

Growth, Inequality and Globalization: Theory, History, and Policy

Phillipe Aghion and Jeffery G. Williamson, Cambridge University Press, 1998, 207pp.

To what extent is some poverty necessary for economic growth? Does poverty motivate the poor to work harder, enabling them to both escape their poverty and in the process increase the total wealth of society? Or does poverty on balance promote those negative influences such as ill-health and a lack of proper education that prevent the poor, and hence society, from attaining its full wealth potential? What effect does a redistribution of wealth from rich to poor have upon the growth rate? Would the poor manage the extra wealth thereby gained in a manner more beneficial for society than when the rich managed it? How does income disparity within an economy wax and wane as growth takes place, and how does income disparity between economies change in the face of globalization? Perhaps most important of all, what can political economists learn from past experiences in informing policy recommendations for the future?

Such are the questions to which two professors of economics address in *Growth, Inequality and Globalization: Theory, History, and Policy*. In the first of two discussions on the topic, Phillipe Aghion from University College London adopts a largely mathematical approach. In the second discussion, Jeffery G. Williamson from Harvard undertakes an empirical analysis. These two approaches compliment one another rather well.

Two ideas are generally handed down to the modern student of economics on the relationship between growth and wealth inequality. One is based upon an incentives theory according to which inequality promotes faster growth. The other derives from the Kuznet's hypothesis which holds that, as an economy passes through a growth phase, inequality first increases and then decreases with the onset of maturity. Aghion labels both of these ideas as fallacies, briefly citing recent evidence which shows widening income inequality in the United States. His mathematical modeling further shows that, under certain circumstances, increases in inequality (as measured by the increased dispersion of investment holdings among members of the society) can lead to lower growth. This is because the marginal return on investment for the poor is greater than for the rich. In plain language, poor people can create more wealth with an additional unit of investment assets than the rich can. Hence, if the rich have all the assets, society as a whole may not achieve the highest available returns. In a perfect capital market, the rich could perhaps lend or invest their surplus

wealth to be utilized by the poor at their (higher) marginal rate of return on investment, but in reality capital markets are not perfect and, therefore, this process does not occur. A resulting policy recommendation is that the state should promote an increase in the efficiency of capital markets and credit institutions.

On the relative shift in demand for skilled labor over unskilled labor in developed countries, and the resulting increase in wage inequality between those two groups, Aghion examines three competing explanations. These are: first, the impact of trade with developing countries which tends to lower the demand for unskilled labor; second, technological change which tends to increase demand for skilled labor; and third, organizational change (for example the weakening of institutions such as trades unions) which tends to undermine the wage bargaining power of lower skilled groups. Aghion concludes that trade liberalization has probably had a negligible impact on shifts in demand for labor in the US and the UK. Technical progress, however, has had a much more marked effect upon inequality through the increasing demand it places on the provision of labor from skilled rather than unskilled groups. Various evidence is cited to support the idea that de-unionization has accounted for a substantial increase in wage inequality, in particular where it has resulted in a weakening of minimum wage regulations. Interestingly, the impact of increased education upon wage inequality is seen to be ambiguous. Indeed, such training may serve to increase productivity growth — in high technology industry for instance — thereby reinforcing the demand for skilled over unskilled labor.

Behind Aghion's conclusions is an approach that will probably leaves those unfamiliar with mathematical economics at a loss. Though provable in a way that social science often is not, and though elegant in its formulation, the mathematical method is often a suspect one when employed in economics. Indeed, to maintain its coherence, mathematical economics usually demands unrealistic assumptions of its practitioners. In order to model an economic system sensibly, one must know which variables are at work within and without that system, what their interaction is, what constants exist, if any, and so on. Admirers of the chaos theory will realize too the importance of knowing the precise starting conditions for the variables one has identified. How many economists, I wonder, can say that they honestly know what all these variables are, let alone how they interact?

Less comforting still for the Muslim reader is the extent to which the rate of interest appears in the mathematics quoted and adopted in Aghion's essay. What, for example, is one to make of Ramsey-Cass-Koopman's proposition that the optimal rate of consumption growth is a function of the after-tax real

interest rate? Would Allah make the optimal rate of anything a function of an interest rate? As usual there follows a qualification: in this case that the proposed relationship between growth and interest rate exists only where agents (people like you and me) are infinitely lived and identical to one another. Some qualification! Yet this particular model has reinforced a view that redistribution of wealth to the poor reduces economic growth.

Despite his use of mathematical methodology, Aghion should at least receive credit for using it to challenge such simplifying assumptions as those that underlay Ramsey-Cass-Koopman's model. He shows that when more realistic assumptions are employed, far from being slower, growth can actually be faster under a system of wealth redistribution based upon lump-sum tax and transfer payments.

Given Aghion's demanding analysis, Williamson's historical narrative on globalization and wealth convergence will come as something of a relief to the lay reader. This author relies heavily upon real wage data on the basis that such is a more indicative and reliable measure of wealth (and hence of the dispersion of wealth between nations) than the standard GDP-based measures that are used elsewhere. These GDP-based measures have misled earlier economists, argues Williamson. This is particularly true in respect of the 1870–1913 period, which is an interesting time for scholars of globalization given the trading patterns and the millions of individuals that were then migrating to the Americas from the Old World countries.

It seems a reasonable proposition that the abundant resources of the New World would have flooded the markets of the Old World, thus cheapening prices, and that migration from the Old World to the New would have increased unskilled real wages in the former but reduced them in the latter. Yet some economists — Abramovitz and Baumol for instance — have held that convergence of wealth between the globalizing nations did not occur prior to 1913. According to Williamson, this is a mistake that results from a wrong choice of data source, because if the level of real wages among countries are examined, instead of figures for GDP per worker or GDP per capita, then convergence clearly appears. Admittedly, convergence is retarded here and there, for example by the actions of land-owning classes who lobbied for the imposition of tariffs, but the overall impact of free trade is clear. Factor price convergence is especially dramatic between the high-rent low-wage Old World and the low-rent high-wage New World, though statistics for GDP per worker hardly show this convergence trend at all.

For Williamson, trade, capital flows, and migration explain at least 50 percent of the real wage and living standard convergence between the Atlantic economies in the 1870–1914 period. Among these factors, migration is held to

be the most important, alone explaining 40 percent of the convergence. Models based upon chronological catch-up and accumulation of capital in a closed economy miss the point in explaining these trends. Instead, Williamson proposes globalization as the underlying cause.

The convergence of wealth within countries receives analysis too. Exactly how does the relative wealth of the various social groups within the domestic economy change as globalization occurs? The data seems to point to a greater dispersion of income between the lower and higher income groups in the New World countries as the absorption of primarily unskilled immigrants took place. Regarding the richer of the Old World countries, Williamson argues that whilst emigration, from Sweden to the United States for example, explains much of the lessening of the wage gap between the two countries, it does little to explain a substantial raising of real wages within Sweden itself during the period under consideration. Other factors were at work here, and perhaps wisely we are left to guess what they may be.

According to Williamson, the late twentieth century and the late nineteenth century share two things in common: on one hand, convergence and globalization, and on the other, divergence of income in the rich countries and convergence of incomes in the poorer countries. So what political comparisons can be drawn between the two eras? Interestingly, even the pre-1913 period shows some telltale signs of political reaction to widening inequality. For example, tighter immigration policies were already being discussed in a hesitant Congress at the end of the nineteenth century. Eventually, the perceived deterioration of living standards among the working poor, pressured by millions of unskilled immigrants from the Old World, determined a political response. Meanwhile, in some European countries, the landed classes exerted pressure for protective barriers to be raised against cheap commodity imports for their own selfish reasons. Thus Williamson assembles evidence for his conclusion that globalization may inspire a retreat away from open policies and towards protectionism.

Aghion's theoretical mathematics and Williamson's empiricism are both deductive approaches, the stock in trade of thousands of economists who ponder how man may better his lot. But for all this intellectual effort, how much has our understanding of the economic environment really advanced? Much of humanity is living in poverty and under the influence of debt interest. Meanwhile, a few thousand people own almost one-half of the planet's financially measurable wealth. This is the reality of inequality in our time. One cannot help but be a little cynical when the financial establishments of the rich world promote their economists to theorize on the cause of this distressing situation. And not one word on fractional reserve banking.

Among some Muslims there is, I suspect, a fear of the Western economists who invent new terminologies and methodologies and then intellectually terrorize others for failing to learn them. Perhaps driven by a desire to be accepted by these men, others among us adopt the same Western methodology in their work. I grant the two professors their mathematical and empirical due, but intelligent minds and reliable data are no substitute for Allah's guidance. Allah has prohibited interest and He requires annual wealth redistribution. Here alone is a sufficient basis for discarding huge quantities of godless theorizing in the field of economics. From the perspective of economists raised in the Western mold, this will probably be seen as a well-argued and well-researched piece of analysis. For me, it confirms how much humanity is in need of an economics that is normative and based upon revealed knowledge.

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