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Pareto gains from trade, reconsidered: Compensating for jobs lost

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Abstract

This paper questions whether commodity taxation can ensure Pareto gains from trade liberalization in the presence of unemployment. To address this question, we extend the standard multi-consumer model of international trade to include efficiency-wage unemployment. Even if trade liberalization does not cause aggregate unemployment to rise, individual workers may lose jobs and would require compensation to maintain their pre-liberalization levels of welfare. This compensation would weaken the incentive to work efficiently and thus reduce the likelihood of Pareto gains. Our analysis in fact establishes that such gains from liberalization are infeasible under certain plausible conditions.



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Keywords

Pareto gains; Trade liberalization; Efficiency-wage unemployment

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