First among unequals

Are increasing imports from third-world countries to blame for the decline in the real wages of American blue-collar workers?

During the past two decades, while America’s imports have doubled as a share of GDP, the real wages of many American workers have shrunk. Many believe that this is no coincidence, and so favours protection against low-wage developing countries. Are such fears about the impoverishment of unskilled workers in rich countries justified?

This is a controversial issue, bedevilled by the difficulty of measuring “real wages”. Perhaps the best measure is average employee compensation (which includes non-wage benefits). This rose by a paltry 5% in real terms between 1973 and 1992. What is certain is that the gap between the wages of skilled and unskilled workers has widened. In manufacturing, the average wages of white-collar workers rose by 10% more than those of blue-collar workers in the 1980s. Many low-skilled workers suffered a cut in real pay. The bottom 10% of wage-earners saw their real wages fall by 13% between 1979 and 1989.

A study by the OECD found that wage inequalities have widened in many other rich industrial economies, but nowhere by as much as in America. In continental Europe high minimum wages have prevented wage rates falling (but unemployment has instead risen sharply).

Economic theory would certainly lead you to expect increased foreign competition to be the main cause of a fall in real wages of unskilled workers. The Stolper-Samuelson theorem (written in 1941 by Paul Samuelson and Wolfgang Stolper) predicts that international trade will lower the real income of a factor of production, such as labour, that is relatively scarce in a country. So if America, where unskilled labour is relatively scarce, trades with Mexico, where unskilled labour is relatively abundant, then, as America’s production shifts towards skill-intensive sectors in which it has a comparative advantage, the wages of skilled workers will rise and those of unskilled workers will fall. In Mexico, by contrast, the wages of unskilled workers will rise.

The theory that under free trade, wages will tend to converge in different countries also has a ring of common sense about it. Yet a rash of economic studies has appeared in recent months, trying to debunk the claim that foreign competition is to blame for falling real wages.

Jagdish Bhagwati, in a paper co-authored with Vivek Dehejia, questions the relevance of the Stolper-Samuelson theorem on the grounds that the assumptions on which it is based—such as perfect competition and constant returns to scale—are unrealistic. But, as Mr Bhagwati would admit, no economic model is ever entirely realistic—if it were, it would not be a model. The question is whether the model is a useful simplification or a dangerous one.

Mr Bhagwati has a stronger case when he asks what else the Stolper-Samuelson theorem would imply if it were true. It suggests that international trade affects real wages by changing the relative prices of goods. Free trade should reduce the price of American traded goods produced mainly with unskilled labour. This will then encourage a shift in production towards skill-intensive sectors and hence a fall in the wages of unskilled workers. Therefore, argues Mr Bhagwati, to prove that international trade is the cause of the fall in the real wages of low-skilled workers, one must show that the relative prices of low-skill goods have also fallen. But this has not happened.

The detailed proof is in another study, by Robert Lawrence and Mark Slaughter. It takes non-production workers and production (blue-collar) workers as a proxy for skilled and unskilled workers. It finds that the relative price of low-skill goods has actually risen, not fallen as the theory requires.

Messrs Lawrence and Slaughter also argue that if international trade were the cause of greater inequality in wages, you would expect to see, industry by industry, a fall in the ratio of skilled to unskilled workers, as employers economised on dearer skilled labour; this would then allow a shift of employment towards skill-intensive sectors within the economy as a whole. Again, exactly the opposite has happened: in almost all industries, the proportion of skilled labour has increased. This suggests that the increase in the demand for skilled labour is due mainly to changes within industries rather than to foreign trade. The real culprit behind the drop in real blue-collar wages, conclude the authors, is technological change, which has reduced the demand for unskilled labour.

Does this mean that the theory is wrong? Not necessarily. The Stolper-Samuelson effect may simply have been swamped by other factors. For instance, America’s trade with low-wage developing countries is still small. Imports from countries with wages less than half those in America account for only 2.8% of America’s GDP. This is little higher than the equivalent figure of 2% in 1960. The difference is that Japan and most of Europe then fell into this low-wage category.

So even if international trade is not to blame for the fall in real wages over the past couple of decades, it is possible that it may have a bigger influence on the real wages of the unskilled in future as more developing countries enter the world market.

There is no need for free-trade economists to deny this. It has always been clear that freer trade makes some workers worse off. The point is that other workers will enjoy bigger gains. Free trade only promises to boost incomes for a country as a whole. It is then up to governments to decide whether, and how, to use some of the gains to compensate the losers. Even if trade was to blame for the slump in real wages of low-skilled workers, protectionism would therefore not be the answer. Governments will do far better to improve the skills of their workforces by investing more in education and training.