SOME COMMENTS ON PROF ED MASKIN'S PRESENTATION AT THE HDCA MEETING, JAKARTA SEPTEMBER 4 2012

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It's a great honor to be given the opportunity to comment on Prof Maskin's presentation which I enjoyed reading. It has introduced me to a new way of looking at skill differentials, and how they might relate to more intensive international economic relationships, commonly summarized under the catch-all phrase of 'globalization' (GLBN).

This is a theoretical paper and I regret that I do not have the tools to comment on more technical aspects of the model (developed in a separate paper with Michael Kremer). My comments on the paper are made in the context of a long interest in empirical and policy related dimensions of employment and labor markets, in Indonesia and Southeast Asia

I. INTRODUCTION

The presentation addresses one of the most important economic and social policy issues of the first decade of the 21st century: increasing **within-country** inequality in developing countries (LDCs), which has accompanied globalization

(Prof Maskin makes the obvious point that **cross-country** inequality has almost certainly have fallen in the first decade of the 2000s, with the rise in average incomes in the two giants India and China. But this is not the focus of his talk).

My comments will be made in four parts.

First, I will make a few comments on what I see as the relevant **context** for thinking about the GLBN-inequality relationship in East Asia, and Indonesia.

Second, I will try to restate the main arguments of the paper and some of the assumptions underlying it. Hopefully, this will be useful for less abstract observers (like myself) to help understand some of the important empirical and policy issues which the paper covers.

Third, I will make a few comments and raise a few questions on the main substance of the presentation, from what we know about empirical relationships mainly in East Asia. As you all know, this is a region where globalization has proceeded faster than anywhere else in the developing world in the past three decades.

And *fourth*, I will close with a few very brief comments on elements of the Indonesian situation that I feel are of relevance of the central ideas of the paper.

II.   THE CONTEXT

By way of background, the following points seem pertinent to me.

Inequality has not been as big a concern in East Asia as it has in other regions in the world. Increasing inequality, and the link to globalization, has not been a focus of policy debate in much of East Asia, to the extent it has in the USA, or Latin America, until quite recently.

- *There have been very major public concerns regarding of rising inequality in the **USA and several other DCs** for several decades.* Some (though not all) observers have associated these developments in DCs with increased GLBN. Prominent figures like George Stiglitz in his recent book "The Price of Inequality" has strongly criticized policies that have contributed to a less equal society in the USA (although most of these relate to government actions that are not directly related to globalization). Others like Dani Rodrik have called for a better (and more flexible) balance between government intervention and market activity. He argues that this is needed if globalization is to work for society as a whole, as well as for the poor.
- *Similarly, inequality and its link to globalization has also long been a serious subject of public debate in **Latin America**.* These complaints are newer in parts of Asia, partly because the early industrializers (especially Taiwan and Korea) experienced improving (or not deteriorating) income distribution for the first decade or more of rapid economic growth.

Debates in East Asia. In contrast to DCs and Latin America, the overwhelming policy concern in developing East Asia has been with poverty alleviation not income distribution. This is a subject which Amartya Sen has written about extensively. As you all know, on that score the outcomes have been quite favorable, in the rapidly growing and more globalized countries in the region.

However, I might suggest that renewed interest in the problem of inequality has probably grown in the wake of the GFC in 2008-9. As economic growth rates have fallen in several of the 'giant' developing countries such as China and India, increases in the wages of poorer workers that were once rising quite fast have slowed. As wages slow, people are becoming more aware of the widening gap in incomes with better-off households.

Now I want to turn to how Prof Maskin explains some of these inequalities.

III.   THE MAIN ARGUMENT AND ITS ASSUMPTIONS

The paper takes as a point of departure one of the central theorems/frameworks of modern economics: the **Heckscher-Ohlin** (H-O) model of international trade. As explained, this predicts that inequality should improve with globalization, essentially because unskilled workers in poor countries gain better job opportunities. They are drawn into more productive work through trade and investment links with the more developed countries (DCs).

Note that the paper does not address the issue of whether unskilled workers are better or worse off **absolutely** as a result of GLBN. Prof Maskin does not address this issue in the paper. It seems quite possible that workers could be worse off in monetary terms after globalization in the model described.

The crux of the argument lies in the theory of (**skill) matching**, which Prof Maskin applies to the changes in economic relationships with GLBN.

- In the simplest form of the model, recall that Prof Maskin identifies four levels of skill (A and B in DCs, C and D in LDCs, in descending order of expertise). He argues that the gap in skills is very large between highly skilled (A), and intermediate skilled (B) workers, especially with skills at level D in the LDCs.
- It is the magnitude of this skill gap which prevents the least skilled workers from matching with even the products produced with intermediate skills in DCs. Instead those with low skills (the D group) in Prof Maskin's model are forced to match with each other after GLBN. Thus they gain little in terms of jobs or productivity.
- Thus there is (more) *homogeneous* matching rather than *cross-matching*, to use Prof Maskin's terms, which is predicted by the H-O framework. The model shows that the more skilled C group of workers, who previously linked to D level workers in LDCs, now link with the second level skill B workers in DCs after globalization. Their wages go up relative to D level workers, and inequality increases.
  - **Examples** given in the paper include young relatively educated workers working in call centers in LDCs, linking to consumers, tourist companies and hospitals in developed countries.
  - Or more capable and better educated workers working in foreign companies, who tend to pay higher wages in LDCs.

IV.   COMMENTS AND QUESTIONS

I have a couple of thoughts and questions.

Fei-Ranis, Lewis. My first thought relates to ideas from development economics about income distribution at various stages in the process of economic growth, in the transition from a low income to a high income country. As Prof. Maskin knows much better than I, earlier theories of economic growth from Kuznets to Lewis and Fei-Ranis all predicted that income distribution would worsen in the early stages of economic growth. The so-called 'Lewis' model has been applied especially to countries like Indonesia. In these countries, the supply of unskilled labor in so-called traditional sectors is elastic and productivity very low.

In the open economy model developed by Fei and Ranis this framework holds. Thus economists have predicted for a long time that if rapid economic growth occurs hand in hand with globalization, inequality would increase in developing countries (at least until unskilled labor becomes quite scarce).

I have always found this a compelling argument to help explain worsening income distribution in the early stages of economic growth in a country like Indonesia. These countries support a high proportion of its work force in low productivity agriculture and the informal sector. When growth has been rapid, new jobs have been created at still very low levels of wages (unskilled jobs or D class workers in Prof Maskin's parlance). People are attracted to the globally linked industries which deploy labor more intensively. However, wages rise much faster among more skilled workers (class C workers) and capitalists in LDCs.

But of course the process and theory underlying it is different from that postulated by Prof Maskin. In particular, it focuses on the elasticity of supply of unskilled labor, or level D workers. As you all are probably aware, in the Fei-Ranis model, the wages of unskilled labor begin to rise as the labor market for unskilled labor tightens. Inequality may still increase, or it may not increase, partly depending on the supply of skilled manpower. Presumably this will depend partly on the extent to which there is cross-matching, as outlined by Prof Maskin. I would like to hear Prof Maskin's view of this as an alternative theory of wage dynamics in LDCs in a globalizing world.

*The supply of skills in **middle income** countries.* A second question relates to the extent of **homogeneous matching** in mostly middle income countries in Latin America that have experienced GLBN for decades. I can understand the application of Prof Maskin's theory to very poor countries in Africa, or some in Asia (Myanmar, Laos or North Korea?). Providing basic education is still a major challenge, especially where there is a history of economic (and political) instability.

But I don't entirely understand why the training recommended by Prof Maskin has not been undertaken (even self funded) to a sufficient extent to reduce the wage premium earned by more skilled workers in middle income countries, such as Mexico, Chile and Brazil, which have been globalizing for some time. Or why haven't efforts to provide more skills by the governments worked better? Perhaps Indonesian policy makers can learn from this experience, since a lack of ready-to-use skills is often cited as one explanation for high levels of youth unemployment.

Empirical testing and applying theory to devise better policies. That leads to my **third question**. How can we study these problems of cross-matching and homogeneous matching empirically? I presume it requires a pairing of data on skills, and on industry and firm characteristics. These data should in turn be linked to broader processes of global engagement. This may be quite challenging empirically.

More broadly, one of the organizers of this conference has asked me to put a similar question in a slightly more abstract format: how might you Prof. Maskin provide insights from the theory of **mechanism design** (for which as you all know he was were awarded the Nobel Prize), and meeting the needs of **individual rationality** and **incentive compatibility** constraints, to produce policies that reduce inequality, in relation to globalization?

V.   INDONESIA

Finally a few observations on **Indonesia** which Prof Maskin, or members of the audience might wish to reflect on.

Gini Ratios on the rise. First, national gini ratios in general in Indonesia have been **rising** in recent times, although they are quite low (around 0.37-38 – partly a function of measurement procedures). This has occurred in a period when the Indonesian economy has been seemingly somewhat divorced from trends in the world economy, and little affected by GFC. Casual empiricism suggests that homogeneous matching related to widening skill gaps in the international arena may not be significant factor behind these developments. Two elements seem to be important.

- One is the rapid rise of a middle class whose wages are mainly earned in a growing modern services sector.
- A second appears employment creation and high wages related to the rise in prices and output in natural resource-based mining and agricultural activities (especially coal and palm oil) in the regions outside Java.

It should be noted however that gini ratios did also rise in Indonesia in the later years of the Soeharto period in the 1990s. Wages began to increase, at a time when Indonesia was host to a lot of FDI in export-oriented manufacturing. At the same time, government and crony intervention in the economy was reputedly growing.

Stubbornly high skill premia: A second feature of income distribution, perhaps partially related to globalization, has been stubbornly high skill premia (that is wage premia for skills) for upper secondary and tertiary workers in Indonesia. This is despite a significant increase in the supply of such workers entering the work force in recent years. The supply of more educated workers has close to doubled in the past five years or so, yet the skill premia in relation to less educated workers has continued to rise. I wonder whether Prof Maskin has any thoughts, or comparative information, on this process.

VI.   CLOSE

These are my few thoughts on what is a very interesting and challenging set of ideas that Prof Maskin has presented to us today. Terima kasih.