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Labor market institutions, international capital mobility, and the persistence of underdevelopment

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Abstract

We show that the impact of globalization on growth and wages crucially depends on the labor market structures of the countries involved. We contrast bargaining and perfect competition. Under perfect capital markets, convergence of capital and income per capita always occurs despite different labor market structures. However, different labor market structures prevent convergence of the income shares, with unionized countries showing a lower wage rate and consequent capital inflows. Therefore unionization, not globalization, is the cause of discrepancies in the within-country income-distribution patterns. Openness is always preferable to autarky for a small developing economy, independently of its labor market structure.

Keywords: Wage bargaining; Globalization; Convergence; Underdevelopment

1. Introduction

The current expansion in international trade and capital flows has linked the economic performances of the developed countries to those of the developing countries as never before.[1] However, the process of integration has been much faster for capital markets than for labor markets and their institutional structure. Within the ongoing debate on the impact of globalization, its potential connection with the issue of labor markets rigidities has not yet been addressed. The main contribution of this paper is therefore to uncover the implications of differential labor market structures for an integrated world.

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[1] See Dowrick and De Long (2001) and Lindert and Williamson (2001) for a recent assessment with a historical perspective.

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The crucial questions that have been raised, and that are still largely unanswered, are the following: Does globalization induce convergence of income and wages? Do workers in rich countries always lose from globalization? And what is the impact on workers in the developing countries? With respect to the first question, i.e., the relationship between globalization and convergence, perfect international capital markets are conventionally viewed as an element that strengthens the case for convergence, and can indeed assure its instantaneous achievement (see Barro and Sala-i-Martin, 1995). In this paper we explore the potential impact on income convergence of differential labor market structures, thus departing from the perfect-competition benchmark with a special focus on to the markets for labor. The second and third questions have to do with the effect of globalization on wages, both in the developed and the developing countries, and in particular with its implications for the relative balance of power between capital and labor within each country. The framework we provide, which distinguishes between different labor market structures, allows to evaluate these questions from a novel perspective.

The effect of globalization on wages in developing country has so far received only superficial attention in the economic literature,[2] despite the fact that in developing countries labor is an abundant resource. Moreover, in a situation where the developing countries' capital thirst cannot be satiated by the scarcer and scarcer saving of the developed countries, domestic labor income plays a crucial role in the process of development. Thus, labor market institutions, and in particular labor-union strength and organization, do carry very important implications for growth in emerging countries. Some of them, such as Eastern Europe, Israel, India, South Africa, and many Latin American countries, have a long tradition of unionization, while others, especially the East Asian NICs, can be viewed as an archetypal case for *laissez faire*.[3] We will show how these countries' relative performances depend crucially not only on the structure of their local labor markets, but also on their decision to open up their economies, and on the labor market structure of their partners. For example, opening towards a country where wages are essentially competitively determined, such as the United States, may have very different growth implications than opening towards countries of the European Union, where bargaining dominates.[4]

We derive our results within a dynamic general-equilibrium model of an open economy with differential labor market structures. Therefore, in contrast with most theoretical and empirical investigations, we pose the convergence question in a model when interactions across countries are explicitly taken into account. We start with an analysis of two different labor market structures, perfect competition and bargaining, in a closed economy. Under bargaining, because of the existence of competitive markets for capital, the relative strength of capital is augmented by the availability of an outside option,[5] i.e., a credible threat to leave the bargaining table, which has the power to reduce wages, and in turn savings and

[2] A notable exception is Krugman and Venables (1995).

[3] Fields (1994), Fields and Wan (1989), Wood (1999), and Saba Arbache (2001) provide descriptions of labor markets in developing countries.

[4] Nickell (1997) provides a recent assessment of the differences in wage-setting institutions between Europe and North America.

[5] Binmore et al. (1986) and Sutton (1986) discuss outside options in a game-theoretic framework.