Comparative Advantage and the Welfare Impact of European Integration
by Andrei Levchenko and Jing Zhang

Discussion

This paper performs a rigorous and thoughtful quantitative assessment of the welfare gains produced by trade integration, that improves our understanding of the role played by comparative advantage. There is a lot that we can learn from this paper as the topic is extremely relevant and the analysis is both accurate and sound. Of course, in order to make the quantitative exercise tractable, some factors have been omitted from the analysis. These limitations have been mentioned throughout the paper and do not undermine the validity of the analysis. However, in order to give an appropriate interpretation to the results of the paper, I believe it is important to keep these limitations into proper consideration. My discussion will elaborate on them.

First, sectoral productivities are kept constant when comparing the actual scenario to the counterfactual scenario where Eastern Europe is in autarky. However, trade integration is likely to make competition in the market more intense and, through this channel, to foster incentives to innovate, thereby changing sectoral productivities and shaping the pattern of comparative advantage. The welfare gains associated to trade integration are likely to be larger when one accounts for this effect. For instance, Italy – given the present structure of comparative advantage – is likely to suffer substantially from trade integration with China. However, Italian firms facing tougher competition from Chinese products might be forced to invest in order to produce superior quality/innovation intensive products, thereby making Italian industrial structure more differentiated from the Chinese one and eventually benefitting from trade integration.

This consideration highlights that trade integration needs to go hand in hand with policy intervention aimed at facilitating innovation. Policy intervention may consist of specific policies, such as subsidies to innovation investment or patent policy reforms; it may also consist of broader policies such as financial markets/corporate governance reforms that alleviate financial constraints innovative firms are particularly vulnerable to, or reforms of the education system that increases the supply of high-skilled workers. This consideration also highlights the second limitation of the analysis, i.e. the fact that the quality of institutions is kept constant across the actual and counterfactual scenario. More intense competition associated with trade integration may instead prompt governments to undertake reforms that improve the quality of institutions, thereby shaping the pattern of comparative advantage also through this channel.

Third, the model does not incorporate worker heterogeneity and does not allow for factors to move across countries. As a consequence it is not the appropriate model to account for distributional issues. (Still, distributional issues are partially addressed by considering the case where factors cannot reallocate across sectors.) Distributional effects associated with trade integration may be sizeable. After integration with Eastern Europe many West European firms, especially the ones active in labour-intensive sectors, have relocated their activity to Eastern Europe attracted by cheap labour. At the same time, West European countries have experienced flows of workers from Eastern Europe, attracted by high wages. Both phenomena have represented a serious threat for low-skilled workers in Western Europe, and have generated opposition against trade liberalization. This makes even more compelling the implementation of active labour market policies, such as policies that assist workers in acquiring more advanced skills, of investment programs in education and, more generally, of social safety net programs.

My last comment concerns the conclusions drawn from the comparison between a counterfactual scenario where trade costs between West European countries are increased by 45% (rolled back to

‘60s values) and a baseline scenario where trade costs are the present ones. Both in the counterfactual and in the base-line scenario Eastern Europe remains in autarky. The (mean) welfare gain for Western European countries is 2.53% (16 times larger than gains from trade opening of Eastern Europe). The authors conclude: “These results speak to the policy trade-off between the benefits of continued ‘deep’ integration within Western Europe and the ‘shallow’ but broad integration with other regions such as Eastern Europe and beyond.” I am not sure that such a conclusion can be inferred from the analysis of the paper. The analysis shows that decreasing trade costs from their value in the ‘60s to their present value has benefitted Western Europe. We cannot conclude that decreasing trade costs by the same amount from the present value generates the same welfare gains, unless one assumes linearity in the relationship between trade costs and welfare. On top of this, integration with emerging blocs is to some extent inevitable and the priority of Western Europe should be perhaps to find the proper tools to benefit as much as possible from it.