International Trade and Income Inequality*

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Abstract

We propose a theory that explains why international trade can widen a wage gap between top income-earners and others. We consider two symmetric countries in which individuals with different abilities work either as knowledge workers, who develop products produced in a differentiated-good sector, or as production workers, who engage in actual production processes. In equilibrium, *ex ante* symmetric firms post different wages for knowledge workers and hence attract workers with different abilities from other firms, creating the difference in quality of their products. International trade will benefit firms that produce high-quality products and harm firms that produce low-quality products. The relative wage gap between individuals with high ability and those with low ability expands as a result. Indeed, we show that international trade increases the real wages for those with lowest and highest abilities but decreases the real wages for those with intermediate abilities. We also extend the basic model to the one with asymmetric countries and show that the wage gap created by international trade is severer in the smaller country than the larger country.

Preliminary and incomplete.

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