Who is Reaping the Gains from Globalisation? – The Role of Labour Market Flexibility

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The speed of globalisation has been accelerating in recent years. China has entered the global stage and became a member of the WTO. The coastline area between Beijing and Shanghai belongs to one of the most booming regions in the world. Low tariffs and negligible transport costs as well as capital mobility allow production on Chinese territory for the global market. For Western Europe, more new competitors have emerged who are even closer – literally in their front garden. The former communist countries have overcome their transition crises in the mid-1990s and are now catching up with the industrialised world. Market integration with these regions implies substantial adjustment pressure for high wage countries.

Many economists and politicians do not see any problems connected with increased global competition and praise the gains from globalisation. They predict welfare gains for all participating countries. Apart from the fact that not everybody wins and welfare gains occur on an aggregated national level only, the crucial underlying assumption is that markets are flexible. Results of standard trade theories are based on full employment. How do the results change, however, if labour markets, say, are rigid?[1]

As is common knowledge from the factor price equalisation theorem, trade can have the same implications as capital mobility and migration. All three channels basically create a pressure towards convergence of goods and factor prices. However, with downwardly rigid wages, unemployment will be the residual adjustment mechanism. In industrialised countries, less skilled workers are typically affected most from global competition. Consequently, for these income groups real wages have been falling in the United States within the last three decades. In some European countries, however, unemployment rates – especially among the poorly educated – have been increasing instead. With regard to national income, globalisation can in principle also lead to a deterioration of the aggregate income position if unemployment arises since fewer factors of production are employed relative to the situation before. Is globalisation in that case still beneficial?

This article examines some causal links between the integration of goods and factor markets and national labour market outcome. It is organised as follows: the next section summarises some brief facts on globalisation within the last decades. Flexibility of labour markets is analysed across some major countries in Section 3. Section 4 relates national labour market outcomes to global competition. The last section concludes and discusses policy implications.

Some brief facts on globalisation

Historically, there has already been an era before World War I when the extent of globalisation was comparable to contemporary levels. But the Great Depression and the deterioration of international relations at the eve of World War II led to a sharp fall in international trade and factor flows. Globalisation was reversed. Recovery took place only slowly in the second half of the 20th century.

Since World War II, the integration of commodity markets has been progressing rapidly. According to the World Bank (2003), world trade flows as a share of world GDP have increased from 25 percent in 1971 to 58 percent in 2001. Germany, for instance, has undergone a similar development. In 1950, the ratio was one fifth of GDP whereas in 2003, it had increased to 56.1 percent.[2] Integration of markets was stimulated by a continuous decline in trade barriers. GATT and later WTO were founded for that purpose only.

Migration is nowadays generally more restricted than it used to be before World War I. Industrialised countries have become target regions and regulate in detail whom they allow to immigrate. Labour mobility is either restricted between poor and rich countries or very low as in the European internal market. Thus, it is inadequate to talk about

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[1] Rigidity of commodity markets can create frictions as well but are not further examined in this context.

[2] German Federal Statistical Office, by request; own calculation.

a world labour market. However, migration flows have been peaking in the 1990s again. The share of the foreign-born labour force relative to the entire labour force has been increasing in all major OECD countries in the last decade (OECD 2004). However, the general impact of immigrants on national wage levels is found to be rather small (see e.g. Borjas et al. 1997 or Friedberg and Hunt 1995).

Capital flows were already very high (relative to GDP) during the Gold Standard Era. After the downturn in the interwar period international capital transactions grew again in the second half of the 20th century. But pre-World-War-I levels were only reached again in the 1990s. The unprecedented characteristic of recent capital market development, however, is the steep rise in foreign direct investment. While in 1990, FDI made up only 5 percent of gross fixed capital formation on average, its share rose to about 20 percent at the turn of the century UNCTAD, FDO Database). This pattern illustrates that investors more than ever have the global perspective with regard to their investment decisions.

Labour market flexibility

With globalised markets, price flexibility is the key issue. Shocks can be more severe and markets need to adjust to the new equilibrium level. Since the focus of this discussion lies on the effects of globalisation on labour markets, we want to take a look at their flexibility in several countries. Labour market flexibility is determined by several factors. The role of trade unions can be mentioned as one of them. Compared to Anglo-Saxon countries, trade unions have a stronger influence in many European states. In Scandinavia, trade union density reaches about 80 percent. However, relocation of firms or bankruptcy have brought about job losses and reduced the bargaining position of trade unions substantially in some countries. Germany, for example, has seen a decline of union membership by about 40 percent between 1993 and 2001. That amounts to 4.4 million in total and a density of 29.7 percent (see www.dgb.de and EIRO, 2004). Another indication is the coverage rate of collective bargaining agreements. In Belgium and France, more than 90 percent of all employees are affected by such agreements. Germany also ranks high with 79 percent. In the UK and the US, collective bargaining is much less dominant and reaches only 39 and 15 percent respectively (European Commission 2003; for US see EEAG 2004). Although collective bargaining on the sectoral level is still common in many OECD countries, many elements in the contracts already allow flexible handling.

Another source of wage rigidity could be minimum wages. In Anglo-Saxon countries, minimum wages do not seem to play a large role since they are set too low to be binding for a large share of employees. In the US, the UK and Ireland, the share of employees earning the minimum wage is lower than 2 percent. In France and Luxembourg, however, the fraction is substantially higher (about 15 percent).[3] Employment effects of minimum wages are widely and controversially discussed in the literature. While Dolado et al. (1996) do not regard minimum wages as a more serious constraint on the labour market than in the 1960s, Nickell and Bell (1995) and Card et al. (1995) explain the rise in unemployment rates as trends against the less-killed in connection with imperfect wage adjustments.[4] However, the overall effect on employment seems to be rather small.

There is considerable evidence that the generosity of the benefit system has a negative impact on employment as unemployment benefits and social aid create a reservation wage under which the market wage cannot adjust (OECD 1994, ch. 8; see also Nickell 1997 and OECD 2002a). The general picture shows that Anglo-Saxon countries – with the exception of Canada – have installed the least generous unemployment benefit scheme. Hence, in these countries wages can adjust to lower levels than in many continental European states.

Labour market flexibility is also determined by strictness of employment regulation. The OECD (1999) has calculated an indicator comprising strictness of individual and collective dismissal regulation and the allowance of temporary work agencies (TWA). The Table summarises the results and states that Anglo-Saxon countries show the least regulation of their labour market whereas continental European states belong to the more regulated countries in this regard.

[3] Paternoster (2004), see also European Commission (2003), pp. 79-80. Other studies like OECD (1999) have different figures since other references are used. However, the ranking basically remains identical.
[4] Card and Krueger (1995) do not find large employment effects of the federal minimum wage in the US.

Summary indicators of the strictness of employment protection legislation

Rank	Late 1990s	Indicator (0-6)	Rank	Late 1990s	Indicator (0-6)
1	United States	0.7	16	Slovakia	2.4
2	United Kingdom	0.9	17	Belgium	2.5
3	New Zealand	0.9	18	Korea	2.5
4	Canada	1.1	19	Estonia	2.6
5	Ireland	1.1	20	Sweden	2.6
6	Australia	1.2	21	Norway	2.6
7	Switzerland	1.5	22	Germany	2.6
8	Denmark	1.5	23	France	2.8
9	Hungary	1.7	24	Spain	3.1
10	Poland	2.0	25	Italy	3.4
11	Finland	2.1	26	Slovenia	3.5
12	Czech Republic	2.1	27	Greece	3.5
13	Netherlands	2.2	28	Turkey	3.5
14	Japan	2.3	29	Portugal	3.7
15	Austria	2.3			

Source: OECD (1999), p. 66; Riboud et al. (2002).

Although it is difficult to generate one single indicator reflecting the degree of labour market flexibility, the mosaic shows a pattern that Anglo-Saxon countries regulate least and allow for highest flexibility in various fields. This supports the commonly stated view that labour markets in continental Europe are more rigid than in the US or the UK.[5]

Wage structure, unemployment and gains from globalisation

How does the integration of China in the world economy relate to national labour market outcome? Theory suggests that factor mobility directly leads to factor price convergence whereas trade can create factor price equalisation via convergence in commodity prices. If rich OECD countries integrate their markets, there is only limited pressure on national markets since factor price differentials are rather small. It might only be that the structure of the economy changes in the sense that firms merge or grow in order to exploit scale economies. Welfare gains accrue due to a larger variety of products available for consumers and lower goods prices because of cost advantages at higher output levels. This is the one line of argument, but it is not the main focus here. The effects are different if a rich country and a poor country integrate their markets. Then, wages are much more affected due to larger factor price differentials. This brings us back to the central question: What role do institutional labour market characteristics play in this case?

Trade

Heckscher-Ohlin type trade models indicate that trade between two countries that possess different relative factor endowments (and hence, different marginal productivities) will equate factor prices if both countries continue to produce all goods. Specialisation, however, would prevent full convergence of wages. The basic mechanism is that factors of production are shifted between national industries to exploit comparative advantages. The country which possesses relatively high amounts of labour will produce more of the labour-intensive good in order to export some of it. The relatively capital-abundant country produces more of the capital-intensive goods. Thereby, goods prices will converge and hence, factor prices as well. Global output is thereby maximised.

Adrian Wood (1994) among others provides evidence that OECD countries import more manufactured goods from low-wage countries relative to the past. In 1955, only 6 percent of the South's exports to the North were manufactured goods. This share rose to 71 percent in 1989.[6] Especially less skilled workers in the North using labour-intensive production technologies were affected by this development. According to the theory, their wages must fall to sustain employment levels whereas the marginal return of capital and wage income of the highly skilled can rise. This creates a divergence of wage income. If wages cannot fall, unemployment emerges.

Factor mobility

In the case of vertical FDI, firms will relocate parts of their production since low wage costs promise higher profits. As workers in target regions (low-wage countries) are generally less skilled than in industrialised countries, firms export the production of labour-intensive goods. This, as in the trade

[5] Bauer, Bonin and Sunde (2003) argue that wages were rigid in West Germany between 1976 and 1997.

[6] Wood (1994), p. 2. Wood divides the world into rich countries (North) and poor countries (South).

example above, creates the same downward pressure on unskilled wages in the North. One example is the textile industry that has mostly settled in Romania and now is again on the move to Ukraine and other countries with even lower wages.[7]

Although immigration to OECD countries is restricted, the share of the foreign-born labour force has been increasing in the 1990s in all major countries (OECD 2004 and Eurostat). For Germany, for instance, the share rose from 7.6 to 8.4 percent between 1992 and 2001. Moreover, foreign workers tend to have a lower education than natives and concentrate in certain sectors of the economy (OECD 2004). In Germany, about one third is employed in manufacturing (OECD 2003). This shows that downwards pressure on wages might well be substantial in some sectors of the economy although the share of foreigners in the labour force is small on an aggregate level.

Inequality versus unemployment

The quintessence of the previous analysis is that relative wages in industrialised countries have to increase if wages for less skilled workers come under pressure and highly skilled employees in these states tend to benefit from the division of international labour. Figure 1 illustrates the dispersion of earnings for France, the United States, Germany and the UK. as measured by the ratio of the upper limit of the ninth decile relative to the upper limit of the first decile of the income distribution. The expected development can be observed in the United States and also in the United Kingdom. However, relative wages stayed relatively constant in France and even decreased slightly in Germany.

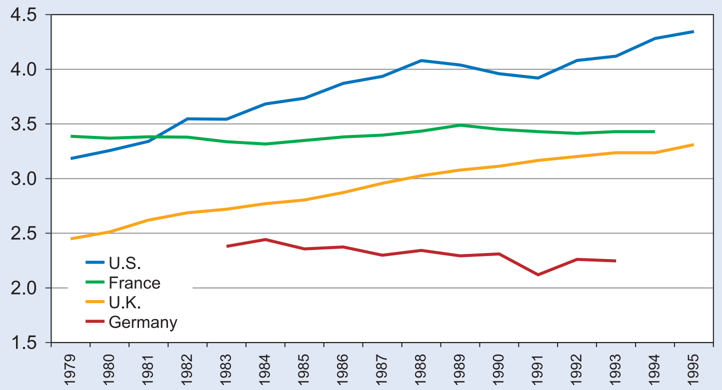
How can this be explained? In France and Germany, wages in the lower part of the income distribution could not fall for some reason. Either minimum wages or other institutional regulations like benefit payments are usual suspects. Since Germany has not installed an explicit minimum wage floor, the expansion of the welfare state delivers an alternative explanation.[8] In fact, social aid increased by 450 percent since 1970 whereas industrial real wages increased "only" by 350 percent (Sinn 2004). The wage structure could thus be compressed. However, pressure from international competition can never be absorbed by defending wages or guaranteeing an alternatively high income. Some adjustment always has to take place. The residual in this case is unemployment. It is well known that Germany has experienced a continuous increase in unemployment. In 1970, only 150,000 people were registered as being unemployed. The figure has risen to nearly 4.5 million in 2004.[9] The upwards trend was mostly driven by unemployment of less skilled workers. As Figure 2 shows, unemployment among the poorly educated is by far the highest in Germany with 15.6 percent.

Many studies blame the welfare state for the inflexibility of low wages (see e.g. Siebert 1990; Nickell 1997; OECD 2002a). Especially the high share of long-term unemployment can be attributed to long-term generous welfare benefits. This is the big difference between Germany and Scandinavian countries that grant high benefits for the first months but cut them rigorously thereafter. In Germany, the share of long-term unemployment in total unemployment exceeded 50 percent in 2000 (OECD 2002b, p.192).

Who is reaping the gains from globalisation? If trade and factor mobility cause unemployment in the industrialised world, then potential gains from the international division of labour

Figure 1

TRENDS IN EARNING DISPERSION, D9/D1
male persons



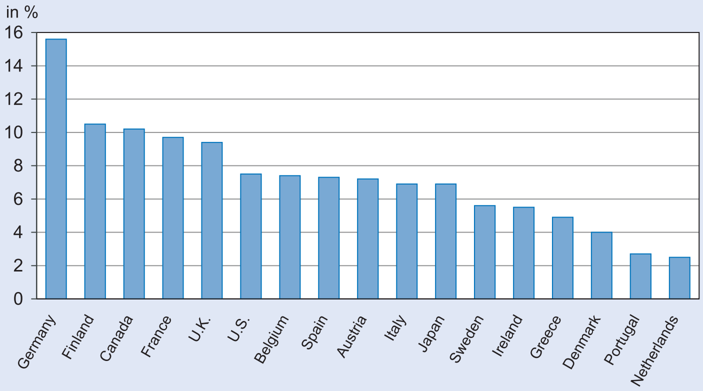
Source: OECD (1996) Employment Outlook, p. 61-62, table 3.1.

[7] With regard to Eastern Europe, one has to admit that also some R&D departments have been relocated to Eastern European countries due to lower wages for engineers and other highly skilled workers.

[8] Of course, trade union power can also be an explanation.
[9] Reunification in 1990 has just shifted the trend-line upwards.

Figure 2

UNEMPLOYMENT RATES OF THE LOW-EDUCATED[a)], 2001



a) below secondary education, 25 to 64 year-old men

Source: OECD (2003) - Education at a Glance, OECD Indicators, Chapter 12, p. 151, Table A12.2.

are forgone – at least to some extent.[10] This result is straightforward since national income ceteris paribus must be suboptimal if a fraction of the production factors lie idle and can no longer contribute to national income. The size of the cake will be smaller than it could have been. It is hard to tell, though, whether net gains from globalisation are still positive if unemployment emerges. What is clear, however, is that countries with the most flexible factors (and goods) markets benefit most.

Conclusions and policy implications

I have argued that welfare gains from globalisation cannot be exploited entirely if labour markets are inflexible. If global competition creates unemployment, it is even possible that a country experiences net welfare losses on an aggregate level. Anglo-Saxon countries are hence in the best position to reap the gains from globalisation since their labour markets were found to be the most flexible ones. In continental European states, however, generous benefit payments are regarded as the major cause for rigidities in the low-wage segment of the wage distribution.

It seems that economies face the choice between the pest and cholera. Either a country allows for an increase in wage inequality to reap the benefits or it will generate unemployment – especially of the unskilled – by keeping the wage distribution constant. The latter outcome is only sustainable if the welfare state guarantees the unemployed a reasonable income. However, a small open economy – and nearly every country is relatively small compared to the rest of the world – cannot redistribute an increasing share of the shrinking cake by levying taxes on the employed. It seemed to have worked in Germany and other European states for the last 30 years. Compared to 1970, however, more low-wage countries are catching up with the industrialised world and competing with their highly paid jobs. To avoid a total collapse of the social insurance system, more wage flexibility has to be allowed for. It will just not be financially feasible to distribute unemployment benefits and social aid to a growing share of the population.

[10] Although there has been a wide discussion to what extent globalisation, namely trade, is responsible for the shift in relative labour demand in favour of highly skilled workers, even supporters of alternative explanations like technological change do not doubt that this mechanism was and still is at work. The alternative view blames technological change for this shift. Krugmann/Lawrence (1993) among others support this view whereas Wood (1994 and 1995) is a prominent representative of the globalisation story. The impact of trade, for instance, is stated to be between 20 and 70 percent.

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