

Discuss the factors that have led to the increase wage inequality in the UK over the last twenty years. Is wage inequality something the government should be concerned about, or should it be left to the free market?

Labour Economics

March 2006

Word count: 1472
(Excluding references)

David Towers

Introduction

Over the past thirty years, there has been a growing polarisation of wages within the UK (Briggs et al. 2006). The aim of this essay is to identify why wage inequality has increased and subsequently to assess whether wage inequality is a problem that the government should concern itself with.

Although this essay could consider a large number of factors that have led to the increase in wage inequality, building upon the work of Hijzen (2003), technological change and globalisation will be considered as the key drivers in the rise of wage inequality. Globalisation and technology will firstly be considered through looking at their impact on supply and demand in the UK economy. Consequently, the extent to which the UK has been affected by wage inequality will be discussed. It will be demonstrated that the UK government should ensure education is accessible and the free market model is strived for. Accessible education should lead to a gradual increase in the supply of a well-educated workforce and a fall in the ranks of unskilled workers (Andrews, 2001: 36). Through the analysis of Italy's economic situation, it will be suggested that international free trade is indeed the *pareto*, and that ultimately workers are most happy in a free market environment as low paid jobs are not such a 'bad' thing (Siebert, 2002: 2).

Globalisation and technology

The development of international trade has resulted in the growth of national economies in real terms, whilst at the same time increasing inequalities within these countries (Duranton, 1999: 1). Figure 1 shows that the economies of rich countries and the top globalising developing countries are growing, whilst the economies of the non-globalising developing countries are shrinking. Therefore, this suggests that globalisation is a good, increasing the wealth and economies of countries (Pfeffermann, 2002: 1).

Essentially, the process of globalisation creates a larger pool of workforce and materials, the result is that countries share resources (Fligstein, 2003: 449). Figure 2 shows the effect of globalisation within the UK labour market. Globalisation has resulted in the demand for unskilled labour decreasing, shifting the demand curve inwards and in turn lowering the free market wage. Because globalisation has resulted in manual work being outsourced to developing countries such as Brazil and China, the result has been unskilled workers within the UK being made unemployed (Weber, 2006).

Whilst globalisation has decreased the demand for unskilled workers in the UK, in contrast, technological progress has increased the demand for skilled workers. According to Hijzen (2003), skill biased technological change is the main reason for the growing wage inequality. Figure 3 shows the demand for skilled workers has shifted the demand curve outward from D1 to D2, resulting in an increase in the free market wage of skilled workers.

Over the last twenty years there have been remarkable developments in technology,

particularly within industries such as manufacturing (Rover is a case in point). As technology advances figure 3 shows that unskilled labour will be replaced by machines which are less expensive (particularly if there is a minimum wage above the free market equilibrium). As a consequence of unskilled labour being replaced by machines, there is then an increase in demand for skilled labour to operate the machines. This results in a fall in demand and real wage of the unskilled workforce and an increase in demand and real wage of the skilled workforce (Smith, 1994: 86).

Growing wage dispersion: is inequality really wrong?

It has been demonstrated thus far that globalisation and technology have resulted in an increase in wage inequalities. Figure 4 and figure 5 demonstrate the extent to which these inequalities have grown in the past twenty years. While the lowest tenth percentile have only seen very small increases in real wage, the top ten percent, both male and female, have seen a substantial rise in their real wage. Relative to the wage of unskilled workers, the wage of skilled workers has increased by approximately 35% over the past twenty years (Dickens and Ellwood, 2001: 47). However it can be seen that whilst the wage dispersion is clearly increasing, the lowest tenth percentile have actually been making small real term gains of about 1.5% and are certainly no worse off.

Figures 4 and 5 show how the market in the UK is operating, and as previously discussed, globalisation and technology are two contributors to this trend. However, before looking at whether the government should attempt to improve wage inequality, the concept of wage inequality needs to be addressed. Welsh cites that Ely argues that inequality is in fact an economic 'good' (1999: 1). This position makes rational sense as it is inequalities which keep the labour market moving; for example, the market encouraging individuals to relocate or be trained. If a free market is to function it is important that the market is able to set the equilibrium wage without interference from the government, as interference will not give the *pareto optimum*. Essentially therefore, if governments have trade tariffs or limit the ability to implement technology changes at work, the result will be a loss of efficiency; effectively dead-weight loss to society.

When wage inequality is unfair

Ely argues that wage inequality is not an economic bad unless low-wage citizens view society as unfair, where mobility is considered impossible or illegal attempts are made to redistribute income (Welsh, 1999: 2). Ely is correct in his assertion, because in this situation unskilled workers would effectively give up on the labour market which goes against the basic assumptions of supply and demand and will inhibit reaching *pareto efficiency*. Essentially, the pivotal issue is that of accessibility to education. The UK government should ensure opportunities exist whereby if the free market dictates a shift in demand for unskilled to the left, and a shift to the right in the demand of skilled workers, the unskilled labour need to be able to re-train.

One of the most serious problems the UK labour market has is a lack of skilled workers. Nickell, argues that the high rising inequalities in wage have been made worse by ‘the very long tail in skill distribution’, stating that over 20% of the UK working population have very low skills (2004: 24). Andrews (2001) recognises that a shift in demand to the well educated poses a problem to unskilled workers. However, Andrews argues that it is a signal from the market that young people should acquire skills before entering the job market and low-wage workers should invest in improving their competencies (2001: 36). Essentially therefore, the government should not interfere with the free market but should merely facilitate it, helping reduce the frictions that may exist.

The question of happiness

When the UK is considered in comparison to Italy, empirical evidence reveals that Italy’s wage inequality has actually got smaller over the past twenty years (Siebert, 2002: 13). Although this might at the outset seem attractive, as Siebert argues, there are two possible reasons for the increased wages of unskilled labour: demand increases, or alternatively, collective agreements which push up unskilled wages (2002: 4). The Italian government’s strict labour regulation has actually artificially pushed the wages of unskilled workers up. As figure 6 suggests this has been to the detriment of the Italian economy, thus the UK government should not follow a similar policy.

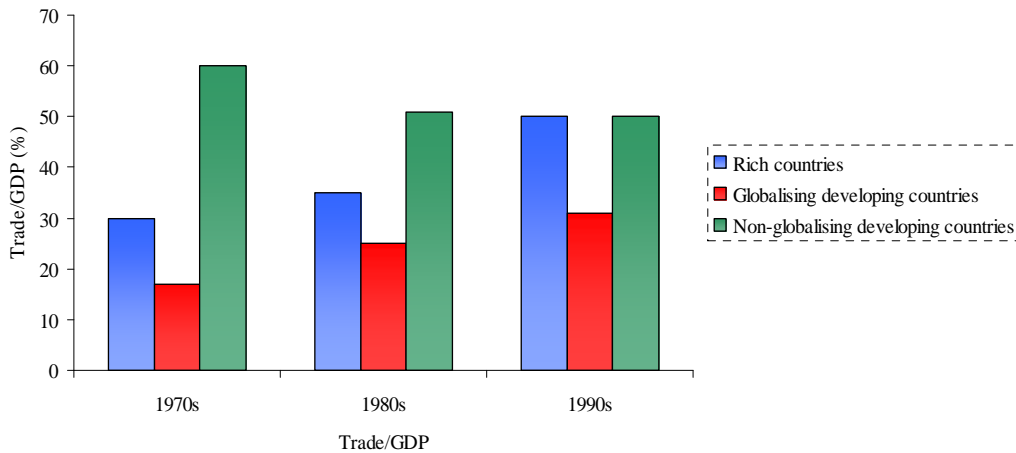
As increasing wage inequality is growing within the UK and the demand for unskilled workers is getting less, the relationship between work and happiness should be considered, and whether the growing wage inequality is having a positive or negative impact upon the UK. Within the US, a country where wage inequality is growing even faster than the UK (Salverda et al. 2001: 22), Ely states that wage inequality has worked positively to highlight the importance of education (Welsh, 1999: 13). The growing importance of education is also evident within the UK, with the government encouraging young people to stay in education for longer (BBC, 2002). Whilst the training of unskilled workers needs to take place, in reference to a number of studies Siebert states that an unemployed person would typically prefer to have a ‘bad’ job rather than be unemployed receiving state benefits (2002: 2). Furthermore, empirical evidence suggests that income only has a small insignificant effect upon happiness (Siebert, 2002: 10). Consequently, although unskilled workers who do not invest in training may be paid a low wage, a higher wage would not significantly raise their levels of happiness.

Conclusion

This essay has discussed how technological progression and globalisation have reduced the demand for unskilled labour and increased the demand for skilled labour. It has been demonstrated that the free international market economy is the best economy to operate in as it is the *pareto optimum*. This essay has shown that the current situation of increasing wage inequality is actually an economic good as it encourages unskilled workers to invest in training and education. In conclusion therefore, the role of the UK government should

be to help communicate the market needs to the workforce, thereby ensuring that all is done to minimise any market frictions that may exist such as imperfect knowledge on the part of unskilled labour.

Figure 1: Development of globalising countries



Adapted from: Dollar D and Kraay A, 2001. Trade, Growth, and Poverty. The Economic Journal, 114. February. Page 2.

Figure 2: Supply and demand of unskilled labour before and after globalisation

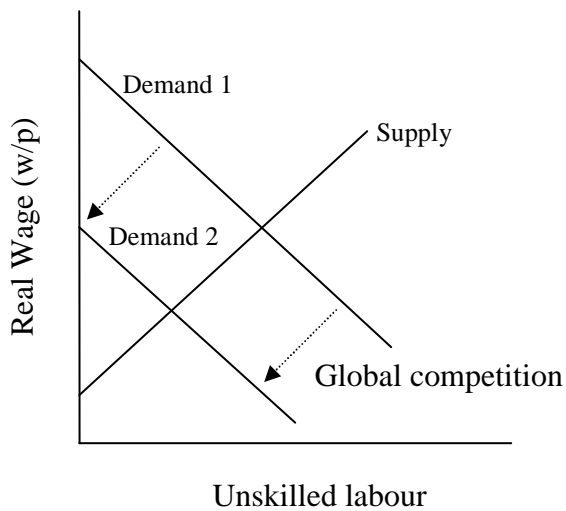


Figure 3: Supply and demand of labour before and after technological advances

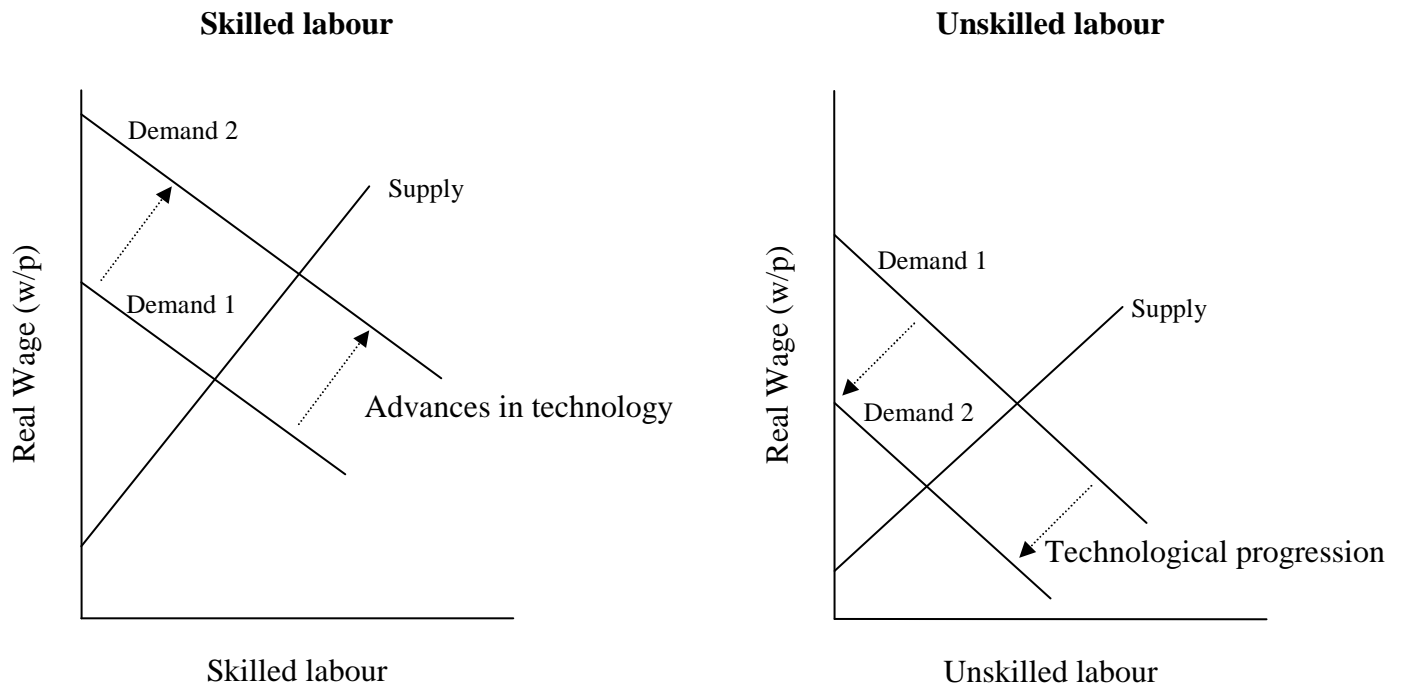
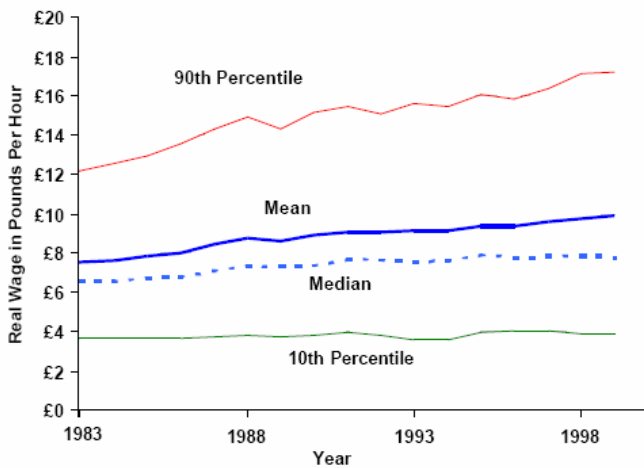
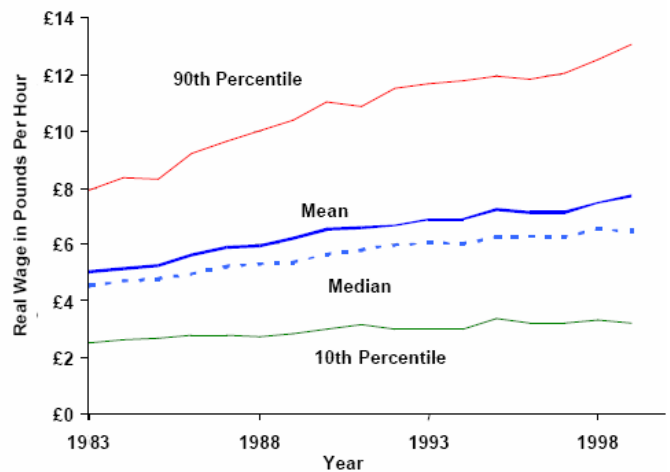


Figure 4: Real wages in Britain for males working at least half time



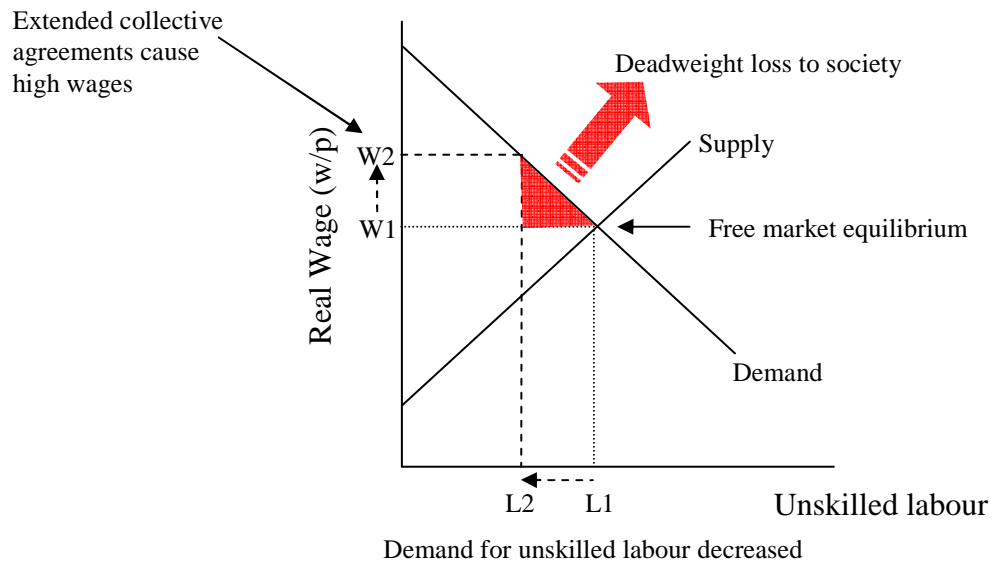
Adapted from: Dickens R and Ellwood D, 2001. Whither poverty in Great Britain and the United States? The determinants of changing poverty and whether work will work, Centre for Economic Performance, London School of Economics. Page 46.

Figure 5: Real wages in Britain for females working at least half time



Adapted from: Dickens R and Ellwood D, 2001. Whither poverty in Great Britain and the United States? The determinants of changing poverty and whether work will work, Centre for Economic Performance, London School of Economics. Page 46.

Figure 6: Supply and demand of unskilled labour in Italy



References:

- Pfeffermann G, 2002. The Eight Losers of Globalization. Globalist Paper: Global Development. <http://theglobalist.com/DBWeb/StoryId.aspx?StoryId=2429>
- Briggs C, Buchanan J, Watson I, 2006. Wages Policy in an Era of Deeping Wage Inequality. The Academy of the Social Sciences in Australia, 4; 1-20.
- Hijzen A, 2003. Fragmentation, Productivity and Relative Wages in the UK: A General Equilibrium Approach, GEP Research paper, 2003/17, University of Nottigham, Nottingham.
- Andrews M, 2001. The Political Economy of Hope and Fear: Capitalism and the Black Condition in America. New York University Press.
- Duranton G, 1999. Trade, Wage Inequalities and Disparities between Countries: The Technology Connection, Growth and Change, 30; 455-478.
- Smith S, 1994. Labour Economics (second edition). Routledge.
- Fligstein N, 2002. The Architecture of Markets: An Economic Sociology of twenty-First-Century Capitalist Societies. Princeton University Press.
- Dickens R and Ellwood D, 2001. Whither poverty in Great Britain and the United States? The determinants of changing poverty and whether work will work, Centre for Economic Performance DP No. 506, London School of Economics.
- Dickens R and Manning A. 2002. Has the national minimum wage reduced UK wage inequality?, Centre for Economic Performance DP No. 533, London School of Economics.
- Weber T, 2006. Outsourcing firms eye new markets, BBC Business News. <http://news.bbc.co.uk/1/hi/business/4644698.stm>

- Welsh W, 1999. Richard T. Ely lecture: In defense of inequality, *The American Economic Review*; 89 (2).
- Nickell S, 2004. Poverty and worklessness in Britain. *The Economic Journal*, 114. March.
- Salverda w, Bazen S, and Gregory M, 2001. The European-American Employment Gap, Wage Inequality, Earnings Mobility and Skill: A Study for France, Germany, the Netherlands, the United Kingdom and the United States. European Low-Wage Employment Research Network.
www.economics.ox.ac.uk/Members/mary.gregory/JobsGap.pdf
- Siebert S, 2002. Notes on Labour market flexibility: Questions for the new economy. Chapter 4 in Cheng R, Meadows R and Sugden R (eds.) 2002. *Urban and Regional Prosperity in a Globalised, New Economy*. Edward Elgar.
- BBC, 2002. £40 a week to stay in education, BBC Business News.
<http://news.bbc.co.uk/1/hi/education/2081742.stm>
- Dollar D and Kraay A, 2001. Trade, Growth, and Poverty. *The Economic Journal*, 114. February.