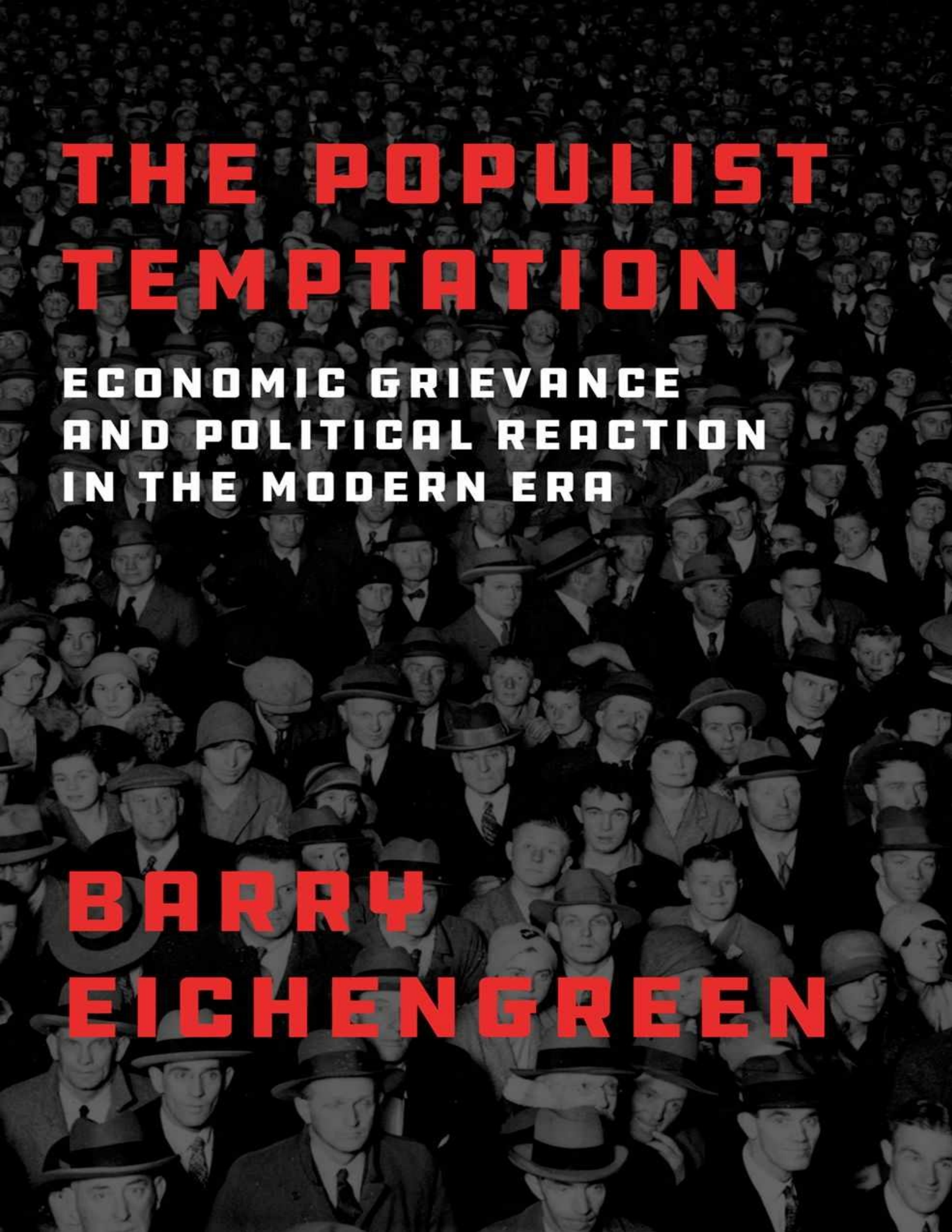

THE POPULIST TEMPTATION

ECONOMIC GRIEVANCE AND POLITICAL REACTION IN THE MODERN ERA

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8

Things Come Apart

after 1973, everything ran in reverse. The growth of GDP per head in the United States slowed to 1.2 percent between 1973 and 1992, down from 2.4 percent in the period 1950–1973.[1] Growth similarly fell by half in Western Europe, from 3.8 to 1.8 percent. In Japan, where growth in the golden age had run fastest, the deceleration from 8.0 to 3.0 percent was even more dramatic.

Slow growth made everything harder. It was harder for governments to find the resources to help displaced workers. It was harder to credibly maintain that the benefits trickled down. Governments deriving support from their success in delivering growth saw their popularity wane. Jimmy Carter may have lost the 1980 presidential election because of Iran's failure to release the fifty-two

American hostages it was holding (a release that happened shortly after Ronald Reagan finished giving his inaugural address), but he also lost because of his less than stellar management of the economy. An econometric model by the Yale economist Ray Fair pinned Carter's loss on a handful of economic indicators, notably inflation and unemployment.[2] As the economist Sidney Weintraub put it, Carter succeeded "where all Democrats—and Republicans—have failed—namely, in making his own name a synonym for economic mismanagement and expunging memories of Herbert Hoover dawdling at the onset of the Great Depression."[3]

Disaffected voters in the United States and elsewhere turned initially to other mainstream parties and leaders. But the grasp on power of those leaders hinged on their ability to deliver the economic goods. In some cases, such as those of Reagan and Margaret Thatcher, they could claim some success. But Reagan's policies pushed up the dollar, which accelerated the deindustrialization of the heartland. Thatcher's policies of disinflation were accompanied by a sharp rise in unemployment. In no case were governments able to restore growth to the heights of *les trente glorieuses*, the thirty glorious years after World War II.

Blaming political incompetence was tempting insofar as there was no other convincing explanation for the slowdown. The slump in the advanced economies was necessarily a slump in productivity, since productivity accounts for the majority of GDP growth. Popular accounts emphasize the OPEC oil shocks of 1973 and 1979, queues at the pump being visible signs of economic distress. But energy is too small a part of GDP to explain more than a fraction of what happened to the economy as a whole. If higher energy prices depressed productivity by causing the obsolescence of energy-using capital equipment, moreover, then we would expect to see a sharp fall in the secondary-market price of such equipment, where no such fall in fact occurred.[4]

Some analysts blamed business-cycle volatility for discouraging investment and innovation.[5] This argument had appeal insofar as not just energy-price

shocks but also other factors, from the resignation of Richard Nixon to rising inflation, could have contributed to that volatility. But there was no agreement on the sources of business-cycle fluctuations and, in particular, on whether one such source was the inept and destabilizing policy response of central banks and governments (the Jimmy Carter effect)—something that again pointed the finger of blame at establishment politicians.

Maybe the post-1973 slowdown was just the inevitable by-product of success. In the 1950s and 1960s growth had flowed from improvements in the quality of labor. With higher incomes it then became possible to invest still more in education. The 1940s had seen the fastest increase in U.S. high school and college graduation rates of any decade, as noted in Chapter 7, an upward trend that continued for an additional twenty years. But now high school graduation rates plateaued at 75 percent. It was hard to boost graduation rates still further with such a large share of capable students already completing school. The share of American men with university degrees plateaued at about the same time, at roughly 25 percent.

But the same was not true outside the United States. The high school movement of the 1910–1940 period was a distinctively American phenomenon.[6] The rise and broadening of educational attainment began later and proceeded more gradually in other countries. Average years of education of people between ages fifteen and sixty-four therefore continued to rise in Europe and Japan in the 1980s and after, continuing well after the growth of productivity slowed.[7]

Or maybe the growth slowdown just reflected the end of catch-up. Europe and Japan could grow rapidly so long as there existed a backlog of technology to be acquired from the United States, and so long as there was still underemployed agricultural labor to be shifted to more productive uses in manufacturing. By the 1970s, however, the technology gap vis-à-vis the United States had been closed, and the pool of underemployed agricultural labor was drained.

But this perspective suggests a gradual deceleration, when in fact productivity

fell off a cliff. The pool of underemployed rural labor did not evaporate on a single day. The United States offered a range of technologies, some more advanced than others. European producers could start with the most attractive, but there was no reason to stop there, on a single day or in a single year like 1973. Similarly, the fact that the United States, which had no one to catch up to, suffered an equally pronounced slowdown underscores the limits of this interpretation.

By process of elimination, we are left with the possibility that the scope for productivity-enhancing technological progress had diminished. Robert Gordon has famously argued that productivity growth in the United States and more widely was supported by one great wave of innovation—the railway, the internal combustion engine, synthetic chemicals, electricity, radio, jet propulsion, and antibiotics. But after 1970 boosting output through the application of these products of nineteenth- and early twentieth-century science became harder. Nothing since has had comparable productivity-enhancing potential.[8]

This begs the question of why there was only one great wave of scientific advance. Maybe post-1970s governments invested too little in basic research to maintain the momentum. Maybe they provided inadequate incentives for private-sector R&D.[9] Maybe by raising hiring and firing costs as a low-cost response to labor market insecurity they discouraged start-ups and entrepreneurship. This was the view of critics of European policy who, from the early 1980s, spoke of "Eurosclerosis." But to the extent that all this was true, the finger of blame pointed, once again, at inept governments.

Working-class living standards stagnated not just because income growth slowed but also because the income growth that did occur accrued disproportionately to the wealthy. While the growing gap between the incomes of more and less skilled workers was widely noted in the wake of the 2008–2009 financial crisis, the increase in inequality in the United States in fact dates back to the 1970s.[10] This is how the median earnings of prime-age working men,

adjusted for inflation, could fall by 4 percent between 1970 and 2010, despite the fact that the economy as a whole was continuing to expand.[11] While this trend toward greater inequality was most prominent in the United States and United Kingdom, it was similarly evident in a range of other advanced economies in the 1980s and 1990s, especially when one focuses on full-time male wage earners.[12]

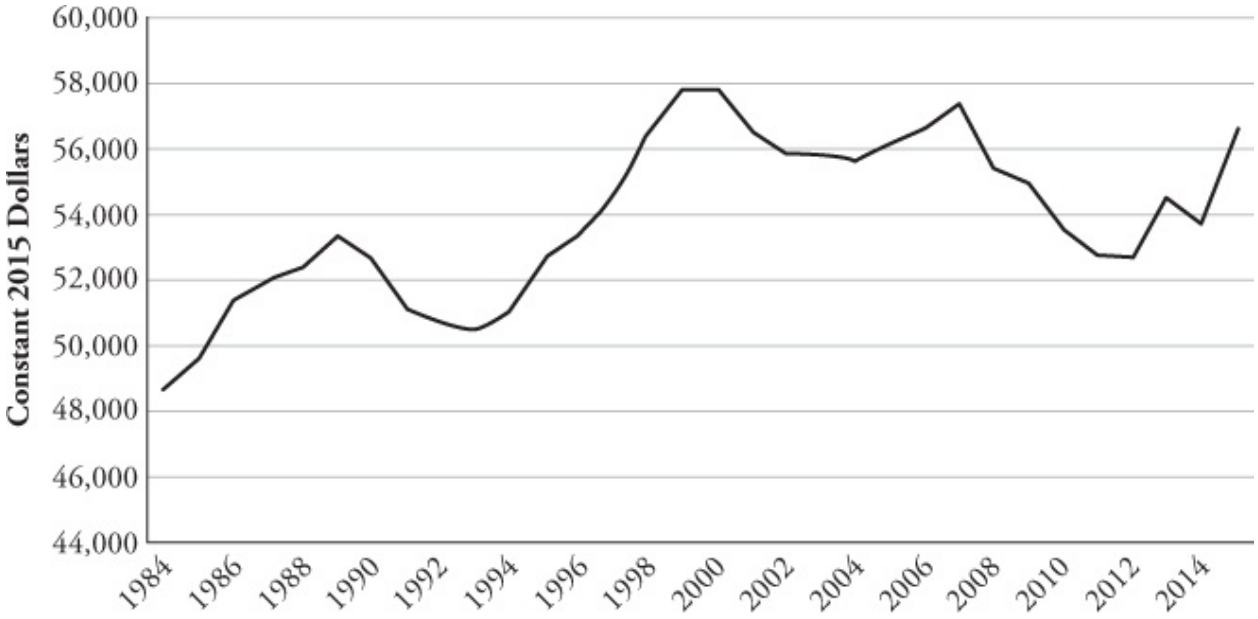

Figure 8.1 Real Median Household Income in the United States, 1984–2015

Source: U.S. Bureau of the Census, [MEHOINUSA672N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MEHOINUSA672N, February 23, 2017.

If there is a shortage of convincing explanations for the productivity slowdown, then the problem for inequality is the opposite, namely, an embarrassment of riches. These start with changes in technology, which for decades, if not centuries, had favored unskilled workers but now favored the skilled. The mechanization of weaving in nineteenth-century Britain had undermined the demand for skilled handloom weavers, allowing them to be replaced by women and children tending automatic looms.[13] The Luddites were skilled workers who lost out to technical change, in other words. More generally,

the transition from the workshop to the factory and assembly line allowed artisans, who spent years in apprenticeship, to be replaced by workers responsible for only a narrow set of tasks who could be trained up in a short period of time. Henry Ford famously observed that assembly line workers could be trained up to their peak productivity in a matter of days.[14]

In the language of production theory, new technology and unskilled labor now complemented one another. In other words, the introduction of assembly-line technology and the creation of additional good jobs for unskilled and semi-skilled workers went hand in hand. Because this situation persisted through the third quarter of the twentieth century, American, European, and Japanese factories, fitted out now with machinery and assembly lines, offered an abundance of good manufacturing jobs.

But then the direction of technical progress shifted. New kinds of machinery replaced assembly-line workers undertaking routine tasks. General Motors installed the first industrial robot, UNIMATE, in its New Jersey assembly plant in 1962. Robots were first used in significant numbers on assembly lines in the 1970s and 1980s, when they replaced less skilled workers engaged in routine tasks. Maintaining this machinery required relatively high levels of literacy and numeracy; it required education and skill. Capital and unskilled labor were now substitutes (the more machines, the fewer jobs for unskilled and semi-skilled workers), while capital and skilled labor were complements (the more machines, the more need for skilled operatives to maintain them).

This change visibly affected the demand for more- and less-skilled workers and therefore their compensation. Whereas in 1965 American workers with college degrees earned just 24 percent more than high-school graduates, that gap widened to 47 percent in the mid-1980s and 57 percent in the mid-1990s.[15] The situation in Europe and Japan differed in extent but not in kind.[16]

This change in technological trajectory is best understood as a response by employers to rising educational attainment. So long as skilled workers were few,

it didn’t pay to design jobs for them, or to install machines that required tending by skilled operatives. Instead firms hired less-skilled workers, trained them on the job, and gave them positions where they worked with limited amounts of complex machinery. But as the supply of high school and college graduates rose, it paid to design jobs expressly for them and to invest in advanced machinery for them to oversee. The result was higher productivity for skilled workers and fewer well-paying jobs for the less skilled.[17]

But this was not just a matter of machinery; it was also a matter of organization. Firms with ample supplies of skilled labor had an incentive to group workers into teams whose members were responsible for solving problems and developing ideas about how to better organize production. This was the essence of the Toyota Production System, pioneered by that company in the 1950s but adopted more widely in the 1970s and 1980s as workers with the requisite skills became more widely available.

This is an appealing story because it explains not just why technical change took the form it did—it was a response to increased educational attainment after World War II—but also how it was that the earnings premium for college graduates rose despite the fact that the supply of graduates was rising as well.[18] And there is evidence of its operation in a wide range of countries.[19]

The unskilled-labor-saving bias of technical change is not the entire explanation for the post-1970 increase in inequality, to be sure.[20] In a 2003 study, the economists David Autor, Frank Levy, and Richard Murnane concluded that computer-enabled technology, of which industrial robots are perhaps the most visible manifestation, accounted for no more than 30 to 40 percent of the shift in earnings toward college graduates in the preceding three decades.[21] Subsequent studies put the share attributable to technology a bit higher, perhaps because the full impact of computers and robotics was not yet evident at the turn of the century. But those subsequent analyses don’t change the basic conclusion that more than robots matters.

Import competition and immigration are the other usual suspects for the shift in income toward skilled labor. One of the most robust propositions in international economics is that foreign trade doesn't raise all boats. Some groups benefit disproportionately, while others lose in relative and absolute terms.[22] In the case of the advanced countries, skilled labor benefits, since it is the abundant factor used in the production of exports, while unskilled labor is left worse off. Because skilled workers already have high incomes, the result in this case is additional inequality.

This is not a controversial proposition, although there is less than full agreement on the magnitude of the effects. Most investigators agree, however, that those effects were "appreciable," in the judiciously chosen terminology of one recent study.[23] Their impact on the skilled-unskilled wage differential was roughly equivalent to that of technology.

Moreover, the negative effect on some workers and communities is strikingly persistent. Studying the impact of import competition from China on the United States, David Autor, David Dorn, and Gordon Hanson found substantial and persistent distributional consequences and adjustment costs. Wages and employment in local markets that were home to industries suddenly exposed to Chinese competition remained depressed for more than a decade. Workers formerly employed in the affected industries found it hard to secure stable employment in other sectors. They experienced income losses not just in the short run but over the balance of their working lifetimes.[24]

The mystery is why these impacts were neglected by economists and downplayed by politicians—and, equivalently, why globalization was embraced so wholeheartedly by the intellectual and political elites. The populist answer is that the elites knew on which side their bread was buttered. As skilled workers themselves and as investors in high-tech companies and multinationals, they were self-interested promoters of globalization. A less cynical response is that it took time for the full negative effects to materialize. Prior to the 1970s, when

growth was rapid, it was still possible to argue that foreign trade raised all boats. As late as 1990, most trade flows were among advanced countries with similar factor endowments and average incomes, limiting the distributional consequences.[25] The trade-to-GDP ratio worldwide remained more or less flat through the 1980s; there was no massive globalization shock. All this changed with the rapid growth of exports from emerging markets in the 1990s and China's accession to the World Trade Organization. The decline in U.S. manufacturing employment accelerated, and the inequality trend grew more pronounced.[26]

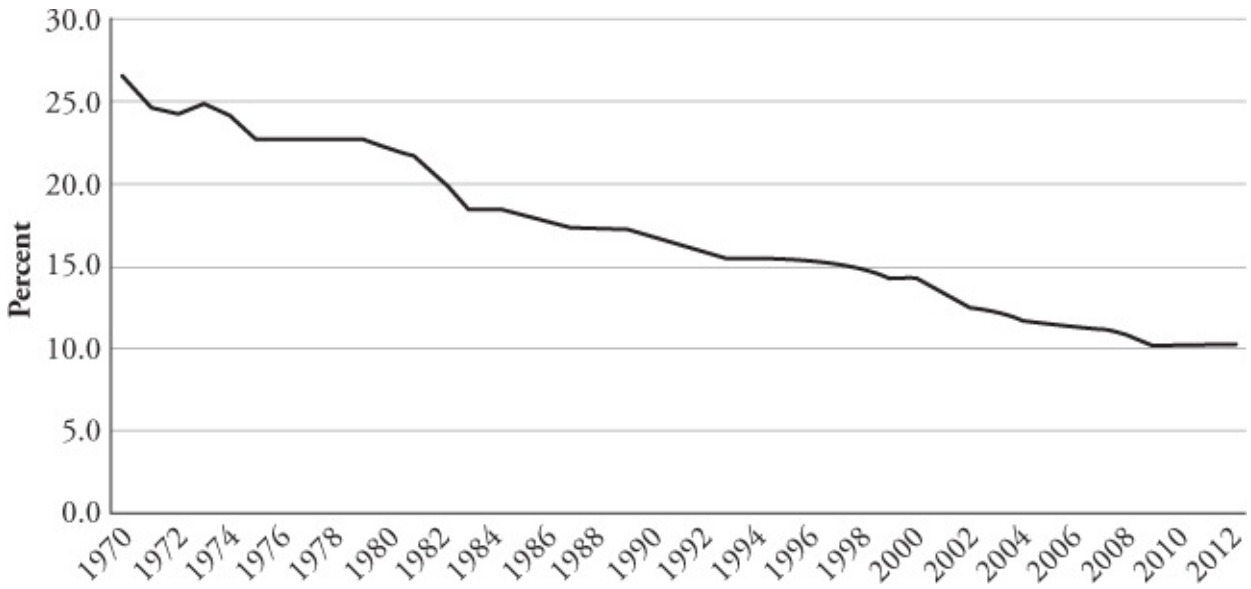

Figure 8.2 Percent of Employment in Manufacturing in All Nonfarm Employment in the United States Since 1970

Source: Retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/USAPEFANA.

None of this challenges the presumption that trade can be beneficial for advanced countries as well as emerging markets. But if trade has distributional consequences and adjustment costs, then these must be addressed by income transfers, training schemes, and regional policies if there is to be a political consensus in its favor. These observations are straightforward, but they run

headlong into free market ideology, skepticism about the problem-solving capacity of government, and budgetary constraints. They were paid lip service but little more in the countries now experiencing an anti-trade backlash.

The impact of immigration is even more contentious, given that there is no agreement on its overall effects. Its impact on native-born workers depends, moreover, on whether immigrants are skilled or unskilled. It depends on how directly immigrants compete with natives—whether their skills and experience are different, and whether they choose similar occupations. It depends on the size and suddenness of the immigrant inflow, since larger flows mean higher adjustment costs.

In the United States, the immigration issue is fraught because the distributional impact is the same as that of trade. Most immigrants are less-skilled workers.[27] Their impact has thus been to depress the living standards of natives who are not high school graduates while raising those of U.S.-born workers with at least a high school diploma. Workers in fast food outlets and poultry processing plants earn less, but skilled workers consuming McChicken sandwiches see their earnings go further. Most studies conclude that the positive effects on the wages of native-born workers dominate on balance.[28] But the fact that the losers from immigration are the same folks who have lost from trade makes the issue socially and politically problematic.

Studies of other advanced economies reach similar conclusions. Research on the United Kingdom suggests that "immigration has a small impact on average wages of existing workers but more significant effects along the wage distribution: low-wage workers lose while medium- and high-paid workers gain."[29] But if the direction of the effect is the same as in the United States, the operative word here is "small." Half of all immigrants in the United Kingdom are from other EU countries.[30] They are more likely than natives to have some post-high-school education. Hence they do not have a pronounced effect on the wage distribution or disproportionately impact workers at its lower end. Even

U.K. regions with a large influx of immigrants from Eastern Europe after 2004 did not see larger-than-average falls in the wages of native-born workers or a larger rise in inequality.[31] More generally, most immigrants to European countries possess at least some post-secondary education, the opposite of what is the case in the United States. It follows that those immigrants have done little to raise inequality in the recipient countries and may have even reduced it. Recent inflows of undocumented immigrants and refugees from Africa and elsewhere, many of whom lack the same education and skills, are a different matter—which is one reason why their presence and the inability of governments to control the influx are so contentious.

Even after taking all these factors into account, recent changes in income distribution vary across countries. It's not all about technology, trade, and immigration, in other words—it's also about institutions. We saw in Chapter 7 how the increased strength and legitimacy of unions after World War II enabled their members to share in the rents accruing to employers.[32] This was true of not just union members but also nonunion workers, whose pay was similarly influenced by union wage norms. It was true even in the United States, never a hotbed of unionism, following the Treaty of Detroit in 1950. We also saw how the existence in Germany of strong trade unions with a seat in the boardroom helps to explain why that country didn't share in the more general decline in full-time male real wages experienced in other countries in the final decades of the twentieth century.

It follows that declining unionization has been a factor in rising inequality. The share of American workers covered by unions fell from 27 percent in 1973 to barely 17 percent in 1993 and 11 percent in 2016. Some authors ascribe as much as a third of rising inequality over the period to this decline in union coverage.[33] Since unions also help to restrain CEO pay, their decline may have also facilitated the explosion of compensation at the top. It is revealing that the rise in inequality was greatest in the United States and United Kingdom, where

the fall in union coverage was most pronounced.

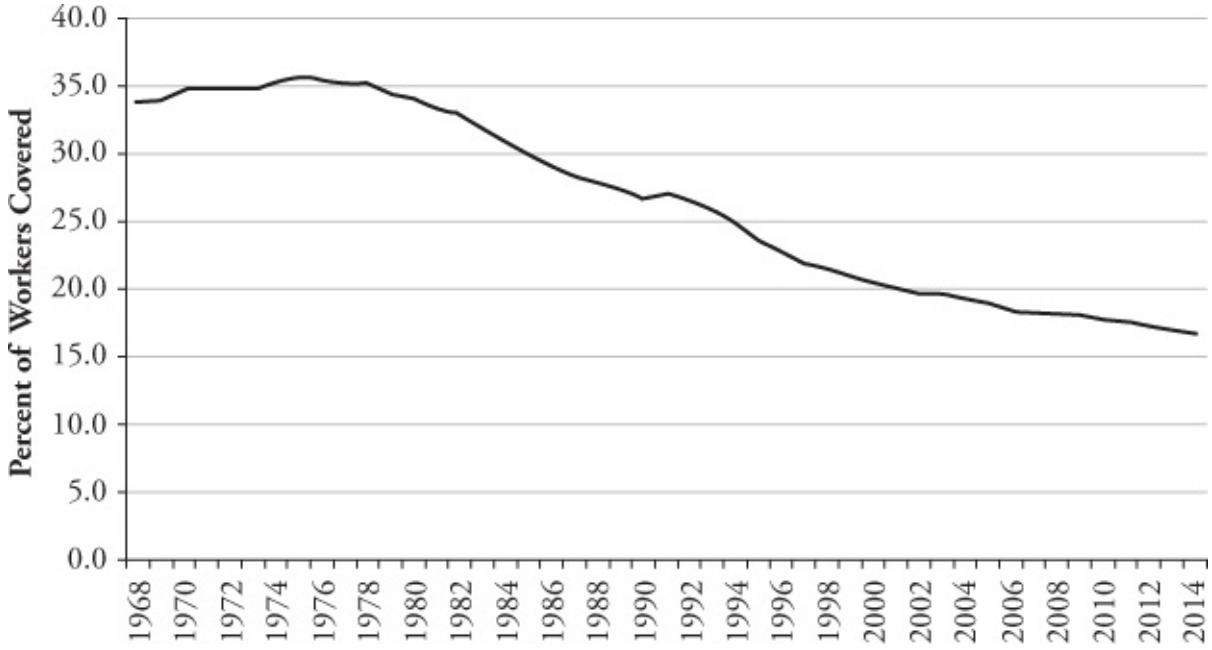

Figure 8.3 Trade Union Density in OECD Countries, 1968–2014

Source: OECD.Stat, https://stats.oecd.org/Index.aspx?DataSetCode=UN_DEN#.

An extended analysis of why unionization declined would take us far afield. One factor was the falling share of the workforce in manufacturing, where unions traditionally organize. That fall resulted from automation, globalization, and simple economic maturation, as we have seen. But it had negative implications for the union movement, given the greater difficulty of organizing workers in the service sector.[34] Another factor was the same skill-biased technical change described above. Changes in technology and organization favoring skilled workers, by creating new high-paying opportunities, weakened their support for union policies of wage compression, from which those skilled workers stood to lose. Those changes thereby undermined the coalition of skilled and unskilled workers traditionally supporting unions.[35]

The result was a vicious spiral of deunionization and inequality. As jobs were reorganized, improving opportunities and pay for skilled workers, those same skilled workers withdrew their support for union organizing efforts. Weaker

unions were less able to enforce norms of wage compression—they were less able to raise wages for less-skilled workers. Inequality rose further, advantaging skilled workers more. This in turn undermined the skilled-unskilled worker coalition still further, weakening the union movement even more and reinforcing the wage-inequality trend.

In addition, there was the changed political climate. By the 1980s, the role of union members in having helped win the war was a distant memory. A postwar settlement that spoke of social partners and shared wage norms was valued only so long as it successfully delivered fast growth. Hence as growth slowed, those norms were increasingly questioned by skilled workers who now saw themselves as sacrificial lambs. They voted in growing numbers for Reagan and Thatcher, who defined their political reputations in opposition to the air controllers and coal miners unions. In this changed political climate, employers were empowered to intensify their opposition to unionization efforts and free to relocate to regions like the U.S. South, where union tradition was weak.

Elected officials were also less inclined to embrace labor's legislative agenda. Organized labor was less effective in countering those who argued for lower top tax rates. Minimum wages were allowed to lag inflation where unions were in decline. A substantial body of evidence suggests that that increases in the minimum wage reduce inequality, and that reductions in the real value of the minimum wage have the opposite effect.[36] Modest increases in the minimum wage push up the earnings of those at the bottom of the income ladder at the cost of few if any jobs. They reduce turnover in firms employing low-wage workers, enhancing efficiency and encouraging hiring. The debate about the minimum wage may be ideologically charged, but the facts are reasonably clear. Similarly, that a more progressive tax system reduces inequality is self-evident.[37] But these inequality-reducing policy interventions became harder when organized labor was in decline.

Finally there was welfare state retrenchment. Slower growth meant tighter

budgets, making some welfare state cuts unavoidable. This was especially true in Scandinavia and the Netherlands, where the provision of social benefits overshot sustainable levels.[38] Unemployment benefits, pension payments, public employment, the public share of health care spending, and sick pay were all ratcheted up in response to the economic volatility of the 1970s.[39] Norms adapted to enable workers to exploit permissive aspects of the social-welfare system. By 1980, for example, fully 10 percent of Dutch workers were claiming sickness and disability benefits.[40] This situation, clearly, was unsustainable, a realization that led the Dutch to overhaul their system in 1987.

Welfare state retrenchment was as much political as economic, of course. Inequality meant greater social distance between more and less skilled workers and less inclination to contribute to collective goods.[41] Where unions were in decline, they were less able to support political candidates favoring an extensive welfare state.[42] Pension payments were cut back in the 1980s as aging populations put pressure on pay-as-you-go systems.[43] Unemployment replacement rates were cut in six OECD countries, with the largest cuts in the United Kingdom.[44] Sick pay was cut in another half dozen OECD countries besides the Netherlands. And even where welfare programs were not cut, their growth slowed or stopped. Replacement rates were lower in absolute terms at the turn of the century than they had been in 1975 in eight of seventeen countries in the case of sick pay, and in ten of eighteen in the case of unemployment insurance.[45]

Popular support for welfare-state institutions meant that these changes were incremental, not radical.[46] Pay-as-you-go pension systems, for example, were formidably difficult to reform. But the era when the welfare state grew faster than the economy was now over, and significant cuts were no longer the exception.

Indeed, the same pattern of cuts occurred both where the welfare state was most extensive, in Northern Europe, and where it was least, in the United States.

It was evident in countries with left-of-center and right-of-center governments. Retrenchment was undertaken in response to slower growth, aging populations, and fiscal strains. It reflected changes in technology and workplace organization that made for greater inequality and social distance between those up and down the economic ladder. It was influenced by ideology and by changed perceptions of the welfare state, ideology and perceptions that themselves flowed from underlying economic conditions. And the same factors operated, with broadly similar effects, across the advanced economies.

The bottom line is that there was now a more limited safety net protecting unfortunates who fell from the economic trapeze. The hopeful response to this was that the economy was now more stable, so fewer participants were at risk of losing their grip. This, recall, was the era of the "Great Moderation," from the second half of the 1980s through the first half of the 2000s.[47] Business cycle volatility declined not just in the United States but across the advanced countries. Economists credited a combination of improved policy (the stable monetary policies of inflation-targeting central banks) and good luck (the absence of commodity-price shocks and then improved productivity performance, especially in 1995–2005, when the boost from new information and communications technologies was greatest). Some observers credited financial deregulation and innovation for making it easier for households to borrow and smooth their spending over the cycle.[48]

Subsequent events, in the form of the global financial crisis, showed the Great Moderation to have been an illusion. The same factors credited with having reduced business cycle volatility—low and stable inflation, financial deregulation, and the absence of shocks as an inducement to risk taking—set the stage for an exceptional episode of volatility and economic loss. And that episode, it turned out, was one with which Western societies were singularly ill prepared to cope.