Making Globalization More Inclusive: When Compensation is not Enough

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How to deal with the globalization backlash: the new conventional wisdom

- “Further trade integration is important to reinvigorating global growth” but “domestic policies to address trade-related adjustments are critical”

-- IMF, World Bank, WTO joint report, March 2017

Three arguments that undercut the compensation thesis

- Feasibility: the distribution-to-net-gains ratio
- Credibility: ex-post compensation inherently subject to time inconsistency
- Rules: political conflict today increasingly about the behind-the-border encroachments of new-style trade agreements

The basic economics of opening up to trade

- Three implications of basic trade theory:
  - reducing barriers at the border generally enlarges overall economic pie
    - with some important caveats…
  - but not everyone wins
    - less-skilled workers and import-competing sectors lose out
  - **and as trade barriers get smaller, redistribution looms larger compared to the magnitude of aggregate (efficiency) gains**
- Last point particularly important
  - as it helps explain why trade agreements become politically more contentious as trade and financial barriers get smaller

How much redistribution? The political cost-benefit ratio of globalization

- Let PCBR = ratio of redistribution to efficiency gains generated by the removal of trade barriers in partial equilibrium
- PCBR rises as trade liberalization tackles progressively lower barriers
- because import tariffs are a tax, and hence their efficiency costs rise with the square of the tax rate
  - efficiency gains of trade liberalization become progressively smaller as the barriers get lower
- meanwhile redistribution is linear in the price changes generated by trade liberalization
- the losses incurred by adversely affected groups per dollar of efficiency gain are higher the lower the barrier that is removed
- globalization becomes naturally more divisive as it advances
  - how much? (see simulations)

The PCBR in partial equilibrium

- Ratio of redistribution to efficiency gains of removing trade barriers in partial equilibrium = $\frac{1}{\mu \varepsilon t}$
  - where μ = share of imports in domestic consumption, ε is the (absolute value) of the price elasticity of import demand, and t is the size of the trade barrier (in percent terms).

μ	ε	t	redistribution per dollar of aggregate gain
0.25	2	**0.4**	**5**
0.25	2	**0.3**	**6.7**
0.25	2	**0.2**	**10**
0.25	2	**0.1**	**20**

as trade is liberalized further and further…

See Rodrik (1994)

The PCBR in general equilibrium

initial tariff being removed	change in low-skill wages (A)	increase in real income of economy (B)	absolute value of ratio (A)/(B)
40%	-19.44%	4.00%	4.9
30%	-15.22%	2.25%	6.8
20%	-10.61%	1.00%	10.6
10%	-5.56%	0.25%	22.2
5%	-2.85%	0.06%	45.5
3%	-1.72%	0.02%	76.6

Notes: Column (B) is computed using the standard formula for the gains from trade (e.g. Feenstra 2016, p. 220), assuming an import-GDP ratio of 25% and an import demand elasticity of -2. Column (A) is generated using a model with two factors (low- and high-skilled labor) and two goods with mobile factors, assuming the import-competing sector is low-skill-intensive. The cost shares of low- and high-skill labor in the import-competing sector are taken to be 0.80 (denoted θ_l^L) and 0.20 (θ_h^L), respectively. The factor cost shares in the exportable sector are symmetric – 0.20 (θ_l^H) and 0.80 (θ_h^H). To compute the change in real wages ($\widehat{\omega}_l$), I assume low-skilled workers spend 75 percent of their budget on the importable and 25 percent on the exportable. The corresponding derivation yields $\widehat{\omega}_l = \{[\theta_l^L - \theta_h^L \frac{\theta_l^H}{\theta_h^H}]^{-1} - 0.75\}\hat{p}$, where $\hat{p}$ is the percent change in the relative price of the importable implied by the tariff reduction.

See Rodrik (2017)

The political cost-benefit ratio of globalization in the real world

- NAFTA
  - small on average worker or economy as a whole
    - estimated aggregate “welfare” gains between 0 and 0.2%
  - but wage growth in in the most affected industries was reduced by 17 percentage points (relative to other industries) (Hakobyan and McLaren 2016)
    - so a small group of workers was hit very hard
- China’s entry into WTO
  - large, sustained employment/wage effects in hard-hit communities (Autor et al., 2016)
  - without corresponding employment/wage gains in other places
  - large aggregate gains hard to pick up over relevant time horizon,
  - but large price/distributional effects, as U.S. manufacturing prices fall by 7% (Amiti et al., 2016)

Implication for compensation

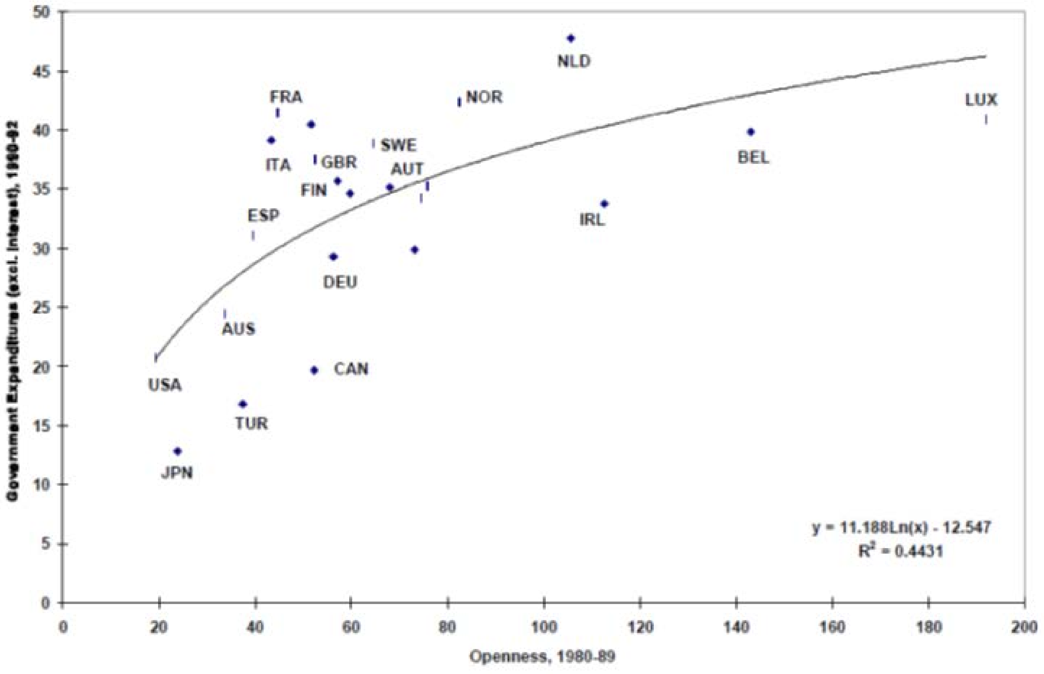
- Lump sum transfers typically not possible
- In practice compensation involves economic distortions at several margins (taxes, transfers to recipients)
- Antras et al. (2017):
  - "trade-induced increases in inequality of disposable income erode about 20% of the gains from trade, while the gains from trade would be about 15% larger if redistribution was carried out via non-distortionary means."
  - Note that in Antras et al. trade costs are iceberg costs, not tariffs (or QRs). The latter have revenue implications, and imply greater redistribution.
- In advanced stages of globalization, economic costs of compensation would eat up bulk (if not all) of the gains from trade
  - Even with an excess burden of taxation as low as $0.10 per dollar, the gains from trade are more than exhausted with the kinds of redistributions yielded by simulations above
- Moreover, as capital become more mobile internationally, burden of taxation shifts to labor, defeating the purpose

Credibility of compensation

- Promises to redistribute ex-post are time-inconsistent when a trade deal undermines power of veto players
  - economic reform with individual-specific uncertainty (Fernandez and Rodrik, 1991)
  - industrialization and economic backwardness in Europe and Africa (Acemoglu and Robinson, 2006)
- Borne out by actual evidence from TAA
  - GAO (2012): TAA has been underfunded and ineffective

When does compensation work?

- When it is part of a constitutive political bargain and embedded in social policies
- Welfare state arrangements in Europe are generous, permanent part of the system, and do not make separate allowance for trade shocks



Cameron (1978), Rodrik (1998)

“Free trade” agreements are no longer about trade barriers at the border

- Post-WTO: from reducing barriers at the border to reducing/harmonizing domestic regulations
  - shallow vs deep integration
- From reducing import protectionism to promoting export/investment protectionism
  - TRIPs
  - ISDS
  - restrictions on CFMs
- Compensation does not provide a solution to conflicts created by these agreements
  - not clear “deep integration” generates gains from trade, in light of differences in preferences and needs across nations (e.g., TRIPs)
  - and the political tensions that are created have to do not with redistribution but with a clash in values (e.g., over safeguarding regulatory autonomy and diversity, as in ISDS)

Concluding remarks

- So, compensation is likely to remain inadequate, is hard to render credible, and fails to address deeper conflicts trade agreements pose.

- Much better solution: make the rules fairer ex ante, instead of compensating ex post.