

# Globalization and Inequality

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- Enormous increase in globalization last 20 years
  - more *trade* of goods/services between countries
  - more *production* of goods/services across national boundaries

## Globalization has promised

- prosperity to emerging economies
  - has often delivered: China and India
- significant GDP increases in US and Europe
  - delivered on that too
- to reduce gap between haves and have nots (inequality) in emerging economies
  - has not delivered
- in fact, in many emerging economies, inequality has *increased*
  - notably in China and India

- Is increased inequality in emerging economies surprising?
- Yes - - contradicts *theory of comparative advantage*
  - goes back 200 years (David Ricardo)
  - has been impressively successful in explaining international trade patterns
  - predicts free trade should *reduce* inequality in poor countries

- Theory of comparative advantage asserts:  
important difference between countries is in their  
relative endowments of “factors of production”  
i.e., the inputs to production
- Assume 2 factors: high-skill labor and low-skill labor

- Compare developed country with emerging economy
  - *ratio* of high-skill to low-skill workers higher in developed country
  - so, developed country has *comparative* advantage producing goods requiring high proportion of high-skill workers - - e.g., computer software
  - emerging economy has comparative advantage producing goods where skill doesn't matter so much - - e.g., rice

To see effect of globalization on production:

- look at production patterns *before* globalization (no trade)
- look at production *after* globalization
- compare the two

## Before globalization (before trade)

- companies in developed country produce *both* software and rice  
(both demanded by developed country consumers)
- companies in emerging economy also produce both goods
- emerging economy's software production "inefficient"
  - emerging economy's labor force better suited to rice

- low-skill workers in emerging economy *hurt* by emerging economy's software production
  - not needed much for software
  - greatly needed for rice
  - if production diverted from rice to software, demand for low-skill labor *reduced*
  - downward pressure on low-skill wages
- similarly high-skill workers in emerging economy *benefit* from software production
  - puts them in higher demand

Suppose door for trade between developed country and emerging economy opens

- developed country will shift production from rice to software – – will import rice from emerging economy
- emerging economy will shift production from software to rice – – will import software from developed country

So, emerging economy now produces *more* rice and *less* software than before

- raises demand for low-skill workers
  - rice uses low-skill workers more intensively than does software
- reduces demand for high-skill workers
- so, low-skill wages *rise* and high-skill wages *fall*
- inequality *reduced* in emerging economy
- but this prediction *contradicted* by recent globalization

# Alternative theory (in collaboration with M. Kremer)

- globalization = international *production*
  - computers
    - designed in U.S.
    - programmed in Europe
    - assembled in China
- *many* skill levels (not just 2)
  - today: 4 levels
- production process consists of different *tasks*
  - “managerial” task - - sensitive to skill level
  - “subordinate” task - - less sensitive to skill

# Two economies - - one developed, one emerging

- developed country
  - workers of skill levels  $A$  and  $B$
- emerging economy
  - workers of skill levels  $C$  and  $D$

- $A > B > C > D$

(argument still holds if  $C > B$  )

- output produced by “matching” managers and subordinates
- Matching pattern will *maximize output* (competition)

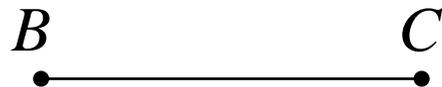
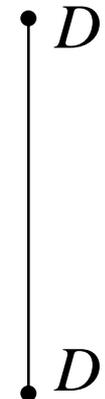
# Pre-globalization (no international production)



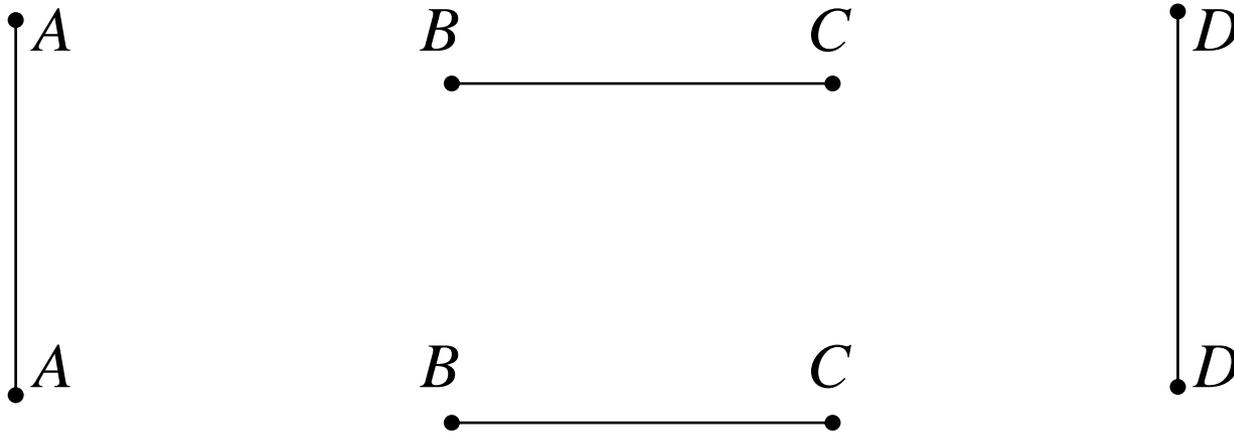
*As and Bs*  
matched together

*Cs and Ds*  
matched together

# Post-globalization (international production possible)



*Bs and Cs* matched together



- What is effect of globalization on wages?
  - Competition implies worker paid according to productivity
  - Before globalization, *D*-workers benefited from being matched with higher-skill *C*-workers (this enhanced their productivity)
  - After globalization, *D*-workers left to match with each other
    - So *D*-worker wages *fall*
  - By contrast, *C*-worker wages *rise*
    - (because of new international matching opportunity with *B*s)
- So inequality in developing country is made *worse*

- Problem has been aggravated by COVID-19
- COVID has accelerated elimination of low-skill jobs
  - jobs where biggest contribution is manual labor
- COVID has reduced opportunities for *D*-workers
  - probably increased opportunities for *C*-workers

# Strong policy implication:

Raise skill level (through education) of *D*-workers, so have international matching opportunities too

Who's going to pay?

- not producers
  - education raises workers' productivity
  - but then have to pay higher wages
- not workers themselves
  - can't afford to
- role for investment by *third parties*
  - domestic government
  - international organizations like ASEAN

- government and ASEAN need not do the training themselves
- can subsidize employers that are willing to hire *D*-workers
- can subsidize families that are willing to send their children to school

## Thus, right course of action:

- *not* to stop globalization
  - globalization brings prosperity
  - ASEAN is right to encourage it
- allow low-skill workers share benefits by investing in their training