Matching Efficiency with Fairness in a New Era of Globalisation

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Today we Europeans live in one of the most prosperous of societies – at least in a material sense – ever known to mankind. However, there appears to be a growing perception, not only in Europe but perhaps even more so in the US, that the benefits of this prosperity have been fairly unevenly distributed resulting in a widening gap between the rich and the poor and a squeezing of the middle classes.

Two observations are typically quoted in this context:

- Real wage growth has fallen significantly behind productivity increases (at least for the median income worker), and profits as a share of GDP are at their highest level since many decades in many countries.

- Within the wage income distribution, many workers at the lower end of the wage scale are seeing their incomes stagnate, while those at the higher end of the pay scale (particularly the top income earners in the US) cash in on fatter incomes.

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Many people blame globalisation, economic integration and migration for rising inequality in our high-income countries. And indeed, even hard-nosed economists would admit that the rising tide has not lifted all boats. Moreover, several reforms to tax and benefit systems in recent years are perceived to have mainly hurt the "poorer" segments of the population, while the more affluent segments of society have been largely unaffected or even benefited from structural reforms.

In this context we also have to face allegations here and there that policies at the Community level have even accentuated a trend towards widening income gaps. Anxieties about the social dimension of a fully functioning single market, for example, or the assertion of an anti-welfare bias attached to the fiscal discipline of the Stability and Growth Pact have sometimes led to accusations of a 'neo-liberal' agenda in Brussels disregarding or eroding the social dimension in EMU.

I strongly believe such allegations are unfounded. Contrary to the perceptions in some quarters, we are not sponsoring a race to the bottom. We are promoting a dynamic, internationally open and socially mobile society in which all our citizens are equipped with the skills, support and incentives they need to succeed in a changing world. And this means - almost by definition - that we of course care about inequality and access to opportunity for everyone, thus spreading the benefits of prosperity more evenly across society.

This is not only a matter of justice. An ever widening income gap could have a profoundly negative impact on our economies, giving rise to pernicious political reactions spurring trade protectionism and/or a comeback of inefficient welfare state provisions of previous decades. Put simply, public support for our democratic and open societies is going to
erode, and economic and political integration cannot advance if in this
process too many people are left behind.

I am deeply convinced that our overall economic policy design is
conducive to growth and social cohesion. We have established a stable
and consistent macroeconomic framework in EMU, the Economic and
Monetary Union. We have achieved a low and stable rate of inflation
across the euro area. Europe has successfully broken away from the
traditions of the 1970s and 1980s of exchange rate crises, devaluations
and protectionist counter-measures in the wake of large and sudden
exchange rate realignments. Price level stability is a necessary condition
for growth and social cohesion, avoiding the utterly unfair distributional
impact of volatile and unexpected swings in the inflation rate.

High costs of servicing ever growing public debts carry unfavourable
distributional implications as well. This holds true both in inter-personal
perspective of current interest payments, but also in intergenerational
perspective of the burden that we pass onto our children. Thus, lower
interest rates and sound public finances are also conducive to
distributional fairness.

But before I turn to make the case for our policy response in somewhat
more detail, let us examine some of the evidence a bit more closely. Let
me begin with a look at the functional distribution of incomes. It is true
that wage shares have been on a downward trend in many countries for
more than two decades now. But wage shares have not fallen
everywhere. In some countries, such as Belgium, the Netherlands,
Portugal, Sweden and the UK, and to some extent also in France, wage
shares have remained relatively stable, so it is hard to discern an
inevitable common trend. In fact, the prime suspect, namely the influence
of globalisation via the expansion of the global low-skilled labour force, cannot be easily held accountable for the erosion of wage shares for several reasons. First, wage shares started to fall in the mid-1980s, partly as a reaction to the rise in the late 1960s and throughout most of 1970s, but in any case well before the entry of China, Eastern Europe and other countries into the global market economy. Second, if it really were abundant global labour that is causing the fall in wage shares, then the relative price of investment goods should have risen, but actually the opposite has been the case. Moreover, manufacturing sectors in industrialised countries should have been affected more strongly, but again this is not supported by the evidence. These arguments, together with the variety in experiences across countries and over time, suggest that putting all the blame for downward trending wage shares on a global power shift from labour to capital is way too simple.

And obviously, while there may have been various factors driving down the equilibrium wage share, it cannot and will not fall forever. It should be noted, for example, that the adjustment process following employment-friendly shifts in wage bargaining mechanisms may initially entail a temporary fall in the wage share, but over time and with investment kicking in the wage share should gradually recover and return to its previous level. But this process requires flexible markets to reap new job opportunities and to drive down excessive profit margins. The available evidence indeed suggests that, all else equal, economies with rigid labour and product markets are exposed to stronger downward pressures on wage shares.

Anyway, the labour share of income is of course a poor indicator for income inequality at the personal or household level. Income inequality rose sharply in the UK in the 1980s and in the US in the 1980s and
1990s and still continuing, while wage shares remained relatively stable. Again, national experiences vary over the last decades and there is no one overarching common story. While income dispersion has apparently increased moderately in the Nordic countries, Austria and Germany, inequality did not show any persistent tendency to rise in the Netherlands, France and Italy. These diverse developments provide clear evidence for the importance of country-specific events and policies.

Policy obviously matters. Disposable incomes are more equally distributed than market incomes reflecting the equalising impact of tax and benefit systems. Inequality falls, on average, by about 40% for the six EU countries for which the respective data is available from the Luxembourg Income Study. Note that this is almost twice the reduction calculated for the US.

But do we have to pay a price for this in terms of economic dynamism and growth? Are we confronted with an inevitable trade-off between efficiency and equality? What kind of policy interventions can we devise that make the distribution of the cake more equal without shrinking the size of the cake too much – or perhaps even help to make it bigger?

I am convinced that Europe can do better, moving towards higher productivity without necessarily compromising on the social dimension. Provided the right incentive structures are in place, it is possible to ensure economic dynamism while maintaining comprehensive social protection systems as the experience in a number of EU countries shows.

Confronted with globalisation and the ageing of our populations, the way we address these issues will be crucial for the future prosperity of the
Union and the well-being of its citizens. The Lisbon Strategy for Growth and Jobs forms the backbone of Europe’s efforts to respond to the challenges. At its core are reforms of product, labour and capital markets, while promoting social cohesion within the framework of the Open Method of Coordination for social protection and social inclusion.

Product market reforms aim to inject a new dynamism into our economies by eliminating excessive and unnecessary regulatory burdens on businesses and by facilitating market entry and exit of firms. More integrated and well functioning capital markets are essential to reduce the financing costs of needed investments in knowledge and innovation. Labour market reforms should enable workers to move smoothly from declining to expanding activities. We must make it easier for wage earners to rapidly find new employment, as this is still the best social inclusion policy.

In today's labour markets, people inevitably have to make "transitions" more often: from education to employment, from unemployment back to employment or from one job to another. While we cannot alter this economic reality, we can help people to manage these transitions more successfully. Europe is ready to go beyond old assumptions that flexibility is the enemy of social justice and recognise that the right kind of flexibility in European labour, product and capital market can and must advance not only economic efficiency but also social cohesion.

The Commission has recently issued a Communication on pathways toward flexicurity. The idea behind is that flexibility and security are mutually reinforcing, rather than opposites. Flexicurity can be a way to strike a better balance between more flexible labour markets to respond rapidly to changes in the structure of comparative advantages, and
appropriate security in the labour market, necessary to have stable income and thus consumption patterns and respond to the anxiety of European citizens.

When the Lisbon strategy looks to encourage reforms to drive competitiveness, improve regulation and unleash the potential of our workforce and firms, this is not change for the sake of it. We can and must use the ensuing economic success to support and fund our modern social systems and thus improving the quality of life for all European citizens.

It seems obvious to me that education and training is central to any economic strategy promoting fairness and equal access to opportunity. Human capital formation and increased labour force participation have been essential to reduce the gender divide in our societies, but more needs to be done to further narrow down the gender pay gap and to better reconcile the worlds of family and work. And human capital formation is a key pathway to upward mobility in our societies. Indeed, available evidence suggests that inter-generational mobility now appears to be smaller in the US and the UK than in the Nordic countries or in Germany.

We are inevitably engaged in a perpetual race between technology, foreign competition and skill formation, but the rapid pace of innovation and international economic integration makes it at present even more important to invest in education and human capital formation. Raising the average skill level in the population would ensure a better match between skills and labour market needs, so raising productivity and employability. Better educated and skilled people are more likely to find their place in the new international division of labour and have a greater
capacity to adjust to the challenge of globalisation. Increased employability reduces inequality by improving the life chances of those most in need, especially immigrants whose crucial contribution to our economy and society is too often ignored.

The public sector has an important role to play in this respect. It should channel public spending towards more growth-enhancing budgetary areas, such as education and research and development. Increased efficiency in public spending can ensure that the overall budgetary objectives are met and sound public finances are maintained. It should also help in dealing with the increased budgetary pressures associated with ageing populations.

Indeed, when we are concerned about growing inequality in the distribution of income and wealth we need to get serious about effective public spending, improved taxation systems and the role of redistributive taxation.

Recently, many Member States have undertaken major reforms of their tax systems, not least with the objective to shift taxes away from labour and boost employment. Pursuing further reductions in labour taxes raises difficult issues, given the need to complete the consolidation of public finances in many Member States. Moreover, the difficulties are exacerbated by increasing pressure related to ageing and globalisation.

Let me be clear: I adhere to the view that taxes are the price we pay for civilisation. Tax receipts fund public expenditure on education, health, child care and long-term care that can address key inequalities in economic well-being, including some not captured by conventional income measures. In addition, they can be directly redistributive,
financing cash transfers to poorer citizens, including social security. But I also strongly believe that striving for a fair and inclusive society does not necessarily mean higher taxes and higher public spending, but rather smarter taxes and more effective spending.

Against this backdrop, there is a need to look for robust alternative tax bases and to partially compensate for the decrease in labour taxation in order to finance the welfare state and redistributive policies. Within this framework, revenue-neutral tax reforms deserve particular attention. Several possibilities exist but any solution carries its own problems. Shifting the tax burden from low-skilled workers to high-earners or to capital is theoretically possible, and would go a long way towards addressing income inequality.

But admittedly, the issue of progressive taxation on income is becoming increasingly difficult due to the increased mobility of capital income, and to some extent of labour income as well. However, seriously redistributive income taxation will, inevitably, have to be progressive. Progressivity is inherent in any imaginable tax system, but it is important to minimise benefit traps and crippling marginal effective tax rates. Other negative effects have to be considered as well, in particular by reducing people’s willingness to embrace entrepreneurial careers or to invest in education when young.

For the future, it is important to maintain the momentum towards more neutral and more efficient tax systems within the EU, while ensuring sound public finances and budgetary discipline. It is essential to find alternative robust tax bases if we want to achieve a more efficient and growth-enhancing tax structure. It would also be most helpful to simplify
tax systems and to increase the fairness, transparency, and efficiency of taxation by broadening tax bases and eliminating unjustified loopholes.

Since the review of the Lisbon Strategy in spring 2005, we have sought close interaction between Europe's policies on social protection and social inclusion (especially within the framework of the Open Method of Coordination) and policies for employment and growth. The Commission has undertaken a social reality check, a kind of social audit with the aim of checking whether and which European policies need adjustment. We are also currently debating a policy strategy for "active inclusion", to improve coordination at EU level, to better combine policies to make work pay and to improve labour market integration with 'adequate' financial support for those who cannot work (in particular, some sort of minimum income schemes at national level), and to ensure a better access to social services for those at the margins of the society and of the labour market.

I think that Europe has a lot to offer in the area of social and economic accomplishments, as the standard of living and the degree of social welfare for the vast majority of citizens is among the highest in the world. I do believe that Europe is also well-equipped to respond to the pressing challenges that we are facing today. I do believe that we can meet the challenge of globalisation and ageing while preserving a quality of life that the rest of the world envies.