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More **pain than gain**

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Many workers are missing out on the rewards of globalisation

RICH countries have democratic governments, so continued support for globalisation will depend on how prosperous the average worker feels. Yet workers' share of the cake in rich countries is now the smallest it has been for at least three decades (see chart 5). In many countries average real wages are flat or even falling.

Meanwhile, capitalists have rarely had it so good. In America, Japan and the euro area, profits as a share of GDP are at or near all-time highs (see chart 6, next page). Corporate America has increased its share of national income from 7% in mid-2001 to 13% this year.

Like so many other current economic puzzles, the redistribution of income from labour to capital can be largely explained by the entry of China, India and other emerging economies into world markets. Globalisation has lifted profits relative to wages in several ways. First, offshoring to low-wage countries has reduced firms' costs. Second, employers' ability to shift production, whether or not they take advantage of it, has curbed the bargaining power of workers in rich countries. In Germany, for example, several big firms have negotiated pay cuts with their workers to avoid moving production to central Europe. And third, increased immigration has depressed wages in sectors such as catering, farming and construction.

Most of the fears about emerging economies focus on jobs being lost to low-cost foreign competitors. But the real threat is to wages, not jobs. In the long run, trade and offshoring should have little effect on total employment in rich countries; rather, they will change its composition. So long as labour markets are flexible, job losses in manufacturing should eventually be offset by new jobs elsewhere. But trade with emerging economies can have a big impact on both average and relative wages.

Over long periods of time, real wages tend to track average productivity growth. But so far this decade, workers' real pay in many developed economies has increased more slowly than labour productivity. The real weekly wage of a typical American worker in the middle of the income distribution has fallen by 4% since the start of the recovery in 2001. Over the same period labour productivity has risen by 15%. Even after allowing for health and pension benefits, total compensation has risen by only 1.5% in real terms. Real wages in Germany and Japan have also been flat or falling. Thus the usual argument in favour of globalisation--that it will make most workers better off, with only a few low-skilled ones losing out--has not so far been borne out by the facts. Most workers are being squeezed.

If GDP per person is growing fairly briskly, why are most workers missing out on real pay rises? Partly because a bigger share is going to profits, and partly because high earners have pocketed a huge slice of the **gains** in income, causing inequality to widen. America's top 1% of earners now receive 16% of all income, up from 8% in 1980. Wage inequality in Europe and Japan has also increased, but not by as much.

A decade ago, the consensus among economists was that increasing wage inequality was caused mainly not by trade but by information technology, which has raised the demand for skilled workers relative to unskilled ones. Today, a growing number of economists agree that trade is playing a bigger role. It is hard to separate the impact of globalisation and IT on relative wages because they both reduce the demand for low-skilled workers. But now that the majority of workers are losing out, the finger of blame points at globalisation.

Traditional trade theory, based on the ideas of David Ricardo, a 19th-century economist, argues that economies **gain**

from trade by specialising in products where they have a comparative advantage. Developed economies have lots of skilled workers, whereas emerging economies have lots of low-skilled ones, so according to the theory advanced countries will specialise in capital-intensive products requiring skilled labour and emerging economies in low-tech products. Competition from cheaper imports will reduce the wages of unskilled workers in developed economies, but workers as a whole will be better off.

Yet, according to the evidence above, the average worker does not seem to be enjoying his fair share of the fruits of economic prosperity. Richard Freeman, an economist at Harvard University, points to several reasons why the traditional theory may need modifying. The first is that the sheer size of the emerging giants' labour forces has shifted the global capital-labour ratio (which determines the relative rewards of capital and workers) massively against workers as a group. The entry of China, India and the former Soviet Union into market capitalism has, in effect, doubled the world supply of workers, from 1.5 billion to 3 billion. These new entrants brought little capital with them, so the global capital-labour ratio dropped sharply. According to economic theory, this should reduce the relative price of labour and raise the global return to capital--which is exactly what has happened.

Over time, competition should reduce profit margins and distribute benefits back to consumers and workers in the form of lower prices. But downward pressure on wages in rich countries could continue for a long time. China still has perhaps 200m underemployed rural workers who could move to factories over the next two decades, so wages for low-skilled workers are rising more slowly than productivity, reducing China's unit labour costs.

A second reason why the traditional trade model needs modifying has to do with a rise in emerging countries' skill levels. It used to be thought that only rich countries had educated workforces able to produce skill-intensive goods, but poor countries have invested heavily in education in recent years, allowing them to start competing in more sophisticated markets. Every year, 1.2m engineers and scientists graduate from Chinese and Indian universities, as many as in America, the European Union and Japan combined and three times the number ten years ago (see chart 7). In 1970 America accounted for 30% of all university enrolments worldwide; now its share is down to around 12%.

The McKinsey Global Institute estimates that only one-tenth of engineering graduates in China and one-quarter in India would meet the standards expected by big American firms. But this will improve over time. A report by the World Bank also points out that a large share of engineering graduates in China and India become civil and electrical engineers, needed for the boom in domestic construction. There are not enough engineers and scientists to produce high-tech goods across the board. But it remains true that there has been a big increase in the global supply of educated as well as unskilled workers.

A third flaw in the traditional trade model, says Mr Freeman, is its assumption that rich countries would make high-tech products and developing economies low-tech ones. In fact, rich countries no longer have a monopoly on high-tech capital and know-how. The OECD says that in 2004 China overtook America as the world's leading exporter of information-technology goods. This exaggerates China's move up the ladder: laptop computers, mobile phones and DVD players are no longer cutting-edge technology, and they are typically only assembled in China by foreign firms, with most of their high-value components being imported. Even so, the faster spread of technology to poor countries is weakening the rich world's comparative advantage in high-tech sectors. As emerging economies start to export high-tech goods and services, this reduces the prices of such products in world markets, and hence the wages of skilled workers in the developed world.

It is no longer just dirty blue-collar jobs in manufacturing that are being sucked offshore but also white-collar service jobs, which used to be considered safe from foreign competition. Telecoms charges have tumbled, allowing workers in far-flung locations to be connected cheaply to customers in the developed world. This has made it possible to offshore services that were once non-tradable. Morgan Stanley's Mr Roach has been drawing attention to the fact that the "global labour arbitrage" is moving rapidly to the better kinds of jobs. It is no longer just basic data processing and call centres that are being outsourced to low-wage countries, but also software programming, medical diagnostics, engineering design, law, accounting, finance and business consulting. These can now be delivered electronically from anywhere in the world, exposing skilled white-collar workers to greater competition.

The standard retort to such arguments is that outsourcing abroad is too small to matter much. So far fewer than 1m American service-sector jobs have been lost to offshoring. Forrester Research forecasts that by 2015 a total of 3.4m jobs in services will have moved abroad, but that is tiny compared with the 30m jobs destroyed and created in America every year. The trouble is that such studies allow only for the sorts of jobs that are already being offshored, when in reality the proportion of jobs that can be moved will rise as IT advances and education improves in emerging economies.

Alan Blinder, an economist at Princeton University, believes that most economists are underestimating the disruptive effects of offshoring, and that in future two to three times as many service jobs will be susceptible to offshoring as in manufacturing. This would imply that at least 30% of all jobs might be at risk. In practice the number of jobs offshored to China or India is likely to remain fairly modest. Even so, the mere threat that they could be shifted will depress wages.

Moreover, says Mr Blinder, education offers no protection. Highly skilled accountants, radiologists or computer programmers now have to compete with electronically delivered competition from abroad, whereas humble taxi drivers, janitors and crane operators remain safe from offshoring. This may help to explain why the real median wage of American graduates has fallen by 6% since 2000, a bigger decline than in average wages.

In the 1980s and early 1990s, the pay gap between low-paid, low-skilled workers and high-paid, high-skilled workers widened significantly. But since then, according to a study by David Autor, Lawrence Katz and Melissa Kearney, in America, Britain and Germany workers at the bottom as well as at the top have done better than those in the middle-income group. Office cleaning cannot be done by workers in India. It is the easily standardised skilled jobs in the middle, such as accounting, that are now being squeezed hardest. A study by Bradford Jensen and Lori Kletzer, at the Institute for International Economics in Washington, DC, confirms that workers in tradable services that are exposed to foreign competition tend to be more skilled than workers in non-tradable services and tradable manufacturing industries.

None of this makes a case for protectionism. Offshoring, like trade, is beneficial to developed economies as a whole. The increased mobility of capital and technology does not invalidate the theory of comparative advantage, as some commentators like to argue. China and India cannot have a comparative advantage in everything; they will export some things and import others. Emerging economies' comparative advantage will largely remain in labour-intensive industries. A country's trading pattern is determined by its relative capital intensity compared with other economies. Emerging economies still have relatively little capital, so they are unlikely to become significant capital-intensive exporters until their capital-to-labour ratio catches up. That will take time. Developed economies will retain their comparative advantage in knowledge-intensive activities because they have relatively more skilled labour, but that advantage will be eroded more quickly in future.

The developed economies as a whole will still benefit hugely from trade with emerging economies. Increased competition and greater economies of scale will boost the growth in productivity and output. Consumers will enjoy lower prices and a greater variety of products, and shareholders will enjoy higher returns on capital. Although workers will continue to see their pay squeezed, they can still **gain** as consumers or as shareholders, either directly or through their pensions. The snag is that richer people own more shares, so the increased return on capital tends to reinforce income inequality.

In recent years the stagnation of real wages in America has been masked by surging house prices, which make families feel better off. If the housing market stumbles and the growth in pay remains feeble, there will be increased calls for the introduction of import barriers, restrictions on overseas investment and higher taxes on profits. But in a globalised economy, such measures would be worse than useless. Firms would simply move their head offices to friendlier countries.

The fact that many workers seem to be excluded from the spoils of globalisation is a big challenge to orthodox economics. Many of its practitioners refuse to come clean about the costs to workers of trade with emerging economies for fear of handing ammunition to protectionists. At the same time, protectionists exaggerate those costs and ignore the benefits. It is time for a more honest debate about trade.

A study by the Institute for International Economics estimates that globalisation is benefiting America's economy by \$1 trillion a year, equivalent to \$9,000 a year for every family. But in practice the average family has not seen such a **gain** because much of it has gone to those at the top or into profits. This explains the lack of support for globalisation from ordinary people. Unless a solution is found to sluggish real wages and rising inequality, there is a serious risk of a protectionist backlash. Rather than block change, governments need to ease the **pain** it inflicts in various ways: with a temporary social safety-net for those who lose their jobs; better education to equip workers for tomorrow's jobs; and more flexible labour markets to encourage the creation of new jobs.

More controversially, governments may need to redistribute the benefits of globalisation more fairly through the tax and benefits system. Studies suggest that countries with more generous social welfare policies are less likely to support protectionism. For instance, one reason why opposition to offshoring in Europe is less vocal than in America is that European health-care systems tend to be independent of employment, whereas in America losing your job means losing your health insurance too. In a riskier labour market, there may be a stronger case for health care to be financed by the state rather than by firms. Tax redistribution does not mean a return to taxing high earners at 70-80%, which would blunt economic incentives. Instead, scrapping tax breaks such as those given to home-buyers could make the tax system more progressive.

It is often argued that generous social-insurance and redistribution policies are inconsistent with globalisation because in an open world governments cannot raise taxes and spending in isolation. But if real wages continue to stagnate and no compensation is forthcoming, political support for globalisation may fade and the vast **gains** from the biggest economic stimulus in world history will be lost.

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