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Compensating the Losers of Globalisation

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INTRODUCTION

Objectives of the research

Globalisation is widely believed to disadvantage some groups in society. In fact, current debates on the effect of globalisation on Western economies are dominated by fears of job losses and rising inequality. While standard economic theory predicts that the net economic effects of globalisation are generally positive, it also suggests that both the overall gains and the distributional consequences of globalisation depend crucially on labour market institutions and other country-specific characteristics. Policy makers thus face the twin challenge of maximising the benefits of globalisation and making it more inclusive.

This Policy Brief first reviews the evidence on the link between globalisation and inequality. It then establishes practical guidelines on how the losers of globalisation could be compensated. Such compensation schemes, which help disadvantaged workers in the short run, should be coupled with institutional reforms that increase the overall long run gains from globalisation.

The Policy Brief focuses on one particularly important aspect of globalisation, namely on increasing international trade flows. We start by reviewing key facts about the evolution of international trade. We then argue that at least since the 1990s, growing trade with emerging economies has contributed to the increase in income inequality in Western economies. The available evidence suggests that low-skilled workers in routine occupations suffer the most from globalisation, while well-educated and flexible workers in non-routine occupations stand to gain the most.

The main argument in favour of compensating the losers of globalisation, apart from potential fairness considerations, is that only compensation may render globalisation sustainable. If a majority of voters does not benefit from globalisation, they will support measures to protect domestic firms from foreign competition. Such measures risk annihilating the overall gains from globalisation. The need for effective and credible compensation may be particularly important for euro area crisis countries for which closer integration into global markets is widely believed to be a necessary element of their adjustment strategy. Such a strategy will, however, receive only limited support from voters if it aggravates inequality and is not coupled with appropriate compensation schemes.

How should compensation policies look like in practice? We argue that compensation policies should target workers in branches exposed to import competition. Rather than subsidising unemployment, compensation policies should strengthen the incentives of displaced workers to seek re-employment and improve their chances of success. In the long run, sound skill and education policies are key instruments both for increasing the benefits of globalisation and for making it more inclusive. Although "one size fits all"-strategies should be avoided given the specific strengths and weaknesses of EU countries' education systems, a particular focus ought to be set on the early phase of the life cycle. Early childhood education programmes targeted at children of disadvantaged background are a particularly promising tool for reducing inequality of educational and labour market outcomes.

KEY OBSERVATIONS

Trends in and perception of international trade

International trade, i.e., the flow of goods across borders, has grown rapidly in recent decades. Over the last half century, total world trade as a percentage of global GDP has more than doubled. At the same time, the nature of international trade has changed. New information and communication technologies and falling transport costs have facilitated offshoring, i.e., the relocation of production processes abroad. Hence, the exchange of intermediate goods rather than of final products or raw materials increasingly dominates world trade flows.

In opinion polls, most Europeans acknowledge that globalisation can boost economic growth and thereby yield economic benefits on aggregate. However, a majority of Europeans also believes that the benefits of globalisation are unevenly distributed in society and that globalisation increases social inequality. A particular source of anxiety in the public debate on globalisation is the rise of China and other emerging economies. Economically isolated until the late 1970s, China is nowadays the largest exporter in the world and the EU's second largest trading partner. Higher imports from China and other emerging economies are widely believed to drive down wages, endanger jobs, and raise inequality in Western economies.

Trends in inequality

A look at the data suggests that inequality has indeed increased since at least the mid-1980s. The main stylised facts emerging from the data are as follows:

- In the large majority of developed countries, overall inequality in disposable household income (after transfers and taxes) has increased since the mid-1980s.

- Much of the increase in household income inequality is due to the fact that gross wages grew much faster at the top than at the bottom of the wage distribution.
- The distribution of capital income has also become more unequal over time.
- In many countries, the wage premium for high-skilled workers has increased.
- There is also some evidence for the relative employment shares of low- and high-wage jobs having increased at the expense of middle-wage jobs (“polarisation” of the labour market). These middle-wage jobs are often characterised by a high degree of routine tasks. Given the crucial role of the “median voter” for democratic decisions, polarisation is also a particular concern for political-economic stability.
- Wage differentials have increased not only between workers of different skill level but also among workers with similar education and professional experience.
- Since the mid-1990s, redistributive government policies (income taxes and cash transfers) have become less effective in reducing market income inequality.

Does trade increase inequality?

Is the expansion of international trade responsible for the observed increase in wage inequality? Early empirical evidence from the 1990s suggests that technological progress – and, in particular, the computerisation of the workplace – played a much more important role in explaining increases in wage inequality. Computer endowment increased the demand for high-skilled workers and thus led to an increase in their relative wages.

However, there is growing evidence that since the 1990s, trade with emerging economies has indeed had a profound effect on labour market outcomes in developed economies. A recent study for the US shows, for instance, that imports from China have increased unemployment and reduced wages in regions that host manufacturing industries exposed to import competition. The study concludes that rising imports from China explain about one-quarter of the observed decline in U.S. manufacturing employment between 1990 and 2007. Evidence for Germany suggests that intensified trade with China and Eastern Europe had a positive aggregate effect on employment but led to significant job losses in German regions specialised in industries that face strong import competition.

There is also growing evidence that international trade and offshoreing can have negative effects on wages in developed economies. Such effects are most pronounced for low-skilled workers who perform routine tasks. In contrast, high-skilled workers who perform interactive non-routine tasks are largely shielded from negative wage effects (or might even enjoy wage gains). Globalisation is, therefore, likely to have contributed to the observed increase in wage inequality by increasing the wage premium for high education and for the performance of non-routine tasks.

Negative wage effects for low-skilled workers in routine occupations are likely to be permanent, as globalisation will, in all likelihood, decrease the relative demand for these workers also in the long run. In addition to such permanent long run effects, international trade may also give rise to temporary adjustment costs in the short to medium run, costs which will again fall disproportionally on specific groups of workers. Opening up economies to trade will lead to a more efficient (international) division of labour, and will, therefore, increase aggregate output in the long run. However, realising these gains from trade frequently requires workers to move between firms, sectors, occupations, or regions. Worker mobility, in turn, carries costs. Workers who lose their jobs in a sector threatened by import competition may, for instance, have to engage in a lengthy job search or a job training programme before finding a job in an expanding sector – and they often suffer major wage losses in their new jobs. Likewise, the cost of regional mobility slows down the adjustment process. While the magnitude of such (temporary) costs of international trade is difficult to measure, existing estimates suggest that they might be substantial.

Overall, the available evidence suggests that globalisation has indeed contributed to the observed increase in inequality. Importantly, the effect of globalisation on individual workers depends crucially on their education and job tasks. Low-skilled worker who perform routine tasks are particularly prone to lose from free trade and offshoring. High-skilled workers in non-routine occupations, in contrast, are likely to gain. High levels of general skills also allow workers to adapt more quickly to the rapidly changing conditions that globalisation brings about.

Compensating the losers of globalisation?

Economic theory suggests that, despite increasing inequality, the overall welfare effects of free trade are positive. This offers the possibility for those who lose from trade to be compensated by those who gain. There are three main arguments in favour of compensating the losers of globalisation:

1. It might be considered unfair that some individuals should lose from free trade while the economy as a whole benefits (equity argument).
2. Voters who lose from free trade or perceive its distributional consequences as unfair are likely to support protectionist measures that may wipe out the overall gains from globalisation. Compensation may therefore be necessary to ensure that a majority of voters, including the pivotal median voter, benefit from globalisation (political economy argument).
3. Compensation policies may increase the overall benefits of free trade if they address existing market failures and improve the efficiency of matching trade-displaced workers to new jobs (efficiency argument).

The main arguments against compensating the losers of globalisation are as follows:

1. Compensation policies may reduce the aggregate benefits of free trade by distorting the incentives of workers to move to their most productive use.
2. It may simply not be possible to identify the losers of free trade.
3. Redistributive welfare state policies may, in general, be incompatible with globalisation, as they reduce international competetiveness, lead to capital flight and prohibit necessary structural reforms.

Counter-arguments 1 and 2 have to be carefully considered when designing compensation schemes in practice. Before we do so in the Recommendations Section, we first discuss the validity of counter-argument 3.

Globalisation and the future of the welfare state

Doubts are routinely expressed about the compatibility of generous welfare state provision with a country's successful participation in the global economy. The distortions arising from welfare state programmes are perceived as a threat to international competitiveness. Moreover, the increasing 'foot-looseness' of firms and workers is seen as challenging the financial sustainability of welfare state programmes by constraining governments' control of their tax revenues. However, both theoretical arguments and empirical evidence cast doubt on the robustness of these arguments.

Indeed, theoretical work that captures the linkages between welfare states, production structures and globalisation suggests that welfare state retrenchment may not be an inevitable consequence of globalisation. For example, given vertical linkages in production that typically increase with industrialisation and generate aggregate economies of scale, globalisation can complement welfare state provision in stimulating aggregate demand and result in a virtuous circle of higher social protection, efficiency and welfare.

This prediction is supported by evidence from a recent study using data for OECD countries for the years 1995 to 2007. The study finds that welfare expenditure is positively associated with a country's overall productivity if vertical linkages (resulting in aggregate economies of scale) are high. Hence, welfare expenditure may actually boost a country's competitiveness as firms increase their efficiency due to higher demand.

Moreover, the study provides evidence on the choice of location by multinationals and finds that countries with high levels of social expenditure are not only attractive for foreign investors but may also act as a hub for firms in the home country. This is because, in addition to other factors, firms' perceptions of a country's economic and social environment are important for their choice of location. In this regard, welfare expenditure contributes to a stable social fabric in a country.

Furthermore, processes of competitive selection within industries are a channel through which globalisation affects labour market outcomes and a country's performance. Globalisation has an impact on firm selection – typically redistributing market shares towards more efficient firms and pushing some of the least efficient firms out of the market. Empirical and theoretical work shows that these reallocations within industries affect flows in and out of the labour market as well as the degree of wage inequality. Recognising the existence of intra-industry competitive selection is important for a full appreciation of how welfare state institutions and policies can counter the effects of internationally generated shocks and dislocations. For example, Active Labour Market Policies (ALMPs), by softening the competitive selection among heterogeneous firms, can limit the negative effects of internationally generated shocks.

Current compensation schemes

Our discussion so far suggests that, at least in theory, there may be good reasons to compensate the losers of globalisation. In practice, however, only few industrialised countries have implemented such compensation policies. One important exception is the Trade Adjustment Assistance (TAA) programme that the United States operates since 1974. Among other things, TAA offers extended unemployment benefits and reemployment services to workers certified as trade-displaced. The European Globalisation Adjustment Fund (EGF) is a more recent initiative on this side of the Atlantic that "provides support to people losing their jobs as a result of major structural changes in world trade patterns". The EGF has an annual budget of EUR 150 million, and, unlike the TAA, provides only for re-employment services, but not for unemployment benefits.

While there are only few programmes specifically targeting trade-displaced workers, many developed countries use labour market policies to provide support for all unemployed workers. Expenditure on labour market policies tends to increase with trade openess. Therefore, governments appear to use labour market policies for mitigating the negative effects of free trade, although only few government programmes focus specifically on trade-displaced workers.

RECOMMENDATIONS FOR POLICY-MAKERS

Making globalisation more inclusive

The best way to make globalisation more inclusive is to prevent workers from becoming losers in the first place. This requires investment in the human capital base of a country's workforce, since adaptive and well-educated workers stand to gain the most from globalisation (as we have argued before). Education policies that generate better and more equitable educational outcomes are, therefore, not only a promising instruments for spreading the gains from globalisation more widely in society but also for increasing the aggregate gains from globalisation. At the downside, the effects of education and skill policies unfold only in the long run.

The available evidence suggests that a number of policies can make an educational system more equitable without lowering the overall level of achievement:

- Early childhood education programmes targeted at children from disadvantaged family backgrounds strongly reduce the inequality of educational outcomes. Returns on investment into early childhood education are high because skills acquired early in life also improve the outcome of learning processes later on.

- Combining public funding of schools with private operation can increase both the level and equity of educational outcomes.
- Attracting and retaining high-quality teachers is key for the achievement of students.
- Postponing early tracking of children into different school types can lead to more equitable education outcomes.

Clearly, investment in human capital must not stop after formal schooling, but needs to be sustained over the full course of a working life.

Devising compensation schemes

The effects of sound education and skill policies are only felt in the long run. This raises the question of how today's losers of globalisation can be compensated. The establishment of compensation schemes is particularly important in those EU Member States where general protection against poverty is ineffective, a prevalent feature of many southern European welfare states. However, even a well-functioning protection system cannot prevent substantial losses for those who lose well-paid jobs in declining industries. How should a compensation scheme look like in practice? The existing literature offers some important guidelines.

First, compensation schemes should be targeted at displaced workers, i.e., at workers who lose their jobs because of globalisation. Workers in declining industries who are able to keep their jobs will typically suffer "only" via lower earnings growth. In contrast, displaced workers usually suffer large (and protracted) income losses. Targeting compensation schemes to displaced workers reduces the overall cost and distortions of such schemes. Since one can usually not identify trade-displaced workers, compensation could be targeted at displaced workers in industries exposed to import competition more generally. Compensation schemes might also target groups of workers who generally find it difficult to regain employment after displacement, such as older and low-skilled workers. In fact, a number of existing active labour market policies target specific groups of workers (the German employment agency, for instance, offers on-the-job training subsidies for low-skilled workers in small- and medium-sized firms).

Second, compensation schemes should give displaced workers strong incentives to seek re-employment. This can be done by making compensation payments conditional on finding a new job – and by simultaneously improving the employment chances of displaced workers through job search assistance and training programmes (see next point). Workers would be compensated for a fraction of the wage loss that they incur because of the job change. Such wage insurance programmes have been tested in Canada (Earnings Supplement Project) and Germany (Entgeltsicherung). To maximise the incentives to become re-employed, workers should be eligible for compensation payments only for a limited time period after the initial job loss. Compensation schemes geared towards re-employment will compensate the losers of globalisation at the lowest cost and may even increase aggregate output by channelling workers from declining to expanding sectors.

Third, workers displaced by import competition should not receive more generous unemployment benefits than other unemployed workers. Workers' sectoral, occupational and regional mobility is important to reap the benefits of free trade, and extended unemployment benefits would only reduce the incentives for workers to find a new job. Instead, job search assistance, training programmes and other active labour market policies can help to improve the chances of re-employment for displaced workers and foster sectoral, occupational and regional mobility. Training programmes should be offered specifically in times of high unemployment. Offering training programmes when re-employment opportuneities are low minimises so-called lock-in effects. The latter occur when unemployed reduce their job efforts and have a lower chance of re-employment while being enrolled in the programme. Active labour market policies are already widely used in Europe. They are an important pillar of the Flexicurity concept, a crucial element of the European Employment Strategy that aims to enhance flexibility and security in the labour market.

Fourth, compensation schemes must be credible *ex ante*. A mere promise to compensate possible losers of globalisation will have no political impact if voters distrust politicians' promises. This insight points to the substantial handicap of any globalisation strategy in countries where trust has been eroded. Here, the (lack of) trust in political actors must be replaced by credible institutions. Options include constitutional guarantees at the national level or resources from the EU budget at the European level.

Correcting biases in the perceived fairness of free trade

An important aim of any compensation scheme is to make globalisation sustainable and to counter protectionist demands by enabling the median voter to benefit from globalisation. However, free trade policies may sometimes meet resistance not only because of an objective winner-loser-pattern but also because of a biased perception of this trade-off. Correcting the perception bias can also help to make globalisation sustainable.

The potential winners of globalisation (future workers in emerging new industries) are often unknown and, hence, have less political influence than the potential losers (current workers in industries threatened by import competition). Perception biases of this kind will be reinforced if the media give greater attention to the visible losers than to the unknown winners. To counter these biases, communication strategies should, for example, refer to the experience of neighbouring countries in order to make winners visible. Drawing on other countries' experience also helps to convey the message that a protectionist status quo creates its own questionable distributional outcomes (substantial advantages for workers in protected industries against disadvantaged outsiders in long-term unemployment).

A low weight put on the interests of consumers is another typical bias in societal debates on free trade. Lower prices and a wider choice among consumption goods and services add to the material well-being of all groups in society. Communication strategies should give due weight to this aspect.

Procedural fairness approaches stress the importance of impartial and unbiased decision making with a broad involvement of voters. Thus, transparent decision-making and the involvement of all groups concerned is central for the acceptance of outcomes. The current TTIP negotiations are a striking example in this regard. Confidentiality of these negotiations is giving rise to public suspicion, which provokes *ex-ante* and premature rejection of the whole project, without serious consideration being given to its potential benefits and advantages for today's disadvantaged groups.

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RESEARCH PARAMETERS

Objective of the research

In the face of the financial and economic crisis and long-term challenges from globalisation, demographic shifts, climate change and new technologies, Europe needs to redefine its development strategy. The objective of WWWforEurope – Welfare, Wealth and Work for Europe – is to strengthen the analytical foundation of this strategy. It goes beyond the Europe 2020 targets of smart, sustainable and inclusive growth and lays the basis for a socio-ecological transition. The new development strategy aims at high levels of employment, social inclusion, gender equity and environmental sustainability.

The research programme

WWWforEurope will address essential questions in areas of research that reflect vital fields for policy action to implement a socio-ecological transition:

- It will deal with challenges for the European welfare state, exploring the influence of globalisation, demography, new technologies and post-industrialisation on welfare state structures.
- It will analyse the impact of striving towards environmental sustainability on growth and employment and provide evidence for designing policies aimed at minimising the conflict between employment, equity and sustainability. This involves using welfare indicators beyond traditional GDP measures.
- It will investigate the role that research and innovation as well as industrial and innovation policies can play as drivers for change by shaping the innovation system and the production structure.
- It will focus on governance structures and institutions at the European level and the need for adjustments to be consistent with a new path of smart, sustainable and inclusive growth.
- It will explore the role of the regions in the socio-ecological transition taking into account institutional preconditions, regional labour markets and cultural diversity and examining the transitional dynamics of European regional policy.

This research will be conducted within a coherent framework which from the outset considers linkages between research topics and highlights how different policy instruments work together. The results of all research areas will be bound together to identify potential synergies, conflicts and trade-offs, as a starting-point for the development of a coherent strategy for a socio-ecological transition.

Methodology

The project builds on interdisciplinary and methodological variety, comprising qualitative and quantitative methods, surveys and econometrics, models and case studies.

PROJECT IDENTITY

Coordinator	Karl Aiginger, Director, Austrian Institute of Economic Research
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