A significant number of countries have experienced important increases in income inequality in recent years. The evolution of incomes at the top percentiles of the income distribution has received a lot of attention in the public debate and globalization has often been pinpointed as one of the possible causes of diverging revenues.

Recent studies have analyzed the long-term evolution of the share of total income held by individuals positioned in the top 1 percent of a country’s income distribution for a significant number of developed and developing countries. Almost all countries turn out to experience a sharp decline in the top share of income in the first half of the 20th century, a phenomenon that has been attributed to a decline in capital income, due to shocks attributed to the wars and the Great depression. For a majority of countries for which information is available the decline continued after WWII. In many countries, however, both developed and developing, the trend was reversed in the 1980s when the share of the top 1 percent started to increase. In particular, Anglo-Saxon countries and a number of developing countries for which data are available experienced an increase in the share of top 1% starting in the 1980s and 1990s. This increase in inequality is also captured by other inequality measures, such as the wage gap between the educated and less educated workers. In the second half of the 20th century, in particular the period following 1980, trade and capital flows also increased significantly. This may be one of the reasons why observed increases in inequality have frequently been associated in the public debate with the phenomenon of globalization.

In the 1990s and early 2000s, economists focused their analysis on the links between merchandise trade and wage inequality. Most of this literature examined the channels emphasized in the workhorse model of trade, the Hecksher-Ohlin model. A simple version of this model suggests that in countries with a relatively abundant educated workforce, trade will increase the relative demand for educated labor and thus increase the wage gap between educated and less-educated workers. On the other hand, the relative demand for less skilled labor in unskilled-labor abundant countries will increase, thus reducing the wage inequality between educated and less educated workers there. A large body of empirical research on this topic, however, finds little evidence that international trade in final goods induced by relative factor endowment differences can account for much of the observed increase in skill premium in developed and developing countries. The lack of evidence of wage inequality increases induced by Hecksher-Ohlin type mechanisms is often cited in support of the idea that the main driver of growing wage inequality is skilled-biased technological change and not trade.

While many economists now agree that skilled-biased technological change plays an important role in accounting for recent trends in wage inequality recent research has uncovered evidence on new channels through which trade could have contributed to observed increases in wage inequality in developed and developing countries. In particular, the recent literature on trade with heterogeneous firms suggests that trade could contribute to wage inequality via residual wage inequality, by influencing differences in wages paid to workers across firms. Moreover, the growing skill premium in developed and developing countries could in part be driven by increases in offshore outsourcing.
Recent literature has documented large heterogeneity in various performance measures across firms within narrowly defined industries. In particular, this literature has shown that in the presence of fixed cost of exporting, the initially more productive firms select to become exporters and expand, in response to increased export market profitability, while less productive firms contract. In addition, more productive firms also upgrade product quality or production technology in response to new export opportunities. Both changes tend to raise demand for relatively skilled labor, as well as wage disparities across heterogeneous firms which lead to increases in residual wage inequality.

An increasing share of trade occurs in intermediate goods and firms increasingly engage in “global production sharing”. In the mid 2000s, trade in intermediate goods accounted for two thirds of world trade. Several theory papers have argued that the expansion of “global production sharing” could account for part of the growing wage gap between skilled and unskilled workers in both developed and developing countries. The latter would be the case because offshoring can directly contribute to skill biased technological change in developing countries. A number of empirical studies have found evidence consistent with this theory.

Recent studies have also argued that in the context of offshoring, it may be more important to analyze income changes at the occupation, rather than at the skill or sectoral level. Occupations vary vastly in exposure to offshoring, ranging from no exposure in occupations such as teachers to high increases in exposure in categories such as shoe machine operators. Relevant empirical work has found that workers in occupations characterized by an increase in offshoring to low-wage countries observe a decline in earnings, while workers in occupations characterized by an increase in offshoring to high-wage countries experience earning gains. The declines in earnings associated with low-wage offshoring occur at all levels of education and are particularly pronounced for older workers.

The relevant studies find no relationship between offshoring and wages during the 1980s, a period when fragmentation of production was perhaps less prevalent. However, the offshoring to low-wage countries has a negative effect on US occupation-specific wages in the 1990s and early 2000s. Interestingly, increased service offshoring to China and India during this period appears to have a negligible effect on earnings in the United States.

Overall, the large literature on the link between trade and wage inequality indicates that the fact that wage inequality increased significantly in a period in which many developing countries implemented large trade liberalizations does not necessarily imply that trade has been a major driver of increased inequality. Indeed, the literature on the topic has shown that the effect of international trade on wage inequality is rather nuanced and depends on the specific country in question, the nature of trade liberalization, and/or the type of trade that countries engage in.