# For Richer, for Poorer

## International trade can deepen inequality in developing economies

*Nina Pavcnik*

DURING the past three decades, developing economies have become ever more integrated into the world market. Fewer policy barriers to trade—combined with better communication and transportation—have helped companies reorganize and manage production facilities across borders, incorporating the relatively cheap workforces of developing countries.

These shifts are often blamed for growing inequality and the demise of manufacturing employment in developed economies and contribute to the current backlash against international trade.

In many developing economies, income inequality has also increased over the past three decades, especially in Asia. Pew Research Center polls indicate that 80 to 96 percent of people in emerging market economies such as Brazil, China, India, and Vietnam perceive inequality as a key problem facing their countries. However, only 1 to 13 percent of people in these countries view trade as inequality's main driver.

This public perception agrees with evidence from academic literature surveyed in Goldberg and Pavcnik (2007), which finds that trade has contributed to growing inequality in developing economies but is not the main cause.

The effects of trade on inequality within a country are complex, as trade influences people's earnings and consumption in several ways, and its uneven effects vary according to context. The nature of trade integration; how easily workers and capital move across firms, industries, and geographic regions; and where the people affected by trade fall on a country's income distribution all play a role. This article highlights some insight into these issues from recent studies of trade's uneven effects in several developing economies.

### Earnings inequality

The usual gains from trade occur when countries specialize and trade reallocates workers from import-competing industries to exporting industries. This leads to lower earnings of workers in import-competing industries and increased earnings for workers in export-oriented industries, at least in the short run.

Trade's uneven effects on earnings also operate in other dimensions.

International trade can contribute to unequal earnings of comparable workers across companies in an industry. Firms differ in their performance, and those that do better are more likely to export. Two recent studies from Argentina and Mexico find that winning firms benefit from new export opportunities and share revenue gains with their workers in the form of higher earnings (Verhoogen, 2008; Brambilla, Lederman, and Porto, 2012).

**Developing economies are not in a good position to deal with growing income and opportunity inequality.**

In addition, more highly educated workers in companies that export to high-income countries get an additional earnings boost, relative to less-educated workers. Why? Consumers in high-income countries often demand higher-quality products than those in developing economies. The production and marketing of quality goods, in turn, require more skilled workers or more effort, and the gap between the earnings of the two types of workers within a firm widens.

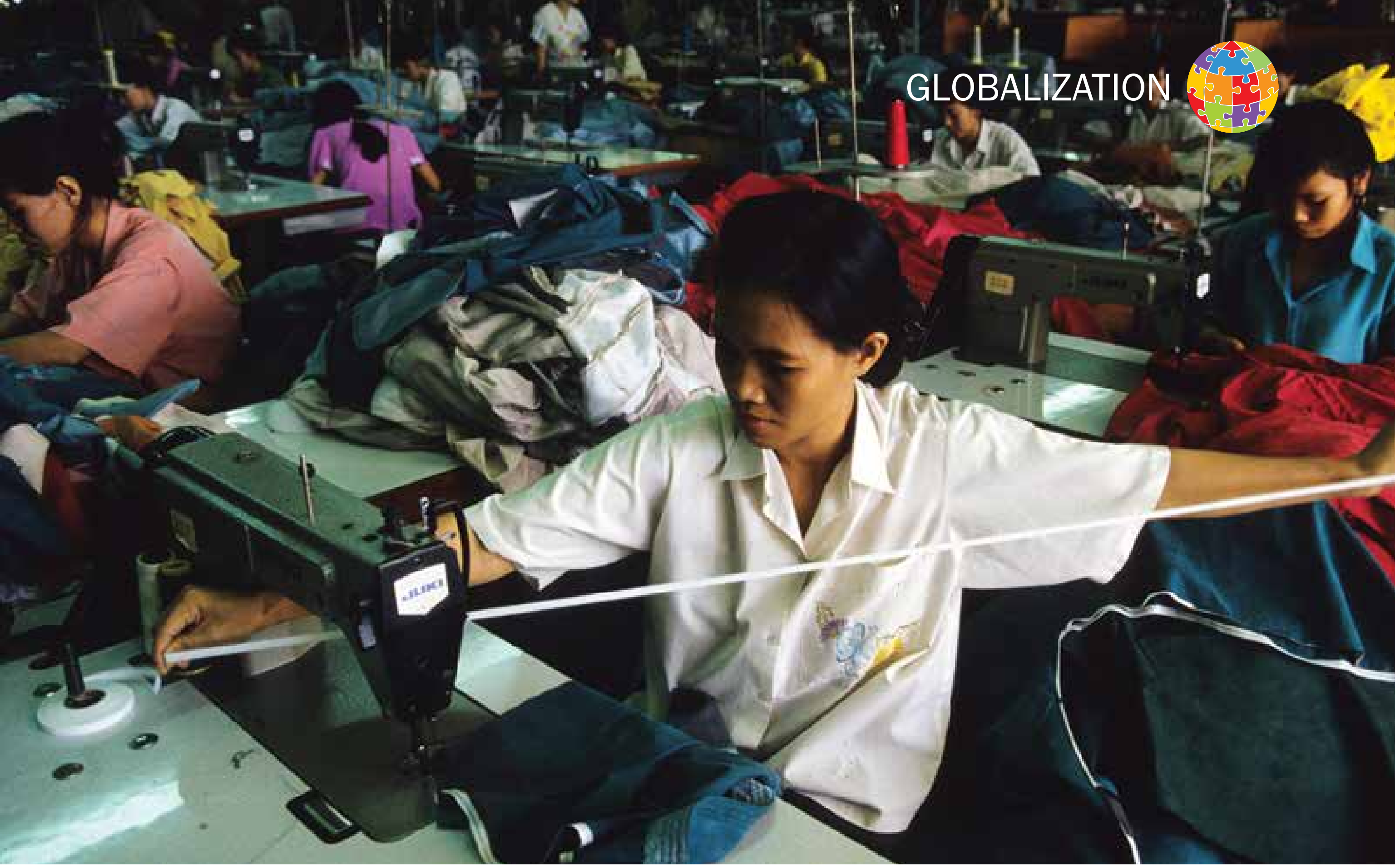
Importantly, trade affects earnings unevenly across local labor markets within a country, according to several studies.

Vietnam is a case in point. A 2001 trade agreement with the United States lowered the tariffs on Vietnamese exports by 23 percentage points on average. These tariff cuts varied widely across industries. Vietnam's provinces specialize in different industries, and employment in some provinces was concentrated in industries affected by large tariff cuts; in other areas few people worked in these industries. As a result, lower export costs affected workers differently across provinces.

One study finds that poverty declined more in provinces whose industries benefited from larger declines in export costs (McCaig, 2011). Poverty decreased because access to the U.S. market stepped up demand for local workers and raised provincial wages—particularly for workers with at most a primary education. Provinces that benefited more were richer to begin with, so as trade went up so did regional wage inequality.

The findings from Vietnam suggest that international trade generates an earnings wedge across regions within a country, a finding borne out in several studies. Some regions are more exposed than others to international trade because of variations in what they produce.

Earnings differences can be stubbornly entrenched because workers and capital do not move freely and there is little redis-



Garment workers, Ho Chi Minh City, Vietnam.

tribution between regions, particularly in developing economies. As a result, the effects of international trade on workers vary depending on how it influences the local economy.

## The case of India

Consider the experience of India, home to a third of the world's poor when it began to liberalize trade in 1991. The reform had reduced quantitative restrictions on trade and decreased import tariffs on average from 87 percent to 37 percent by 1996. Petia Topalova (2010) looked at the effects of lower import tariffs across districts in India, which increased foreign competition.

National poverty declined in India during this period. However, the study finds that poverty decreased less in rural districts of India where there was more competition from imports. Relative poverty increased because tariff cuts reduced the demand for local labor, lowering industrial and agricultural wages and disproportionately harming poor households. Ultimately, families in the bottom 10th and 20th income distribution percentiles experienced the largest relative decline in per capita consumption.

Regional earnings disparities might be expected to dissipate over time as workers move from areas beset by foreign competition to higher-earning regions. But this did not happen in India. Migration was not affected by a district's exposure to trade reform—in fact, fewer than 0.5 percent of rural Indians and 4 percent of city dwellers moved for economic reasons in the decade after trade reform. Geographic mobility was particularly low for those with no education or from poor households.

So why didn't more people move?

Moving is expensive, and people often can't borrow in order to pull up stakes. In developing economies such as India, family and institutions such as the caste system are a kind of informal social insurance, which further inhibits mobility. Sometimes people just don't know that there are better job prospects elsewhere. And sometimes the skills and experience of workers hurt by import competition don't match those needed in expanding sectors in other regions.

It turns out that the effects of import competition on local labor markets can persist and worsen over time. A recent study examines how workers adjusted over two decades following Brazil's tariff liberalization, which reduced import taxes in the early 1990s (Dix-Carneiro and Kovak, 2015). As in India, the reform reduced worker earnings in regions with increased competition from imports. Unlike in India, however, inequality between regions of Brazil decreased, because the more affected regions were richer to begin with.

Surprisingly, the negative effects on regional earnings widened over time, but why?

Local earnings worsened over time because the demand for labor began a slow decline as company owners downsized or shut down local plants in response to import competition after capital depreciated. Less demand for services followed, depressing the local labor market even more. As was the case in India, the workers did not move out of regions depressed by import competition. Many of them ultimately found jobs in the informal sector.

The examples above illustrate that barriers to worker mobility contribute to the unequal effects of international trade. Further work is needed to better understand the key barriers to mobility—whether across firms, industries, or regions—that keep people hurt by import competition from taking new jobs in expanding sectors.

## Consumption: Poor versus rich

Integration into the global market benefits consumers in developing economies through the availability of cheaper imports. It also gives people access to goods not produced by domestic firms, including medicine and cell phones. And some of the benefits of these goods go beyond simple consumption. A farmer in Kenya can use a cell phone not only to keep in touch with friends and family but also to benefit from mobile banking and gather information about prices of cash crops in distant markets.

At the same time, the consumption gains from trade can be uneven and can differ substantially between the rich and the poor. The poor often spend a larger share of their budget on traded goods such as food and clothing than on nontraded services such as housing and education. A recent study of 40 countries, including 12 developing economies, suggests that the consumption benefits of international trade integration are proportionally larger for the poor, since international prices of traded goods on average drop more than those of nontraded services, which tend to be consumed by the rich (Fajgelbaum and Khandelwal, 2016).

But there are other considerations as well.

The effects might depend on the type of liberalization and the shopping patterns of households across income levels. Several middle-income and transition economies, including Mexico and Argentina, have recently opened their retail sectors to foreign retail chains, a policy move thus far strongly opposed in India. Mexico's experience suggests that while the poor benefit from the entry of foreign retail chains, they benefit less than richer families.

A forthcoming study finds that Mexican consumers at all income levels benefit from the entry of a foreign retail chain, because of lower prices, a broader range of products, and better shopping amenities, such as location and parking (Atkin, Faber, and Gonzalez-Navarro). However, the consumption gains were larger for households in the top 20 percent of Mexico's income distribution than in the bottom 20 percent because richer households were much more likely to switch to shopping in foreign retail chains.

Moreover, lower prices of goods at the border do not necessarily translate into lower prices for consumers in remote markets. The consumption benefits from trade are unequally distributed within countries because of poor internal infrastructure and little competition in developing economies' domestic wholesale and retail sectors. A recent study finds that consumers in remote areas of Ethiopia and Nigeria do not benefit much from imports because internal transportation costs and intermediaries with market power eat up most of the potential consumer gains (Atkin and Donaldson, 2015).

In sum, although consumers benefit, consumption gains from trade are uneven. Since poorer people in developing economies spend a large share of their income on traded goods, these aspects of inequality should not be overlooked.

## Ensuring equality of opportunity

People in countries such as Brazil, China, India, and Vietnam appear committed to freer international trade, according to recent opinion polls from the Pew Research Center.

This does not mean that uneven effects of trade and growing inequality—whether caused by trade or by other factors—should be ignored. The current backlash against trade in developed economies such as the United States is a cautionary tale. At the same time, developing economies are not in a good position to deal with growing income and opportunity inequality. They spend less on education, have weaker social safety nets, and their people do not have equal access to public goods. Limited educational opportunities are particularly worrisome. Well-educated workers are in great demand in today's global economy and adjust more easily to negative labor market shocks.

The policy debate must focus on ways to put domestic institutions to work to ensure equality of opportunity, especially when it comes to quality education and geographic mobility, and to share the benefits of trade more broadly with those currently left behind. ■

*Nina Pavcnik is the Niehaus Family Professor of International Studies and Professor of Economics at Dartmouth College.*

*References:*

*Atkin, David, and Dave Donaldson, 2015, "Who's Getting Globalized? The Size and Implications of Intranational Trade Costs," NBER Working Paper 21439 (Cambridge, Massachusetts, National Bureau of Economic Research).*

*Atkin, David, Ben Faber, and Marco Gonzalez-Navarro, forthcoming, "Retail Globalization and Household Welfare: Evidence from Mexico,"* Journal of Political Economy.

*Brambilla, Irene, Daniel Lederman, and Guido Porto, 2012, "Exports, Export Destinations, and Skills,"* American Economic Review, *Vol. 102, No. 7, pp. 3406–38.*

*Dix-Carneiro, Rafael, and Brian Kovak, 2015, "Trade Liberalization and Regional Dynamics," unpublished (Durham, North Carolina: Duke University).*

*Fajgelbaum, Pablo, and Amit Khandelwal, 2016, "Measuring the Unequal Gains from Trade,"* Quarterly Journal of Economics, *Vol. 131, No. 3, pp. 1113–80.*

*Goldberg, Pinelopi, and Nina Pavcnik, 2007, "Distributional Effects of Globalization in Developing Countries,"* Journal of Economic Literature, *Vol. 45, No. 1, pp. 39–82.*

*McCaig, Brian, 2011, "Exporting out of Poverty: Provincial Poverty in Vietnam and U.S. Market Access,"* Journal of International Economics, *Vol. 85, No. 1, pp. 102–13.*

*Topalova, Petia, 2010, "Factor Immobility and Regional Impacts of Trade Liberalization: Evidence on Poverty from India,"* American Economic Journal: Applied Economics, *Vol. 2, No. 4, pp. 1–41.*

*Verhoogen, Eric, 2008, "Trade, Quality Upgrading, and Wage Inequality in the Mexican Manufacturing Sector,"* Quarterly Journal of Economics, *Vol. 123, No. 2, pp. 489–530.*