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Policy review: Is inequality a policy choice?

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Abstract. The paper is a short literature review that suggests that trade policy as opposed to general measures of openness does correlate with inequality. The review suggests that developing countries are not ready to fully integrate with global trade because significant segments of populations are unskilled whereas global trade patterns benefit only skilled or semi-skilled.
Keywords. Inequality, Integration, Trade Policy.
JEL. F10, F13, F19.

1. Introduction: Pro-poor ecquity

With the advent of Poverty Reduction Strategy Papers (PRSPs), the focus of the contemporary world of developing countries has been on policies which are not only pro growth but which are also pro poor as it has been realized that growth can not by itself trickle down to alleviate poverty. So, today the determinants of growth are not only evaluated for their contribution to economic activity, but they are also checked for their contribution to the general welfare of the public in order to be sure that good for growth policies are also good for poor. This paper tries to find out whether in a developing country context international trade, which is considered to be vital for growth by economists belonging to both the right and left, is pro poor as claimed by many (e.g. Dollar & Kraay, 2004) or it may contribute to increased poverty through worsening the gap between haves and have nots (e.g., Bardhan, 2003 and Rodriguez & Rodrik, 2000).

Though the bastions of neo classical economics (e.g. World Bank) realizes that pro poor growth is not possible without ensuring that the incomes generated by growth are equally distributed, they (e.g. Dollar & Kraay, 2004) presume that processes of growth like international trade have no or insignificant effects on inequality despite the evidence of rise in inequality in many developing countries which have opened up (i.e., China, Vietnam, Mexico, Brazil, Chile, Columbia and Venezuela etc).

In this context it becomes all more important to understand where we stand apropos distributional effects of international trade. The paper undertakes a review of Mamoon (2015) whereby it tries to answer questions such as: "why and how does international trade aggravate income disparity in a developing country?"

2. Theory and empirical evidence

Mamoon (2015) identifies at least eight such effects through which trade favors one segment of a society over other and cause uneven development in a country. All the effects unanimously suggest that international trade causes inequality by increases in relative wages of skilled labor over unskilled ones in developing countries.

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1. Protection Effect
2. Endowment Effect
3. Technology Transfer Effect
4. Technology Catch-up Effect
5. Outsourcing effect
6. Familiar factor Endowment Effect
7 Price Elasticity Effect
8. Wage Premium Effect

In order to validate the theoretical debate, Mamoon & Murshed (2013) undertakes an extensive empirical exercise based on cross country analysis for more than 100 developing countries. Since the paper suggests that inequality seeps into the developing economy through increased trade by effecting the relative wages, I have selected UTIP-UNIDO wage inequality 'THEIL" measure recently calculated by University of Texas Inequality Project (UTIP) instead of measures which represent income inequality i.e., GINI etc.

Simple graphical representations of THEIL index for some selected countries, which have embraced liberalization, evidently show that wage inequality has been sharply rising after the initiation of trade reforms. To confirm the graphical trends, the paper undertakes regression analysis whereby 30 trade policy measures were carefully selected from the literature. The OLS regression equation regressed Theil index on openness, Human capital and geography. The results were mixed and failed to develop any explicit relationship between openness and inequality.

Though geography is a pure exogenous concept here (Rodrik *et. al.,* 2002), literature suggests that openness and human capital are highly correlated. In order to solve for the problem of multicolinearity, openness is regressed on geography and predicted trade shares computed by Frankel & Romer (1999) from gravity equation. Recently FR has been used extensively in the literature as the instrument for openness (i.e., Dollar & Kraay, 2002, Rodrik *et. al.,* 2002 etc). As a second stage, Mamoon & Murshed (2013) have regressed Theil index on predicted values of openness and human capital. To my anticipation, this time the relationship between wage inequality and international trade came out to be highly significant and negative for nearly all the 30 trade policy variables. Additionally, the results complement previous studies which suggest that the countries with better human capital actually do well on inequality front.

3. Policy remedy of trade induced inequality

Since the results of Mamoon & Murshed (2013) show that trade liberalization cause inequality, they proceeded to find out how we can make trade more equal. As oppose to new classical paradigm of free markets, the literature suggests that trade favors skilled labor over unskilled in developing countries. This means that international trade benefits the educated segments of the society where as the illiterate who are largely poor and unskilled are excluded. If this is true, then human capital which is accrued through the processes of trade is guilty of inequality. In order to get values of human capital which depend on trade, they regressed human capital on Frankel and Romer (FR) predicted trade shares. This gave them predicted values of human capital which are explained by processes of international trade. The regressions based on predicted human capital validate the argument. The paper has also interacted predicted human capital with trade policy and they found out that both compliment each other in explaining wage inequality in developing countries.

There are very important guide lines for policy makers. There is strong evidence that international trade leads to wage inequality as wages of skilled labor increase relative to unskilled ones. In order to neutralize the unequal effects of trade, the focus of policy makers should be on education. The countries which have greater frequency of educated people are in a better position to benefit from international trade. However our results suggest that there is a caveat. Generally the governments in developing countries tend to focus more on higher education in order to accrue quicker benefits from processes of growth and ignore the fact that such a policy would lead to unequal outcomes as education should be for all. For example, Pakistan has focused its education policy on higher education in the anticipation that investments in higher education would accrue faster dividends by exploiting the international business environment. Though the government is right, it is promoting higher education at the cost of primary education. This means that only a limited segment of the society will benefit from it, whereas the ones who are excluded will also be barred from the benefits of growth and its processes (i.e., trade) at least in the short term. Earlier the same mistake has been committed by China and India who are the most prominent beneficiaries of international trade. Though, both the countries are able to achieve high growth rates as their relatively skilled and cheaper human capital (a direct outcome of their higher education focus) has utilized the recent surge of international outsourcing by multinationals, they have suffered from increasing inequality because large portions of the population are left out because they were illiterate and unskilled.

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