

INEQUALITY, COSTLY REDISTRIBUTION AND WELFARE IN AN OPEN ECONOMY*

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Abstract

This paper studies the welfare implications of trade liberalization in a world in which trade raises aggregate income but also increases income inequality, and in which redistribution needs to occur via a distortionary income tax-transfer system. We provide tools to characterize and quantify the effects of trade opening on the distribution of *disposable* income (after redistribution). We propose two model-based adjustments to standard measures of the welfare gains from trade: a ‘welfarist’ correction inspired by the [Atkinson \(1970\)](#) index of inequality, and a ‘costly-redistribution’ correction capturing the efficiency costs associated with the behavioral responses of agents to trade-induced shifts across marginal tax rates. We calibrate our model to the United States over the period 1979-2007 using data on the distribution of adjusted gross income in public samples of IRS tax returns, as well as CBO information on the tax liabilities and transfers received by agents at different percentiles of the U.S. income distribution. Our quantitative results suggest that these corrections are nonnegligible: trade-induced increases in inequality of disposable income erode about 20% of the gains from trade, while the gains from trade would be about 15% larger if redistribution was carried out via non-distortionary means.

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1 Introduction

Two of the most salient phenomena in the world economy in recent years have been a rapid increase in the extent to which economies have become interconnected and a significant rise in income inequality in many countries. For instance, during the period 1979-2007, the U.S. trade share (defined as the average of exports and imports divided by U.S. gross output) increased from a value of 4.9% to 7.7%, while the Gini coefficient associated with the distribution of U.S. market income grew dramatically from a level of 0.48 all the way to 0.59. Furthermore, as is clear from Figure 1, trade integration and inequality grew very much in parallel even at fairly high frequencies. The extent to which these two phenomena are causally related has been the subject of intense academic debates, but it is by now a widely accepted view that trade integration has been a significant contributor to increased wage and income inequality in the U.S. and many other industrialized countries.¹ The picture emerging from developing countries also points to the importance of trade-induced inequality. [Goldberg and Pavcnik \(2007\)](#) summarize a body of literature studying the consequences of trade liberalization across a number of developing countries after 1970s, with the bulk of episodes triggering significant increases in inequality.

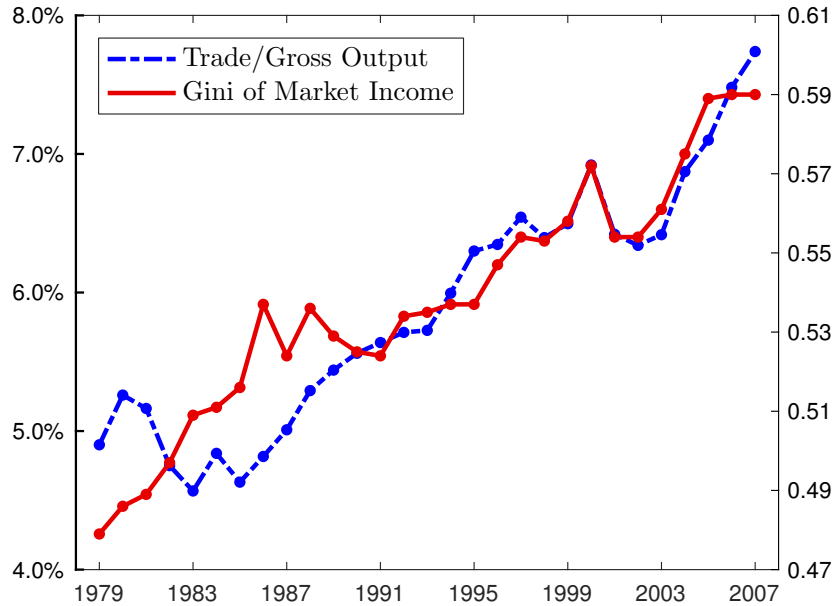


Figure 1: Trade Integration and Income Inequality: United States (1979-2007)

Despite these recent trends, the standard approach to demonstrating and quantifying the welfare gains from trade largely ignores the implications of trade-induced inequality. The paradigm used to evaluate the social welfare consequences of trade integration is the Kaldor-Hicks compensation principle ([Kaldor, 1939](#); [Hicks, 1939](#)). This approach begins by computing the compensating (or equivalent) variation of a policy change at the individual level, and then aggregates

¹[Feenstra and Hanson \(1999\)](#), for instance, estimate that outsourcing alone could account for as much as 40% of the increase in the U.S. skill premium in the 1980s. Other studies, summarized in [Krugman \(2008\)](#), arrive at more conservative estimates suggesting that trade accounted for about 15-20% of the increase in income inequality.

this money metric across agents. The celebrated ‘gains from trade’ result demonstrates that, in competitive environments, when moving from autarky to any form of trade integration, the losers can always be compensated and there is some surplus to potentially turn this liberalization into a Pareto improvement. A key advantage of the Kaldor-Hicks criterion as a tool for policy evaluation is that it circumvents the need to base policy recommendations on interpersonal comparisons of utility, thus extricating economists’ prescriptions from their own moral convictions (cf., [Robbins, 1932](#)).

As influential as the Kaldor-Hicks compensation principle has proven to be, it has two basic shortcomings. First, the fact that there is the *potential* to compensate those that are hurt from a particular policy does not imply that these losers will be compensated *in practice*. If one knew that the redistribution or compensation necessary for a policy to generate Pareto gains would not happen or would not be complete, shouldn’t the evaluation of such a policy take this fact into account? Second, the simple aggregation of individual compensating or equivalent variations in the Kaldor-Hicks criterion implicitly assumes the existence of nondistortionary means to redistribute part of the gains from the policy to those that do not directly benefit from it. In reality, compensation often takes places through a tax and transfer system embodying nontrivial deadweight losses, so it seems reasonable to build this characteristic of redistribution into measures of the social welfare effects of a policy.

In this paper, we study the welfare implications of trade opening in a world in which international trade affects the shape (and not just the mean) of the income distribution, and in which redistribution policies need to occur via a distortionary income tax-transfer system. In this environment, we provide tools to characterize and quantify the *actual* amount of compensation that will take place following trade opening, as well as the *efficiency costs* of undertaking such redistribution. More specifically, we propose two types of adjustments to standard measures of the welfare gains from trade. On the one hand, we develop a ‘welfarist’ correction which captures the negative impact that an increase in inequality in the distribution of disposable income has on the welfare an inequality-averse social planner. This first adjustment is tightly related to the [Atkinson \(1970\)](#) index of inequality, which has been rarely applied to trade contexts.² On the other hand, we derive a ‘costly-redistribution’ correction which captures the behavioral responses of agents to *trade-induced* shifts across marginal tax rates. This second adjustment builds on the voluminous public finance literature on the efficiency costs of taxing income, and is especially related to the structural work of [Benabou \(2002\)](#), although our approach is generalized to apply to income distributions other than the lognormal one, and also to models with an extensive margin response to taxation.

We begin our analysis in section 2 within a fairly general environment that illustrates the rationale for these two corrections when evaluating *any* policy (not just trade liberalization) that has the potential to affect the shape of the income distribution beyond its mean. In this environment, we derive explicit formulas for these adjustments in terms of specific moments of the income distribution, the level of progressivity of the tax-transfer system, the degree of

²Three very recent exceptions are the ongoing projects by [Rodriguez-Clare et al. \(2015\)](#), [Porto \(2015\)](#) and [Carrère et al. \(2015\)](#).

inequality aversion of the social planner, and the elasticity of taxable income to changes in marginal tax rates.

Our environment in section 2 is silent on the primitive determinants of the income-generation process or on the precise mechanism that leads to a positive elasticity of income to changes in marginal taxes. In section 3, we develop a microfounded simple general equilibrium framework that illustrates how the ability of individuals and their labor supply decisions translate in equilibrium earnings and welfare levels given the tax system in place. When solving for the closed-economy equilibrium of the model, we are able to decompose changes in welfare into three terms: (i) changes in the welfare of a hypothetical ‘Kaldor-Hicks’ economy with access to costless redistribution and no inequality aversion, (ii) changes in the welfarist correction, and (iii) changes in the costly-redistribution correction.

The economic environment we develop builds on [Itskhoki \(2008\)](#), and is inspired by the canonical optimal taxation framework of [Mirrlees \(1971\)](#) and the workhorse model of trade of [Melitz \(2003\)](#). Agents in our economy are workers each producing a distinct task associated with the production of a final good. Unobservable heterogeneity in productivity across agents generates income inequality, which an inequality-averse social planner may try to moderate via a progressive system of income taxation. The two key departures from the classic Mirlees framework is that we allow for imperfect substitutability in the task services provided by different workers and that we restrict attention to a specific form of nonlinear taxation that, consistently with U.S. data, implies a log-linear relationship between income levels before and after taxes and transfers (see also [Heathcote et al., 2014](#)). Imperfect substitutability is not essential for our closed-economy results but is the source of the welfare gains from trade later in the paper.³

Before moving to this open-economy environment, in section 4 we provide a brief calibration of the closed-economy model that decomposes the evolution of social welfare in the U.S. over the period 1979-2007 in terms of the welfarist and costly-redistribution corrections and the welfare of the hypothetical ‘Kaldor-Hicks’ economy. We calibrate our model using data on the distribution of adjusted gross income in public samples of IRS tax returns, as well as CBO information on the tax liabilities and transfers received by agents at different points of the U.S. income distribution. Our calibration unveils a very significant decline in the degree of tax progressivity over this period despite the concomitant increase in ‘primitive’ income inequality. This naturally resulted in an exacerbated increase in inequality in the distribution of *disposable* income. As a consequence, even for modest degrees of inequality aversion, the implied social welfare gains are significantly lower than the average real income gains recorded over this period. We also use our simple calibration to shed light on the growth in average real income that the U.S. would have attained if the progressivity of the U.S. tax system had been kept constant at its 1979 level, or if tax progressivity had increased to avoid the observed rise in income inequality. We find that real income growth in those counterfactual scenarios would have been markedly lower than the 1.32% annual increase observed in the data. For instance, for the case of a degree of inequality aversion equal to 1 and an elasticity of taxable income equal to 0.5, we find that real

³Imperfect substitutability between different types of labor in the Mirrlees model were studied by [Feldstein \(1973\)](#) and [Stiglitz \(1982\)](#) in a two-class economy.

income would have grown at an average annual rate of 0.90% if tax progressivity had remained constant, and at an even lower annual rate of 0.44% if progressivity had increased to keep income inequality unchanged over the period.

Armed with this suggestive evidence of the empirical relevance of our two key inequality corrections, in section 5 we move to an open-economy environment, which is a direct extension of the closed-economy framework in section 3. In particular, our assumed imperfect substitutability of the tasks performed by different workers worldwide results in welfare gains from trade integration associated with final output being produced with a wider range of differentiated tasks. These love-for-variety gains from trade are thus analogous to those in [Krugman \(1980\)](#) or [Ethier \(1982\)](#). In order to generate nontrivial effects of trade on the income distribution, we follow [Melitz \(2003\)](#) and introduce fixed costs of exporting, which allow only the most productive agents to participate in international trade. Consequently, trade disproportionately benefits the most productive agents in society, leading to greater income inequality in a trading equilibrium than under autarky. The progressivity of the tax system attenuates the rise in inequality following trade liberalization, but unless tax progressivity increases with trade, the distribution of disposable income will necessarily become more unequal with trade, thus leading to a higher welfarist correction than under autarky. Furthermore, selection into exporting generates an extensive margin of trade, which is sensitive to national redistribution policies and contributes to the overall efficiency costs of taxation. We thus find that our ‘costly-redistribution’ correction is also generally exacerbated by a process of trade integration.

In section 6, we calibrate our open-economy model with the same IRS tax returns data employed in section 4, together with measures of trade costs and trade shares to calibrate the key trade frictions parameters of the model. We then perform counterfactuals to gauge the effects of trade on aggregate income and inequality. Our quantitative results suggest that our two suggested welfare corrections are nonnegligible. Under our preferred parametrization, trade-induced increases in disposable income inequality erode about one-fifth of the U.S. gains from trade, while gains from trade would have been about one-sixth larger if redistribution had been carried out via non-distortionary means. The welfarist correction increases in the degree of inequality aversion of society, but even for inequality aversion levels as high as 2, the gains from trade are reduced by not more than a quarter of their values in the absence of inequality aversion. Similarly, the welfare loss from the costly redistribution correction rises with the elasticity of taxable income, but even when this elasticity takes a high value of one, the costly-redistribution correction does not erode more than a quarter of the gains from trade. The size of the two corrections also appears to be fairly insensitive to alternative parametrizations of the model.

Our model of the effects of trade on the income distribution is highly stylized and abstracts from many features that have been emphasized in past and more recent research on trade and labor markets. For many years, the Heckscher-Ohlin (HO) model, and in particular its Stolper-Samuelson theorem, provided the key conceptual framework used to analyze the links between trade and wage inequality. Nevertheless, the empirical limitations of this framework have become apparent in recent years. As mentioned above, trade liberalizations have led to sharp increases

in inequality not only in rich countries but also unskilled-labor abundant developing countries, a phenomenon at odds with the predictions of the HO model.⁴ In addition, the contribution of the residual component of wage inequality within groups of workers with similar observable characteristics appears to be at least as important as the growing skill premium across groups, as emphasized by the HO model.⁵ Finally, contrary to the main mechanism of adjustment in the HO model, the reallocation within sectors appears to be more important than across sectors for both adjustment to trade and inequality dynamics.⁶

For these reasons, recent work has explored alternative models featuring richer interactions between labor markets and trade liberalization. One branch of this literature has explored the role of search frictions and other type labor-market imperfections (see, for instance, [Helpman et al., 2010](#), [Egger and Kreickemeier, 2009a](#) or [Amiti and Davis, 2012](#), among many others), while a second branch has focused on the role of sorting of heterogeneous workers into firms or technologies (see, for instance, [Yeaple, 2005](#), [Costinot and Vogel, 2010](#) or [Sampson, 2014](#)), or the matching of heterogeneous workers into production teams (see [Antràs et al., 2006](#)). Our international trade model is much more parsimonious than those developed in this recent research, yet the mechanism through which it generates trade-induced inequality is similar in spirit to the one generating the same link in those models. A crucial advantage of our stylized model relative to these alternative ones is that it is much more amenable to calibration and quantification of the counterfactual inequality effects of a trade liberalization. Furthermore, the sparse nature of our framework also allows us to incorporate behavioral responses to taxation, which previous models in this literature do not feature. An open question for future research is the extent to which the inequality corrections arising from our framework are similar in magnitude to those one would obtain in richer frameworks.

Within the international trade field, our paper is also related to previous work studying the redistribution of the gains from trade.⁷ Following [Dixit and Norman \(1980, 1986\)](#), this strand of the literature has mainly focused on the possibility of compensating losers from trade through a variety of tax instruments. Dixit and Norman themselves focused on the sufficiency of commodity and factor taxation for ensuring Pareto gains from trade, while [Spector \(2001\)](#) and [Naito \(2006\)](#) showed how Mirrlees-type incentive constraints could undermine differential factor taxation, thereby opening the door for the possibility that trade could lead to welfare losses by hampering redistribution.⁸ Relative to this body of work, our goal is to instead characterize and quantify the *actual* efficiency costs of redistribution given the observed features of the

⁴A related observation is that the movements in relative prices of skilled to unskilled goods, which are at the core of the Stolper-Samuelson mechanism, tended to be small (e.g., see [Lawrence and Slaughter, 1993](#)).

⁵For example, see [Autor et al. \(2008\)](#) for the evidence for US and [Attanasio et al. \(2004\)](#) for the evidence for a developing country (Colombia).

⁶For example, [Faggio et al. \(2007\)](#) show that most of the increase in wage inequality in the U.K. happened within industries, while [Levinsohn \(1999\)](#) shows the relative importance of within-industry reallocation in response to trade liberalization in Chile.

⁷Another strand of literature, started by [Cameron \(1978\)](#) and [Rodrik \(1998\)](#), studies the optimal size of the government sector in an open economy.

⁸[Davidson and Matusz \(2006\)](#) design the lowest cost compensation policies for the losers from trade in a two-sector economy with heterogeneous agents and participation decisions, but fixed labor supply (see also [Egger and Kreickemeier, 2009b](#)).

system used to carry out such compensation in the real world.⁹ In that sense, our focus on the income tax-transfer system as the vehicle for redistribution is motivated by the small scale and limited relevance of more direct means of compensation, such as trade adjustment assistance programs. For instance, in their influential recent study on the U.S. labor-market implications of the rise of Chinese import competition, [Autor et al. \(2013\)](#) find that the estimated dollar increase in per capita Social Security Disability Insurance (SSDI) payments following trade-induced job displacements is more than thirty times as large as the estimated dollar increase in Trade Adjustment Assistance (TAA) payments.

Finally, our welfarist and costly redistribution corrections are not only related to the contributions of [Kaldor \(1939\)](#), [Hicks \(1939\)](#), [Atkinson \(1970\)](#), and [Benabou \(2002\)](#), but they also connect to a large body of related work. The welfarist approach to policy evaluation originates in the pioneering work of [Bergson \(1938\)](#) and [Samuelson \(1948\)](#), and has constituted an important paradigm in the optimal policy literature since the seminal work of [Diamond and Mirrlees \(1971\)](#), and the more recent literature that spun from the work of [Saez \(2001\)](#). Similarly, we are certainly not the first to incorporate the costs of redistribution into the analysis of the welfare effects of policies. The need to do so was actually anticipated by Hicks in the concluding passages of his 1939 paper, and was subsequently explored by [Kaplow \(2004\)](#) and, more recently, by [Hendren \(2014\)](#). [Hendren \(2014\)](#), in particular, estimates the *inequality deflator* associated with the transfer of one dollar of income from individuals at different positions in the U.S. income distribution to the rest of the U.S. population. He finds that this deflator is higher for rich individuals than for poor individuals and uses it to quantify the effects of increased income inequality on U.S. economic growth. His approach to costly redistribution is certainly more sophisticated than the one adopted in this paper, as it involves an estimation of the joint distribution of marginal tax rates and the income distribution using the universe of U.S. income tax returns in 2012. The thought experiment that motivates his work is however distinct from ours. While we seek to understand the efficiency costs associated with the behavioral responses of agents triggered by trade-induced shifts across marginal tax rates, his focus is on understanding the efficiency consequences of *local changes* to the nonlinear income tax schedule aimed at compensating the losers from a particular policy. It might be fruitful to adopt his approach to the study of the effects of trade liberalization, but we leave this for future research.

2 Inequality and Welfare: A Primer

We begin our analysis in this section by considering various approaches to measuring the evolution of social welfare in the face of changing inequality and when complete and costless redistribution is infeasible. We first review the Kaldor-Hicks principle and the Atkinson’s welfarist approach, and then present our costly redistribution approach. While doing so, we introduce our two main inequality correction terms for measuring welfare gains—the welfarist correction and the costly-redistribution correction—and discuss their properties. In order to simplify the

⁹[Rodrik \(1992\)](#) is a noteworthy antecedent to our work in discussing the costs of redistribution following changes in trade policy.

exposition, the framework developed in this section will leave some of the primitive determinants of income, welfare and costly redistribution unspecified. In section 3, we formalize these correction terms in a context of a simple yet fully microfounded general-equilibrium model, and we illustrate how to use this framework to provide back-of-the-envelope calculations of welfare changes when both aggregate income and inequality change over time.

2.1 Economic Environment

Consider a society composed of a measure one of individuals indexed by their ability level φ with associated real earnings r_φ . Agents' preferences are represented by a utility function U defined over consumption c_φ . Agents' consumption is in turn equal to their real *disposable* income r_φ^d , defined as:

$$r_\varphi^d = [1 - \tau(r_\varphi)]r_\varphi + T_\varphi, \quad (1)$$

where $\tau(r_\varphi)$ denotes a non-linear income tax and T_φ represents a lump-sum transfer. The distribution of φ in the population is given by the cumulative distribution function H_φ , while the associated income distribution for real before-tax earnings is denoted by F_r . For simplicity, we assume –for the time being– that the government budget is balanced so that

$$\int r_\varphi^d dH_\varphi = \int r dF_r = R.$$

The society is evaluating the consequences of a policy (such as a trade liberalization) that would generate heterogeneous effects on agents' real incomes, thereby leading to a shift from the initial distribution of earnings F_r to a new distribution of real income F_r' . What are the welfare consequences of the move from F_r to F_r' ?

We discuss below three different approaches to the evaluation of the social welfare implications of the move from F_r to F_r' .

2.2 The Kaldor-Hicks Principle

The Kaldor-Hicks compensation principle constitutes the standard approach to evaluating the welfare effects of a policy. To identify a Kaldor-Hicks improvement, one starts by computing the compensating or equivalent variation for each individual associated with the particular policy under study, and these money metrics are then aggregated across all individuals. In our example above, this principle implies that *mean* real income growth is a sufficient statistic for comparing social welfare under F_r and F_r' , regardless of the effect of the policy on the higher moments of the income distribution.

Let us illustrate this for the case of the compensating variation, which we denote with v_φ for an individual of type φ and which satisfies:

$$u(r_\varphi^{d'} + v_\varphi) = u(r_\varphi^d). \quad (2)$$

It follows that the required aggregate compensation satisfies:

$$-\int v_{\varphi} dH_{\varphi} = \int r_{\varphi}^{d'} dH_{\varphi} - \int r_{\varphi}^d dH_{\varphi} = \int r dF_r' - \int r dF_r. \quad (3)$$

Clearly, the right-hand-side of (3) corresponds to the change in aggregate real income, which we write as $R' - R$. If this quantity is positive, it means that the amount of money necessary to restore the losers' welfare to its pre-policy level is lower than the amount that winners are jointly willing to give up for the policy to be adopted. In order to quantify the gains from trade, it is standard to express the change in (3) as a percentage change relative to the initial level of aggregate real income R , which we can denote by

$$\left. \frac{W'}{W} \right|_{\text{Kaldor-Hicks}} = 1 + \mu^R \equiv \frac{R'}{R}. \quad (4)$$

The welfare gains from the policy thus correspond to the mean real income growth μ^R it generates. More generally, the overall welfare impact of other exogenous shocks can be evaluated analogously by only considering their effect on average income (or GDP).

Although we have assumed that all agents have a common indirect utility function U , it is clear from equation (2) that the result in (3) will apply even when agents are heterogeneous not only in income but also in preferences. This is a key appealing feature of the Kaldor-Hicks criterion: it does not rely on interpersonal comparisons of utility.¹⁰

As noted in the Introduction, there are however two key limitations of the Kaldor-Hicks criterion. First, the fact that there is the *potential* for the winners to compensate the losers does not mean that this compensation *actually* takes place in practice. If little redistribution takes place and the ex-post distribution of income is much more unequal than the ex-ante one, it is less clear that mean income should be a sufficient statistic for measuring welfare changes. Second, the focus on compensating or equivalent variations is justified only in the presence of lump-sum taxes that are needed to ensure the frictionless redistribution of gains across the individuals. While a useful theoretical tool, lump-sum transfers are informationally intensive and rarely feasible in practice. Naturally, compensation may also be achievable via other forms of redistribution, but these alternative instruments are likely to impact economic efficiency and thus the magnitude of the welfare gains from a policy.

In light of these limitations, we next discuss two alternative (and complementary) approaches to policy evaluation that explicitly correct for the induced effect of a policy on income inequality.

2.3 The Welfarist Approach

The welfarist (or social welfare) approach to policy evaluation begins by positing the existence of a social welfare function that maps the vector of agents' welfare levels into a single real number. It is customary to express this function as an integral of concave transformations of agents'

¹⁰In other words, the welfare gains in (4) are independent of the particular cardinal utility functions that are chosen to represent the ordinal preferences of individuals.

actual (and not potential) disposable incomes (and thus consumption levels).¹¹

$$V = \int u(r_\varphi^d) dH_\varphi, \quad (5)$$

where $u'(\cdot) > 0$ and $u''(\cdot) \leq 0$. There are at least two possible justifications for specifying $u(\cdot)$ as a concave function. First, given two distributions of *disposable* income with the same mean, one would expect society to prefer the one with the lowest dispersion or inequality (c.f. [Atkinson, 1970](#)), with the concavity of $u(\cdot)$ reflecting inequality aversion on the part of the social planner. It is important to emphasize that, under the plausible assumption that agents' preferences feature diminishing marginal utility of income, inequality aversion is completely consistent with a utilitarian social planner that simply seeks to maximize the sum of agent's utilities. A second justification for the concavity of $u(\cdot)$ is that it might capture risk aversion on the part of ex-ante identical individuals in some sort of "original position" attempting to compute the individual welfare implications of changes in the environment behind a "veil of ignorance" (c.f., [Vickrey, 1945](#); [Harsanyi, 1953](#)).

To fix ideas, we shall follow [Atkinson \(1970\)](#) and consider a constant-elasticity function:

$$u(r_\varphi^d) = \frac{(r_\varphi^d)^{1-\rho} - 1}{1-\rho}, \quad (6)$$

where $\rho \geq 0$ can be interpreted as reflecting a constant degree of inequality aversion on the part of the social planner or a constant degree of risk aversion on the part of agents in the original position (or a combination of both). In order to express social welfare changes in terms of equivalent changes in aggregate consumption, it will further prove convenient to consider the simple monotonic transformation

$$W = [1 + (1-\rho)V]^{1/(1-\rho)} \quad (7)$$

of the social welfare function in (5). With this transformation, social welfare can be expressed as a multiplicatively separable function of aggregate real income R and a term Δ , which is inversely related to the level of inequality underlying the distribution of disposable income:

$$W = \Delta \times R, \quad (8)$$

where

$$\Delta = \Delta(F_r^d, \rho) = \frac{\left[\mathbb{E}(r_\varphi^d)^{1-\rho} \right]^{\frac{1}{1-\rho}}}{\mathbb{E}r_\varphi^d}. \quad (9)$$

The term Δ , which we will refer to as a *welfarist inequality correction*, corresponds *exactly* to one minus the [Atkinson \(1970\)](#) index, a widely used measure of inequality. By Jensen's inequality we have that $\Delta \leq 1$, with $\Delta = 1$ only if either there is no inequality aversion ($\rho = 0$) or if the

¹¹More generally, the social welfare function is represented by a vector (density function) of utility weights which the planner uses to aggregate individual welfare levels.

distribution of disposable income F_r^d is fully egalitarian (has zero dispersion). Furthermore, Δ tends to be lower, the higher is the level of inequality in the distribution of income F_r^d or the higher is inequality aversion ρ . To be more precise, while Δ is invariant to proportional changes of the income distribution (i.e., when all income levels are scaled by the same constant), Δ is reduced by mean-preserving spreads of the distribution of disposable income (c.f., [Atkinson, 1970](#)). And holding constant the distribution of disposable income, F_r^d , the higher is the degree of inequality (or risk) aversion ρ , the greater is the correction and the smaller is Δ (see [Appendix A.1](#) for a formal proof). As we show in [Appendix A.2](#), for certain often-used distributions of income, it is also possible to relate Δ to the Gini coefficient associated with F_r^d .

The expression for welfare (8) immediately implies that the percentage welfare gains from a policy are given by:

$$\left. \frac{W'}{W} \right|_{\text{Welfarist}} = (1 + \mu^R) \times \frac{\Delta'}{\Delta}, \quad (10)$$

where μ^R is the growth rate of real income as defined in (4) and $\Delta' = \Delta(F_r^{d'}, \rho)$ corresponds to the correction term under the new income distribution. Thus in the absence of any effect of trade on inequality as captured by Δ , the change in welfare corresponds exactly to the percentage change in real income μ^R , as in the Kaldor-Hicks compensation principle approach in (4). Nevertheless, if trade increases inequality, then welfare increases by less than $1 + \mu^R$, with a larger downward correction the larger ρ is and, of course, the larger the increase in inequality. The particularly size of the correction can be easily computed with data (real or counterfactual) about the distribution of disposable income before and after the policy, as we shall illustrate in [sections 4 and 6](#).

As mentioned above, an advantage to using the function W in (7) instead of any other monotonic transformations of V in (5) is that the change in welfare in (10) also corresponds to the consumption-equivalent change in social welfare of moving from F_r^d to $F_r^{d'}$. More specifically, it is easy to verify (see [Appendix A.1](#)) that if one were to compute the percentage change in all agents' consumption or disposable income that would make society indifferent between F_r^d and $F_r^{d'}$, the answer one would get would be $\mu^C = (1 + \mu^R) \times \frac{\Delta'}{\Delta} - 1$ regardless of whether social welfare is measured in terms of the function V or of any monotonic transformation of V (including W).

2.4 The Costly-Redistribution Approach

Despite its widespread use in the optimal policy literature, the welfarist approach remains controversial. This is in large part due to the sensitivity of its prescriptions to the value of certain parameters, such as the degree of inequality aversion (or, more generally, the social marginal weights assigned to agents with different income), that are difficult to measure and over which people have vastly different ethical views.

We next consider a complementary approach that is more akin to the Kaldor-Hicks compensation principle, but that explicitly models the fact that redistribution is costly, and the costs of redistribution are increasing in the extent of economic inequality. The welfare correction in

this case quantifies the forgone gains in real income due to the costly redistribution mechanism put in place by society to reduce income inequality.

For this purpose, we return to our previous example but suppose now that lump-sum transfers are not feasible (i.e., $T_\varphi \equiv 0$) and redistribution has to work through the income tax system. Above, we have introduced a general nonlinear income tax $\tau(r_\varphi)$, but we will now focus on the particular case, used among others by [Benabou \(2002\)](#) and [Heathcote et al. \(2014\)](#), in which

$$r_\varphi^d = [1 - \tau(r_\varphi)]r_\varphi = kr_\varphi^{1-\phi}, \quad (11)$$

for some constant k that can be set to ensure that the government budget is balanced. Average net-of-tax rates thus decrease in reported income at a constant rate ϕ , with this parameter governing the degree of progressivity of the tax system. When $\phi = 0$, all agents face the same tax rate k and there is no redistribution from the rich to the poor; in fact, with budget balance there is no redistribution whatsoever. When $\phi = 1$, (11) implies that all agents end up with the same after-tax income and thus redistribution is full and eliminates inequality.¹²

The specification in equation (11) may seem quite ad hoc and unlikely to provide a valid approximation to the complicated tax and transfer systems employed in modern economies. Nevertheless, its implied log-linear relationship between market income and income after taxes and transfers fits U.S. data remarkably well, as we will illustrate in more detail in section 4 (see also [Heathcote et al., 2014](#) and [Guner et al., 2014](#)).

A larger degree of progressivity tends to compress the after-tax income distribution, but it implies that rich people face disproportionately larger marginal tax rates. More specifically, the marginal tax rate implied by (11) is given by $\tau^m(r_\varphi) = 1 - k(1 - \phi)r_\varphi^{-\phi}$ and thus rises with both the degree of tax progressivity ϕ as well as the level of income r_φ . To the extent that higher marginal tax rates generate behavioral responses of agents that lead them to generate less income than they would under a lower marginal tax rate, the increased redistribution brought about by a higher degree of progressivity will generate costs. To capture this costly aspect of redistribution in a simple though fairly standard way, we posit the existence of a positive, constant elasticity of taxable (realized) income to the net-of-marginal-tax rate $1 - \tau^m$:

$$\varepsilon \equiv \frac{\partial \log r_\varphi}{\partial \log(1 - \tau^m(r_\varphi))} \geq 0, \quad (12)$$

where $\tau^m(r_\varphi)$ is the marginal tax rate faced by agents with income r_φ .

The combination of a progressive tax system of the type in (11) and a positive elasticity of taxable income ε makes redistribution from rich people to poor people costly, thereby motivating an alternative correction to the standard measures of the welfare effects of a policy. More

¹²More generally, the results in [Jakobsson \(1976\)](#) and [Kakwani \(1977\)](#) imply that, starting from a fixed arbitrary distribution of pre-tax income, an increase in ϕ necessarily leads to a more egalitarian distribution of after-tax income, in the sense that it makes disposable income more evenly distributed according to the Lorenz criterion.

specifically, one can manipulate equations (11) and (12) and impose budget balance, to obtain:

$$R = \Theta \times \tilde{R}, \quad (13)$$

where $\tilde{R}$ is the *potential* income in the absence of progressive redistribution ($\phi = 0$) or behavioral responses to taxation ($\varepsilon = 0$), and

$$\Theta = \Theta(F_r, \phi, \varepsilon) = (1 - \phi)^\varepsilon \frac{(\mathbb{E}r_\varphi)^{1+\varepsilon}}{\left(\mathbb{E}r_\varphi^{1-\phi}\right)^\varepsilon \cdot \left(\mathbb{E}r_\varphi^{1+\varepsilon\phi}\right)} \quad (14)$$

is a term we refer to as our *costly-redistribution inequality correction*.

Although perhaps not immediate from inspection of (14), Hölder's inequality implies that the second term is no larger than 1, which in turn implies $\Theta \leq 1$. Furthermore, $\Theta = 1$ if and only if the tax-transfer system features zero progressivity ($\phi = 0$) or if the elasticity of taxable income is zero ($\varepsilon = 0$). It thus follows that, when $\phi > 0$ and $\varepsilon > 0$, real income is lower than it would be in the absence of distortionary redistribution. In fact, in Appendix A.1 we show that Θ is strictly decreasing in the tax progressivity rate ϕ for any primitive distribution of potential output $\tilde{r}_\varphi$, thus formalizing the efficiency costs of enhancing redistribution. Holding the other parameters constant, the term Θ also depends on the *primitive* degree of income inequality: Θ is highest whenever the income distribution is perfectly egalitarian and it tends to be lower the more unequal is the distribution of income. More specifically, when considering two distributions of income F_r and F'_r , it is easy to show that $\Theta(F'_r, \phi, \varepsilon) < \Theta(F_r, \phi, \varepsilon)$ when F'_r is a mean preserving multiplicative spread of F_r .¹³ Conversely, Θ is invariant to proportional changes of the income distribution (i.e., when all income levels increase proportionately). In analogy to the Atkinson index, one can interpret Θ as a complementary welfare-relevant measure of inequality, and for certain standard distributions, Θ can be related to the Gini coefficient associated with F_r (see Appendix A.2 for details).

We are now ready to revisit our initial question of how should society evaluate the welfare implications of the move from F_r to F'_r . Even when one adheres to a welfare criterion, such as the Kaldor-Hicks principle, that judges policies based on their implications for real income growth, with costly redistribution society will take into account the effects of the policy on higher moments of the income distribution. The reason for this is that, in the absence of lump-sum transfers, those higher moments shape the determination of mean disposable income. More precisely, building on (13) we can express the aggregate real income gains of the policy as

$$\left. \frac{R'}{R} \right|_{\text{Costly Red.}} = (1 + \tilde{\mu}^R) \times \frac{\Theta'}{\Theta}, \quad (15)$$

¹³The distribution F'_r is a mean preserving multiplicative spread of F_r whenever there exists a random variable θ independent of the original income r such that $r' = (1 + \theta)r$ with $\mathbb{E}(\theta) = 0$. Note that Θ is less than one even when all agents share the same income and thus there is no redistribution in equilibrium. The reason for this is that when considering an off-the-equilibrium path deviation that would increase an agent's income, this agent understands that it will be taxed as a result of that deviation. This is captured by the term $(1 - \phi)^\varepsilon$ in (14).

where $1 + \tilde{\mu}^R \equiv \tilde{R}'/\tilde{R}$ measures the real income gains in the absence of costly redistribution. Whenever the policy has no measurable impact on Θ , the change in welfare corresponds exactly to real income growth of a hypothetical *Kaldor-Hicks economy* that could use lump-sum transfers for redistribution purposes. Such an equivalence would hold when the policy increases the incomes of all agents proportionately (and ϕ and ε do not change). If however the policy increases inequality and thereby lowers Θ , the implied change in aggregate income will be strictly lower than in the case in which inequality had remained unaffected. To summarize, the costly redistribution correction measures the forgone gains in real income due to the interaction between the increased inequality and the progressivity of the tax schedule.

Although we hope that the discussion in this section has served a useful pedagogical role, a proper analysis of how the welfarist and costly redistribution corrections shape social welfare requires the development of a fully specified model in which the income distribution is endogenized and in which the response of agents to taxation is microfounded and taken into account in computing social welfare. We turn to this task in the next section.

3 Inequality and Welfare in a Constant-Elasticity Model

In this section, we develop a simple general equilibrium framework, which specifies how the ability of individuals and their labor supply decisions translate in equilibrium earnings and welfare levels given the tax system in place. In light of our choices of functional forms, we refer to our model as the constant-elasticity model.

The model features four constant elasticity parameters, which we introduce below: (i) a constant Frisch elasticity of labor supply ($1/(\gamma - 1)$); (ii) a constant elasticity of substitution between the labor services (or tasks) performed by different agents in society ($1/(1 - \beta)$); (iii) a constant degree of tax progressivity (ϕ); and (iv) a constant social inequality aversion (ρ). This constant-elasticity structure results in a tractable general equilibrium characterization, which is particularly useful to illustrate our welfare corrections terms. We should emphasize, however, that our model will place little structure on the underlying primitive distribution of ability, and can thus flexibly accommodate *any* equilibrium distribution of income one may choose to calibrate the model to. Let us next introduce the key ingredients of the model more formally.

3.1 Preferences, Technology and Individual Behavior

Consider for now a closed economy inhabited by a continuum of agents with GHH preferences (c.f., [Greenwood et al., 1988](#)) over the consumption of an aggregate good c and labor ℓ :

$$u(c, \ell) = c - \frac{1}{\gamma} \ell^\gamma. \quad (16)$$

The parameter $\gamma \geq 1$ controls the Frisch elasticity of labor supply, which is given by $1/(\gamma - 1)$ and is decreasing in γ . In the presence of elastically supplied labor, theoretically-grounded measures of welfare need to correct income for the disutility costs of producing it, an issue we ignored

in section 2. This utility specification results in no income effects on labor supply and is often adopted in the optimal taxation literature.

Each individual produces output $y = \varphi \ell$ of his own variety of a task (or intermediate good) where φ is individual ability and is distributed according to H_φ as in section 2. The tasks performed by different agents are imperfect substitutes and are combined in the production of the aggregate consumption (final) good according to

$$Q = \left(\int y_\varphi^\beta dH_\varphi \right)^{1/\beta},$$

where $\beta \in (0, 1]$ is a parameter that controls the elasticity of substitution $1/(1 - \beta)$ across tasks. In the limiting case of $\beta = 1$, the individual tasks become perfect substitutes, and the model turns into a special case of a neoclassical [Mirrlees \(1971\)](#) economy. Imperfect substitutability becomes essential when we introduce an explicit model of international trade in section 5, but for the qualitative implications of this section whether $\beta = 1$ or $\beta < 1$ is not important.

Under the above assumptions, the market (real) earnings of an individuals supplying y units of his task to the market are given by:¹⁴

$$r = Q^{1-\beta} y^\beta. \quad (17)$$

Notice that when $\beta < 1$, the demand for each individual task is increasing in aggregate income

$$Q = R = \int r_\varphi dH_\varphi,$$

yet the agents face decreasing demand schedules and as a result their revenues are concave in their own output. When $\beta = 1$, the individual revenues are simply $r = y$, and thus are only a function of their ability and labor supply decisions.

Individual consumption equals after-tax income, $c = r^d = [1 - \tau(r)]r$. As in section 2, we assume that the tax-transfer system is well approximated by equation (11), where the parameter ϕ governs tax progressivity and the parameter k controls the average tax rate across agents. The government uses collected taxes for redistribution and to finance exogenous government spending G , and runs a balanced budget. In other words, the total income of the economy equals the sum of total private consumption (aggregate disposable income) and government spending, so $Q = \int r_\varphi^d dH_\varphi + G$. We further assume that government spending is a fraction g of GDP, i.e. $G = gQ$, and it does not directly affect the individual utilities in (16). Under these circumstances, we can rewrite the government budget balance as:

$$k \int r_\varphi^{1-\phi} dH_\varphi = (1 - g)Q, \quad (18)$$

¹⁴The demand for an individual task variety is given by $q = Q(p/P)^{-\frac{1}{1-\beta}}$, where p is the price of the variety and $P = \left(\int p_\varphi^{-\frac{\beta}{1-\beta}} dH_\varphi \right)^{(1-\beta)/\beta}$ is the price of the final good. We normalize $P = 1$ so that all nominal quantities in the economy are in terms of the final good, and thus are in real terms as well. Under these circumstances, task revenues are $r = pq = Q^{1-\beta} y^\beta$, where we have substituted the market clearing condition $q = y$.

which defines a relationship between k and g given the tax schedule progressivity ϕ . In other words, given the exogenous share of government spending g , there exists a unique average tax parameter k which balances the government budget for any given level of tax progressivity ϕ .

Individuals maximize utility (16) by choosing their labor supply and consuming the resulting disposable income, a program that combining (11) and (17) we can write as:

$$u_\varphi = \max_{\ell} \left\{ k \left[Q^{1-\beta} (\varphi \ell)^\beta \right]^{1-\phi} - \frac{1}{\gamma} \ell^\gamma \right\}.$$

The solution for equilibrium revenues and utilities is given by:

$$r_\varphi = \left[\beta(1-\phi)k \right]^{\frac{\varepsilon}{1+\varepsilon\phi}} \left[Q^{1-\beta} \varphi^\beta \right]^{\frac{1+\varepsilon}{1+\varepsilon\phi}}, \quad (19)$$

$$u_\varphi = \frac{1+\varepsilon\phi}{1+\varepsilon} k r_\varphi^{1-\phi}, \quad (20)$$

where we have made use of the following auxiliary constant:

$$\varepsilon \equiv \frac{\beta}{\gamma - \beta},$$

which also equals the overall elasticity of taxable income to changes in marginal tax rates, as previously defined in (12).¹⁵ When tasks are perfectly substitutable ($\beta = 1$), this elasticity ε coincides with the Frisch elasticity of labor supply $1/(\gamma - 1)$. Yet with imperfect substitutability in tasks ($\beta < 1$), this elasticity is reduced by the downward pressure of increased output on prices.

Equations (19)–(20) show how individual ability translates in equilibrium into market revenue and individual utility, which is proportional in this model to the after-tax income, as the utility cost of labor effort is proportional to disposable income under the optimal allocation. Equilibrium revenues are a power transformation of underlying individual abilities, with the power increasing in the elasticity parameters ε and β , and decreasing in the progressivity of taxation ϕ . The tax progressivity not only reduces the dispersion of after-tax incomes and utilities, but also compresses the distribution of pre-tax market revenues as it has a disincentive effect on labor supply, which is particularly acute for high-ability individuals.

3.2 Aggregate Income and Social Welfare

The characterization of equilibrium revenues and utilities relies on two endogenous aggregate variables, k and Q . The closed-form solutions for these variables are provided in Appendix A.3, where we show that aggregate income (GDP) of the economy can be expressed as

$$Q = \Theta^\kappa \tilde{Q}, \quad (21)$$

¹⁵To see this, remember that the marginal tax rate associated with (11) is given by $\tau^m(r_\varphi) = 1 - k(1-\phi)r_\varphi^{-\phi}$. Plugging this marginal tax rate into (19) and simplifying delivers $r_\varphi = (\beta(1-\tau^m(r_\varphi)))^\varepsilon (Q^{1-\beta} \varphi^\beta)^{1+\varepsilon}$.

where $\Theta < 1$ is the same costly-redistribution correction term introduced above in equation (14), and where

$$\tilde{Q} = [\beta(1 - g)]^{\kappa\varepsilon} \left(\int \varphi^{\beta(1+\varepsilon)} dH_\varphi \right)^\kappa$$

is the counterfactual (potential) aggregate real GDP with a flat tax schedule characterized by $\phi = 0$ and $k = 1 - g$ to finance government spending. In these expressions, the auxiliary parameter κ

$$\kappa \equiv \frac{1}{1 - (1 - \beta)(1 + \varepsilon)} \geq 1$$

captures an amplification effect associated with the aggregate demand externality (or love-for-variety effect) stemming from the imperfect substitutability of tasks.¹⁶

Several comments are in order. First, note that aggregate real income in equation (21) depends on the costly redistribution correction term Θ and on potential real income, which is a simple function of the primitive fundamentals of the model, namely the ratio g of government spending to GDP, the distribution of ability H_φ , the task-substitutability parameter β , and the Frisch elasticity of labor supply γ (which together with β determine the elasticity of taxable income ε). Second, in the absence of progressive taxation, realized and potential GDP coincide because remember that when $\phi = 0$, $\Theta = 1$. Third, note that (21) is the counterpart to equation (13) in section 2, with the only difference being that now the output loss $Q/\tilde{Q}$ is amplified by the aggregate demand externality, which manifests itself in the exponent $\kappa > 1$ on Θ , and operates in the model whenever $\beta < 1$.

So far, we have focused on a discussion of the determination of aggregate real income in the model. Equation (20) provides the utility level associated with the disposable income and labor supply decisions of an individual with ability φ . In order to aggregate these utility levels into a measure of social welfare, we adopt the welfarist approach and express social welfare as

$$W = \left(\int u_\varphi^{1-\rho} dH_\varphi \right)^{\frac{1}{1-\rho}}, \quad (22)$$

which is the exact counterpart to our earlier equation (7). Note that the risk aversion parameter $\rho \geq 0$ is inconsequential for the choices of individuals in this static model, and only matters for cross-individual welfare comparisons. Therefore, ρ can be viewed as either the property of individual utilities of the agents or the social inequality aversion parameter. When $\rho = 0$, social welfare corresponds to the simple integral of utility levels across individuals, which remember are linear in real disposable income.

This completes the description of the model environment, and we can now characterize equilibrium welfare W given the solution for equilibrium utilities in (20). We do this in two steps. First, we characterize (see Appendix A.4 for a proof):

¹⁶Note that when $\beta = 1$, $\kappa = 1$, but κ is otherwise increasing in ε and decreasing in β . As is clear from the definition of κ , we need to impose the stability condition $(1 - \beta)(1 + \varepsilon) < 1$, which is satisfied if ε is not too large or β is not too small.

Proposition 1 *The welfare in the economy with zero tax progressivity ($\phi = 0$) and no inequality aversion ($\rho = 0$) is given by:*

$$\tilde{W} = \frac{1-g}{1+\varepsilon} \times \tilde{Q}. \quad (23)$$

Note that welfare in this case is closely related to real GDP, with the (welfare) cost of producing GDP captured by the discount term in front of $\tilde{Q}$ in (23). The numerator $1-g$ of this term reflects the share of the output of the economy that goes towards the provision of the public good, which is financed via a proportional tax schedule $k = 1-g$ when $\phi = 0$.¹⁷ The denominator $1+\varepsilon$ reflects the disutility costs of producing the output $\tilde{Q}$. The immediate corollary of Proposition 1 is that in the absence of inequality aversion and tax progressivity, changes in welfare can be measured using the growth rate of GDP

$$\frac{\tilde{W}' - \tilde{W}}{\tilde{W}} = \tilde{\mu}^R = \frac{\tilde{Q}' - \tilde{Q}}{\tilde{Q}},$$

provided that the elasticity ε and the share of public spending g stay constant over time.

This result illustrates that a criterion analogous to the Kaldor-Hicks prescription in (4) may still apply in more general settings, even when lump-sum taxes are unavailable and average taxes are positive, provided that society does not care about inequality and does not use a progressive tax system to address it.

Nevertheless, outside this limiting case with $\phi = \rho = 0$, real income growth is no longer an appropriate measure of welfare gains, and instead we have (see Appendix A.4 for a proof):

Proposition 2 *Outside the case $\phi = \rho = 0$, social welfare can be written as:*

$$W = \Delta \times (1 + \varepsilon\phi)\Theta^\kappa \times \tilde{W}, \quad (24)$$

where Δ and Θ are the welfarist and the costly-redistribution corrections defined in (9) and (14), respectively.

Note that the two inequality correction terms that were introduced earlier in section 2 appear explicitly in the welfare expression in (24). Indeed, realized welfare W equals potential welfare $\tilde{W}$ discounted in turn by the two correction terms, which are both less than 1 (see our discussion in section 2).

The effect of inequality aversion on social welfare is captured by the exact same term Δ derived in section 2, and is closely related to the Atkinson inequality measure. The effect of costly redistribution is instead slightly modified relative to our previous derivations in section 2. First, and as already discussed above, the presence of aggregate demand externalities magnify the loss of output associated with distortionary taxation, and $\Theta < 1$ is now raised to a power $\kappa > 1$. Second, note that (24) incorporates a new term $(1 + \varepsilon\phi)$ which captures the fact that lower output comes along with a lower disutility of labor effort, which other things equal, raises welfare.

¹⁷Remember that potential output is given by $\tilde{Q} = [\beta(1-g)]^{\kappa\varepsilon} \left(\int \varphi^{\beta(1+\varepsilon)} dH_\varphi \right)^\kappa$, and hence is itself decreasing in $k = 1-g$ due to the disincentive effect of the average tax rate g even in the absence of progressivity of taxation.

Despite the presence of this term, the overall effect of distortionary taxation captured by the term $(1 + \varepsilon\phi)\Theta^\kappa$ inherits the same properties of the term Θ described in section 2. In particular, this term can be split into the product of $(1 + \varepsilon\phi)(1 - \phi)^{\kappa\varepsilon}$ and $(\mathbb{E}r_\varphi)^{\kappa(1+\varepsilon)} / \left[(\mathbb{E}r_\varphi^{1-\phi})^\varepsilon \cdot (\mathbb{E}r_\varphi^{1+\varepsilon\phi}) \right]$, with both of these terms being strictly less than 1 when $\phi > 0$ and the dispersion of income is positive. The first term captures the utility loss from taxation in the absence of inequality (and continues to be decreasing in ε and ϕ), while the second term captures the additional loss due to the interaction of inequality with a progressive income tax schedule.

Although this is not the focus of this paper, the welfare decomposition in equation (24) captures the tradeoff faced by a benevolent government (maximizing social welfare W) when deciding on the degree of progressivity ϕ of the tax system. Because the welfarist correction Δ is negatively affected by an increase in inequality in disposable income, this correction term is increasing in ϕ . Conversely the costly-redistribution correction (and also the full correction term $(1 + \varepsilon\phi)\Theta^\kappa$) is decreasing in ϕ , due to the higher marginal tax rates associated with a more progressive tax system. Therefore, when setting the optimal ϕ , the government necessarily balances these two conflicting forces (see Appendix A.1 for details).

To summarize, we have shown that social welfare can be expressed as a multiplicatively separable function of three terms: (i) potential welfare in a hypothetical (Kaldor-Hicks) world with non-distortionary taxation, discounted by (ii) our welfarist correction, and (iii) our (modified) costly-redistribution correction. The presence of these two correction terms introduces a tradeoff for the policy maker when deciding on the optimal degree of tax progressivity. Independently of the amount of redistribution that society chooses to implement, these two corrections reduce welfare disproportionately more in environments with higher economic inequality. In the model developed so far such increases in inequality can only originate from increases in the dispersion of ability across agents (perhaps due to skill-biased technological change) or from increases in the primitive parameters β and γ . In section 5, we will show however that trade integration can generate qualitatively similar effects. Before doing so, and to build some intuition for our quantitative analysis, in the next subsection we provide a preliminary look at U.S. data through the prism of our closed-economy model.

4 A Preliminary Look at the Data

Although the main goal of this paper is to apply the tools developed so far to the study of the welfare gains from trade integration, in this section we take a brief detour to illustrate the usefulness of our closed-economy model in interpreting the consequences of the observed rise in inequality in the U.S. in recent times.

More specifically, in this section we decompose social welfare in the U.S. over the period 1979-2007 according to equation (24), thus backing out the size and evolution of the welfarist and inequality correction terms. We then use this expression to compute the income and welfare levels that would have attained in counterfactual scenarios in which U.S. income inequality had not increased as much as it did over this period.

4.1 Calibration

In order to put the above model to work, it is necessary to calibrate its key parameters. Remember that the primitive parameters of the model are the Frish elasticity parameter γ , the task substitutability parameter β , the degree of tax progressivity ϕ , the share of government spending in GDP g , the distribution of ability in society H_φ , and the inequality aversion parameter ρ . Some of these objects, such as the distribution of agents' ability, are notoriously difficult to calibrate. Fortunately, we shall see that, for our purposes, it will suffice to calibrate (i) the degree of tax progressivity of income ϕ , (ii) the distribution of market income r_φ , (iii) the elasticity of taxable income $\varepsilon = \beta/(\gamma - \beta)$, and (iv) the degree of substitutability between the tasks provided by different workers, as captured by β . Let us discuss each of these in turn.

Consider first our modeling of the tax-transfer system in equation (11). This specification may seem quite ad hoc, but the log-linear relationship between market income and income after taxes and transfers implied by equation (11) fits U.S. data remarkably well. This is illustrated in Figure 2 using CBO data for eight percentiles of the income distribution for various years in the period 1979-2007.¹⁸ The best log-linear fit of the data achieves a remarkable R-squared of 0.983 or higher in all years.¹⁹

Inspection of the different panels of Figure 2 suggests that the degree of tax progressivity appears to be lower in recent years than at the beginning of the period. This is more clearly illustrated in Figure 3), which reports the estimate of ϕ year by year. Given the remarkable fit of equation (11), we will use these yearly estimates of ϕ to calibrate the time path of progressivity over the period 1979-2007.²⁰

We next turn to our calibration of the distribution of market income. Because we are wary that our quantitative results might be sensitive to fine features of the income distribution (such as the shape of its right tail), we deem it necessary to seek richer information on the U.S. income distribution than that provided by the CBO data we used to calibrate ϕ . Following recent empirical work on top income levels (e.g., [Piketty and Saez, 2003](#)), we employ the public use samples of U.S. Federal Individual Income Tax returns available from the NBER website. These amounts to approximately 3.5 million anonymized tax returns (about 150,000 per year) over the period 1979-2007. Contrary to survey-based sources of income distribution data, the NBER IRS data is more likely to provide an accurate picture of the income of particularly rich taxpayers. To ensure the representativeness of the sample, we further apply the sampling weights

¹⁸In particular, each panel of Figure 2 depicts market income and income after taxes and transfers for the first four quintiles of the income distribution, as well as the 81st to 90th percentiles, the 91st to 95th percentiles, the 96th to 99th percentiles, and the top 1 percent, for the period 1970-2007. Market income consists of labor income, business income, capital gains (profits realized from the sale of assets), capital income (excluding capital gains), income received in retirement for past services, and other sources of income. Government transfers include cash payments and in-kind benefits from social insurance and other government assistance programs. Federal tax liabilities include individual income taxes, social insurance or payroll taxes, excise taxes, and corporate income taxes.

¹⁹Even when pooling the data for all years in 1979-2007, this log-linear specification achieves an R-squared of 0.988, with an implied average degree of progressivity ϕ over the period equal to 0.183.

²⁰[Heathcote et al. \(2014\)](#) find an equally good fit of this log-linear relationship with data from the Panel Study of Income Dynamics (PSID) for survey years 2000, 2002, 2004, and 2006, with an implied value $\phi = 0.151$, which is very much consistent with the estimates we obtain from CBO during the 2000-06 period.

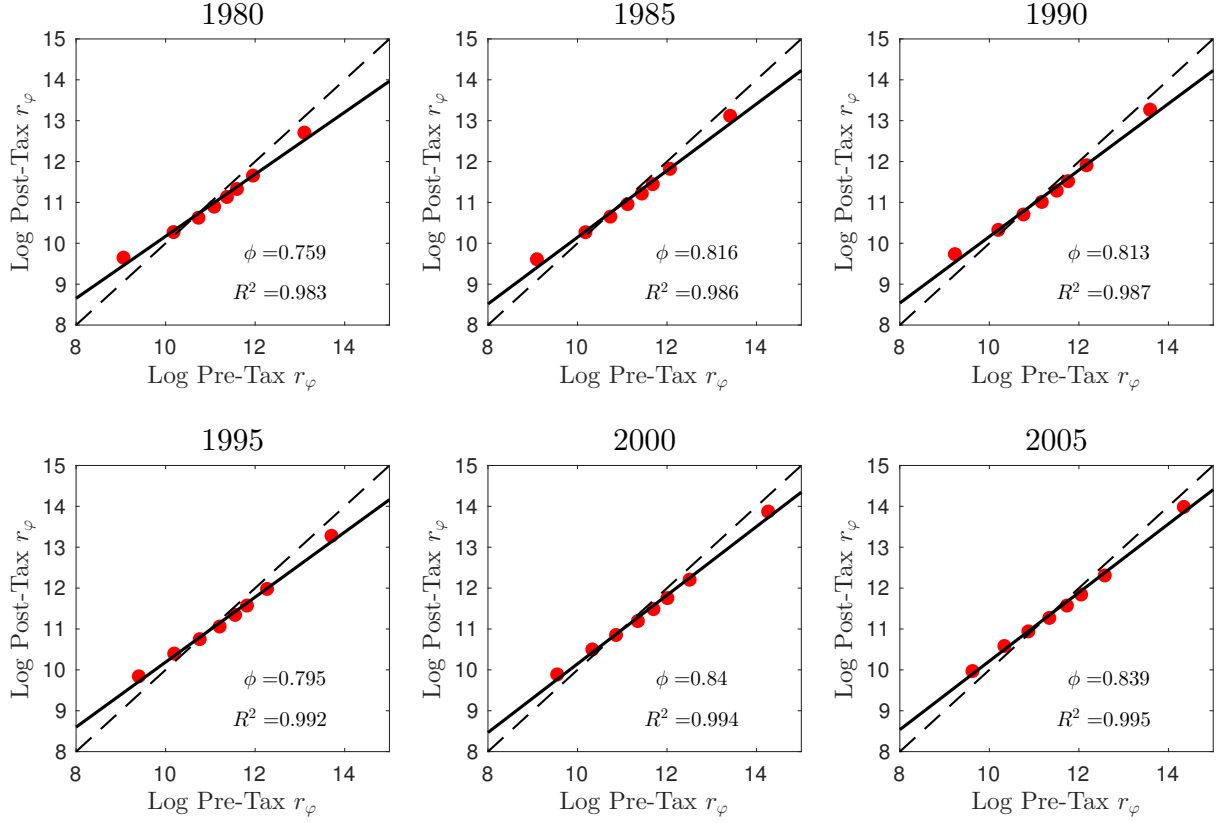


Figure 2: Progressivity

provided by the NBER. We map before-tax income r_φ in the model to adjusted gross income (AGI) in line 37 of IRS Form 1040 and restrict the sample to returns with a strictly positive AGI. Together with our yearly estimates of ϕ , it is then possible to estimate disposable income r_φ^d up to a constant (k) which is irrelevant for the computation of our two inequality corrections.²¹

In the left panel of Figure 4, we plot the cumulative distribution of income for the year 2007, and for comparison we also plot the best lognormal fit of the distribution. As can be seen, the empirical distribution of income is pretty well approximated by a lognormal distribution. Nevertheless, the right panel of Figure 4 demonstrates that the lognormal fit is really poor for relatively high incomes, and in that range, a Pareto distribution appears to fit the data much better. More specifically, following [Diamond and Saez \(2011\)](#), this right panel plots the ratio $r_m / (r_m - r)$, with $r_m = \mathbb{E}(r_\varphi | r_\varphi > r)$, for different values of income r . Consistently with the properties of a Pareto distribution, for large enough income levels this ratio is relatively flat (at a value close to 1.5), whereas a lognormal distribution would predict this term to rise with income. As we shall see in our trade application, this right-tail deviations from a lognormal distribution have significant implications for the quantitative results discussed below.

Having discussed the calibration of the progressivity parameter ϕ and the income distribution

²¹We could have in principle obtained disposable income by using the NBER TAXSIM program which calculates federal and state income tax liabilities from market income data. Nevertheless, this would have missed government transfers which are essential for understanding why disposable income is higher than market income for low-income individuals.

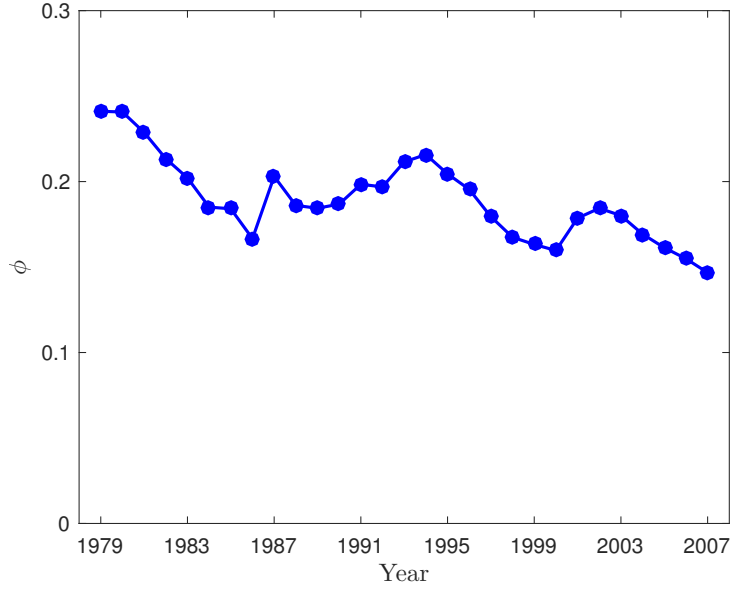


Figure 3: Progressivity Over Time

for each year in 1979-2007, we are left with the parameters ε , β and ρ . The size of the elasticity of taxable income ε has been the subject of heated debates in the academic literature. The influential work of [Chetty \(2012\)](#) has demonstrated, however, that when interpreting the wide range of estimated elasticities through the lens of a model in which agents face optimization frictions, an elasticity of taxable income to changes in marginal tax rates of around 0.5 can rationalize the conflicting findings of previous studies. With that in mind, we shall set $\varepsilon = 0.5$ in our benchmark calibration.²²

Moving on to the substitutability parameter β , in our benchmark calibration we will set $\beta = 0.8$. The resulting elasticity of substitution $1/(1 - \beta) = 5$ is slightly larger than that the one typically estimated with product-level trade (see [Broda and Weinstein, 2006](#)) or with firm-level mark-up data (see [Bernard et al., 2003](#) or [Antràs et al., 2014](#)), but it seems reasonable to us to postulate that workers' tasks are more substitutable than the products that embody those tasks. When we quantitatively evaluate the effects of trade opening we will consider the sensitivity of our results to different values of β .

Finally, we discuss the calibration of the coefficient of inequality (or risk) aversion ρ . The often-used logarithmic utility case, which corresponds to $\rho = 1$, will provide a focal point for our quantitative analysis, but we readily admit that little is known about this parameter (especially when interpreted in terms of inequality aversion), and thus we will report results for various

²²It should be noted that five of the fifteen studies [Chetty \(2012\)](#) builds on to provide bounds on the intensive margin labor supply elasticity are based on the response of hours worked (rather than taxable income) to changes in marginal tax rates. In our model, these two elasticities are not identical due to the imperfect substitutability in tasks. We have however replicated Chetty's (2012) calculations restricting the analysis to the ten papers estimating taxable income elasticities. The resulting *intensive* margin elasticity is equal to 0.33, which is identical to the one obtained by [Chetty \(2012\)](#) when using all fifteen papers. [Chetty \(2012\)](#) also finds that the compensated and uncompensated elasticities taxable income are very similar, which helps to motivate our assumption of GHH preferences in (16). It is important to mention however that the evidence suggests that these elasticities appear to be higher for rich individuals than for poor ones, a feature that is absent in our model.

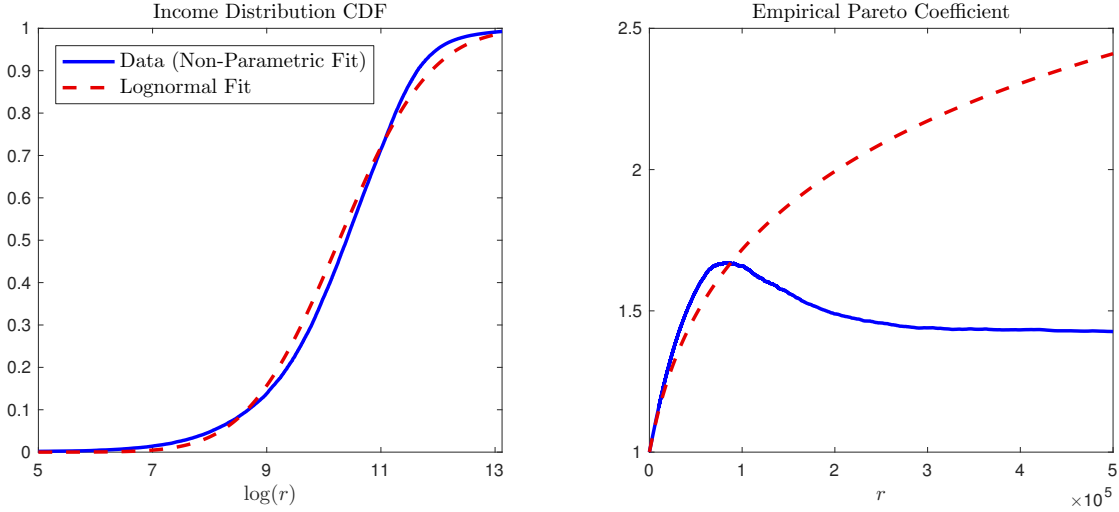


Figure 4: U.S. distribution of reported income (2007)

values of ρ ranging from $\rho = 0$ (no inequality aversion) all the way to $\rho = 2$.²³

4.2 Evolution of the Inequality Correction Terms

Figure 5 depicts the evolution of the welfarist correction Δ and costly redistribution correction $(1 + \varepsilon\phi)\Theta^\kappa$ over the period 1979-2007 for the case $\rho = 1$. The smallest dot corresponds to the 1979 value of these terms, while the the largest dot corresponds to their 2007 value (the size of the dots grows over time). This graph embodies different pieces of information. Notice first that the welfarist discount factor Δ has been falling steadily over time, starting at a value of 0.757 in 1979 but ending at 0.587 in 2007. This decline necessarily reflects an increase in inequality in the distribution of disposable income. The graph however also shows that the causes of this increased dispersion in disposable income are twofold. On the one hand, the degree of tax progressivity has declined over time, something which was made clear in Figure 3, but which is also reflected by a noticeable upwards shift in the costly redistribution correction, which increased from 0.897 in 1979 to 0.926 in 2007. If that was the only change in the environment, however, we would have expected the dots to line up along a negatively sloped locus. Instead, it is clear that the dots have also shifted *inwards* during this period, which necessarily implies an increase in the primitive determinants of inequality. In our closed-economy model, and holding the parameters β and ε constant, such an increase can only be generated by an increase in the dispersion of the distribution of ability. In section 5 we will show, however, that trade integration can generate an analogous inward shift even when the distribution of ability is held constant.

Table 1 further illustrates the consequences of these shifts for the evolution of U.S. social welfare over the period 1979-2007. The table uses equation (24) to decomposes changes in social

²³Layard et al. (2008) relate ρ to the degree to which marginal utility of income falls with income, and use survey data to argue that a value of $\rho = 1.26$ best explains the data. We have explored which value of ρ would rationalize the observed degree of tax progressivity as being optimal in light of the social welfare function (22), and we have found the implied ρ to be much lower (around 0.6), which can be interpreted as reflecting a lower degree of inequality aversion or a higher influence of rich individuals in the setting of tax policies.

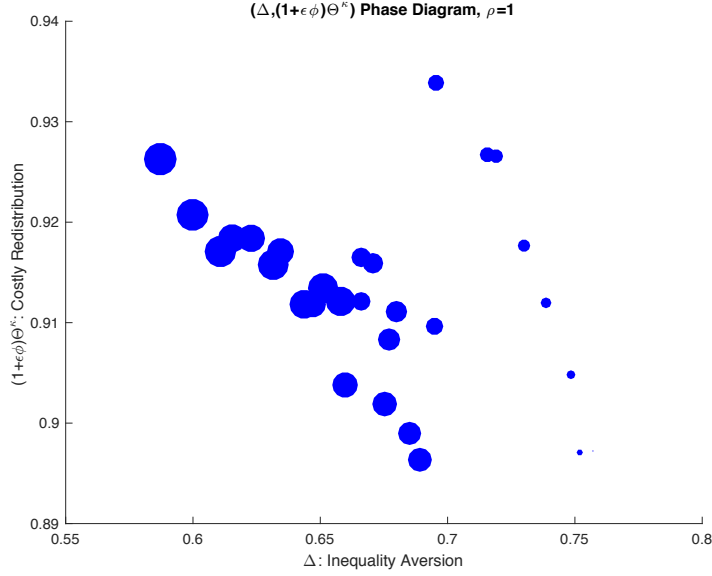


Figure 5: Evolution of the Welfarist and Costly-Redistribution Corrections

welfare according to

$$\frac{W'}{W} = \frac{\Delta'}{\Delta} \times \frac{(1 + \varepsilon\phi)'}{(1 + \varepsilon\phi)} \times \underbrace{\frac{\Theta'^{\kappa}}{\Theta^{\kappa}} \times \frac{\tilde{W}'}{\tilde{W}}}_{Q'/Q},$$

where as indicated, changes in real income correspond to the changes in the product of Θ^{κ} and $\tilde{W}$ (for a constant ε and g over time).²⁴ The top panel of the Table performs the decomposition for various values of ρ . This serves to isolate the role of the welfarist correction in shaping the evolution of social welfare given the observed growth in real income. According to our data, mean real income grew 43.9% over 1979-2007, which translates into an annualized growth rate of 1.31% per year. In the absence of inequality aversion (or if the welfarist correction had not changed over time), the associated increase in U.S. social welfare over this period would have been slightly lower (38.5% or 1.17% per year) due to the increase in labor supply triggered by the decline in progressivity. Nevertheless, given that Δ fell considerably over time, the growth in social welfare was necessarily lower, and more so the higher is the degree of inequality aversion ρ . The first column of Table 1 provides the discount factor by which the gross cumulated inequality-neutral growth rate 1.385 needs to be deflated in order to obtain the inequality-adjusted growth in social welfare for different values of ρ . The adjustment is potentially sizeable. For instance, for the logarithmic case ($\rho = 1$), the implied annual growth rate in social welfare is down to 0.31% (i.e., $(1.090)^{1/28} - 1$). Adopting a constant inequality aversion of 2, would actually result in a sizable *decline* of social welfare of 3.92% per year.

Turning to the costly redistribution correction, Figure 5 indicates that $(1 + \varepsilon\phi)\Theta^{\kappa}$ has been rising over time – thus resulting in lower taxation inefficiencies – despite the observed increase in inequality. The reason for this is the marked decline in tax progressivity observed over these

²⁴The share of government consumption in total GDP has indeed been relatively flat over the period 1979-2009, equalling 15.4% in 1979 and 15.3% in 2007.

Table 1: Welfare, Inequality, and Costly Redistribution

$\rho =$	Change between 1979-2007				
	Δ	$1 + \varepsilon\phi$	Θ^κ	$\tilde{W}$	W
0	1.000	0.962	1.064	1.353	1.385
0.25	0.927	0.962	1.064	1.353	1.285
0.5	0.874	0.962	1.064	1.353	1.211
1	0.787	0.962	1.064	1.353	1.090
1.5	0.654	0.962	1.064	1.353	0.906
2	0.235	0.962	1.064	1.353	0.326

years. On account of this costly redistribution channel, social welfare has thus been growing by *more* than it would have in an economy without costly redistribution. This effect is however quite modest: in a hypothetical *Kaldor-Hicks* economy with access to costless redistribution, average income would have grown by 1.09% (i.e., $(1.353)^{1/28} - 1$) per year on average, rather than the observed 1.32% annual growth.

4.3 Counterfactuals

Some readers might be struggling to wrap their heads around the interpretation of the costly redistribution correction since it involves a comparison of actual data with a hypothetical economy having access to costless redistribution. The usefulness of the adjustment will perhaps become more apparent when considering a couple of counterfactual exercises. As mentioned above, part of the reason why the welfarist term Δ decreased so markedly over time is the fact that U.S. redistribution became much less progressive over that period. One might then wonder: by how much would real disposable income and social welfare have increased if the degree of tax progressivity had been held constant at its 1979 level? And by how much would they have changed if tax progressivity had *increased* to ensure that the Atkinson measure of inequality (or our welfarist correction Δ) had not changed over 1979-2007?

Figure 6 provides answers to these questions for the benchmark case of $\rho = 1$ and also for a slightly lower value $\rho = 0.5$. The figure indicates that real disposable income would have grown at an average annual rate of 0.89% (instead of the observed 1.31%) if tax progressivity had been held constant at its 1979 level, while it would have grown at a significantly lower annual rate of 0.42% for $\rho = 1$ and 0.33% for $\rho = 0.5$ if tax progressivity had been raised so as to keep the Atkinson index constant at its 1979 level.²⁵ Despite the negative effect of these counterfactual policies on real income growth, the figure also shows that for $\rho = 1$, these policies would have increased social welfare by a nontrivial amount (from 0.31% to 0.52% and 0.56%, respectively). Conversely, for $\rho = 0.5$, social welfare would have instead declined had these policies been put in place.

²⁵In the second counterfactual, the effect is more pronounced for $\rho = 0.5$ than for $\rho = 1$ because the sensitivity of Δ to changes in ϕ is lower, the lower is ρ , and thus the necessary increase in ϕ is higher for $\rho = 0.5$ than for $\rho = 1$.

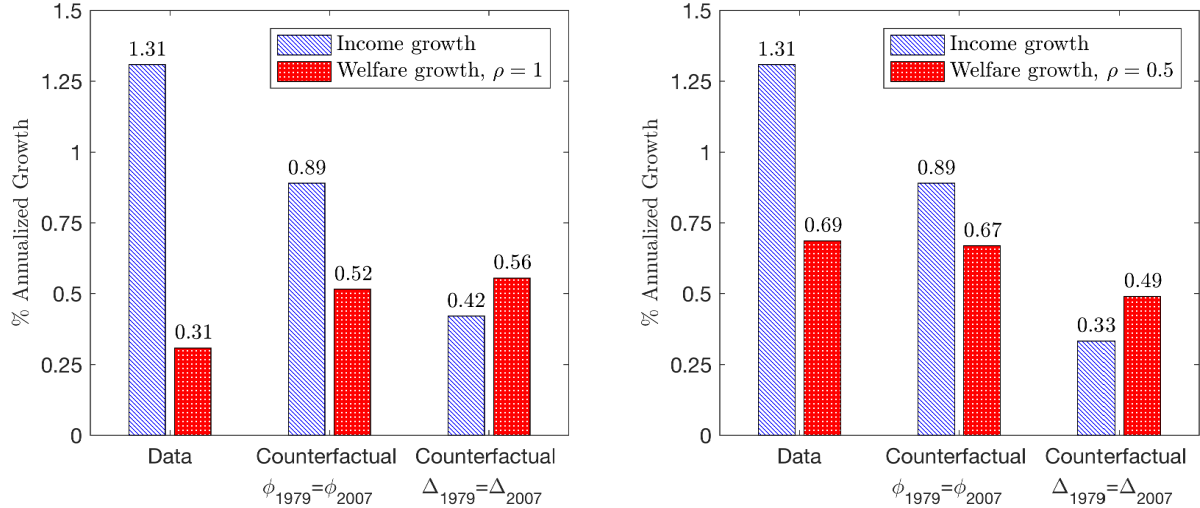


Figure 6: Counterfactuals: Holding ϕ constant and holding Δ constant

5 Trade, Inequality and Costly Redistribution

For the remainder of this paper, we turn to the study of the interplay between inequality and costly redistribution in shaping the welfare consequences of trade liberalization episodes. With that goal in mind, in this section we consider a simple extension of our constant-elasticity model in section 3. Our model is highly stylized but generates trade-induced inequality via an intuitive mechanism that features prominently in the recent international trade literature (c.f., Melitz, 2003). More specifically, our model captures the notion that agents can market their labor services in foreign markets only by incurring certain costs that are (at least in part) fixed in nature. Due to these costs, exporting is worthwhile *only* for the most productive agents in society. As a result, an even though all agents benefit as consumers from access to a larger measure of imperfectly substitutable tasks, trade integration raises real income disproportionately more for the highest-ability agents in society, thereby increasing income inequality.

These results are reminiscent of those delivered by models of trade-induced inequality featuring either labor market imperfections or matching and sorting of heterogeneous agents. Relative to these alternative models, the simplicity of our framework allows us to tractably incorporate behavioral responses to taxation into the study of the welfare effects of trade integration. Furthermore, as we shall illustrate in section 6, our parsimonious model is particularly amenable to calibration and quantification.

5.1 A Simple Model of Trade-Induced Inequality

Consider a world economy consisting of $N+1$ symmetric regions analogous to the closed economy described in section 3. The fact that all regions are symmetric is essential for tractability because we lack the necessary cross-country data to discipline a calibration exercise in a world with asymmetric ability distributions, redistribution systems, and trade frictions. At the same time, it is not clear how the symmetric nature of our world economy will bias the quantitative

results described below.²⁶ As in our closed-economy model, individuals worldwide share the same preferences in (16) defined over the consumption of an aggregate final good and leisure, and they produce units of their differentiated task according to a linear technology in their labor effort. We assume that the aggregate final goods produced in different regions are non-tradable perfect substitutes, and hence, given our symmetry assumption, they are not traded across regions. Conversely, all task (or intermediate inputs) produced worldwide are imperfectly substitutable and thus trade integration allows the final good to be produced more efficiently by combining a greater diversity of tasks provided by agents worldwide.

Agents can market their task in the local market at no cost, while in order to send the output of their task to other markets they need to incur trade costs which are both fixed and variable in nature. Specifically, in order to access $M \leq N$ foreign markets, any individual needs to pay M separate fixed costs $f(1), f(2), \dots, f(M)$. We interpret these fixed costs as being associated with the human capital investments necessary to make a worker's task marketable in a foreign country, and we characterize the fixed cost associated with the n -th market with the constant-elasticity function:

$$f(n) = f_x n^\alpha, \quad \alpha \geq 0, n > 1. \quad (25)$$

Notice that f_x governs the average level of these fixed costs, while the parameter α shapes the curvature of the fixed cost function with respect to the number of foreign markets serviced. We introduce this parameter to allow us to more flexibly match a rich extensive margin of trade by which relatively more able individuals market their tasks in a larger number of markets (i.e., n_φ will be nondecreasing in φ). It should be stressed, however, that even when $\alpha = 0$, and unlike in the Melitz (2003) model, more able individuals will still select into a (weakly) large number of foreign markets. The reason for this is that, as we shall see, export entry decisions are interdependent in our framework.²⁷ On top of these fixed costs, when exporting to particular market, an agent needs to ship $\tau > 1$ units of task services for one unit to reach that foreign market. As a result, the export revenues obtained by an individual with ability φ from any foreign market j are given by $Q^{1-\beta}(q_\varphi/\tau)^\beta$, where q_φ is the number of units of task services shipped by that agent to that market.

An agent with ability φ thus invests in access to n_φ foreign markets, and optimally allocates the total output of its task y_φ across the markets, which yields a total revenue of:²⁸

$$r_\varphi = \Upsilon_{n_\varphi}^{1-\beta} Q^{1-\beta} y_\varphi^\beta, \quad (26)$$

²⁶Furthermore, these regions need not be interpreted as countries, but rather as trading blocks chosen to be symmetric with regards to the model's primitives.

²⁷We have also experimented with a variant of the model featuring heterogeneity of fixed costs of exporting across individuals, in a manner analogous to Eaton et al. (2011) or Helpman et al. (2012).

²⁸Formally, $r_n(y) = \max_{\{q_0, q_1, \dots, q_n\}} \left\{ Q^{1-\beta} \left[q_0^\beta + \sum_{j=1}^n (q_j/\tau)^\beta \right] \mid \text{s.t. } \sum_{j=0}^n q_j = y \right\}$, with the solution given by $q_0 = y/\Upsilon_n$ and $q_j = \tau^{-\beta/(1-\beta)} y/\Upsilon_n$ for $j = 1, \dots, n$. Lastly, the agent with ability φ optimally choose $n = n_\varphi$ and $y = y_\varphi$, as we describe below, and we denote with $r_\varphi = r_{n_\varphi}(y_\varphi)$.

where

$$\Upsilon_{n_\varphi} = 1 + n_\varphi \tau^{-\frac{\beta}{1-\beta}}. \quad (27)$$

For a given output level y_φ , revenues are higher when sales are spread over a large number of markets n_φ because marginal revenue in each market falls by less relative to a situation in which all the output is sold in a single market, as in our closed-economy model. Given the symmetry in our model, we assume that individuals are indifferent with regards to which particular markets to serve, and choose to access a random subset of n_φ markets out of the total N foreign markets, thus maintaining symmetry across markets.

Market revenue is taxed according to a schedule $T(r)$ given by (11). Note that the tax is conditional only on market revenue, but not on the number of non-local markets served, n_φ . In other words, we assume that neither the ability of individuals nor their export investment decisions are observable. As in our constant-elasticity model in section 3, we continue to adopt the log-linear tax schedule introduced in section 2 and empirically motivated in section 4, so after-tax income for an agent with ability φ is given by

$$r_\varphi - T(r_\varphi) = k r_\varphi^{1-\phi},$$

where k is chosen to ensure balanced government budget, $\int_0^1 T(r_\varphi) dH_\varphi = gQ$. Agents consume their after-tax income net of the fixed cost of entry,

$$c_\varphi = k r_\varphi^{1-\phi} - f_x n_\varphi^\alpha, \quad (28)$$

and choose their labor supply ℓ_φ and export entry decisions n_φ to maximize utility (16) given the production technology $y_\varphi = \varphi \ell_\varphi$, the revenue function (26) and the budget constraint (28). Given the quasi-linearity of preferences, we could alternatively treat the fixed cost of exporting as a utility cost (e.g., effort rather than spending on human capital investments), with no bearing for the welfare results discussed below.

The tasks sold in each market are combined by competitive firms into final output and sold on the local market. In equilibrium, trade across regions is balanced and the government spends all its net tax revenue on the final good, and thus the total expenditure on the local final good equals the total revenues of individuals in the region, $Q = \int r_\varphi dH_\varphi$, which using (26) can be rewritten as:

$$Q = \left(\int_0^1 \Upsilon_{n_\varphi}^{1-\beta} y_\varphi^\beta dH_\varphi \right)^{1/\beta}. \quad (29)$$

This completes the description of the open-economy environment of our framework. We will use the model to study the effect of a reduction in trade costs τ on social welfare, taking into account the effects of trade liberalization on aggregate income but also on inequality. As in our previous closed-economy model, we will measure social welfare according to the constant-inequality aversion function in equation (22).

5.2 Open-Economy Equilibrium

Solving the individual labor supply and market access problem results in the following before-tax revenue and utility schedules

$$r_\varphi = (\Upsilon_{n_\varphi})^{\frac{(1+\varepsilon)(1-\beta)}{1+\varepsilon\phi}} r_{0\varphi}, \quad (30)$$

$$u_\varphi = (\Upsilon_{n_\varphi})^{\frac{(1+\varepsilon)(1-\beta)(1-\phi)}{1+\varepsilon\phi}} u_{0\varphi} - f_x \sum_{n=1}^{n_\varphi} n^\alpha \quad (31)$$

where

$$r_{0\varphi} = (\beta(1-\phi)k)^{\frac{\varepsilon}{1+\varepsilon\phi}} \left[Q^{1-\beta} \varphi^\beta \right]^{\frac{1+\varepsilon}{1+\varepsilon\phi}} \text{ and} \quad (32)$$

$$u_{0\varphi} = \frac{1+\varepsilon\phi}{1+\varepsilon} k (r_{0\varphi})^{1-\phi}, \quad (33)$$

correspond to before-tax revenue and utility of an agent with ability φ that only sells locally, and where $\Upsilon_{n_\varphi} = 1 + n_\varphi \tau^{-\frac{\beta}{1-\beta}}$ with $n_\varphi \in \{0, 1, \dots, N\}$ being determined by

$$\left[\Upsilon_{n_\varphi}^{\frac{(1+\varepsilon)(1-\beta)(1-\phi)}{1+\varepsilon\phi}} - \Upsilon_{n_\varphi-1}^{\frac{(1+\varepsilon)(1-\beta)(1-\phi)}{1+\varepsilon\phi}} \right] u_{0\varphi} \geq f_x n_\varphi^\alpha, \quad (34)$$

$$\left[\Upsilon_{n_\varphi+1}^{\frac{(1+\varepsilon)(1-\beta)(1-\phi)}{1+\varepsilon\phi}} - \Upsilon_{n_\varphi}^{\frac{(1+\varepsilon)(1-\beta)(1-\phi)}{1+\varepsilon\phi}} \right] u_{0\varphi} < f_x (n_\varphi + 1)^\alpha. \quad (35)$$

Because $(1+\varepsilon)(1-\beta) < 1$ and $\alpha \geq 0$, the existence of a unique $n_\varphi \in \{0, 1, \dots, N\}$ is guaranteed.

These equilibrium expressions are cumbersome, but they can be used to establish that, starting from autarky, trade integration induces an increase inequality in our framework. To see this, define an *increase in inequality* in a given variable x as a situation in which the ratio $x_{\varphi^H}/x_{\varphi^L}$ for two individuals with abilities $\varphi^H > \varphi^L$ is either left unchanged or increased, with this ratio being increased for at least a pair of individuals. With this definition in hand, we can then show (see Appendix A.4) the following result, which is reminiscent of the main result in Helpman et al. (2010):

Proposition 3 *A move from autarky to a trade equilibrium in which some (but not all) individuals export to some markets necessarily increases inequality in pre-tax and after-tax real income and in utility levels.*

The intuition for the result is simple. In the presence of fixed costs of exporting, some relatively low-ability individuals will not be able to profitably market their task in foreign markets, while these same agents will now face increased competition from foreign high-ability individuals selling their task in their local market.

This result is illustrated in Figure 7 which plots the Gini coefficient and coefficient of variation of real market and disposable income for different levels of trade costs. As is clear, these measures of inequality are minimized for the largest values of variable trade costs τ , which indeed place the economy close to autarky. The figure also shows that the effect of trade integration on inequality

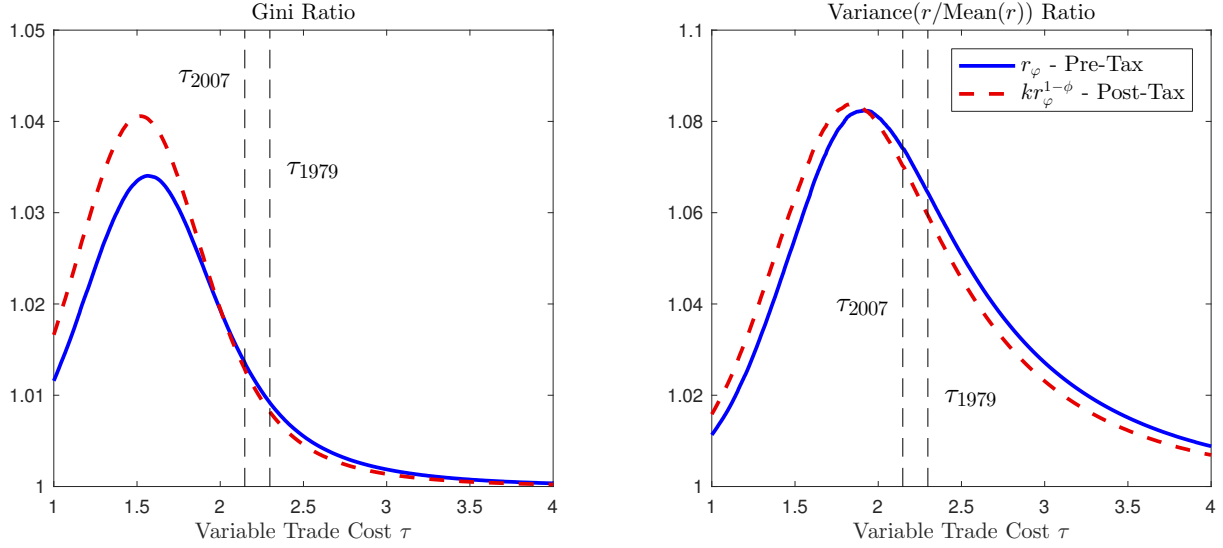


Figure 7: Trade Integration and Income Inequality

need not be monotonic. In fact, it is straightforward to show that if fixed costs of exporting are sufficiently low, a reduction in iceberg trade costs that leads all individuals to market their tasks in all regions will necessarily reduce inequality. This is because the level of inequality associated with an economy in which all individuals sell in all markets is identical to the level of inequality under autarky. Despite the fact that trade cost reductions could *theoretically* reduce income inequality, our calibration exercise (to be discussed in detail in the next section) indicates that it would take a significant decline in trade costs relative to those estimated for the U.S. in both 1979 and 2007 to enter the region in which trade is associated with reduced rather than increased income inequality (see the dashed vertical lines in Figure 7).

So far we have focused on the implications of the model for the effect of trade on inequality and we have been able to state Proposition 3 without solving for the endogenous aggregate variables k and Q . In order to study the welfare gains from trade integration it is, however necessary to solve for these objects. Aggregate income Q can be solved as a function of k as the fixed point of

$$Q = \int r_{\varphi}(Q, k) dH_{\varphi},$$

where $r_{\varphi}(Q)$ is obtained by combining equations (30)-(35). The value of Q and k can then be obtained by noting that $k = (1 - g) \int r_{\varphi}(Q, k) dH_{\varphi} / \int (r_{\varphi}(Q, k))^{1-\phi} dH_{\varphi}$ as in equation (18).

Manipulating these equations, we show in Appendix A.4 that:

Proposition 4 *A move from autarky to a trade equilibrium in which some individuals export to some markets necessarily increases aggregate real income Q . Furthermore, the utility of all agents is higher than under autarky.*

In sum, despite the fact that trade typically decreases the relative revenues obtained by low-ability individuals, the reduction in the price index faced by these individuals when acting

as consumers is always large enough to leave them at least as well off as before the reduction in trade costs. Despite the existence of Pareto gains from trade, the fact that some agents benefit more than others will have significant implications for the quantifying of the overall social welfare gains from trade, as we shall see in section 6.

5.3 Social Welfare and the Gains from Trade

Once we have solved for the aggregates of the model, we can plug them back into (31) and (33) and invoke (22) to compute social welfare in the open-economy equilibrium. As in section 3, we can denote by $\tilde{W}_T$ as social welfare in the economy with zero tax progressivity ($\phi = 0$) and no inequality aversion ($\rho = 0$), and use this definition to decompose social welfare as

$$W = \frac{\left[\mathbb{E}(u_\varphi)^{1-\rho} \right]^{\frac{1}{1-\rho}}}{\mathbb{E}u_\varphi} \times \frac{\mathbb{E}u_\varphi}{\tilde{W}} \times \tilde{W} = \Delta_T \times \Theta_T \times \tilde{W}_T. \quad (36)$$

Welfare is thus the product of the potential welfare level $\tilde{W}_T$ attainable in the absence of tax progressivity or inequality aversion, and two terms, Δ_T and Θ_T , that are analogous to the welfarist and costly-redistribution corrections developed in sections 2 and 3.

Given the equilibrium values of u_φ in (31), the welfarist correction term Δ_T can easily be computed for a particular value of ρ . Furthermore, the fact that, by Proposition 3, trade integration increases inequality in utility levels implies that (see Appendix A.4):

Proposition 5 *Relative to its value under autarky, Δ_T is strictly lower in a trade equilibrium in which some (but not all) individuals export to some markets. Furthermore, the welfare gains from trade are strictly decreasing in the degree of inequality aversion ρ .*

This result formalizes the fact that in the presence of trade-induced inequality, the ‘welfarist’ gains from trade will necessarily be lower than those implied by the Kaldor-Hicks criterion, and more so, the more society is averse to inequality.

How is the costly-redistribution correction Θ affected by trade? The increase in inequality demonstrated in Proposition 3 would appear to hint at a reduction in Θ following a move from autarky to some form of trade integration. Nevertheless, the result does not hold generally because, in a trade equilibrium, redistribution policy not only reduces the incentives to supply labor given a trade status, but also shapes the extensive margin decisions of agents as to whether service particular foreign markets.²⁹ For certain parameter values, an open economy can be closer to its costless redistribution counterfactual than its autarky counterpart. Despite this theoretical ambiguity, in our quantitative analysis with realistic parameter values (see section 6), we have found that Θ is always reduced when moving from autarky to an equilibrium with positive trade flows. This of course implies that our costly redistribution correction will also modify the magnitude of the gains from trade *downwards*.

²⁹This feature of the model bears some resemblance to analysis of optimal income taxation with both intensive and extensive margins of labor supply responses, as in Saez (2002).

6 Calibration and Trade Counterfactuals

We are now ready to turn to a quantitative exploration of our model centered on the U.S. experience over the period 1979-2007. Our ultimate goal is to quantify the role of trade-induced inequality in shaping the welfare consequences of the observed rise in trade integration over the period 1979-2007. We proceed in two steps. On a first pass, we calibrate our model to match certain key moments of the 2007 United States economy. We then increase trade frictions to bring the openness of the U.S. economy back to its 1979 level (and also back to autarky, in an auxiliary exercise). This allows us to compute the effect of changes in trade openness on aggregate income and on inequality, thereby allowing us to gauge the quantitative importance of the two corrections developed in this paper. More specifically, we seek to answer the following questions: how large are the gains from trade for different degrees of inequality aversion? How large would the gains from trade have been if costless redistribution had been available?

6.1 Calibration

The calibration of our model to 2007 U.S. data is analogous in many ways to the one we performed in section 4 for the closed-economy version of the model during the period 1979-2007. In particular, we continue to set $\beta = 0.8$ and $\varepsilon = 0.5$, while we again back out the tax progressivity parameter ϕ by regressing the logarithm of CBO post-tax and transfer income on the logarithm of market income, though in this case we focus on the years 2006, 2007 and 2008. As in the different panels of Figure 2, the fit of this simple log-linear regression is remarkable for all three years and delivers an average value of $\phi = 0.157$ with an R-squared higher than 0.99 in each year.³⁰

The only new sets of parameters to calibrate in the open economy are (i) the number of symmetric foreign regions N , (ii) the iceberg cost parameter τ , and (iii) the parameters f_x and α determining the structure of fixed costs of exporting. According the World Bank's world development indicators, the U.S. accounted for 18.3% of world (PPP-adjusted) GDP in 2007, so we set $N = 5$ in our benchmark calibration, though we will also present some sensitivity results for different values of N in section 6.3.

The calibration of the other trade parameters is more involved. Realizing that the income distribution produced by the model is crucially affected by the exporting decisions of agents, we jointly calibrate the ability distribution H_φ and the trade parameters (τ, f_x, α) to exactly match the 2007 distribution of market income (from the public use samples of U.S. Federal Individual Income Tax returns) as well as three moments of the U.S. trade sector. These three "trade moments" are: (M1) the U.S. trade share in 2007, defined as the ratio of the average between U.S. exports and imports and gross output in the U.S. (7.74%); (M2) the share of exporters' sales in the total sales of U.S. firms (61.8%); and (M3) the share of U.S. exports accounted by for exporters that sell to more than five foreign markets (89%).

³⁰We choose the average value of ϕ over the period 2006-08 because its value in 2007 ($\phi = 0.147$) is the lowest in the period 1979-2010, and is thus a bit of an outlier. Our quantitative results are, however, not materially affected by this choice.

The choice of these three moments is motivated by the following two considerations. First, it is not clear what a firm is in our model, and thus we unfortunately cannot rely on the large number of firm-level moments developed in the literature (e.g., [Bernard et al., 2007](#)) to discipline our model. Instead, we rely on moments aggregated across firms (and workers). Second, we target moments that we think are particularly useful in jointly identifying the parameters of interest. In that respect, (M2) and (M3) both relate to the extensive margin of trade, which is crucially affected by the shape of the fixed cost function in (25). More specifically, (M3) is a measure of concentration that should be largely shaped by the curvature α of the fixed cost function. The overall trade share (M1) is determined by a combination of the extensive and intensive margins of trade, and thus it seems reasonable that, conditional on the other two moments, this moment will help pin down the empirically relevant value for iceberg trade costs τ .

We provide more details on the sources of data used to compute these moments in Appendix A.5, where we also include a discussion of the technical aspects of the calibration. The resulting parameter estimates are $\tau = 2.142$, $f_x = 675$, and $\alpha = 0.543$. Our estimated iceberg trade costs may appear to be rather high, but it is important to emphasize that we are calibrating the model to the entire U.S. economy, rather than to its manufacturing sector, as is standard in quantitative models of trade.³¹ Conversely, our estimated fixed costs of exporting might appear low relative to those estimated in the literature (e.g., [Das et al. 2007](#)), but note that ours apply at the individual level, while the literature has estimated them at the firm level. Furthermore, in our framework, these fixed costs rise with the number of markets serviced.

When performing our counterfactuals, we hold all parameters fixed, including the distribution of ability, and we first set $\tau_{1979} = 2.295$ to match the 1979 trade share of 4.90% in the data. This amounts to rolling back the U.S. economy to its openness level in 1979, so we can isolate the effects of trade integration on aggregate income and inequality. In a second more extreme counterfactual, we study a shift to autarky by setting $\tau_{autarky} = +\infty$ while again holding all other parameters fixed to their 2007.

6.2 Counterfactuals

Table 2 reports the implications of a move to the 1979 openness level and to autarky for aggregate consumption, for aggregate welfare in the absence of inequality aversion (i.e., Kaldor-Hicks welfare), and for the Gini coefficient on disposable income. For our benchmark taxable income elasticity of 0.5, a move to 1979 openness levels would reduce consumption by 1.2% percent and Kaldor-Hicks welfare by 1.1%, the difference reflecting a lower labor supply (and thus higher leisure) in a world with depressed export sales. A move to autarky naturally magnifies these numbers, which are (respectively) 3.5% and 3.3% percent in that case.³² Importantly for our purposes, the last two columns of Table 2 show that these income and Kaldor-Hicks welfare

³¹When calibrating our model to the U.S. manufacturing sector we indeed back out a smaller value of τ (1.79), which is very much in line with those in [Anderson and van Wincoop \(2004\)](#) and [Melitz and Redding \(2015\)](#).

³²These numbers are broadly in line with those obtained in the literature calibrating models of trade featuring no income dispersion within countries ([Costinot and Rodríguez-Clare, 2013](#)).

losses are accompanied by nonnegligible declines in inequality, with the Gini coefficient falling by 0.5% in the 1979 counterfactual and by 1.3% in the autarky counterfactual. These numbers are somewhat dwarfed by the actual increases in the Gini coefficient observed during the period 1979-2007 (see Figure 1), but of course many other forces were at play in the last few decades contributing to the drastic increase in income inequality. As we will next see, even when trade might have been a small contributor to the observed increase in inequality, such a contribution still has nontrivial consequences for the measurement of the welfare gains from trade.

Table 2 also shows that the real consumption gains from trade are higher, the higher is the taxable income elasticity ε . This is consistent with the findings of Arkolakis and Esposito (2014). Notice, however, that the amount of inequality induced by trade opening also increases with ε .

Table 2: Welfare Gains from Trade and Induced Inequality

	% Consumption Gains		% K-H Welfare Gains ($\rho = 0$)		% Increase in Gini	
	τ_{1979}	$\tau = \infty$	τ_{1979}	$\tau = \infty$	τ_{1979}	$\tau = \infty$
$\varepsilon = 0.25$	0.9	2.4	0.8	2.3	0.4	1.1
$\varepsilon = 0.5$	1.2	3.4	1.1	3.2	0.5	1.3
$\varepsilon = 1$	2.1	6.1	1.9	5.7	0.6	1.6

We are now ready to put the tools developed in this paper to use, and invoke equation (36) to compute modified social welfare gains from trade that take into account the inequality-enhancing consequences of trade opening. In order to better compare the impact of inequality on the gains from trade under different counterfactual exercises, parameter values, and calibration approaches, we will focus on reporting what we refer to as the *welfarist modified statistic* and the *costly redistribution modified statistic*. The former, which we denote by Δ^{Stat} , corresponds to the factor by which the social welfare gains from trade in the absence of inequality aversion need to be multiplied to obtain the gains from trade whenever $\rho > 0$. The latter, denoted by Θ^{Stat} , is instead the factor by which the gains from trade in a hypothetical Kaldor-Hicks economy need to be multiplied in order to obtain the gains from trade in an inequality-neutral economy in which redistribution is costly. In more formal terms, and analogously to the decomposition in equation (36), we are effectively decomposing the (net) gains from trade as follows:

$$\frac{W'}{W} - 1 = \underbrace{\left(\frac{\frac{W'}{W} - 1}{\frac{W'/\Delta'_T}{W/\Delta_T} - 1} \right)}_{\Delta^{Stat}} \times \underbrace{\left(\frac{\frac{W'/\Delta'_T}{W/\Delta_T} - 1}{\frac{\tilde{W}'_T}{\tilde{W}_T} - 1} \right)}_{\Theta^{Stat}} \times \left(\frac{\tilde{W}'_T}{\tilde{W}_T} - 1 \right)$$

Given our theoretical results, we expect both Δ^{Stat} and Θ^{Stat} to be less than one, thus leading to a downwards adjustment to the gains from trade.

Figure 8 plots the welfarist modified statistic in each of the two counterfactuals for our benchmark parameter values, and for different values of ρ and ε . The left panel focuses on our benchmark with $\varepsilon = 0.5$, while the right panel replicates the figure for $\varepsilon = 0.25$ and $\varepsilon = 1$. Even though the effects of trade on aggregate income and income inequality are quite different in the

two counterfactuals under study (see Table 2), the figure indicates that the welfarist modified statistic turns out to be almost identical in both counterfactuals, regardless of the value of ε . For the case of logarithmic utility ($\rho = 1$) and a benchmark taxable income elasticity of $\varepsilon = 0.5$, we have that $\Delta^{Stat} = 0.78$ for both the 1979 and autarky counterfactuals, which implies that inequality aversion is associated with welfare gains that are 22% lower than in a world with an inequality-neutral ($\rho = 0$) social planner. For $\varepsilon = 0.25$ and $\varepsilon = 1$, the analogous factors are 0.74 and 0.84, respectively, which are associated with 26% and 16% lower gains from trade.

Naturally, this welfarist modified statistic approaches 1 as ρ goes to 0, but notice that even for relatively low values of ρ , such as $\rho = 0.5$, the adjustment still erodes between 10% and 20% of the gains from trade. On the other hand, and although the gains from trade decline in ρ (see Proposition 5), notice that the relationship between Δ^{Stat} and ρ quickly flattens. As a result, even for very large value of ρ , such as $\rho = 2$, our welfarist adjustment is unlikely to eliminate more than 30% of the gains from trade.

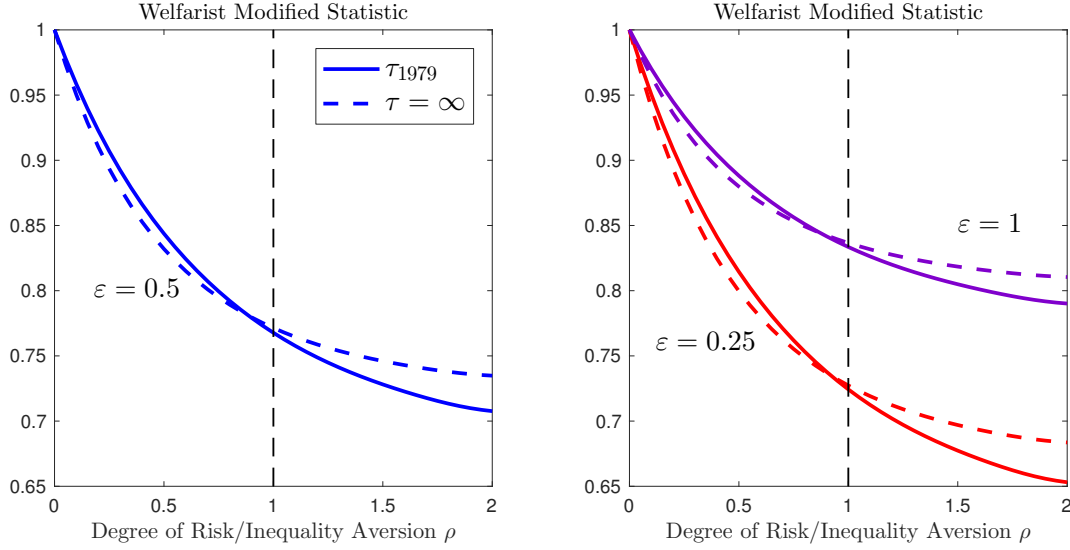


Figure 8: Welfarist Adjustment to the Welfare Gains from Trade

Turning to our costly redistribution modified statistic Θ^{Stat} , Figure 9 plots this statistic for the 1979 and autarky counterfactuals, and for various values of ε . Because the inefficiencies associated with costly redistribution are increasing in the elasticity of taxable income ε , it is not surprising that Θ^{Stat} is declining in ε . Unlike in the case of Δ^{Stat} , the specific counterfactual under consideration does appear to matter for the size of Θ^{Stat} , with the autarky counterfactual being associated with a larger downwards adjustment. For our benchmark value of $\varepsilon = 0.5$, we find that $\Theta^{Stat} = 0.85$ in our autarky counterfactual and $\Theta^{Stat} = 0.90$ in the 1979 counterfactual. This implies that in the presence of costless redistribution, the gains from trade would have been about one-sixth larger in the autarky counterfactual and about one-ninth higher in the 1979 counterfactual.

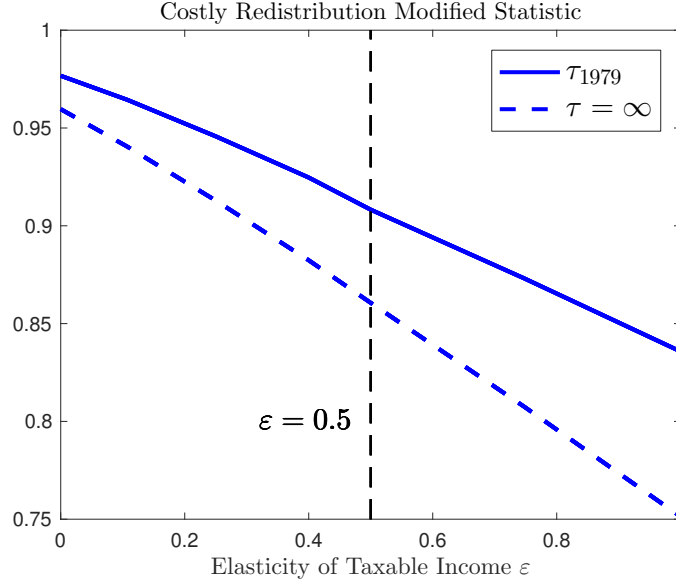


Figure 9: Costly Redistribution Adjustment to the Welfare Gains from Trade

6.3 Robustness

[TO BE WRITTEN]

7 Conclusions

In this paper, we have explored the welfare consequences of trade integration in an environment in which trade-induced inequality is partly mitigated by a progressive income tax-transfer system. Despite the progressive nature of taxation, trade integration leads to an increase in inequality in the distribution of disposable income. We have argued that, under these circumstances, the application of the Kaldor-Hicks criterion to quantitatively evaluate the welfare gains from trade is not devoid of value judgments. More specifically, unless one is willing to assume that a dollar in the hands of a poor individual has the same social value as a dollar in the hands of a rich individual, trade liberalization episodes that increase the real disposable income of some individuals but reduce that of others cannot be evaluated by simply adding those real incomes. Furthermore, in situations in which trade integration benefits some agents in society disproportionately, the progressivity of the tax system implies that these fortunate individuals will necessarily transition into higher marginal tax brackets, so they will naturally adjust their labor supply (or effort in production) in a way that diminishes the realized gains from trade relative to a situation in which redistribution was performed in a nondistortionary manner. In this paper, we have formalized these insights and we have developed welfarist and costly redistribution corrections to standard measures of the gains from trade integration. Under plausible parameter values, these corrections are nonnegligible and eliminate about one-fifth of the (static) gains from trade.

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