World of Work Report 2008

Income Inequalities in the Age of Financial Globalization

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Executive summary

The financial crisis is hitting the world of work…

The financial crisis which developed over the past year and erupted last August represents one of the most significant threats to the world economy in modern history. The credit crunch and collapse of stock markets are starting to affect firms' investment decisions as well as workers' incomes and jobs. Several major developed economies have practically entered into recession and unemployment is on the rise. Economic growth in emerging economies and developing countries has slowed down, in some cases significantly.

Ongoing attempts to overcome the financial crisis are of course welcome and, in principle, should help avoid another Great Depression. Important as rescue packages are, however, it is crucial to address the structural dimensions of the crisis as well. As this *World of Work Report* shows, the widening of income inequalities that occurred before the crisis is especially instructive in this respect.

… and happens in the face of income inequalities which are widening…

While the costs of the financial rescue packages will be borne by all, the benefits of the earlier expansionary period were unevenly shared.

Between the early 1990s and the mid-2000s, in about two thirds of the countries for which data exist, the total income of high-income households expanded faster than was the case for their low-income counterparts (Chapter 1). Similar trends have occurred when looking at other dimensions of income inequality such as labour income vis-à-vis profits, or top wages vis-à-vis wages of low-paid workers. In 51 out of the 73 countries for which data are available, the share of wages in total income declined over the past two decades. Likewise, during the same period, the income gap between the top and bottom 10 per cent of wage earners increased in 70 per cent of the countries for which data are available.

This was a period of relatively rapid economic growth and strong job creation. In 2007, world employment was almost one third higher than in 1990. In short, the gains from the expansionary period which ended in 2007 benefited more high-income groups than their medium- and low-income counterparts.

...at a pace which has probably been excessive

Wider income inequality can be helpful. It can signal stronger rewards to work effort, innovation and skill development. This, in turn, will improve economic prospects for all, rich and poor. Conversely, an overly compressed income differential may affect job prospects – for instance because the labour market is not sufficiently attractive to would-be workers. Too little income inequality may also weaken the incentive to take risk or invest in human capital, thereby adversely affecting economic growth prospects.

However, there are instances where wider income inequality is both socially harmful and economically problematic.

There is evidence that social conflict grows when inequalities are perceived to be rising excessively. Social support for pro-growth policies will be eroded if low-income groups and the middle class believe that such policies do little to improve their situation or that of their children, while benefiting high-income groups. Surveys suggest a declining tolerance among respondents vis-à-vis growing inequality.

The report also shows that, prior to the financial crisis, there were already signs that observed trends in income inequality might not be sustainable. In the face of strong wage moderation, workers and their families became increasingly indebted in order to fund their housing investment decisions – and sometimes consumption decisions as well. This has sustained domestic demand and economic growth in some countries, and was made possible by financial innovations. However, the crisis has underlined the limits to this growth model.

It is therefore crucial for policy makers to ensure that income inequality does not rise excessively. At the same time, any action in this area should take into account the need for sustaining employment. But the report shows that it is possible to fulfil both employment and equity objectives.

Inequality patterns reflect, first, a process of financial globalization which has intensified economic instability...

Chapter 2 of the report shows that financial globalization – caused by deregulation of international capital flows – has been a major driver of income inequality.

The expectation was that financial globalization would help improve the allocation of savings and thus stimulate economic growth, while also relaxing credit constraints and improve income prospects of low-income groups.

Yet, financial globalization has failed to contribute to the enhancement of global productivity and employment growth. Moreover, financial globalization has intensified economic instability. In the 1990s, systemic banking crises were ten times more frequent than was the case at the end of the turbulent 1970s. Such increased instability typically comes at a steep cost to low-income groups. Earlier experiences suggest that the job losses entailed by systemic financial crisis have been especially strong, with long lasting effects on vulnerable groups. Unemployment can also be expected to rise as a result of the investment slump and this may further intensity income inequalities. Moreover, there is evidence that financial globalization has reinforced the downward trend in the wage share recorded in most countries. On the other hand, financial globalization has exercised a disciplining effect on macroeconomic policies, in both developed and emerging countries.

Therefore, the policy requirement is neither financial deregulation nor isolation. There are several possible policy options to achieve this "mid-road". What matters is that governments take into account the social impacts of each of the options. A cautious approach to financial globalization is especially important in countries where financial markets are not sufficiently developed and where supervision mechanisms are weak, as is the case in many developing countries. But in all countries, it is crucial to reinforce prudential

regulation so as to reduce irresponsible risk-taking on the part of certain financial actors. Indeed, there is a "moral hazard" problem in that these actors grasp all the gains from irresponsible financial positions, while the losses from such operations are partly shifted to society and taxpayers. There is also a role for coordinated action among countries.

...second, steep increases in executive pay de-linked from firm performance...

Developments in global corporate governance have also contributed to perceptions of excessive income inequality. A key development has been the use of so-called "performance pay systems" for chief executive managers and directors.

The result has been a steep increase in executive pay. In the United States for example, between 2003 and 2007, executive managers' pay grew in real terms by a total of 45%, compared with a real pay increase of 15% in the case of the average executive, and less than 3% for the average American worker. Hence, by 2007, the average executive manager in the 15 largest US firms earned more than 500 times the average employee in the United States, compared with over 300 times in 2003. Similar patterns can be observed in other countries such as Australia, Germany, Hong Kong (China), the Netherlands and South Africa.

Importantly, empirical studies show only very moderate, if any, effects of these systems on company performance. Moreover, large country variations exist, with some countries displaying virtually no relation between performance-pay and company profits. Though more research is clearly needed in this area, a plausible explanation behind observed trends is that executives are in a dominant bargaining position with respect to company owners, something which is facilitated by the institutional set-up.

Altogether, evidence suggests that developments in executive pay may have been both inequality-enhancing and economically inefficient. This suggests a role for policy action. In this regard, several options are being considered at present but it is too early to assess the pros and cons of each of them.

... third, institutional change and weaker redistribution policies

Domestic labour, social and tax policies too have contributed to observed outcomes. Labour institutions continue to play a redistributive role in the majority of countries under analysis, despite the decline in trade union density documented in Chapter 3. In particular, high trade union density, a more coordinated collective bargaining structure, and greater coverage of collective bargaining agreements tend to be associated with lower inequality. However, it is difficult for these institutions to counteract the global trends arising from globalization. Overall, it seems that the bargaining position of employees has weakened, even in countries where labour markets have been tight.

Another important factor has been the rising incidence of non-standard employment observed over the past 15 years or so in the majority of countries (Chapter 4). Indeed, non-standard jobs pay significantly less than their standard counterparts. More fundamentally, the changing employment patterns may have also contributed to weakening the bargaining position of workers, especially the low-skilled.

Finally, taxation has become less progressive in the vast majority of countries and thus less able to redistribute the gains from economic growth. This reflects a cut in taxes on high incomes (Chapter 5). Between 1993 and 2007, the average corporate tax rate (for all countries for which data exist) was cut by 10 percentage points. In the case of top personal income tax rates, the cut was of 3 percentage points over the same period. Chapter 5 also shows that declining tax progressivity has generally not been offset by social policy.

Cutting taxes on high incomes or profits can be justified on economic efficiency grounds. They may even meet equity objectives in certain cases – the lifting-all-boats

effect. However there are other cases where such tax cuts produce sub-optimal results, even when considering efficiency-equity tradeoffs. Likewise, stronger social protection, if well designed, can serve employment objectives. The report gives examples of such policies among countries at different levels of economic development. The use of conditional cash benefits provides an interesting innovation in this respect.

It is therefore time to move ahead with the Decent Work Agenda.

But evidence presented in this World of Work Report shows that, if policy makers are concerned about excessive inequalities in their country while also sustaining employment, they have at their disposal an effective tool. Chapter 6 shows that countries that have relatively strong tripartite institutions, well-designed labour regulations and social protection, and respect for basic workers' rights do well, not only in terms of employment but also with respect to limiting the trend increase in income inequalities. Indeed, this is the essence of the Decent Work Agenda.

Moving ahead with the Agenda would help address the social consequences of the financial crisis. Together with a reform of the financial architecture, it would also contribute to achieve a more balanced, sustainable economy.

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