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The “China Effect” on the Rise of Global Inequality

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Recent literature has provided convincing empirical evidence that global trade integration and inequality grew very much in parallel (Helpman, 2016; Dreher and Gaston, 2008). Empirical efforts have been made to explore likely relationships between globalization and inequality from different perspectives, between and within countries, yet little attention has been paid to factor cost distortion-induced inequality, typically, underpaid labor cost hence subsidized compensation for capital. Such an effect on inequality could be considerable if it is caused by a giant trade participating country like China. We are highly motivated to explore the “China effect” on the rise of the global inequality because hundreds of millions migrant workers, most of whom are unskilled and engaged in labor-intensive manufacturing industries, have been in inferior position in competing for fair compensation due to institutionally banned collective bargaining at all levels and highly growth-motivated local governments, under a politically centralized and economically decentralized authoritarian regime, tend to work in the best interest of investors (Xu, 2015; Wu, 2016 and 2019).

It is not only that the unskilled Chinese workers who are typically engaged in technologically lower-end manufacturing industries are especially underpaid, but more importantly that China’s sheer size has also strengthened such a cost advantage. Manufacturers in other countries whose productivity is not high enough to compensate for the cost gap are forced to exit from the global market. Consequently, the unskilled workers in other countries are squeezed out and suffer from unemployment and reduction in income. By the same token, skilled workers of high-tech industries of other economies who are not exposed to this effect, but likely become better off with cheaper consumer goods made in China, will be benefitted though incompatible with capital owners both in China and capital-rich countries.

To model the above idea, first, we measure the factor cost distortions in China following the ideas proposed by Restuccia and Rogerson (2008) and Hsieh and Klenow (2009). Second, we build a multi-country and multi-sector general equilibrium model featuring international trade, introducing factor cost distortions in China based on Eaton and Kortum (2003). Third, we characterize firms’ behavior of entry to and exit from the global market due to the distortions

based on Melitz (2003). In this model, the productivity of firms in each sector follow a distribution. Firms with higher productivity are able to provide lower export price, and are easier to survive in the global market. While firms with lower productivity are more vulnerable to the China's low price attack and will be forced to exit from the global market. Finally, using the WIOD data and China Industry Productivity (CIP) database (Wu, 2016), we calculate the equilibrium with and without distortions, calibrate the model and compare the employment distribution, wage distribution and welfare change to see how China's factor cost distortions affect the wage inequality of other countries.

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