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Globalization and Risk Averse Workers: The Roles of Labor Market and Trade Policies ¹

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Abstract

This paper studies the implications of globalization for aggregate output and welfare when risk averse workers face the risk of unemployment. The impact of globalization on the welfare of workers and aggregate output depends on the degree of substitutability between domestic workers and imported inputs. When the degree of substitutability is high (low), then globalization reduces (increases) wages and increases (reduces) unemployment. Irrespective of the substitutability, free trade doesn't maximize the aggregate output. A small tariff (import subsidy) increases aggregate output when the substitutability is low (high), however, it can exacerbate the distributional conflict. Domestic labor market policies such as unemployment benefits and severance payments can protect workers against labor income risk but the firing restrictions do not. Free trade is optimal when labor market policies provide insurance against unemployment.

Keywords: offshoring, unemployment, endogenous job destruction, severance payments, unemployment benefits

JEL Codes: F16, F66, F68

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