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Which Countries' Citizens Are Better Off With Trade?

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Summary. — We attempt to reconcile competing arguments regarding international trade's implications for citizen well-being: that trade either erodes citizen welfare by decreasing the incentives and resources for welfare improvements or leads to higher welfare by increasing those incentives and resources. We find that which of these two dynamics a country experiences depends on its level of human capital. In countries already well-endowed with human capital, greater international trade reinforces further improvements in welfare. But in most countries, the workforce has not yet developed such capacities, and in these countries trade is associated with slower improvements in welfare.
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1. INTRODUCTION

What are the consequences of international trade for average citizen well-being? On the one hand, increasing trade and government policies that encourage it might increase economic growth and the returns to productive human capital, thereby increasing both the incentives for governments and households to invest in productivity-enhancing human capital, as well as the resources for such investments. But on the other hand, these efforts to lower barriers to trade may erode important sources of tax revenue that governments can spend on social services, and may also lock in existing comparative advantages, increase wage instability, and decrease labor bargaining power—all dynamics that may decrease the incentives for governments to provide social services, as well as the resources that both households and governments have to increase citizen well-being. A generation of scholarship has provided a convincing case, both conceptually and empirically, for both perspectives. [1]

Which is the reality? In this paper we argue that there is a simple reason for the lack of consensus about whether international trade improves or erodes citizen well-being: both are true. We argue that which dynamic a country will experience should depend on its existing level of human capital. This is because a country's level of human capital helps to determine trade's implications for the incentives and resources of households and governments to make further investments in human capital that, in turn, raise citizens' quality of life: their skills and capacities as well as their health and income (Morris, 1979; Sen, 1999; UNDP, 1990). One consequence of increased trade is the reallocation of economic activities that require high levels of human capital to countries with capable, productive workers. In countries that already have such workforces, increasing trade appears to reinforce human development, adding both resources and rationale for further improvements in people's lives and capacities. But in most countries, the workforce has not yet developed such capacities; and in these countries, increased trade tends to undermine the incentives and the ability of governments to invest in citizens and citizens to invest in themselves. In other words, increased international trade—one of the hallmarks of our era of increased economic globalization—accelerates improvements in citizen well-being in countries that already have a high level of human capital, but depresses it in countries with low human capital.

We examine the validity of this argument with a new empirical strategy. Much of the scholarly work on trade's implications for well-being focuses on either economic growth and income (e.g., Anderson, Cockburn, & Martin, 2010; Dowrick & Golley, 2004; Feyrer, 2009; Frankel & Romer, 1999; Yanikkaya, 2003) or government spending (e.g., Cameron, 1978; Garrett, 1998; Quinn, 1997; Rodrik, 1998a, 1998b). Both have long been known to be insufficient proxies for the welfare of average citizens, for reasons we detail in Section 4. Some studies try to correct for these problems by focusing specifically on trade's associations with government social spending (Brady, Beckfield, and Seeleib-Kaiser 2005; Ha, 2008; Rudra, 2002). But this measure describes only one contribution to average citizen welfare; government spending ignores households' own efforts to improve their welfare, and it includes many aspects of government spending that are only indirectly related to citizen welfare. In addition, data on government social spending are available for relatively few countries, putting results at a high risk of selection bias.

Thus it is difficult to empirically explore the relationship between trade and average citizen welfare. In this paper, our approach is to build from the decades-old literature devoted to measuring the welfare of average citizens, which has resulted in the United Nation Development Program's (UNDP) Human Development Index (HDI)—a widely used composite measure designed to capture the most important dimensions of average citizen well-being: education, health, and income (Sen, 1999; UNDP, 1990). The HDI has been collected by the UNDP for most countries in the world over the past four decades. The HDI allows us to examine how international trade is associated with changes over time in the well-being of average citizens in the vast majority of developed and developing countries.

In examining the relationship between international trade and changes in the pace of human development, we find a dual reality. In countries that already have high human capital, greater international trade is associated with faster human development, while in countries with lower levels of human

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capital, greater international trade is associated with slower human development. This basic result holds for the main indicator of trade and openness to trade used in the empirical trade literature—the ratio of a country's exports and imports to its Gross Domestic Product (GDP). And avoiding this pattern appears to be extremely difficult: indeed it is so pervasive that almost no countries deviate from it. As we detail below, when countries with low human capital were able to outperform expectations in their human development, they could do so only temporarily, before their human development reverted back to its lower trend.

The results suggest that the implications of international trade for citizen well-being depend on whether the country opening its economy to trade already has a high or low level of human capital. This is not to say that welfare *declines* in countries that open to trade with low levels of human capital—the post-war era is one of increasing human development in almost all countries. Rather, the implication of our results is that in countries with low human capital that have fully embraced international trade, human development is slower than it would be otherwise. Our analysis shows a disparity in the degree to which international trade translates into accelerated human development, including the tendency of countries to expand the health and skills of their populations—key factors in whether they are equipped for future gains from trade. The results suggest that if a citizenry is to benefit from opening to the world economy, they generally must first raise their level of human capital.

This paper is in six sections. Section 2 reviews the seemingly contradictory literature on the welfare consequences of international trade. We argue that the divergent results are due to sample bias and mis-measurement: studies reach differing conclusions depending on whether they examine countries that already have high human capital and whose citizens therefore benefit from international trade or whose citizens have low human capital and are therefore hurt by it, and broader studies reach weak and sometimes contradictory conclusions because they typically rely on measures of welfare spending that are available for a limited and inconsistent group of countries. Section 3 explicates our argument. In Section 4, we introduce an alternative empirical strategy to test our explanation that relies on changes in the United Nation's Human Development Index. Section 5 presents our findings and Section 6 concludes.

2. HOW MIGHT TRADE IMPROVE AVERAGE CITIZEN WELFARE?

There are good arguments that increased international trade hurts efforts to improve citizen welfare, and good arguments that it helps. We begin by examining the general arguments for each. The following section then introduces our argument that the relationship between trade and average citizen welfare depends on the country's existing level of human capital.

The argument that increasing international trade and policy efforts to encourage it should hurt efforts to improve average citizen welfare gained prominence in the 1980s and 1990s. Scholars in this tradition typically argued that the process of reducing barriers to trade undermines the welfare state and, with it, the foundations of the postwar boom in health, education, and the well-being of average citizens. Part of the argument deals with eroding government resources. Many developing-country governments are highly dependent on trade tariffs because they tend to be among the easiest taxes to collect. For example, taxes on trade provide more than a fifth of total revenue for the average African government,[2] which is more than the typical African government's combined spending on health care and primary education.[3] Efforts to encourage international trade also make taxing the owners of capital more difficult. As efforts to encourage international trade erode these sources of government revenue, the burden of paying for the welfare state shifts from capital to labor (Cerny, 1995; Evans, 1997; Grunberg, 1998; Reich, 1992; Rodrik, 1997, 1998a; Ruggie, 1982). Skilled labor faces an additional hurdle, as efforts to reduce barriers to trade also tend to limit the ability of governments to preserve employment opportunities for skilled workers—and thus maintain the incentive for workers to invest in skills—because the rules governing international free trade limit subsidies, public ownership, and preferential government procurement from domestic producers, thus locking in existing comparative advantages in production.[4] All this has led influential scholars such as Joseph Stiglitz and Dani Rodrik to argue that globalization may have gone too far.[5]

The other side of the argument relies first on the gains in national income that classic trade theory predicts. If international trade does raise national income in most countries, this aggregate economic improvement might benefit average citizens (e.g., Anderson *et al*., 2010). Even if the rules around international trade limit certain government responses and revenue sources, governments of more interdependent economies might face—and respond to—countervailing domestic pressure to shield workers from the insecurity and uncertainty that accompany global economic fluctuations (Rodrik, 1998a; Scheve & Slaughter, 2004, 2007). Governments in developed countries do in fact appear to have responded to this pressure (Garrett, 1998), as have those in developing countries where labor is well-organized and thus more politically powerful (Rudra, 2002). Indeed a number of studies of advanced countries find that increased international trade is strongly associated with higher, not lower, government spending, in general and specifically on redistribution and social programs that can help compensate citizens as well as equip them with the human capital to more effectively compete in the global economy (Cameron, 1978; Garrett, 1998; Ha, 2008; Katzenstein, 1995; Ruggie, 1982; Swank, 2002).

Separately, writers like the *New York Times*' Thomas Friedman and the *Financial Times*' Martin Wolf popularized the argument that international trade has increased the pressure on governments to *improve* welfare, forcing government welfare policies to be more efficient and effective (Friedman, 1999; Wolf, 2004). Wolf notes that while capital may be mobile, to be productive, it needs productive labor, which generally is not very mobile, and therefore flocks to countries with productive workforces. This dynamic should create incentives for individuals to invest in their own human capital and governments to invest in their workforces. And to the extent that these investments lead to growth, they may also increase government revenue, providing a reinforcing basis for further investments in workforce capabilities.[6]

This debate leaves us with contradictory expectations about the relationship between trade and citizen well-being. On the one hand, increased international trade might lead countries to invest less in citizen well-being as it erodes government revenues and leads them to favor the interests of capital over citizens, and as citizens face greater income insecurity and uncertain payoffs to investment in skill. On the other hand, increased international trade might pressure households and governments to *increase* investments in human capital, as citizens try to equip themselves to compete in the global economy and governments try to increase economic

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