import-competing sectors to export-oriented sectors in China, India, Indonesia, Malaysia, the Philippines, and Taiwan (China) in the 1980s and 1990s, Ghose (2000) 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), to labor regulations, or to various adjustment processes by firms that can reduce margins or increase productivity rather than lay off workers (Currie and Harrison 1997). Erdem and Tybout (2003) confirm this pattern of adjustment to trade

[14] See Cragg and Epelbaum (1996), Revenga (1997), Harrison and Hanson (1999), and Feenstra and Hanson (1997) for Mexico; Beyer, Rojas, and Vergara (1999) for Chile; Goldberg and Pavnick (2003) and Attanasios, Goldberg, and Pavnick (2003) for Columbia; and Pavcnik and others (2002) for Brazil.

[15] See, for instance, Goldberg and Pavnick (2003) and Attanasios, Goldberg, and Pavnick (2003) for Colombia; Pavcnik and others (2002) for Brazil; and Levinsohn (1999) for Chile.

liberalization by firms through productivity gains, summarizing work that uses microenterprise or firm data to examine the effects of five trade-liberalizing experiences in developing countries (Brazil 1991–94, Chile 1973–79, Côte d'Ivoire 1985–87, India 1991, and Mexico 1984–89). Virtually all of the studies find productivity rises in import-competing sectors. These gains are attributed to exit by less efficient producers, investment by firms in capital and new technologies, and reduction of inefficiencies in their production process.

Significant effort has also been made to assess the impact of trade liberalization on the bottom of the income distribution, that is, the link between trade and poverty. McKay, Winters, and Kedir (2000) and Bannister and Thugge (2001) provide recent surveys of the literature, which shows that trade liberalization can affect poverty through many links. While there is a general presumption that trade reforms enhance the static and dynamic opportunities of the poor and have done so in a number of cases (China and India, for instance), the impact of trade integration on poverty is very country specific and depends on the initial local conditions before liberalization. While it is not possible to make a general statement about the effect of trade on poverty, a few observations can be made:

- Trade liberalization that promotes agriculture is more likely to reduce poverty.
- The existence of efficient distribution channels helps ensure that the poor receive the benefits of increased incentives and access to imported inputs.
- Access by the poor to assets (human and social capital) is critical to enable them to adopt effective supply responses.
- Safety nets are needed to shelter agents who may inevitably become losers and pushed into poverty after trade liberalization.

*What Can We Conclude about the Distributive Impact of Trade Integration?*

Although each approach has its own limitations, put together they point to the following set of statements about the effects of trade on poverty and inequality:

- Absolute global poverty has decreased, and the reduction is related to growth in some large poor countries. As there is a positive correlation between growth and trade openness, trade does not seem to be systematically biased against the poor, although the local impact of trade on poverty is very country specific.
- There is mixed evidence on the relationship between trade integration and within-country inequality. While North-South trade integration contributed a significant but small part of the increase in wage inequality in developed countries, the impact of trade liberalization in

developing countries is mixed and depends on the continent, the timing, and the pattern of specialization.

- The channels through which trade integration affects income distribution have less to do with the conventional Samuelson-Stolper Theorem 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, technology or technology catch-up, and increased internationalization of production and outsourcing.

## Perceptions and the Potential for a Political Backlash against Globalization

These conclusions lead many economists and policymakers to think of trade integration as a rather socially benign phenomenon. Some economists, such as Freeman (2003), go so far as to conclude that international trade flows are having such a small global impact on labor markets that one can wonder why there is so much ado about nothing.

These rather positive, or at least neutral, positions are at odds with the perceptions shared by demonstrators in the streets and critics of the process of globalization. As Mayda and Rodrik (2002), Scheve and Slaughter (2001a, 2001b), and O'Rourke and Snotty (2001) show, public opinion is generally more skeptical about the benign impact of trade flows than most trade economists are. Given the intensity of the debate (and demonstrations in the street), 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*

The way people in the street and civil society more generally conceive the distributive impact of trade flows is very different from the way economists tend to discuss the same distributive issues. Kanbur (2001) emphasizes four dimensions on which conceptions tend to vary: the level of aggregation, the time horizon, monetary versus multidimensional measures, and relative versus absolute measures.

Concerning the level of aggregation, the standard economic approach tends to consider measures at the global, national, or regional level, focusing on average effects. In contrast, critics of trade integration are more sensitive to individual and local trajectories. For instance, while economists might be content with a situation in which the total number of poor decreases, critics may not be satisfied if some of the poor are made poorer. As Aisbett (2003) argues, economists tend implicitly to assume a utilitarian social welfare function in which tradeoffs across individual destinies are

possible. The alternative approach may be viewed as applying some sort of Rawlsian social criterion by which the position of people who are already poor should be improved.

Implicit differences in time horizon also explain differences in perceptions. Economic analyses tend to take a medium-term perspective, in 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 would emphasize the immediate loss of income and adjustment costs of displaced workers due to more intense foreign competition. Related to the time horizon issue is concern about time irreversibility effects and the associated lack of capacity 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 is 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 such as health and education have to be integrated in policy assessments on poverty outcomes (Kanbur 2001). Other dimensions, such as empowerment, participation, and vulnerability to shocks, are also gaining acceptance as important aspects of poverty. These dimensions are harder to quantify, however, and despite the growing consensus about the appropriateness of using multidimensional poverty measures, they are not applied in empirical analyses of trade integration and poverty (Kanji and Barrientos 2002).

Finally, economists tend to favor relative measures, such as the incidence of poverty (the percentage of people considered poor in the population) or the use of Gini coefficients to describe income distribution. In contrast, critics tend to emphasize absolute measures of poverty or inequality (such as the total number of poor or absolute differences incomes). [16]

Differences in perceptions may be due to differences in emphasis in terms of what inequality or poverty means. Opposition to free trade may also reveal more fundamental cleavages in terms of the distribution of the gains and costs from trade.[17] Economists tend to overlook three issues in their

[16] Ravallion (2003) illustrates the case with a simple example. Consider two individuals, a rich one, with an endowment of $5, and a poor one, with an endowment of $1. Assume that both increase their incomes 100 percent increase as a result of trade liberalization. The postliberalization endowments are therefore $10 for the rich person and $2 for the poor one. As both gain in the same proportion, a relative inequality measure would remain invariant to the trade shock. But an absolute measure of inequality would show a 100 percent increase in income inequality, from $4 ($5 – $1) to $8 ($10 – $2). Critics of globalization focus on this increase.

[17] Critics of the current trade regime object not to international trade per se but rather to the current biases of the trade liberalization process between developed and developing countries (see, for example, the 2002 Oxfam report "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 in which they have a comparative advantage (agriculture, textiles and apparel,

analyses of the distributive impacts of trade integration. The first is the perceived feeling of insecurity and stress generated by trade liberalization. The second is the fact that people care about social status, relative income positions, and fairness in the distribution of income. The third is the fact that many concerns have to do with the domestic political economy feedbacks of trade liberalization and the implied consequences for redistribution by national governments.

*Insecurity, Anxiety, and Trade Integration*

The link between economic integration and worker insecurity fuels public opposition to policies aimed at liberalizing international trade and foreign direct investment flows. Indeed, beyond the impact of trade integration on average income levels, individuals care about market risks and the implied volatility for their income. Trade openness may increase the economic risk borne by economic agents in several ways. First, exposure to international trade may increase economic volatility in domestic prices (Rodrik 1997). Second, trade may induce increased specialization in productive activities away from optimal diversification. Trade integration may also increase the price elasticity of labor demand and render workers more vulnerable to other shocks in the economy. These effects may be felt by workers without any actual observed change in prices or trade flows.

The nature of trade may also affect perceptions about economic insecurity. It is generally thought that intraindustry trade flows based on economies of scale generate fewer distributive conflicts than interindustry trade flows based on differences in endowments. In the first case, both scarce and abundant factors tend to gain (Helpman and Krugman 1985), while the usual Samuelson-Stolper Theorem conclusions imply that scarce factors automatically lose. 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 intraindustry trade, there is also increased ex ante uncertainty about who bears 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 number of people who might be affected (even temporarily) by trade openness increases, which may increase feelings of insecurity.[18]

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labor-intensive manufacturing), or the system is viewed as imposing restrictions on vital technology and knowledge transfer that would help developing economies develop and grow. This position is consistent with mainstream trade theory and finds sympathy and consensus among academic economists (see, for instance, Bardhan 2003 and Deardoff 2003).

[18] This aspect is well illustrated by the reactions in industrial countries to the fast-growing cross-border trade in business and electronic services and the outsourcing of back office operations to low-wage exporting countries,

The empirical evidence on the impact of international trade flows on economic insecurity is mixed. Rodrik (1997) presents evidence that exposure to external risk from trade—as measured by the standard deviation of a country's terms of trade interacted with its degree of trade openness—is positively related to growth volatility. In contrast, Iversen and Cusack (2000) present evidence suggesting no correlation between trade openness and volatility in output or employment, at least in developed countries.

There is mild empirical evidence of a trade-increasing effect on the elasticity of labor demand (see Slaughter 2001 for the United States, Fajnzylber, Maloney, and Ribeiro 2001 for developing countries). Results on foreign direct investment and the globalization of production by multinational firms are stronger (Fabbri, Haskel, and Slaughter 2003). Consistent with this finding, Scheve and Slaughter (2003) present evidence, based on analysis of individual-level panel data from the United Kingdom for 1991–99 that foreign direct investment in the industries in which individuals work is positively correlated with individuals' perceptions of economic insecurity.

To understand how this dimension may create a discrepancy between public opinion and the views shared by many economists, it should be recognized that these vulnerability effects may have strong effects at the individual level without being detected at a more aggregate level. Aggregate inequality measures such as the Gini coefficient, which are static snapshots of countries' income distributions, mask a great deal of movement up and down the income ladder. Moreover, although micro-studies suggest that trade liberalization does not induce major labor reallocation effects across sectors, churning occurs across firms and plants within sectors (Seddon and Wacziarg 2003, Levinsohn 1999).

*Relative Losers and Fairness in the Distribution of the Gains of Trade*

It is well established that, beyond a certain level of absolute income, individuals' satisfaction is partly determined by how they compare themselves with others in their reference group and by concerns about fairness and reciprocity (Fehr and Schmidt 2000). As a result of this phenomenon, situations that would appear as "win-win" from the point of view of standard economic analysis may not appear so once individuals share a concern for their relative position and fairness in the distribution of the gains from trade (Aisbett 2003).

Indeed, the fact that the gains from trade are distributed unevenly may enter negatively into some people's preferences. Even if they receive something positive in absolute terms, individuals

such as China and India. Although the phenomenon is still quantitatively small, white collar workers who previously felt sheltered from external competition tend now to join their blue collar brethren in their fear of job outflows caused by globalization. Reflecting these fears, legislative action in the United States has been initiated to restrict outsourcing of services in government procurement markets (Mattoo and Wunsch 2004).

may be upset about receiving less than others. If they have a concern for social status and relative positions, they may suffer from the new situation if it occurs within their reference group. Graham (2001) argues that inequality in the distribution of the gains from 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 induces people to underestimate their own positive gains.[19]

When the gains are perceived as a windfall, a very 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 modeled by Fehr and Schmidt 2000). The distribution of the gains from trade may well be perceived as being very much independent of one's own efforts. Gaining from trade can be viewed as the result of having had the luck to be in the right (or wrong) sector, in the right (or wrong) firm, with the right or (wrong) timing when trade liberalization occurs. In this case, gains and costs will be considered largely as windfalls, to be shared equally among.[20]

### Trade Integration and the Redistribution of the Gains From Trade

Many concerns about trade integration are related to the capacity and 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 the 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 or regulations, although regulations may reflect legitimate national preferences (on cultural and social cohesion, the environment, health, ethical goods). This is reinforced by the feeling that international trading rules, imposed through the World Trade Organization (WTO), increasingly determine these policies. An often-cited variant of this position is the idea that trade and the international organization of production by multinationals generate outcomes that are naturally biased toward the interests of mobile economic factors (capital, skilled

[19]In Peru during a 10-year period of market reforms, 44 percent of respondents with the greatest upward mobility (gains in income of more than 30 percent) reported that they were worse off (Graham and Pettinato 2001). Most of these respondents were older urban people with average incomes. Poorer respondents tended to respond that their economic conditions were the same as they had been before reform, while middle class respondents were more likely to report that conditions had gotten worse.

[20] Critics of globalization are concerned 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 exemplified in the best-selling books *When Corporations Rule the World*, by David Korten, and *No Logo*, by Naomi Klein).

labor) and prevent governments from redistributing the gains in favor of immobile or less mobile factors (land and unskilled labor).

An important and key aspect stems 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 feed back on the nature of the domestic equilibrium of redistribution (Bardhan 2003) and to induce the implementation of policies further biased toward narrow political interests.

Political feedback effects need not be limited to redistribution within countries. When agents have multinational activities and can successfully pressure their own governments to obtain concessions from foreign governments, this induces further distributive consequences between countries. Deardoff (2003) and Aisbett (2003) present a good case of the influence of "big business" at the WTO in the design of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) or the North American Free Trade Agreement (NAFTA), with its notorious chapter 11, which gives foreign direct investors a private right of action against host country governments.

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 winners to losers can make everyone better off. Public opposition is fed by the fear that the relevant redistributive arrangements will not be realized and that trade integration is affecting the capacity 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? To explore these positive dimensions, this section starts with some conceptual considerations in the economic literature on the government's capacity to redistribution gains from trade in an economy open to international trade. It then turns to political economy feedbacks of trade integration and briefly reviews what is known about the relationship between trade integration and the political willingness and ability of governments to implement domestic redistribution. This discussion paves the way for the last part of the paper, which takes a more normative stance and considers the likelihood of adopting a "socially responsible" trade policy regime with compensation.

*Economic Feasibility: Why Is It Difficult to Redistribute the Gains from Trade?*

An obvious reason why it might be difficult to redistribute the gains from trade is the lack of resources to do so. Raising taxes requires a minimum fiscal infrastructure, and it involves administrative costs. Even with an efficient system and no corruption, these costs can be significant.

Some instruments may be less costly than others. A classic argument is that trade taxes are less costly to administer than other instruments, such as value-added or income taxes. For poor economies in which tariff revenues account for a sizable fraction of their fiscal revenues, trade liberalization may render redistribution and compensation difficult or impossible. The initial tariff structure may, however, be such that tariff revenues are not maximized. In such a case, a trade reform rationalizing the country's tariff structure may actually increase the size of the tax base, thereby increasing revenues available to the government (Ebrill, Stotsky, and Gropp 2002).

More fundamentally, the "technical" assumption underlying the idea that the gains from trade can be redistributed without causing problems within an economy is the existence of nondistortionary (lump-sum) transfers that can be freely used by governments to tax winners and compensate losers. In reality, there is no such thing as a lump-sum tax. Still, the consensus in the optimal taxation literature is that if the government has enough tax instruments to redistribute income across individuals, it is optimal to keep production efficient, implying that the government should not use tariffs, production subsidies, or taxes in a small open economy. In such a case there is complete separation between production efficiency (what trade economists are often most concerned with) and domestic redistribution.

Dixit and Norman (1980) were among the first to show that a free trade regime could be made superior to autarky for everyone 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. Diamond and Mirrlees (1971) show that for a government using commodity taxes and perfect contingent factor taxes, production efficiency is optimal, even when the government is concerned with optimal income redistribution. In a small open economy, the production efficiency result implies that domestic production prices have to be equal to international prices, precluding the use of trade taxes or restrictions.

The problem with the Dixit and Norman and Diamond and Mirrlees taxation schemes is 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, taxes contingent on factors require that the government implement different tax rates for 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, this kind of factor taxes would not be feasible.[21]

[21] A well-established literature in international trade theory 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 is that while trade instruments may improve welfare in some circumstances, they are

When weaker informational requirements are made on the corrective or redistributive instruments available to the government, it is difficult to separate production efficiency from redistributive and 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. Naito (1998), Guesnerie (1998), and Spector (2001) explore this issue more systematically.[22]

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 to unskilled workers. However, it lacks information on individual skills and makes redistribution based only on observable income levels. 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 it can. Therefore the optimal solution involves affecting factor prices and reducing the wage gap between skilled and unskilled workers (manipulating production prices). When the economy opens 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 longer possible for the government to affect domestic wages, and one of the two redistributive tools available in the closed economy context becomes ineffective. Two implications follow from this conclusion. First, if the government can distinguish domestic production prices from international prices through the use of a tariff, it will be welfare improving to do so (Naito 1998). Second, if international agreements or fear of capture by protectionist interests makes doing so impossible, the capacity to redistribute income domestically is limited. When the gains from trade are not large enough, the losers from free trade cannot be fully compensated, even if policymakers want to do so (Spector 2001; Guesnerie 1988).

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generally not the best instruments with which to correct for domestic distortions; trade instruments dominate. This literature does not explicitly take into account the informational constraints that can be imposed on the domestic instruments or their redistributive consequences in the economy

[22] See also Feenstra and Lewis (1991) and Feenstra, Lewis, and McMillan (1990) for a partial equilibrium discussion of the constraints that asymmetric information can impose on the capacity to redistribute the gains of trade between winners and losers.

While expressed in a very stylized 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 to separate the issue of internal redistribution from the issue of opening up the economy to trade flows.[23]

The idea that governments are impeded from redistributing domestic income after openness because factor prices are less sensitive to local interactions underlies the usual argument that openness tends to bias redistribution in favor of mobile agents and factors of production, 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 international market conditions. When domestic taxation is imposed on that factor, the adjustment process tends to occur by 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 must then bear the full burden of the tax-induced adjustment, and there is no capacity to redistribute income from the mobile factor toward the immobile ones. This effect underlies all of the literature on tax competition with capital mobility, foreign direct investment, and firm delocalizations.

*Political Feasibility I: The Political Economy Feedbacks of Trade Integration on Redistribution*

The preceding arguments help us 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 2002) and induce various types of political economy feedbacks, positively or negatively affecting the redistribution of resources inside the economy. [24]

A well-established tradition in political sciences studies how trade openness shapes the structure of the economy in a way that facilitates the formation of organizations and interests imposing high redistributive demands on the state (Cameron 1978; Katzenstein 1985). Cameron (1978) 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

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

[24]For formalizations of political economy feedbacks of trade integration on redistribution, see Bourguignon and Verdier (2003) and Przeworski and Meseguer Yebra (2002).

domestic markets and external competition, these countries specialize in a small number of sectors. The high domestic level of industrial concentration and the low level of fragmentation of the labor force facilitate the emergence of employers' associations and strong centralized labor unions. Two elements promote the implementation of intensive domestic redistribution through an expansion of the public sector: unions contribute to the formation of strong social democratic and labor parties pursuing an intensive redistributive agenda, and centralized wage bargaining at the national level leads to nationwide corporatists arrangements. These "social pacts" moderate wages to maintain external competitiveness in exchange for expansion of public expenditures in areas such as unemployment benefits, health, pensions, and education.

Katzenstein (1985) expands this view in his analysis of small corporatist European states by acknowledging that small open economies are at the mercy of external economic fluctuations. This, in turn, implies public demand for social insurance, which policymakers satisfy through extensive arrangements with unions and employers. Workers accept wage moderation and flexible procedures to allow for adaptations to fluctuations in the world demand, in exchange for which losers are compensated through generous unemployment coverage. The state also undertakes full-fledged public programs in education and physical capital formation 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 critics of globalization, trade integration may also trigger negative feedbacks on the domestic political equilibrium of redistribution.

One channel 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 that trade liberalization induces an increase in income inequality in a country. If the country is a perfect democracy, in which domestic redistribution is decided by majority voting, this increased inequality is likely to increase the social demand for redistribution among the lower-middle class. As these people are politically influential, their demands will be satisfied by political parties competing for votes.[25] If, however, political competition is far from perfect or political

[25] Formally, the politically determined level of income redistribution is the one desired by the median voter in a country (Metzler and Richards 1981), which is negatively related to the voter's position relative to the mean income. When trade integration leads to increased income inequality, it is likely that the relative position of the median agent deteriorates and that he or she therefore wants more redistribution.

outcomes are determined largely 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 would induce polarization 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 to regressive outcomes in domestic redistribution in countries with weak political governance structures.

What does the empirical evidence tell us about the redistributive impacts of trade integration? Several cross-country analyses have shown that higher levels of trade are systematically associated with a larger public sector, both for developed and developing countries. Cameron (1978), looking at OECD countries between 1960 and 1975, 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 empirical research by political scientists tends 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 for nondemocratic governments.

Cross-country analyses have their limitations, and their conclusions should be accepted with caution. In particular, the macroeconomic 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 for these aspects by employing measures of post–government disposable incomes [term clear?] and market incomes that have been calculated for OECD countries from household-level income surveys available in the 1980–90 Luxembourg Income Study. The advantage of the Luxembourg Income Study is that it provides information that is comparable across countries and provides comprehensive dimensions of sources of income at the household level. By comparing the Gini coefficient of the market income distribution to that of the income distribution after taxes and transfers, one can construct a country measure of direct fiscal redistribution. The evidence Mahler presents suggests that trade openness is negatively associated with his measure of fiscal redistribution, while the opposite holds for outbound foreign direct investment. These results thus offer only mixed support to the preceding cross-country analyses. Those analyses may be partly reconciled with the political science literature on small open corporatists countries by recognizing that part of the redistributive dimensions negotiated within

these economies may not be well captured by direct fiscal redistribution. In OECD countries, public education, active labor market policies, regulations, and the provision of public goods may also have important indirect distributive consequences, for example.

*Political Feasibility II: Trade with Compensation or Protectionism? That Is the Question*

In the literature discussed above, the level of trade exposure is considered exogenous to the political decisions of domestic actors. To understand the potential for a political backlash against trade integration and to draw some policy implications from such a potential, 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 Adserà and Boix (2001) note, 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. As both trade policy and fiscal policy are means of redistributing income across economic agents, it is important to adopt a framework in which both types of instruments can be jointly determined by the political process. Such a framework could then provide insights into when protectionism without other forms of compensation is likely to occur and when trade with compensation emerges as a political equilibrium.[26]

Several reasons have been suggested to explain the use of trade policy to redistribute income in a country rather than some other domestic instrument. One explanation 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 (such as those generated by competition for political influence) are taken into account.

Another set of reasons has to do with the existence of incomplete or asymmetric information. As the public finance literature shows, when the power of fiscal instruments to redistribute income is weak because of asymmetric information and poor incentives, 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 (such as a tariff or a rule of origin), even at the cost of economic efficiency, may help politicians disguise the fact that they are redistributing income to specific groups, something that voters might penalize if they knew (Coates and Morris 1995). Finally, when there 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).

[26] There is a vast literature on the political economy of trade policy, including several good surveys. See, for instance, Hillman (1989); Magee, Brock, and Young (1989); Rodrik (1995b); and Adserà and Boix (2001).

Adserà and Boix (2001) emphasize an important dimension that helps explain the emergence of protectionism instead of trade with fiscal compensation: the capacity for winners to fully compensate losers once the reform is done. Take, for instance, the case in which 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, their mobility, or both). If these winners can 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 made or is not credible, then the majority is likely to oppose resistance to trade openness.[27] An interesting implication of such reasoning is the fact that protectionism is less likely to occur in countries that have good political commitment technology, that is, strong parties and well-functioning institutions through which politicians can be bound by their promises.

The time inconsistency issue is also useful for explaining why losers prefer protectionist policies over trade liberalization with efficient income compensation. Once protection such as 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 obtain compensation by the government, may be viewed as a political commitment technology against the previously discussed problems of time inconsistency about compensation.[28]

A vivid example of this kind of situation in Europe is the policy of price support to farmers. For them, obtaining tariff protection and price support mechanisms is a much better way to receive compensation for 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 left indifferent in terms of economic welfare between the two options, they are more likely to prefer the first one. Given lump-sum compensation and retraining subsidies, farmers would leave their farms, get involved in other activities, and lose their size and identity as members of a particular sector. Their political base and capacity to organize politically would be eroded, as would their ability to sustain compensatory policies. Eventually, the government would be able to implement a free trade regime with no compensation at little political cost. Getting a tariff or a price support that allows the sector to endure is a much better way to ensure that compensation will be paid over time.

[27] This reasoning also holds when all winners are not identified ex ante but are still known to be a majority ex post (Fernandez and Rodrik 1991).

[28] Acemoglu and Robinson (2001) have formalized this argument of an economically inefficient but politically consistent mode of redistribution.

Critical to making an open trade regime politically viable in the long run is ensuring that losers are adequately compensated after the change of policy. Under what circumstances is an open trade regime with compensation likely to be politically sustainable? Which kind of mechanism can make winners 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 it possible to do so?

Boix (2002) examines an instructive 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 at the end of the nineteenth century (1890–1900), before the formation of the Australian Commonwealth. The two regions represent a kind of laboratory experiment in the sense that they shared similar population sizes, living conditions, economic structures, endowments, and political institutions (both were parliamentarian democracies with a two-chamber parliament, the upper house representing the propertied interests, the lower house elected through universal male suffrage). In New South Wales a free trade regime was supported by a coalition of free trade interests, the lower-middle class, and the urban working class. Under this regime tariffs were kept low in exchange for the introduction of land taxes, progressive income taxes, and generous public expenditures. In contrast, in Victoria protection was imposed by a coalition of protectionist interests and labor, in which workers supported high tariffs in exchange for wage legislation and regulations, ensuring that part of the gains of protection were passed directly 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 twentieth 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 response to the economic downturn of 1907–08 and stagnant real wages, which created popular pressure for protection, the Liberal government created an old-age pension program, raised land taxes, and introduced trade boards establishing national insurance for sickness, disability, and unemployment. This combination of free trade and broad compensation schemes pushed Conservatives, even those initially opposed to tariff protection, onto the protectionist side (Blewett 1972).

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

These historical examples suggest the importance of the political credibility of the instrument used to redistribute income to workers. 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 manipulating factor prices linking the level of wages to domestic commodities' prices, a political alliance was forged between labor and protectionist sectors.

What determines the political credibility of one type of redistribution rather than another is not obvious from the examples presented by Boix (2002). Certainly, idiosyncratic circumstances about the feasibility of particular political coalitions mattered. Building, however, on the previous conceptual discussion of the redistribution of the gains from trade, a number of structural factors promoting one outcome rather than another can be suggested.

First, when the government has powerful enough fiscal instruments, the need for 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 is related to the elasticity of the tax base, which is determined by informational and mobility characteristics of the factors to be taxed. The second relates to the political capacity of these factors to oppose redistribution through taxation. The less elastic and less politically influential is the targeted tax base, the more likely a free trade and compensation regime is.

Second, the existence of political institutions able to sustain credible intertemporal political deals facilitates a political commitment in which winners compensate losers. As Cameron (1978), Katzenstein (1985), and other political scientists have noted, a low degree of political fragmentation and the existence of centralized economic associations reflecting trade and labor interests promote the capacity of politicians to devise such political arrangements.

Third, the broader the type of compensation proposed in the deal, the more politically sustainable trade with compensation is. First, in order to fully capture the gains from trade openness, compensation should not prevent the adjustment and reallocation of resources across sectors and regions. Compensation should therefore be made on dimensions that facilitate (or at least appear as neutral to) this process of adjustment. Second, public expenditures and redistribution on broader areas, such as education, health, and social insurance, help exploit the potential for multidimensional political tradeoffs. As these programs affect a broad set of individuals, they are more difficult to reverse politically. Potential losers may accept the risks of being hurt by trade integration if in exchange they obtain other types of compensation, such as insurance and social benefits. Trade interests and identified winners may be less reluctant to pay for compensation when redistribution improves their ex post efficiency (an example would be training, which increases the skill pool of workers they may need to employ) and promotes social peace and a stable investment climate. In other words, redistribution that gives losers access to social assets that complement the interests of

the trade-oriented sectors is likely to facilitate an open trade regime with compensation in a politically credible way.

Fourth, the virtue of economic transparency on redistributive instruments may, to some extent, 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 influential about decisionmaking for less distortive compensation schemes. Too much transparency weakens the commitment capacity for compensation after openness, making the current losers reluctant to abandon their veto power on trade liberalization. A delicate tradeoff may be faced under such circumstances.

### "Socially Responsible" Trade Integration with Compensation

The preceding section examined the economic and political feasibility constraints of an open trade regime with compensation. This section considers the normative perspective, described 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 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 conditions promote the emergence of a trade regime with compensation that is socially responsible?

Figure 5 depicts, in a very stylized way, a two-by-two matrix that helps organize the discussion. The horizontal dimension shows the two basic economic outcomes for the poor as a result of trade liberalization (win or lose). These are the first-round distributive effects. The vertical dimension shows whether the poor are politically able to affect the redistribution of the gains from trade. These are the second-round distributive effects.

Whether the poor win or lose from trade liberalization depends on several economic factors, some of which are directly related to the nature of trade and foreign direct investment flows (interindustry trade versus intraindustry trade, outsourcing, global production networks) and the structure of technologies and factor endowments of the country. Samuelson-Stolper Theorem results usually suggest that the poor are likely to win in low-income countries having a comparative advantage in agriculture or unskilled labor–intensive sectors. Conversely, in developed economies poor unskilled workers are likely to lose from trade integration.

The situation is likely to be more complex than this stylized dichotomy suggests. First, some poor people may be winners while other poor may be losers (trade liberalization could help rural poor peasants, for example, while hurting poor urban unskilled workers). Second, whether poor

individuals win or lose may not be completely known ex ante. There is, then, significant uncertainty about how trade integration affects the poor. Multinationalization and global production sharing may be a source of increased individual uncertainty, negatively affecting the welfare of relatively poor unskilled workers, for example.

Whether or not the poor (or the relatively poor) are able to affect redistribution depends on a host of factors (political institutions and coalitions, patterns and culture of political participation, information structure, rent-seeking, access to political resources, the organization of civil society). Everything else equal, one would expect the poor to express more voice in a democratic society than in an authoritarian regime. Often, however, the poor and the disadvantaged lack access to political power. A vibrant and well-organized civil society may sometimes compensate for this lack of access. Access to information and transparency on policy outcomes may also be important. Often the poor are not politically influential because they are ill informed or do not perceive the exact consequences of policy measures. This may be particularly true in trade policy, which is often characterized by a lack of transparency.

The two dimensions on figure 5 generate four stylized outcomes, reflecting different tradeoffs in terms of political feasibility and social responsibility of a trade regime. Cell A depicts the "globalization dream" situation, in which there is no tradeoff between political feasibility and social responsibility: the poor win directly from trade liberalization and are politically influential about redistribution. In this case, losers (the 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 to reflect the real world today.

The second possible situation, cell B, is one in which the poor lose from trade liberalization but are politically influential. In this situation, the final outcome depends crucially on the economic and political capacity to redistribute the gains from trade. The previous section suggests two possible outcomes. If there are powerful enough redistributive instruments (that is, instruments that do not distort relative prices too much) and if openness does not destroy the political credibility of redistribution, the outcome is likely to be "socially responsible" trade integration with compensation. If, however, nondistortive redistributive instruments cannot be implemented or trade openness significantly decreases the political capacity of losers to be compensated, then those at the bottom of the income distribution will oppose trade liberalization. The result is likely to be a restricted trade regime that prevents redistributive outcomes that would hurt the poor. This outcome is called "social protectionism."

In the third possibility, cell C, the poor win directly from trade openness but are not politically effective at influencing the domestic pattern of redistribution. In this case the losers from trade liberalization are likely to be "fat cats," a privileged elite that enjoys economic and political rents from a trade restrictive regime.[29] The outcome depends 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 openness does not threaten their future political power, an open trade regime with compensation is possible. Such an open trade regime with compensation will not be perceived as "socially responsible," as it is accompanied by regressive transfers from the poor to the rich. In this "socially regressive trade integration with compensation," social responsibility and political feasibility considerations are to some extent in conflict.[30] In the alternative case, in which compensation is not possible, the elite will oppose trade liberalization, creating "fat cat protectionism."

In the fourth outcome, cell D, the poor lose from trade integration and have no political power over redistribution. The likely outcome here 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 framework First, the dichotomy between winners and losers may be oversimplified. For a given pattern of trade liberalization, some poor may lose while others win. There may also be ex ante uncertainty about who at the bottom of the income distribution (for the same identifiable individual characteristics) wins and who loses. Redistribution need not mean only pure ex post compensation; it can include insurance schemes and adjustment facilitating mechanisms (training, education) that eventually transform losers into winners.

Second, the two dimensions of the matrix have to be considered within a dynamic perspective that takes 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 weaken or strengthen the capacity for compensation in a "socially responsible" way and implies additional intertemporal economic and political tradeoffs.[31]

[29]Such a situation may occur in a country enjoying a comparative advantage in agriculture. After trade liberalization, domestic cash food prices might rise. If poor peasants sell these goods, they are better off, but urban elites and middle upper–income workers may be hurt by the price shift.

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

[31] Trade openness with redistribution to the poor may imply a loss to the elite in the short run but may stimulate growth, which can be beneficial to the economy as a whole. This change could imply a dynamic shift of power

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

*Moving from Social Protectionism to "Socially Responsible" Trade Integration*

Moving from social protectionism toward a "socially responsible" open trade regime involves improving the economic capacity or political credibility of the redistribution of the gains from trade. The discussion above suggests several simple policy implications:

- When opposition to openness comes from the public perception of insecurity and anxiety generated by trade integration in all its forms (trade, foreign direct investment, outsourcing), in addition to compensating identified losers, policymakers should provide insurance mechanisms to people who view themselves as potential losers. Doing so can shift the balance toward an open trade regime that appears socially fair to a majority of the people. [32]
- The mechanisms for compensation should be broad based in order to make political reversal difficult and increase the set of dimensions on which mutually beneficial pro trade deals can be exploited.[33]
- Manipulation of relative factor prices and goods prices should be minimized. From an economic point of view, for the gains from trade liberalization to be realized, compensation should not prevent trade adjustment and the associated reallocation of resources to proceed. From a political economy perspective, avoiding linking compensation and changes in producer prices reduces the capacity for forging a protectionist coalition.
- Asset-based redistribution or access to social assets delivered by the government is more credible politically than redistribution through transfers and income flows. In the same spirit, the mechanism should try to tie the interests of some losers to those of the winners from trade integration. Obvious examples include educational and training programs and various types of public investments that enhance the productivity of unskilled workers and thereby

toward the poor. See Bourguignon and Verdier (2003) for a formal analysis of this situation in the case of openness and education.

[32] 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 compensating lower-income individuals who are relative rather than absolute losers.

[33] A typical targeted compensation program directly related to trade is the Trade Adjustment Program in the United States. There is a consensus that its results are mixed in terms of compensation and retraining (Kletzer 2003).

the profitability of trade-oriented sectors. These policies may also transform actual (and potential) poor unskilled losers into winners.

- A more speculative avenue that but may be worth exploring is the distribution of shares of stock 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 agency with an appropriate governance structure involving unions, employers' associations, and the state and used to finance social benefits and training to displaced lower-income workers. In this way, their interests could be made partly congruent with those of trade-oriented sectors. This might be a fair price for these sectors to pay to obtain support for an open trade regime with social stability.

A necessary (but by no means sufficient) condition for arrangements of this sort to work is the existence of strong political institutions of conflict management (Rodrik 1998) and encompassing social associations. For the emergence of credible intertemporal political deals and coalitions, pro-trade interests and potential winners should be able to commit and internalize politically the return they get from investing in the human or social assets of present (or potential) poor losers. Such an institutional setting is likely to exist in developed democracies equipped with welfare state institutions. It is not clear how such mechanisms should be designed and developed when the institutional context is weak or polarized, as it often is in 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 to use foreign aid as a commitment device. Consider, for example, 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 they cannot implement a regime of free trade without compensation. To help sustain a "socially responsible" trade regime with compensation, the external institution can commit to provide foreign aid to the country conditional on its liberalizing trade and using the transfer to finance a compensation system targeting a large enough base of poor (potential) losers. Under this situation, foreign aid becomes an asset to the poor losers from trade liberalization that is provided in exchange for their support for trade openness.

For this mechanism to work, two conditions need to be satisfied. First, the leverage of the external institution must be great enough to ensure that the (potential) losers believe the deal is worth making. Second, the external institution should have greater capacity for political commitment than local interests. The first condition depends on the amount of aid the external institution is ready to provide, its monitoring capacity, and the structure of the local coalition necessary to sustain trade liberalization. The second condition depends on the institutional setting in

which the external institution is operating, the political willingness of the donors acting through that institution to create institutions of commitment.[34]

*Moving from Fat Cat Protectionism to «Socially Responsible »Trade Integration*

People at the bottom of the income distribution in a country do not influence the pattern of redistribution determined by fiscal and trade policy , although they would be net winners from trade liberalization. Conceptually, the crucial issue therefore is to try to move them toward the globalization dream regime by giving them opportunities to become empowered.

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 winners, or they may fail to get organized politically. Increasing transparency about policy outcomes may then transform the degree of political participation and shift the political equilibrium toward the disadvantaged and more generally toward those that lose from the current situation.

In nondemocratic regimes a "socially responsible" arrangement is unlikely to emerge without external help. External intervention providing adequate compensation to the elite in place may shift the outcome from fat cat protectionism toward 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, by providing additional resources, trade liberalization may trigger political empowerment of the poor. Domestic growth (particularly pro-poor growth) may have the same effect, transforming a zero-sum distributive problem between the elite and the poor into a "win-win" situation. While international institutions should press for the implementation of pro-poor growth policies, depending on how forward-looking the elite are, a socially regressive compensation may be the price to be paid to satisfy the domestic political feasibility constraints of the initial situation.

*Moving from the Liberal Order Nightmare to "Socially Responsible" Trade Integration*

For the globalization skeptic, this last scenario seems to be the most difficult from which to move to a "socially responsible" open trade regime. It requires both empowering the poor and providing them with feasible and credible compensation or opportunities. 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 to long run, the poor have access to more resources and are

[34] For some poor developing economies, the Poverty Reduction Strategy Paper (PRSP) process could be framed as a commitment instrument for a trade with compensation strategy.

progressively transformed into net economic and political winners, moving the economy from cell D to cell A. While this rosy scenario is possible, it may take time to realize and provides cold comfort to someone who is currently socially and politically disenfranchised. Moreover, as the elite also get access to more resources and power is a relative concept, there is no guarantee that the elite will lose its initial political ability to influence the pattern of redistribution overtime.

In a democratic society in which formal mechanisms can be activated to provide a voice to the losing poor, the situation may be improved by appealing to increased information and political participation, eventually inducing a shift from cell D to cell B.[35] In this case, enlarging the set of policy options available for compensation may facilitate a move toward a "socially responsible" open trade regime.

In nondemocratic countries these rosy growth dynamics (if they exist) need to be supplemented by external intervention. Where 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 are important, as the associated gains are more difficult for the elite to capture. To the extent that the elite can appropriate only part of these gains through internal redistribution, the poor could be expected to be economically better off and eventually, with the resulting resources, politically more effective. NGOs and the international community have an important role to play in stimulating the emergence of a vibrant and locally organized civil society able to reverse the pattern of political power and help the poor claim a fair share of the gains from trade.

## Conclusion

A large discrepancy exists between the optimistic view of trade flows held by most mainstream economists and the views of critics of globalization, who perceive the current international trade regime as generating an unfair distribution of gains and reducing the capacity of national governments to achieve their domestic distributive objectives. Even if one accepts that trade is likely to generate global gains, the distributive and redistributive dimensions of trade integration need to be taken into account if the political viability of the process is to be ensured. 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) will not be enough to make trade acceptable to critics of trade integration. One needs to think about a set of social compensatory arrangements that make the deal politically

[35] The shift from cell D to cell B may occur spontaneously in a democratic society if an increasing number of politically active individuals feel less and less secure in the face of trade openness.

acceptable. Doing so involves finding ways to create pro-trade coalitions with sensible compensation.

The existence of welfare state institutions allowing multidimensional compensation schemes helps promote the conditions for openness with compensation. Current questioning about the long-run fiscal sustainability of the welfare state in rich and middle-income democratic countries imposes, however, a limit on the capacity to sustain an open trade regime that is socially acceptable to a large fraction of public society. Two considerations are worth mentioning in this respect.

First, the form of support inside the welfare state may matter as much as its 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 could entail mobility and educational objectives that are rewarded in an increasingly globalized world (enhanced job search mechanisms, portability of health and pension benefits, and language and cultural training, for example). *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 through their effect on the domestic tax base. The impact can be positive or negative, depending on the sign of the net inflows. Similarly, a liberal migration policy that attracts poor foreign workers may be perceived as undermining the generosity of rich countries' welfare state systems in the short run. When immigrants' fertility rates of are above the national average, however, such a policy may improve the long-run fiscal sustainability of the system of social benefits. These observations suggest that regulatory policies on factor mobility 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 detail when thinking about these issues.

This paper has been concerned mainly 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 this paper, but two quick points should be mentioned.

First, with trade integration occurring at the regional level, credible broad compensation or adjustment facilitating mechanisms can be engineered at that regional level. An example is the European Union (Sapir 2000). Beyond the redistributive capacities of national welfare states, the Treaty of Rome clearly recognized that the abolition of obstacles to freedom of movement for goods, services, and factors of production should be accompanied by a regional social policy. That

policy included the establishment of a European Social Fund, designed to ease workers' adaptation to economic changes. This mechanism, used regardless of whether the cause of dislocation is trade liberalization or technological change, can be viewed as a broad element that has facilitated the political acceptability of trade integration within and outside the European Union. Whether that experience can be reproduced in other contexts is 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 in which 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 prevents a political backlash against trade liberalization and ensures market access by developing countries. In order to obtain the full gains from trade, these poor economies also need to undertake some trade reforms. The political sustainability and social responsibility of these reforms, however, will depend crucially on foreign aid and grants supplementing these country's own meager resources. Hence consistent with the view of the recent International Labour Organization report (2004), domestic social responsibility will need to be complemented for these countries by a sense of global social responsibility.

For a long time economists have focused on the static and dynamic gains from trade because of the logic of specialization according to comparative advantage. They should perhaps 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. If trade integration is not socially responsible, it runs the risk of becoming the political victim of its own economic success.

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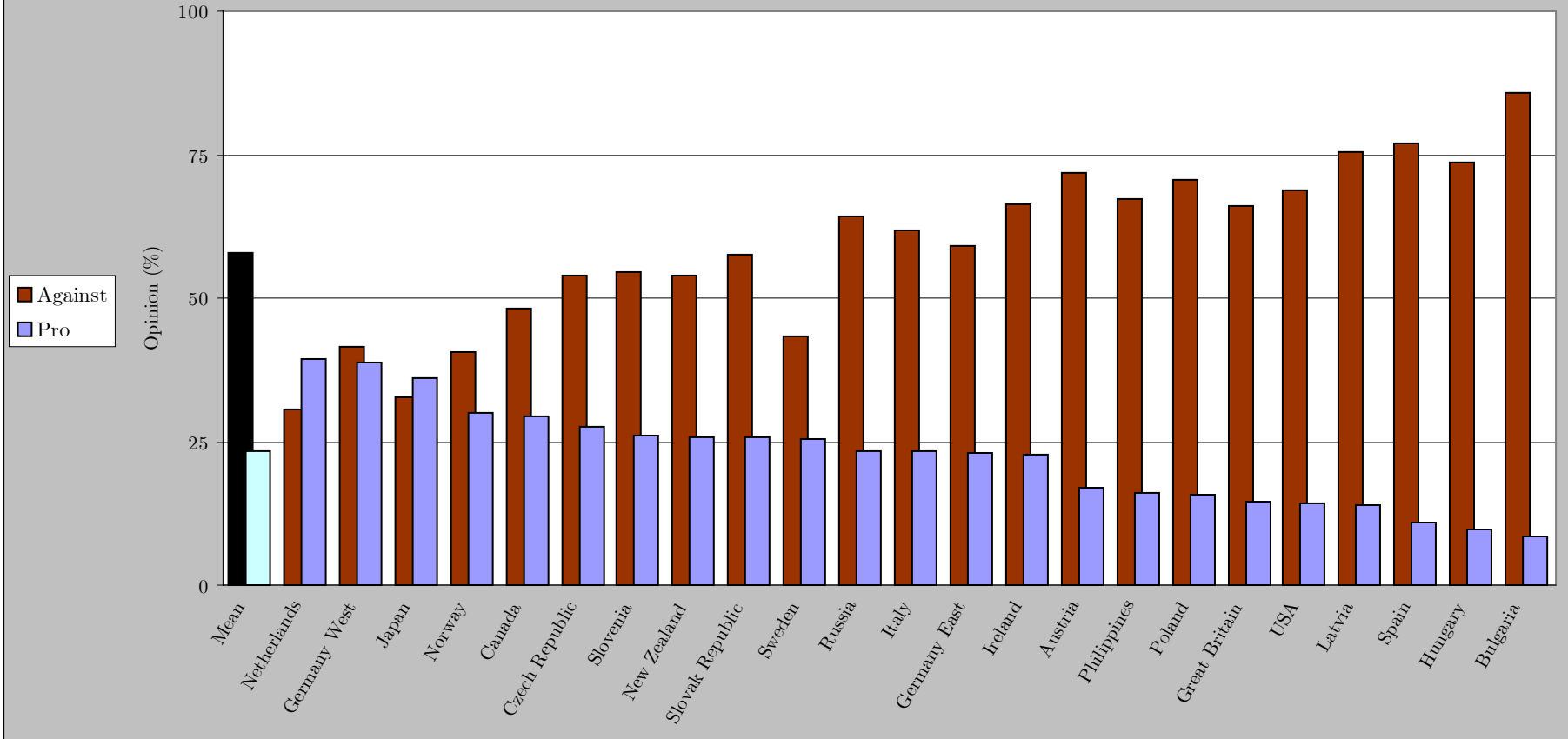
**Figure 1**

**Trade: Pro and Against**




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

**Figure 2**

**People living on less than 1 US$ per day, 1990 and 2000 (millions)**

Source: World Bank, *Global Economic Prospects 2004*

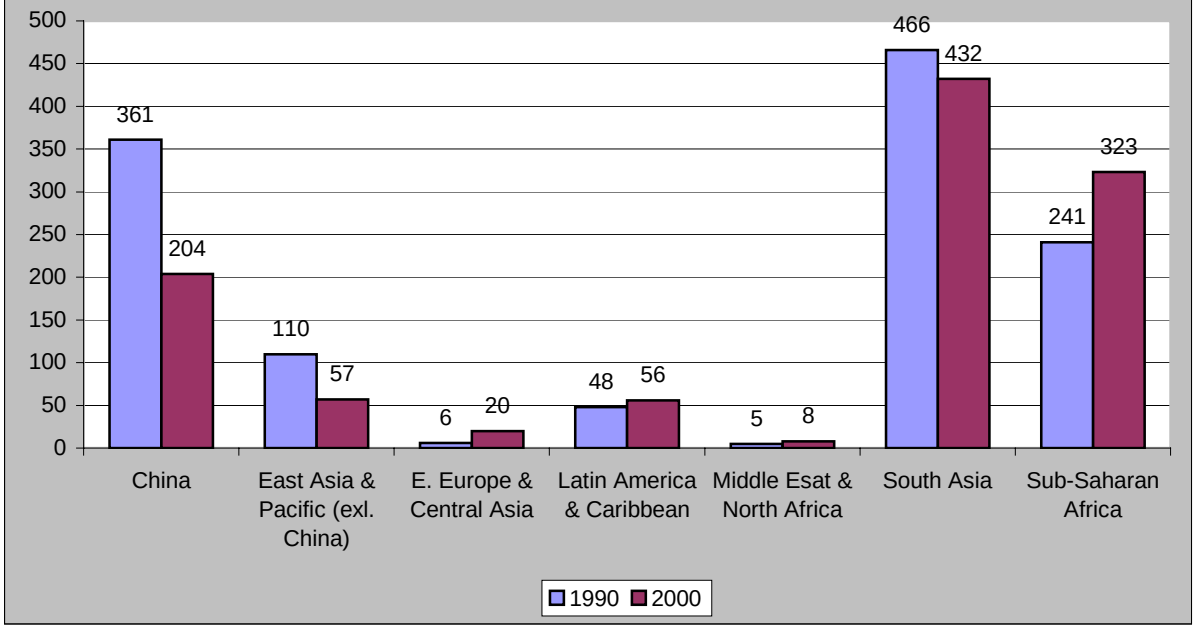
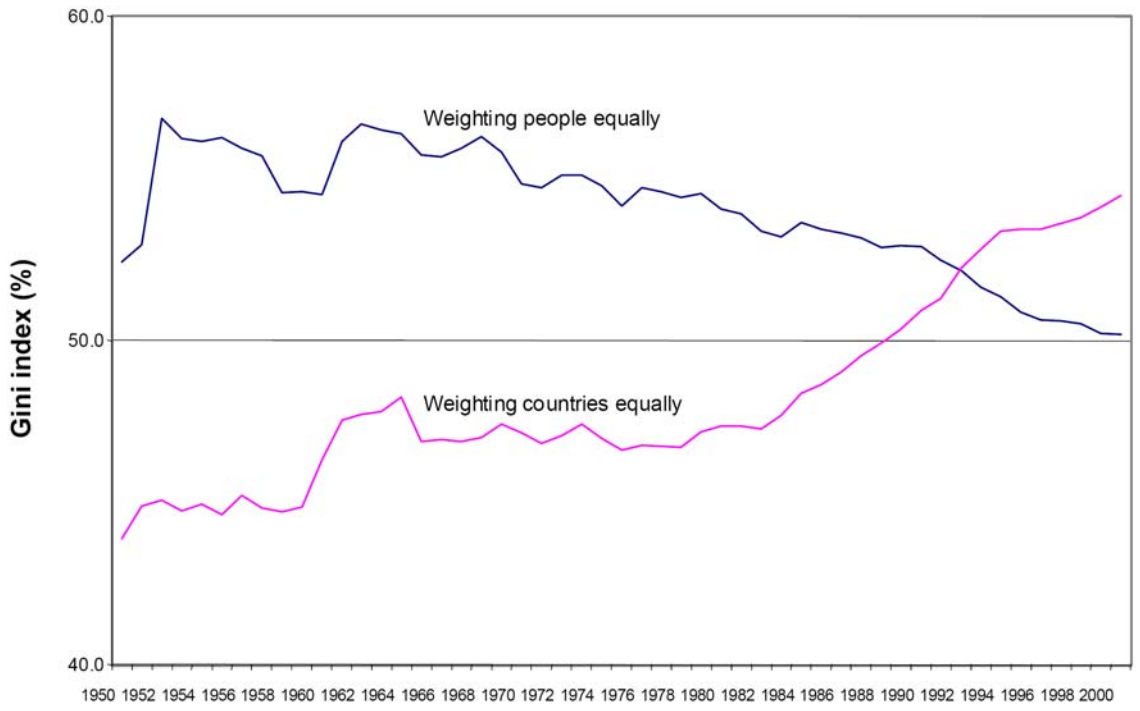



**Figure 3**

Gini indices of GDP per capita across countries under alternative weighting schemes




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

**Figure 4**

**Income inequality in 73 countries, 1960s to 1990s**

Source: Cornia & Kiiski, 2001

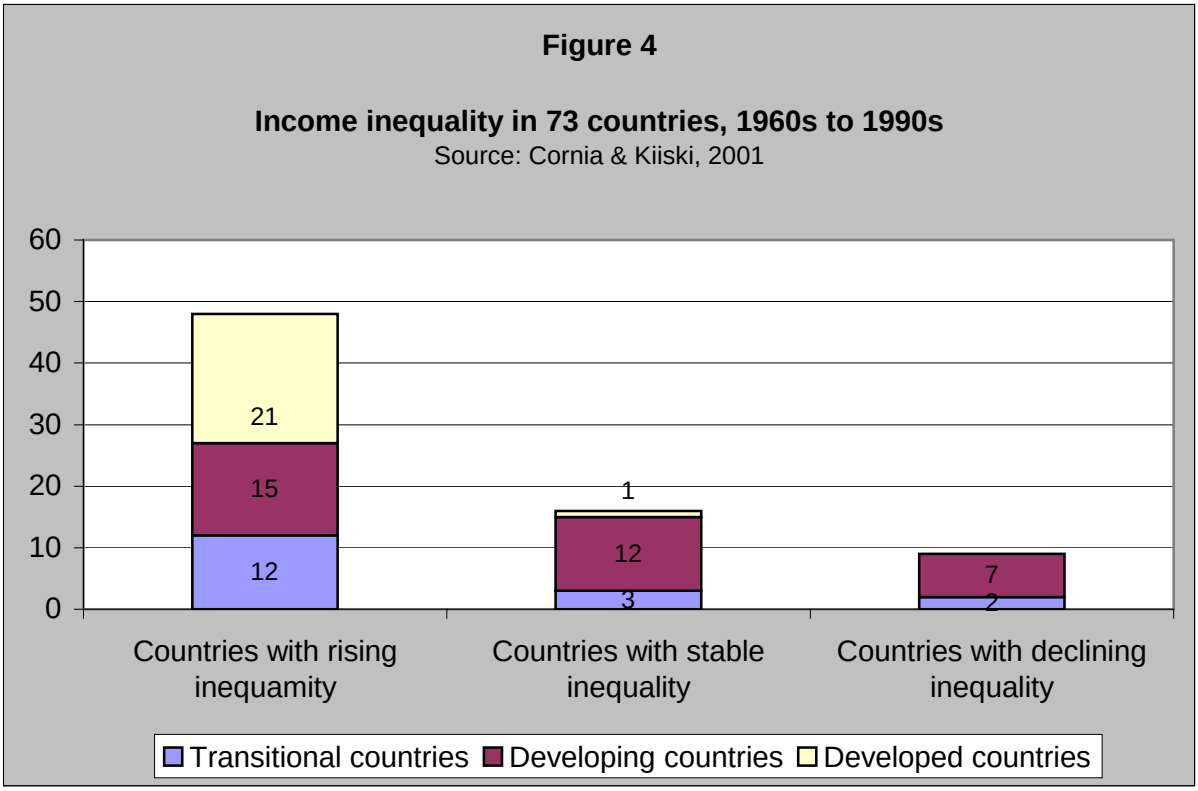


Figure 5

Political Feasibility and Social Responsibility of a trade regime

| The Poor | Winner of trade liberalization | Loser of trade liberalization |
|---|---|---|
| Politically Decisive | A<br>“ Globalization Dream “ | • “Socially Responsible” Open Trade Regime<br>B<br>• “Social Protectionism” |
| Not Politically Decisive | • “Socially Regressive “ Open Trade Regime<br>C<br>• « Fat Cat » Protectionism | D<br>“ Liberal Order Nigthmare “ |