Trade and inequality: does China's integration make a difference?

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The paper revisits the trade and inequality debate of the 1990s, which contended that skill-biased technological progress is the main driver of changes in income inequality with trade playing an only marginal role. The paper examines whether these findings still hold in light of recent advances in trade theory and, especially, the large expansion of labour-intensive exports from China. Two important recent reports (IMF, 2007; OECD, 2011) suggest that the findings of the 1990s-literature are still valid. However, their approach suffers from two main shortcomings: (i) they ignore the link between trade and technology, i.e. trade-induced technological changes; (ii) they measure trade integration by simple openness indicators, ignoring both the origin of a country's imports and the evolution of its terms of trade.

Section 1 discusses five criticisms of the focus on technology in the trade and inequality debate of the 1990s: (1) the debate relied on data that largely predated China's entry into world trade and its rapid export growth (Krugman, 2008); (2) it also predates large-scale offshoring of goods and services activities from high- to low-wage economies, including China, that tends to increase the wages of high-skilled workers and to decrease the wages of low-skilled workers in high-wage economies, thus causing rising wage inequality in these countries (Grossman and Rossi-Hansberg, 2008; Geishecker, Görg and Krieger-Boden, 2011); (3) theoretical advances emphasizing heterogeneity between firms operating in the same sector (Melitz, 2003) are supported by country-case studies indicating that trade may affect income inequality within specific industrial sectors driven by wage dispersion across firms (e.g., Helpman et al, 2011); (4) trade can affect the incentives to develop and adopt new technologies, which in turn increases the demand for skilled labour (e.g., van Reenen, 2011); and (5) looking beyond manufacturing and taking an economy-wide approach is required to capture intersectoral allocative efficiency as well as improvements in within-industry productivity (McMillan and Rodrik, 2011); this criticism reflects Kuznets' basic insight: the essence of inequality lies in the inter-sectoral transitions (i.e., across agriculture, industry, services) that constitute the process of economic development.

Section 2 examines bi-variate statistical evidence regarding the evolution of income inequality in developed and emerging economies since 1980s on the one hand, and a range of variables suggested by the discussion in section 1, on the other hand. It highlights the link between inequality and labour-intensive imports from China and other low-wage economies; innovation and changes in labour productivity in sectors affected by such imports; and the link between inequality and the terms of trade. Section 3 examines these links more systematically on the basis of an econometric estimation, similarly to IMF (2007) and OECD (2011). The main conclusion of this estimation is anticipated to be that trade integration aggravates income inequality when rising manufactured imports from low-wage economies spur technological upgrading and the resulting growth in productivity does not generate additional employment, while trade integration may reduce income inequality when the integrating country's terms of trade improve.