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The Impact of Trade Openness on Income Inequality: A Theoretical and Empirical Review

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Abstract

This paper examines the complex relationship between trade openness and income inequality, integrating classical economic theories with contemporary perspectives and empirical findings. While traditional models, such as the Heckscher-Ohlin framework and the Stolper-Samuelson theorem, predict that trade liberalization should reduce inequality by favoring abundant factors of production, real-world outcomes often diverge from these expectations. Contemporary research highlights that trade can exacerbate income disparities through skill-biased technological change, capital-labor dynamics, and sectoral reallocation, particularly in the absence of robust domestic institutions. Empirical studies reveal that countries with strong education systems, inclusive labor markets, and effective social protection mechanisms are better positioned to distribute the gains from globalization, while others face deepened inequalities. This paper advocates for a comprehensive policy framework centered on investing in human capital, strengthening social safety nets, promoting inclusive labor institutions, and facilitating labor mobility. Recognizing the contingent nature of globalization's effects is critical for ensuring that trade catalyzes for inclusive economic growth rather than a driver of social fragmentation. Future research should continue exploring the interactions among globalization, technological change, and institutional quality to inform more effective policy design.

Keywords: Trade openness; Income inequality; Globalization; Development economics; Labor markets

1: Introduction

The unprecedented expansion of international trade over the past several decades has profoundly reshaped global economies. While proponents highlight the efficiency and growth gains from trade liberalization (Krugman, 1995), concerns regarding its distributional consequences have simultaneously intensified. Classical economic models, particularly the Heckscher-Ohlin framework and the Stolper-Samuelson theorem, predict that trade should narrow income disparities by allowing countries to capitalize on their abundant factors of production (Stolper & Samuelson, 1941). Labor-rich developing economies, for instance, are expected to benefit from greater demand for labor, resulting in higher wages and reduced inequality. However, empirical

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observations increasingly challenge this optimistic view, as both developed and developing countries have witnessed rising income inequality during periods of deepening globalization (Milanovic, 2016).

Understanding the intricate relationship between trade openness and income inequality has thus become a central concern in development economics. Theoretically, trade liberalization enhances overall economic efficiency, expands market access, and fosters productivity growth, yet its benefits are not uniformly distributed across all segments of society (Rodrik, 2018). A growing body of research suggests that trade openness can accentuate pre-existing disparities through several channels, including skill-biased technological change, capital-labor dynamics, and sectoral reallocation (Goldberg &Pavcnik, 2007). Workers in declining industries, particularly those with lower levels of education or concentrated in rural regions, often bear disproportionate adjustment costs, while highly skilled workers and capital owners reap greater gains from integration into global markets.

At the same time, the extent to which trade openness exacerbates or mitigates inequality appears to be strongly mediated by country-specific characteristics. Institutions, labor market structures, educational attainment, and social protection mechanisms critically shape how economies absorb the shocks and opportunities generated by trade (Autor, Dorn, & Hanson, 2013). In contexts with robust education systems, active labor market policies, and inclusive governance, the adverse distributional effects of globalization can be significantly contained. Conversely, in countries where institutional support is weak, trade liberalization may deepen structural vulnerabilities and entrench socio-economic divisions (Jaumotte, Lall, & Papageorgiou, 2013).

Despite extensive scholarly attention, the literature on trade and inequality remains fragmented and inconclusive. Some empirical studies emphasize globalization's role in widening wage gaps, especially in developing economies undergoing rapid industrial transformation. Others highlight that domestic factors such as technological innovation, political institutions, and demographic transitions may play an even larger role than trade itself in explaining income disparities. This lack of consensus underscores the need for a comprehensive synthesis of existing theories and evidence to clarify the conditions under which trade openness promotes or undermines equitable growth.

This paper seeks to address this gap by providing an integrated theoretical and empirical review of the relationship between trade openness and income inequality. We examine both classical and contemporary economic theories, identify key mechanisms linking trade to distributional outcomes, and systematically review empirical findings across different national contexts. Furthermore, the paper offers policy recommendations aimed at maximizing the inclusive potential of globalization while mitigating its adverse effects on vulnerable groups. Before formulating these policy insights, however, it is essential to establish a theoretical foundation by reviewing classical and modern economic frameworks that explain the linkage between trade and inequality.

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The remainder of the paper is organized as follows. Section 2 reviews classical and modern theoretical frameworks on trade and inequality. Section 3 discusses the main mechanisms through which trade openness may influence income distribution, including technological diffusion, capital accumulation, and sectoral transformation. Section 4 synthesizes empirical findings from cross-country and case studies, highlighting the role of institutional quality and policy responses. Section 5 derives practical policy implications. Finally, Section 6 concludes with reflections on the implications for future research and global economic governance.

2: Theoretical Background

2.1 Classical Perspectives

The Heckscher-Ohlin (H-O) model posits that trade benefits the abundant factors of production, implying that labor-rich developing countries should experience reduced inequality following trade liberalization. The Stolper-Samuelson theorem further predicts that trade will increase the real income of the abundant factor while decreasing that of the scarce factor. Together, these foundational models establish a classical theoretical expectation that globalization should not only promote aggregate growth but also foster a more equitable distribution of income across and within nations.

Under the H-O framework, comparative advantage arises from differences in countries' relative factors, primarily labor and capital. Trade liberalization enables countries to specialize according to their abundant factors, raising demand for these factors and thus improving their returns. For labor-abundant developing economies, this implies rising wages for low-skilled workers and a compression of income inequality. Conversely, capital-rich economies are predicted to witness gains accruing primarily to capital owners. The Stolper-Samuelson theorem formalizes this intuition by linking changes in goods prices to real factor rewards: an increase in the relative price of a country's export goods raises the real income of the factor used intensively in its production while reducing the income of the other factor (Stolper & Samuelson, 1941; Feenstra, 2015). As such, classical trade theory suggests that international trade functions as a mechanism for equalizing not only prices of goods but also returns to factors across the global economy.

Nevertheless, the classical models are built on highly restrictive assumptions that rarely hold in reality. Perfect labor mobility across sectors, homogeneous labor and capital within countries, constant returns to scale, and frictionless market adjustments are presumed conditions for the theory's predictions. However, empirical observations suggest that actual economies are characterized by significant labor market frictions, skill heterogeneity, and adjustment costs. Workers displaced by import-competing industries may face prolonged unemployment or wage losses if retraining opportunities are limited, geographic mobility is restricted, or sectoral shifts are abrupt. Furthermore, global supply chains and intra-industry trade, prominent features of modern globalization, introduce complexities not accounted for in the basic H-O model (Krugman, Obstfeld, & Melitz, 2018).

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Empirical evidence, particularly from developing countries, challenges the classical expectation that trade liberalization reduces inequality. Studies of Latin American economies during the 1980s and 1990s, for instance, reveal that trade reforms often coincided with rising wage inequality, disproportionately benefiting skilled workers (Goldberg &Pavcnik, 2007). Rather than unskilled labor gaining from increased trade as classical models would suggest, the diffusion of skill-biased technologies and the erosion of labor-intensive industries appeared to widen income gaps. These outcomes highlight the need to incorporate additional mechanisms—such as technological change, firm heterogeneity, and institutional quality—into analyses of trade and inequality dynamics.

In summary, while the Heckscher-Ohlin and Stolper-Samuelson frameworks provide an elegant and influential foundation for understanding the potential distributive impacts of trade, their explanatory power appears limited when applied to the complex realities of contemporary economies. Their limitations have spurred the development of more sophisticated theoretical approaches that relax restrictive assumptions and integrate factors such as technology, firm dynamics, and institutional structures, which will be discussed in the following section.

2.2 Contemporary Theories

While classical trade models provide foundational insights into the effects of globalization on income distribution, the realities of modern economies have exposed their significant limitations. In response, contemporary trade theories have evolved to incorporate a broader array of mechanisms and more realistic assumptions. These new frameworks emphasize factors such as firm-level heterogeneity, imperfect competition, technology diffusion, and endogenous labor market dynamics, offering a more nuanced understanding of the complex relationship between trade openness and inequality.

One major advancement is the incorporation of firm heterogeneity into trade models, most notably through the seminal work of Melitz (2003). The Melitz model of heterogeneous firms in international trade departs from the classical assumption of representative firms by recognizing that only the most productive firms can survive and export in the presence of trade costs. Globalization thus reallocates resources toward more productive firms, raising aggregate productivity but simultaneously widening disparities within industries. Workers in highly productive, export firms typically enjoy higher wages, while those employed in less competitive firms face job losses or stagnant incomes. Consequently, trade liberalization can lead to an increase in within-industry wage inequality, a phenomenon not predicted by traditional models (Helpman, Itskhoki, & Redding, 2010).

In parallel, the theory of skill-biased technological change (SBTC) has become central to explaining how trade interacts with labor markets to affect inequality. International trade accelerates the diffusion of advanced technologies, but these technologies often complement skilled rather than unskilled labor (Acemoglu, 2002). As a result, demand for high-skilled workers rises, boosting their relative wages and widening income gaps between skilled and unskilled labor. In many developing economies, where access to higher education remains

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uneven, the skill premium has increased markedly alongside globalization, challenging the expectation that trade alone would lift the incomes of the broad labor force.

Another critical refinement comes from recognizing the role of global value chains (GVCs) and vertical specialization. Unlike the assumptions of classical models, where goods are produced domestically from start to finish, contemporary production is highly fragmented across borders. Firms specializing in different stages of production engage in trade in intermediate goods. Participation in GVCs often benefits firms and regions integrated into higher value-added segments, while those relegated to low-skill, low-value-added tasks derive fewer gains (Antràs, 2020). This segmentation can entrench inequalities both between and within countries.

Institutional quality has also been increasingly emphasized in contemporary analyses. Trade's effects on income distribution are not uniform but mediated by national institutions, including education systems, labor market regulations, and welfare policies. Rodrik (1997) argues that globalization increases the premium on good governance: economies with strong institutions can cushion trade-induced shocks and distribute gains more broadly, whereas weak institutions amplify the disruptive aspects of globalization. In this view, the same trade liberalization policy can yield vastly different inequality outcomes depending on the domestic policy environment.

Collectively, contemporary trade theories depict globalization as a complex, multifaceted process whose distributional effects cannot be fully understood through the lens of classical factor endowment models alone. Firm dynamics, skill-biased technological change, supply chain fragmentation, and institutional variation interact to produce highly heterogeneous outcomes. These insights lay the groundwork for a more comprehensive empirical and policy analysis of trade and inequality, as explored in the following sections.

3: Mechanisms Linking Trade Openness and Income Inequality

While trade liberalization is often associated with aggregate economic gains, its effects on income distribution are complex and mediated through multiple channels. Contemporary research identifies several key mechanisms through which trade openness can influence inequality within and across countries. These include skill-biased technological change, shifts in capital-labor dynamics, sectoral reallocation, and the moderating role of domestic institutions and policies. Understanding these mechanisms is essential for developing a comprehensive view of how globalization affects social and economic outcomes.

3.1 Skill-Biased Technological Change

One of the primary mechanisms linking trade to inequality is the diffusion of technology that disproportionately benefits skilled workers. As economies become more integrated into global value chains, exposure to foreign markets fosters the adoption of advanced production technologies. These technologies, such as automation, information systems, and precision manufacturing, are typically complementary to skilled labor while substituting for unskilled labor (Acemoglu, 2002).

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Consequently, firms increasingly demand workers with higher education and technical expertise, driving up the wages of skilled workers relative to the unskilled. In many developing countries, where educational attainment is unevenly distributed, this dynamic exacerbates wage inequality. Empirical evidence from Latin America, for instance, shows that globalization-induced technological adoption significantly increased the skill premium during the trade liberalization episodes of the 1980s and 1990s (Goldberg &Pavcnik, 2007). Thus, skill-biased technological change serves as a critical channel through which trade openness can widen income disparities within societies.

3.2 Capital-Labor Dynamics

Trade openness also alters the balance between capital and labor returns, often to the detriment of low-skilled workers. Increased international competition incentivizes firms to reorganize production in ways that favor capital-intensive methods, seeking efficiency gains to maintain competitiveness in global markets. This structural shift reduces the relative demand for low-skilled labor while enhancing returns to capital and high-skilled labor (Rodrik, 1997).

As a result, the income share accruing to labor tends to decline, while capital owner, who are typically concentrated in higher income groups, capture a greater portion of economic gains. Moreover, globalization facilitates greater capital mobility, allowing multinational corporations and investors to allocate resources across borders in search of higher returns, further decoupling capital incomes from local labor market conditions. This capital-labor imbalance has been identified as a major contributor to rising income inequality in both advanced and emerging economies (Piketty, 2014).

3.3 Sectoral Reallocation

Trade liberalization often leads to profound shifts in the structure of national economies, particularly the relative decline of traditional, labor-intensive sectors such as agriculture, textiles, and low-skill manufacturing. As countries specialize according to their comparative advantage, sectors unable to withstand heightened international competition contract, displacing workers and undermining communities historically reliant on these industries (Feenstra, 2015). The process of sectoral adjustment is rarely smooth. Workers in declining sectors often encounter significant barriers to transition, including limited education, obsolete skills, and geographic immobility. Labor market frictions, insufficient retraining programs, and regional disparities in job creation further compound these challenges. As a result, displaced workers frequently suffer long-term wage scarring, increased unemployment durations, and downward occupational mobility (Artuç, Chaudhuri, & McLaren, 2010).

Rural regions are particularly vulnerable to the adverse effects of sectoral reallocation. In areas heavily dependent on agriculture or resource extraction, the contraction of traditional industries entrenches poverty, underdevelopment, and demographic decline. Infrastructure deficits, educational disadvantages, and restricted access to dynamic labor markets exacerbate regional inequalities, creating a self-reinforcing cycle of marginalization. Empirical studies substantiate

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these concerns. For instance, Topalova (2010) documents that regions in India more exposed to trade liberalization experienced slower poverty reduction and greater economic divergence relative to less exposed areas. Similarly, Autor, Dorn, and Hanson (2013) demonstrate that in the aftermath of China's accession to the World Trade Organization, U.S. regions specializing in import-competing industries suffered persistent employment losses, wage stagnation, and widening spatial income disparities.

Thus, sectoral reallocation driven by trade openness generates distributional consequences that extend well beyond aggregate sectoral averages. The unequal capacity of individuals and regions to adapt to structural change implies that without complementary domestic policies, trade liberalization risks deepening both interpersonal and regional inequalities. Addressing these disparities requires proactive public interventions, including targeted investment in human capital, regional infrastructure development, and policies that facilitate labor market transitions. Acknowledging the localized and heterogeneous effects of sectoral shifts is essential for ensuring that globalization promotes broad-based, inclusive growth rather than reinforcing existing divides.

3.4 Institutional and Policy Mediators

The extent to which trade openness affects income inequality is heavily contingent upon the quality and structure of domestic institutions. Classical economic models often abstract away from the role of institutions, assuming frictionless adjustments across sectors and smooth redistributive mechanisms. However, empirical evidence increasingly underscores that the distributional outcomes of globalization are profoundly shaped by institutional capacity. Strong education systems, inclusive labor markets, and comprehensive social protection mechanisms can significantly mitigate the adverse effects of globalization, ensuring that the benefits of trade are shared more broadly across society (Jaumotte, Lall, & Papageorgiou, 2013).

Countries equipped with effective retraining programs, unemployment insurance, and labor mobility support are better positioned to manage the transition costs associated with structural economic changes. Active labor market policies (ALMPs) can facilitate reemployment, enhance human capital, and prevent long-term labor market detachment (Martin, 1998). Conversely, in environments where institutional support is weak or absent, trade-induced disruptions are more likely to entrench inequality, foster long-term unemployment, and generate political instability. Workers displaced from declining sectors may face significant barriers to reintegration, leading to persistent income polarization and social discontent. Historical experiences, such as the divergent outcomes observed between Scandinavian countries and Anglo-Saxon economies during periods of economic liberalization, illustrate the crucial role of institutions in shaping globalization’s domestic consequences (Rodrik, 1997).

Moreover, fiscal policy plays an equally critical role in mediating the effects of trade on income distribution. Progressive taxation, targeted social transfers, and public investment in education and health can redistribute the gains from trade and cushion vulnerable groups from adverse shocks (ILO, 2016). Countries that mobilize fiscal resources effectively are better able to

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maintain social cohesion in the face of globalization, while those with limited redistributive capacity often experience heightened social and economic polarization. Importantly, institutional quality should not be viewed as a static background condition but rather as an active and dynamic mediator capable of amplifying or attenuating the inequality effects of trade liberalization.

Recognizing the centrality of institutions is therefore essential for designing globalization strategies that are both economically efficient and socially inclusive. Trade openness, while offering significant opportunities for growth and innovation, does not automatically translate into equitable outcomes. Without complementary policies aimed at enhancing resilience, adaptability, and equity, globalization risks exacerbating pre-existing inequalities and undermining social stability. Thus, any meaningful effort to harness the benefits of international trade must be accompanied by a parallel commitment to institutional strengthening and inclusive policy design.

4: Review of Empirical Findings

Empirical studies yield mixed and often context-dependent results regarding the relationship between trade openness and income inequality. A substantial body of research suggests that trade liberalization tends to exacerbate wage disparities, particularly in developing economies. Goldberg and Pavcnik (2007) provide comprehensive evidence showing that trade reforms in Latin America during the 1980s and 1990s often widened wage inequality, disproportionately benefiting skilled workers while harming the earnings prospects of the unskilled. Similarly, Autor, Dorn, and Hanson (2013) document that the surge of Chinese import competition in the United States contributed significantly to employment losses, wage declines, and regional economic distress, particularly among low-skilled manufacturing workers. These findings underscore that, in the absence of adequate institutional support, exposure to international trade can amplify labor market vulnerabilities and deepen pre-existing social inequalities.

Conversely, other studies emphasize the mitigating role of domestic institutions and human capital in shaping the distributional outcomes of trade. Milanovic (2016) argues that in countries characterized by widespread access to education, strong social safety nets, and inclusive labor market institutions, trade openness can contribute to more equitable economic growth. Under such conditions, the gains from globalization are more broadly distributed, and the adverse effects on displaced workers are minimized through effective reallocation mechanisms. Similarly, Jaumotte, Lall, and Papageorgiou (2013) suggest that while globalization has indeed contributed to rising inequality, its role is secondary compared to that of technological change, particularly skill-biased technological progress. Their findings highlight that without accompanying investments in human capital and institutional development, the benefits of trade integration are unlikely to be evenly shared across society.

Recent meta-analyses and cross-country studies further corroborate the context-dependent nature of the trade-inequality nexus. For instance, Bourguignon (2017) emphasizes that the impact of trade on income distribution varies not only across countries but also over time, depending on the stage of development, the structure of the economy, and the prevailing policy framework. In

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economies with flexible labor markets and proactive redistributive policies, trade-induced gains can be more inclusive. In contrast, where labor markets are rigid and social protections are weak, globalization tends to exacerbate inequality and social fragmentation.

These findings collectively indicate that the effects of trade openness on income distribution are far from uniform and are deeply mediated by domestic economic structures and policy environments. Globalization, in itself, neither guarantees equity nor inevitably leads to greater disparity; rather, its outcomes are contingent upon how countries manage the opportunities and challenges it presents. A nuanced understanding of these empirical patterns is critical for informing policy interventions aimed at harnessing the benefits of trade while safeguarding social cohesion.

5: Policy Implications

Given the contingent nature of trade's impact on income inequality, the design and implementation of tailored policy responses are essential. Trade liberalization, while offering significant opportunities for economic growth and technological advancement, does not inherently guarantee equitable outcomes. Without proactive measures, globalization can exacerbate social disparities, leading to economic polarization and political instability. Accordingly, a multifaceted policy framework is necessary to ensure that the gains from trade are broadly shared across society.

One crucial pillar of such a framework is investment in human capital. Expanding access to quality education and vocational training can significantly enhance the adaptability of the workforce in the face of structural economic changes. By equipping workers with the skills needed in emerging industries, education systems can reduce the wage gaps associated with skill-biased technological change and globalization. Policies that promote lifelong learning and continuous professional development are particularly important in dynamic, innovation-driven economies where occupational requirements evolve rapidly (OECD, 2019).

Strengthening social safety nets constitutes a second essential strategy. Providing targeted support for displaced workers—through mechanisms such as unemployment insurance, retraining subsidies, and regional development initiatives—can mitigate the short- and medium-term adjustment costs associated with trade liberalization. Well-designed social protection systems not only cushion individual income losses but also enhance aggregate demand, contributing to macroeconomic stability. Evidence from Scandinavian countries suggests that robust welfare states have been instrumental in maintaining social cohesion during periods of intense global economic integration (Rodrik, 1997).

Third, promoting inclusive labor market institutions is vital to ensuring that globalization does not undermine workers' bargaining power. Encouraging collective bargaining, establishing fair labor standards, and implementing minimum wage protections can help secure a more equitable distribution of economic gains. Inclusive labor market institutions can moderate wage dispersion

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and provide workers with a greater voice in shaping workplace practices, thereby contributing to a more balanced distribution of productivity gains (Freeman, 2007).
Finally, facilitating sectoral and geographic mobility is key to enabling workers to transition smoothly across occupations and regions. Policies that support labor market flexibility—such as relocation assistance, portable pensions, and credential recognition programs—can reduce frictions that often trap workers in declining industries or economically stagnant areas. Enhancing mobility not only improves individual economic resilience but also promotes overall economic efficiency by aligning labor supply with emerging demand (Topalova, 2010).

Collectively, these policy measures can help ensure that the benefits of globalization are more broadly shared, reducing the risk of trade-induced inequality and social fragmentation. Designing an inclusive globalization strategy requires not merely embracing open markets but also committing to complementary domestic reforms that expand opportunities and protect vulnerable populations. Only through such a comprehensive approach can trade serve as a catalyst for both economic dynamism and social cohesion.

6: Conclusion

The impact of trade openness on income inequality is complex and highly context-dependent. While classical trade theories suggest that globalization should reduce income disparities through specialization based on comparative advantage, contemporary empirical evidence highlights that trade can, under certain conditions, exacerbate inequalities. Mechanisms such as skill-biased technological change, sectoral reallocation toward capital- and skill-intensive industries, and variations in institutional quality critically mediate the outcomes of trade liberalization. The effects of globalization are therefore not uniform: countries with robust education systems, inclusive labor markets, and effective social safety nets are better positioned to distribute the gains from trade broadly, whereas those lacking such institutions often experience heightened inequality and social fragmentation. Empirical studies demonstrate that the domestic economic structure, policy environment, and labor market flexibility are central to determining whether globalization becomes a driver of shared prosperity or a catalyst for widening social divisions.

Recognizing the dual nature of globalization is essential for policymakers seeking to harness its benefits while mitigating its risks. Trade openness offers significant opportunities for economic growth, innovation, and productivity gains; however, without complementary policies, it can also threaten social cohesion and political stability. Strategies centered on investing in human capital, strengthening social protection systems, promoting inclusive labor market institutions, and facilitating labor mobility are crucial to ensuring that globalization becomes a force for inclusive and sustainable development. Future research should further investigate the interplay between globalization, technology, and institutional frameworks, particularly by examining how emerging technologies such as artificial intelligence, automation, and digital platforms reshape the distributional impacts of trade liberalization. Additionally, comparative studies across different stages of economic development could elucidate how variations in labor market regulations, social safety nets, and innovation ecosystems mediate these effects. A more granular

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understanding of these dynamics will be indispensable for designing evidence-based policies that foster both economic dynamism and social equity in an increasingly interconnected world.

Declarations

This study did not involve human participants or animals; therefore, ethical approval is not applicable. Since no human participants were involved, consent to participate is not required. The author, Zehao Lin, reviewed and approved the manuscript for publication and was solely responsible for the conceptualization, methodology, formal analysis, writing, and reviewing of the manuscript. No other individuals contributed to this study. The author did not receive any financial support or grants for this study and declares no competing interests, either financial or non-financial, that are relevant to the content of this work.

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