Winners and Losers from Trade Liberalization: The Role of Labor Market Institutions

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Abstract

While the distributional consequences of trade liberalization at the firm level are now well-understood, the previous literature has paid limited attention to how variations of domestic institutions across countries impact both the *selection effect* and *reallocation effect* suggested by the New New Trade Theory. Building on the variety of capitalism literature, we theorize that the distributional effects of trade liberalization are systematically different in "liberal market economies" (LMEs) and "coordinated market economies" (CMEs). This is because CMEs feature the presence of coordinated wage-settlement institutions, which pose a ceiling to the increase of wages, helping smaller firms to weather the raising competition triggered by tariff reduction. Thus, we expect that trade liberalization in LMEs generates sharply asymmetrical distributional consequence between large productive firms and smaller unproductive firms, whereas trade liberalization in CMEs generate welfare effects that are more symmetrically distributed across firms. As a corollary, we expect that the increase in productivity of CMEs is smaller than the increase in productivity in LMEs after trade liberalization. We test this hypothesis using a newly collected firm-level dataset on OECD countries, which covers the period between 1995 and 2015. We rely on preferential tariff reductions to capture the occurrence of trade liberalization. The hierarchical nature of the dataset allows us to exploit variation across firms, industries, and countries over time. The results of our paper inform a growing literature on the winners and losers from trade liberalization at the level of firm, pointing out the importance of institutions in taming the market forces.

Key words: trade liberalization; distributional effect; domestic institutions; firm-level analysis.