Why America will need some elements of a welfare state

By Martin Wolf, Financial Times
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Is globalisation a leading cause of rising inequality in high-income countries? The outcome of the debate on this question may determine whether the US will remain open to trade. If policymakers do not craft an imaginative response, protection against imports may be the outcome, regardless of its (non-existent) merits.

Ben Bernanke, chairman of the US Federal Reserve, laid out the issues in a thought-provoking speech last week.* He embedded his analysis in three principles: "That economic opportunity should be as widely distributed and as equal as possible; that economic outcomes need not be equal but should be linked to the contributions each person makes to the economy; and that people should receive some insurance against the most adverse economic outcomes, especially those arising from events largely outside the person's control."

The question is how these principles apply today. It has become more compelling as inequality has risen. Thus, Mr Bernanke notes that over the past three decades, income gains seem to have been unequally distributed: "In real terms, the earnings at the 50th percentile of the distribution . . . rose about 11½ per cent between 1979 and 2006. Over the same period, the wage at the tenth percentile . . . rose just 4 per cent, while the wage at the 90th percentile . . . rose 34 per cent."

Recent analyses suggest particularly large gains at the top of the income distribution. Also noteworthy has been the jump in the share of profits in gross domestic product since the 1980s (see chart).

Such evidence raises three big questions. Is it true? What is causing the rising inequality? What, if anything, should be done about it?

The first of these is more open than many assume. Alan Reynolds of the Washington-based Cato Institute argues, for example, that studies based on income tax returns are hopelessly vitiated by changes in tax rules and reductions in marginal tax rates.** Equally, the big rise in the share of profits in GDP followed an equally sharp fall in the 1970s. There is, it seems, no long-term trend decline in the share of wages in GDP.

Now turn to the second question. Mr Bernanke mentions the three standard hypotheses: skill-biased technical change; "winner-take-all" markets for the most talented; and globalisation. The last, in turn, would include trade, migration and rewards available to smart players in globalised capital markets.

Mr Bernanke himself comes to the standard and, in my view, largely correct, conclusion that "the influence of globalisation on inequality has been moderate and almost surely less important than the effects of skill-biased technological change". This has long been the persuasively argued view of Jagdish Bhagwati of Columbia University (see Technology, not globalisation, is driving wages down, FT, January 4, 2007). Support for it is given in a very recent paper by Robert Feenstra of the University of California, at Davis.***

Prof Feenstra notes that the relative wages of non-production workers have been rising in US manufacturing (see chart). In the 1980s, there was also increased employment of such people, though this was less true in the 1990s. Interestingly, exactly the same phenomenon could be identified in Mexico: higher wages and employment of non-production workers.

Standard trade theory cannot explain this combination. The normal proposition would be that relative wages of the less skilled production workers should have risen in Mexico, where such people are relatively abundant, and fallen in the US. This suggests that technical change is the more plausible explanation. Yet Prof Feenstra notes that new possibilities for specialisation in tasks along the value chain may increase demand for skilled labour in both richer and poorer trading partners. But his empirical evidence still suggests that technology is more significant. More important still, productivity is the principal determinant of real wages in the long run. It is here that openness almost certainly makes its biggest contribution to the economy.

What, if anything, should be done? At first glance, the trend towards greater inequality should not worry a person with Mr Bernanke's principles. But that response would be quite wrong, for two reasons: first, rising inequality causes declining equality of opportunity; and, second, it also makes losing a job costlier, more objectionable and so more resisted.

Surprisingly perhaps, evidence suggests that inter-generational mobility is smaller in the US and in the UK than in the Nordic countries and even Germany.*** The plausible explanation is that the relative poverty of the parents is visited upon the educational achievements of their children. Thus, rising inequality directly undermines the achievement of Mr Bernanke's first principle. Equally, the more competitive the business environment and the smaller the identification between companies and domestic workers, the less able or willing will companies be to provide either health insurance or pensions.

In a country in which much social insurance has historically been supplied by employers, the loss of jobs and the closure of businesses is particularly traumatic. Protectionism then emerges as the politically correct form of resistance to the market.

For these two reasons, developments now under way threaten the survival of Mr Bernanke's principles. There are two possible responses. One is to insist that people are simply on their own. The present administration will, I predict, be the high water mark of this conservative tide. The other is to create a system of support that does not destroy incentives. That would have to contain at least two elements: greater funding of education for the disadvantaged (ideally, with private supply) and universal health insurance. The left will also want higher minimum wages and generous subsidisation of low earnings.

I am not suggesting that the US should embrace Europe's interventionist follies. But without more generous government-financed services, the US may be unable to maintain a dynamic, internationally open and socially mobile society. That may seem a paradox. It is not.

* The Level and Distribution of Economic Well-Being, February 6, 2007,
** Has US Income Inequality Really Increased? Policy Analysis 586,
*** Globalization and its Impact on Labor, February 8, 2007,
**** Jo Blanden and others, Intergenerational Mobility in Europe and North America, April 2005