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Although skill levels and productivity may be higher in the West, jobs have been lost to countries where wages are lower

Mind the gap

Globalization is exaggerating inequality at both ends of the pay scale. DeAnne Julius looks at a system in need of some tweaking

Income inequality is rising in most rich countries, and has been for many years, analyses show.

People are angry, especially in these tough times. The mood is sour and the rich are under fire: from protesters who occupy St Paul's churchyard, to unemployed youth who march in Madrid, to corporate shareholders who vote against executive pay packages.

Is the widening income gap caused by what Joseph Stiglitz, Professor of Finance and Business at Columbia University, in a recent Chatham House meeting, called 'rent-seeking' by greedy executives, corrupt politicians, self-serving bankers and tax-dodging celebrities?

Consider the facts. In a path-breaking study last year, the Paris-based Organization for Economic Co-operation and Development (OECD) delved into the detail of household income patterns across its 30 member countries. It found that over the past 25 years inequality had risen in 18 of the countries, stayed roughly constant in seven, and fallen in only five.

The biggest rises in income inequality were in countries where it had historically been low: namely, Finland, the Czech Republic, and Sweden. The declines in inequality were generally in poor countries where it already had been high, such as Chile and Greece.

There was no evidence that faster growth causes greater inequality, or that growth 'trickles down' to reduce inequality. So is

Professor Stiglitz right? Is the inequality problem born of national causes? Or, more ominously, is increasing income inequality an inevitable result of global competition? Until the diagnosis is clear, the wrong remedies may make matters worse.

A more intuitive way to see what is happening is to compare the rise in household incomes of the poorest 10 per cent with those of the richest. According to the OECD study, the poor did not get poorer, except in Japan. This is good news. However, the rich got richer faster than the poor in nearly all countries, including the Scandinavian ones where incomes are generally more equal and where high taxes finance generous social benefits.

An even more striking trend is the way in which the very richest households – the top one per cent – have pulled away from the rest. Their share of total income had risen in all 19 countries where data were available. As shown in the table, the US is at one extreme where the richest one per cent accounted for nearly 18 per cent of national income, followed by Britain and Canada.

But it is not true to say that this group largely escapes tax. In the US, they provide 40 per cent of income tax revenues (compared to their 18 per cent of total income) while in the UK they provide 24 per cent of personal income taxes on their 14 per cent of total income. In these days of austerity, it is little wonder that governments compete to attract them and temper populist demands for taxes that could cause them to flee. English-speaking countries, in particular, have become a global market for mobile executives.

Two separate dynamics seem to be driving this growing inequality. Both are related to globalization, but they operate differently on the bottom and the top of the income distribution. At the bottom, globalization works to depress the wages of those in rich countries who have skills that are in ample supply in poor countries. This affects both low-skilled and high-skilled workers where their outputs are tradable. Manufacturing is a prime example. Although skill levels and productivity may be higher in the West, jobs have been lost and wages have been pulled down by the competition from poor countries where low wages more than compensate for lower productivity. Consumers in both countries are winners, as are the workers with new jobs in poor countries. The losers are those working in the manufacturing sector in rich countries.

Advances in technology have amplified these effects and spread the globalization dynamic into large parts of the service sector where most people work. The internet has opened the way for many information processing and administrative jobs to be outsourced to countries such as India where there is a growing supply of educated people seeking such work. This puts downward pressure on service sector wages in rich countries.

For those at the top of the income distribution, globalization has worked the other way. It is quality rather than cost that drives demand for top performers. Cost is easy to measure; in many fields, quality is not. Purchasers have to rely on reputation and track record. This often creates a wide gap between the best and the second-best. A football manager knows that the rewards for winning a championship are many times greater than being runner-up, so he wants to recruit the best players regardless of cost. A company facing an aggressive takeover bid wants the best investment banker on its side even if his fees are the highest in the market. Indeed, high fees may be one measure of perceived quality. Universities compete for the best professors because they bring in research grants, even when most of the research is carried out by more junior staff. Such behaviour is akin to an arms race where competing sides escalate salaries for top people towards an equilibrium which is higher than it need be, but is hard to escape.

Globalization exacerbates this ratcheting effect when the talent search is worldwide. In practice, language and culture set limits on the market for many top jobs. German and Japanese companies fish in a mostly domestic pool for their chief executives because a non-Japanese or German speaker would find it difficult to lead a large domestic workforce or deal with domestic investors. Indeed, one of the main reasons for the rise in top salaries in Britain, Canada and Australia is likely to be the larger talent pool they share with the US due to language.

If globalization is the main cause of rising inequality, what can be done? The OECD study concluded that raising the skills of the workforce to generate more and better-paying jobs was the policy with the fewest negative side effects. Some changes in taxes and transfers can help, but both are already high. Raising tax rates on higher incomes, especially above 50 per cent, as President François Hollande of France has proposed, leads to substantial falls in total taxes paid.

'The internet has put downward pressure on service sector wages in rich countries'

Income share of richest 1% of households

% of total national income for major countries for which data are available

	1990	2000	Latest year available
US	13.0	16.5	17.7 (2008)
UK	9.8	12.7	14.3 (2006)
Canada	9.6	12.4	13.3 (2006)
France	8.2	8.3	8.9 (2006)
Australia	6.3	7.2	8.8 (2008)
Denmark	5.1	6.6	8.5 (2008)
Sweden	4.4	6.0	7.1 (2008)

Source: 'Divided we Stand: Why Inequality keeps Rising', OECD 2011, page 349.

However, most tax loopholes that benefit the rich stem from levying different tax rates on income from different sources. Having a single tax rate for individual income, corporate income and capital gains would close the biggest loopholes and mean that private equity partners and Warren Buffet, who could lay claim to being the world's most successful investor, would no longer pay a lower rate of tax than their secretaries. At the other end of the spectrum, raising welfare benefits for poorer households has reduced measured inequality by about a quarter across the OECD countries, but these have now become very expensive. In addition, they have the unintended consequence of reducing social mobility by creating a disincentive to work, thereby embedding inequality.

A cross-country analysis reveals many complexities and contributing factors to the general trend of rising inequality. Global forces, rather than national policies, are the common cause. Culture and language play a role in intensifying the problem in English-speaking countries that tend to be more open to labour mobility both at the top and the bottom of the income ladder. Railing against the one per cent and occupying Wall Street won't provide a solution, but these protests have focused the political spotlight on the issue. What we need now is not to search for villains but to work out sensible tweaks to taxes and benefits.

Dr DeAnne Julius is an economist and served as Chairman of Chatham House 2003-12