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Don't blame globalisation for the squeezing of the middle class

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Globalisation is being blamed for the squeezing of the middle class and protectionism is being offered as a solution. We argue in this paper that the increase in inequality is a long-term trend resulting from a variety of factors, including the decline in manufacturing, the reduction in the progressivity of taxation and the steady increase in asset prices, and that globalisation has only had a marginal impact on it. Protectionism will not reverse any of these trends. We discuss some policy options aimed at cushioning this increase in inequality and argue that they will likely result in expanding fiscal deficits and pressure on central banks to test the limits of growth.

Introduction

"*In a democratic society, such a stark bifurcation of wealth and income trends among large segments of the population can fuel resentment and political polarisation. These social developments can lead to political clashes and misguided economic policies that work to the detriment of the economy and society as a whole.*" – Alan Greenspan, July 2005

Alan Greenspan made his name as an economic forecaster, but he is also known to have an acute sense of emerging political trends. One of the hotly debated topics on both sides of the Atlantic is how the recent economic expansion has ignored the middle class and how globalisation is squeezing the average worker. In the United States it featured prominently during the recent mid-term election campaigns, and the replacement of John Snow as Treasury Secretary in mid-2006 was, in fact, motivated by the perceived need of the Bush Administration to better communicate the success of its economic policies, as polls were consistently showing voters' dissatisfaction with the economy despite strong economic growth. It is thus not surprising that the first measure to be implemented by the recently elected Democratic Congress, in an attempt to lift overall wages, will be an increase in the national minimum wage, which has not changed since 1997 and, adjusted for inflation, is the lowest of the last 50 years. In Europe, German trade unions recently announced that the 2007 wage round will be aimed at ensuring that workers get a fair share of economic growth after many years of wage moderation. In Japan, concern about the weakness of household income is starting to feature prominently in the political discussion and even the Bank of Japan has discussed income inequality in its deliberations.

The debate can quickly become polarised, as Greenspan hinted, and the risk of selective and narrow analysis to support specific political agendas is high. The truth of the matter is that the economic stagnation of the middle class is clearly apparent in the data, and not limited to the US. The wage share of national income of the developed world is at the lowest point since the mid-1970s, and this process has accelerated in the last few years. In fact, real wages have been stagnant since 2000 despite strong growth and robust productivity gains while profits are capturing a record share of GDP.

Secular trends and globalisation

Globalisation is a reality. Production is being shifted around the globe, and millions of people are being affected, positively and negatively. But before jumping to the conclusion that globalisation is the source of this sharp divergence in income trends, it is important to put these dynamics in a secular perspective. A useful source is Atkinson & Piketty (2006), who study changes in inequality over the last century by analysing the evolution of the top income shares in a variety of countries. Economic theory suggests that inequality would follow an inverted U-shape: gains from technological progress would initially accrue to the wealthy and raise inequality, to then stabilise and eventually benefit the middle and lower classes as more workers have access to the new technologies. In fact, the industrial revolution led to

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an increase in inequality that lasted until WWII, when it declined sharply and stabilised at a lower level, completing the inverted-U. The process started again in the mid-1970s, and since then real median family income has increased by about 15%, compared to a growth rate of about 100% for the top 1% of the income distribution. The inverted-U is recreating itself and inequality is now at levels similar to pre-war levels – to wit: the share of income flowing to 0.1% of Americans has recently reached 7%, the highest since the 1920s – but with an important difference: the rich in the pre-war period were mostly capitalists, i.e. owners of capital, while the rich of the post-1970 period are mostly high-wage earners.

The inflexion point in inequality the mid-1970s seems to coincide with the peak in the share of manufacturing in GDP – as the move towards services allows for wider wage dispersion – and with the beginning of a steady decline in the progressivity of taxation. The OECD's share of manufacturing in GDP has more than halved over the last 25 years. Income tax systems have become flatter; the maximum marginal tax rate has declined over 20 points for the OECD average, halving the difference between the maximum marginal rate and the standard rate.[1]

Overlaying these two trends, the global economy has recently been buffeted by two shocks: on the one hand, the 'globalisation' shock, the combination of the IT revolution, the doubling of the global labour force as the former Soviet Union, China, India and other emerging markets have entered the global supply chain (adding about 1.5 billion workers) and the lowering of barriers to trade and FDI across the globe. On the other hand, the reaction to the Asian crisis (increase in savings and in foreign exchange reserves in Asia) and to the burst of the investment bubble (decline in investment in the OECD), which has lowered real interest rates.[2] What are the implications of these two shocks? Three stand out: a lowering of the price of labour with respect to capital (as the supply of labour has increased), and an increase in the return on capital (as capital embodied technological progress and an increase in the mobility of capital has improved its efficiency); and a steady increase in the price of assets as interest rates have declined.

Who wins and who loses from this constellation of shocks? The winners are those whose income is more linked to capital and assets, mainly the upper classes – who can afford to own a home and whose share ownership is significantly higher.[3] *The losers are those whose income is more linked to wages.* Since the main asset of the average worker is her human capital, and this at the margin has become more mobile and thus subject to global competitive pressures, workers of all skill levels are affected. Wages typically catch up with productivity gains, and probably global wages are following the improvement in global productivity growth, but the very wide differences in wage rates across countries – hourly compensation in Chinese manufacturing is still a mere 3% of industrial world levels – imply that this process of catching up with productivity gains could be very slow in the developed world. *Importantly, and perhaps contrary to conventional wisdom, even the better educated workers have recently lost ground.* Technological progress has exacerbated the trend towards offshoring of services and the computerisation of many lower value-added services has dramatically lowered the value of the average college education – as an example, real wages for bachelor degrees in the US have fallen almost 10% since 2000.[4]

However, despite the global nature of these shocks, the evolution of inequality has been different across countries. While the top income share has gained ground rapidly in the Anglo-Saxon countries, it has remained more stable in Europe or Japan. There are three potential reasons for this disparity: first, the wider development of stock options in Anglo-Saxon countries as a means of compensation – thus linking salaries more closely to the evolution of profits – has contributed to the explosion of earnings at the top of the income distribution;[5] second, the trend towards temporary and part-time employment, combined with sharp differences in social safety nets – in the US, the rise in part time/consultant employment that does not provide benefits has significantly lowered the purchasing power of average workers;[6] third, better financial development in Anglo-Saxon countries has allowed households to better reap the benefits from asset price appreciation.

Overall, this discussion suggests that blaming globalisation for the squeezing of the middle class is a dangerous oversimplification. The discussion

[1] See Zee (2005) for an extensive discussion of the evolution of the taxation of personal income.

[2] See Gros et al. (2006) for a comprehensive discussion of these dynamics.

[3] Census data show that the upper decile owns over 10 times more stocks than the remaining 90%.

[4] This is breaking the long-term trend: since the mid-1970s, real wages of college-educated workers have increased by over 20%, while those of workers with less than high school have declined by about 15%.

[5] It is unclear why this development is different across countries, but non-market mechanisms and social conventions may play a role in compensation decisions.

[6] And, in a perverse cycle, the skyrocketing cost of medical benefits is increasingly pushing companies towards temporary contracts.

suggests, first of all, that the widening of the income distribution is a long term process that started well before the 'globalisation' shock and that it is the result of multiple factors; and second that the key factors behind it are likely to be the declining progressivity of the tax system, the shifts in the composition of household income and the increase in asset prices, and the structure of the welfare system.

What to do about it?

Once the causes and roots of the squeeze are clarified, the question is what to do about it. It seems to be an empirical regularity that income inequality is positively correlated with growth, so it is a value judgment whether this situation should be corrected or not. Democratic societies have mechanisms to evaluate the preferences of their citizens and decide on policies to address them. But regardless of the judgment about the importance of inequality, what *not* to do about it is clear: protectionism should be avoided, because free trade and openness are unambiguously positive for global growth, and because openness is only one small factor contributing to the rising inequality.

The optimal strategy is thus to improve the three factors we identified as the possible key sources of the problem, in order to maximise the trickle down from global growth into average welfare. Several ideas come to mind:

- **Improve the link between household income and asset prices.** This could be achieved by facilitating the access to asset ownership – for example, by fostering the development of deep and sophisticated mortgage markets that increase home ownership[7] or endowing each child with stocks at birth – by enabling the liquification of house prices gains – through cheaper and easier mortgage refinancing and mortgage equity withdrawal – and by rethinking the composition of pay packages and of pensions as regards their connection to overall economic profitability – for example, by offering stock options or variable bonuses to all workers. However, it is important to understand that, given that in Europe the phenomenon of stock options is not widespread and the earnings differences within companies are more compressed than in the US, increasing the linkage between pay and corporate profitability as a means of enhancing the trickling down from global growth would probably lead to an initial increase in inequality.[8]

  One should also understand that this higher sharing in profits and asset appreciation entails upside and downside risks.[9] For every Microsoft millionaire, there are hundreds of employees of failed technology companies who have seen their stock options expire worthless. In other words, the recent widening of the income distribution, since it is mainly due to the expansion of asset prices and return on capital, will likely be accompanied by higher risk and greater exposure to boom-bust cycles.

- **Improve social policies to support those affected by the trend towards temporality and offshoring.** This has different implications in different countries. In the US, where welfare benefits are essentially linked to having a job, the key is to increase the portability of benefits (health care and pension) to match the increased portability of jobs;[10] an obvious and cheaper alternative, developing a universal health care system, seems to be politically unfeasible.[11] In Europe, the key is to reform welfare systems in the direction of providing ample support for workers, not jobs, and a sharpening of incentives to encourage job-seeking, thus reducing the rigidities of labour markets. In a context of increased immigration and duality of labour markets, policies have to be oriented towards reducing the protection of the 'insiders' (those holding highly protected, permanent contracts) in order to reduce the precariousness of the 'outsiders' (those holding part-time and temporary contracts, mainly the young and unskilled). Trade unions must understand that they cannot continue defending the privileges of the insiders at the expense of the outsiders.

- **Increase the human capital of workers by enhancing investment in education and research.** It is clear that growth models based on low-skilled work are not sustainable in the developed world. With wage differentials as wide as they are, countries that do not move up in the value-added ladder will suffer. Two issues are important in this regard. First, investment in

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[7] Fisher & Quayyum (2006) attribute a significant amount of the recent increase in home ownership in the US to improvements in the mortgage market.

[8] Related to this, Nicolas Sarkozy said that stock options should be for everybody or nobody. As the 'superstar model' suggests and we argue here, this would lead to an initial increase in inequality.

[9] The sharp correction in inequality after WWII responded to the destruction of capital that resulted from the war and that affected mainly the richer classes.

[10] An interesting development in this regard is the Freelancers Union, which aims at providing benefits to the increasing share of free agent workers in the US.

[11] This is especially unfortunate because, as the US 2005 census shows, the percentage of Americans with private health insurance has declined to a 20-year low. The recent policy proposals in Massachusetts, however, give some hope to this avenue.

education should be biased towards endowing the population with a robust and general educational base that allows citizens to master the skills needed to engage in continuous and creative learning. With technological change taking place at a fast pace, education that focuses on specific technical specialisation is bound to be inefficient, as the German model of professional training shows. Thus, when faced with competing demands for funds for education, policy-makers will be well advised to prioritise areas that provide a solid foundation for general training and maximise expected returns, such as early childhood education.[12] Second, it is important to understand that just increasing investment in R&D will not be enough, for most of the productivity growth stems from entry and expansion of more productive firms and the exit of the less productive, rather than by productivity increases in existing firms.[13] In this vein, trade openness becomes critical as it fosters product market liberalisation and amplifies the productivity-enhancing effects of investment in education and research by spurring the 'creative destruction' needed to benefit from innovations. This focus on higher-skilled activities and the increased mobility of labour implies, in addition, that reversing the secular trend towards less progressive taxation may be politically unfeasible; if anything, the trend seems to be towards simpler tax systems that reduce distortions in labour supply and where redistribution takes place on the spending side of the budget – raising further the critical need for an efficient welfare system.

The corollary of these suggestions is that fiscal discipline may not be politically feasible and may not be a priority in the years ahead. An increase in the mobility of capital leads to global tax competition and puts a lid on tax increases while the combined spending demands for social networks, education and research, combined with the higher entitlement costs associated with an aging population, will make spending cuts very unpalatable for democratic societies where an increasingly bigger share feels left behind. In a world of ample savings, credible central banks and regional economic arrangements, long-term interest rates are low and have become largely independent from fiscal discipline. As a result, progress in fiscal adjustment will likely be postponed while political systems discuss how to allocate their already-scarce resources,[14] and the combination of an aging population and income inequality will exert considerable pressure on central banks to deliver unanticipated inflation as a means to finance the competing social needs.

[12] See Carneiro & Heckman (2003).

[13] See, inter alia, Foster et al. (2001).

[14] The recent proposal by Jacques Chirac to offer tax breaks to companies who share with their employees the benefits of globalisation is a clear example of this.

Conclusion

In sum, the income distribution has been widening over the last quarter of century and it has accelerated in recent years, but globalisation has only had a marginal impact on it. Technological progress, tax changes, asset price inflation and differences in compensation schemes are as important, if not more, than the offshoring of jobs to emerging markets. Globalisation is a positive development, and the rich world should embrace it as the channel through which the developing world can catch up with the developed world. Policies that smooth this transition and that soften the blow for average workers are certainly needed, but protectionism is certainly not one of them. Priority should be given to matching welfare systems to the new trends in employment to cushion the increased instability of jobs, and improving the access of average workers to asset ownership. Tough choices lie ahead, especially as the needed entitlement reform due to the aging of the population will probably lead to very difficult spending decisions that, likely, will result in higher deficits in the years ahead. As Alan Greenspan cautions in the quote opening this paper, the risk of adopting misguided policies at times of political clashes is high. This paper, by putting the widening inequality in a broader context, has tried to contribute to the reduction of such a risk.

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