

Trade Liberalization, Structural Change, and Income Inequality: Evidence from China

Lingmin Bao

January 11, 2025

Abstract

I investigate the effects of international trade on the skill premium and interregional disparities in China, focusing on the country's accession to the WTO. I first document a positive correlation between trade shocks and changes in the skill premium, using a prefecture-level shift-share measure of trade shocks. I then develop a spatial equilibrium trade model that includes Chinese provinces and the rest of the world. A central feature of the model is the demand-side mechanism due to non-homothetic preferences: as incomes rise, consumption shifts away from agriculture. On the supply side, the service sector is the most skill-intensive, which is consistent with the evidence I provide from Chinese data. Consequently, income growth driven by trade expands the skill-intensive sector, raising the skill premium. The spatial dimension captures heterogeneous costs of trading with the rest of the world as well as differential pace of structural change within the country. Using this framework, I quantify the impact of trade both within and across regions. Trade amplifies within-region inequality by increasing the skill premium, especially in coastal areas, with the income mechanism contributing roughly one-third of this effect. I also find that trade widens interregional inequality as regions face unequal access to global markets. Overall, the model explains approximately 46% of the observed rise in inequality in the data.

Keywords: trade liberalization, structural change, income inequality, skill premium

JEL Codes: F14, F16, I26, J24, O15