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The relationship of international trade to income inequality and unemployment has been widely debated by both labor economists and trade economists. The two groups typically use incompatible analytical frameworks, making it difficult to compare their results. This paper, a collaborative effort by a labor economist and a trade economist, reviews the research to date on internationalization and labor markets, tentatively identifies areas of consensus and areas of remaining uncertainty, and observes that public policy choices may not depend on the fine points of debate among economists.

THE BASIC FACTS

In the early 1970s, the U.S. labor market began changing in three ways. First, average real earnings stopped growing, and in fact have declined slightly since 1973. Second, earnings differentials based on skills have become larger: for example, the gap between the earnings of male college graduates and high school graduates has widened substantially. The combination of these two changes has led to a sharp drop in real earnings for low-skilled workers. Finally, there has been increasing inequality among workers within the same skill level. There has been a rise in the so-called "residual inequality" that remains after controlling for education, work experience, race, and gender; this is an important part of the rise in overall inequality.

The same changes have occurred to a mixed extent in other OECD (developed) countries. In contrast to the U.S. pattern, average real earnings have continued to grow since the 1970s in most countries. Overall inequality has generally increased in recent years, but only in the U.K. has the magnitude of the change approached U.S. levels. There is some tendency for countries with less increase in inequality to have more increase in unemployment, but the relationship is far from perfect. The U.K. has done poorly on both measures, with a rise in earnings inequality and unemployment. Residual inequality appears to have increased in most countries, although again the U.S. and U.K. may have more pronounced increases than others.

Explanations of rising inequality, therefore, should include factors that distinguish the U.S. and U.K. from other OECD nations, as well as trends that have affected all countries.

THE ROLE OF TRADE

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Inequality can be increased by shifts in relative demand for different types of labor, shifts in relative supply of labor, or changes in labor market institutions. It is clear that supply shifts alone cannot explain increasing inequality, since the quantity of skilled labor and the relative wages paid to skilled workers have been increasing at the same time. This strongly suggests a shift in demand toward more skilled labor.

How much of that shift in demand is due to international trade? When analyzing this question, trade economists generally use the "Heckscher-Ohlin" framework, assuming all countries have perfectly competitive economies, making the same diversified mix of products, with perfect factor mobility between industries. In this framework, the Stolper-Samuelson theorem predicts that international trade affects product prices, which in turn affect the demand for, and prices of, factors of production. Thus if trade has led to an increase in the demand for skilled-labor-intensive products in developed countries, the prices of those products, and the earnings of skilled workers, would both increase as a result of trade. However, there is on balance very little evidence that trade has increased prices of technology-intensive or skill-intensive products.

Other studies, often by labor economists, have looked at quantities of employment, or of exports and imports. These, too, have often found little or no role for trade. One model estimates that the expected effects of trade with developing countries on U.S. prices and wages would be within the margin of measurement error. Others have found less than 10% of U.S. earnings inequality to be due to trade. While debate continues, the majority of studies, regardless of methodology, find only a small role for trade in explaining rising inequality in the U.S.

ALTERNATIVE EXPLANATIONS

Skill-biased technical change is a favorite alternative explanation for rising inequality. Often this is just a residual category that has resisted other explanations -- "it is largely a name for our ignorance." (10) Anecdotal or industry-specific evidence has been presented regarding particular technologies, but this, too, is controversial: correlation between wage increases and use of new technologies does not imply causation (see the articles on computer use by Autor, Katz, and Krueger, and by DiNardo and Pischke, summarized in Chapter __); and the same technologies have not produced even roughly similar trends in inequality in different countries.

Changes in labor supply, while inadequate to explain the entire trend toward inequality, might well explain differences between countries and time periods in the strength of this trend. The relative supply of college-educated workers grew more rapidly in Europe than in the U.S. in the 1980s; this would tend to cause slower growth in skill differentials in Europe. Also, the growth of the college-educated labor force was more rapid in the 1970s, leading to declining skill differentials -- a pattern that was reversed in the following decade.

Another labor supply change related to globalization, namely immigration, may play a role in the U.S. earnings distribution. Immigration has increased rapidly since 1970, and the average skill and education level of immigrants has declined. While some studies find that immigration has little effect on U.S. earnings, others find it explains much of the drop in relative earnings for high school dropouts (though having little effect on relative earnings of college and high school graduates). In Europe, immigration seems to have had little effect on inequality.

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The factor most closely related to the international pattern of inequality is the change in labor market institutions. The U.S. and the U.K. have both had decreases in "union density" (the unionized percentage of the labor force). In the U.S. union density dropped throughout the 1970s as well as the 1980s (and later), while in the U.K. the decline began in the 1980s, matching the pattern of growing earnings inequality in the two countries. Moreover, the real value of the U.S. minimum wage declined sharply during the 1970s and 1980s, while in the U.K. the councils that set sectoral minimum wages were abolished in the 1980s. No other OECD country had comparable changes in both of these institutions, suggesting that institutional factors account for the distinctive Anglo-American trends in inequality.

THE NATURE OF GLOBALIZATION

Much remains to be done in assessing the effects of globalization on earnings and employment. Trade economists and labor economists approach the problem differently, the former emphasizing clear theoretical reasoning and the latter valuing careful empirical work. It is important to think about the interaction of many markets simultaneously, as trade economists assert. It is also important to recognize, as labor economists point out, that perfect competition and factor mobility, the foundations of the Heckscher-Ohlin framework, are highly unrealistic assumptions. Thus the published findings that trade has little effect on earnings inequality must be viewed as tentative, since they generally rely on these assumptions. The economics literature has only begun to look beyond the Heckscher-Ohlin framework at other effects of globalization on the U.S. labor market. Such factors as exchange-rate volatility, increases in international capital mobility, and competitive pressures resulting from international trade, are anecdotally said to be important. Some initial analyses of these factors suggest a much larger role for globalization in explaining rising inequality than most of the Heckscher-Ohlin studies.

Finally, do the causes of inequality matter for public policy purposes? In a word, no. If there is to be public intervention aimed at reducing inequality -- a point that is by no means certain today -- then the appropriate policy responses are independent of the underlying causes. Short-term solutions such as earned-income tax credits, and long-term solutions such as subsidies to education and skill acquisition, should be pursued regardless of our understanding of globalization. Even though skill differentials in earnings have increased, market failures (such as imperfect capital markets for borrowing to finance education) prevent some individuals from obtaining skills that they desire. In contrast, policies such as trade barriers, or limits on the use of new technologies that are associated with earnings inequality, would not be desirable regardless of the outcome of future research. While research and debate on the issues raised here are ongoing, the most important message is that economists are much closer to unanimity on policy recommendations than on the causes of the problems that the policies are designed to solve.

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