Why Has Inequality Been Rising?

(based on work with M. Kremer)

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I.S.E.O. Summer School

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- Increases are theoretically puzzling

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- Why not?

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  - leads to greater *relative segregation* of skill *within* firms

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- segregation prediction borne out by evidence for U.S., U.K., and France

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- globalization (increase in trade) *aggravated* inequality

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- trade should *decrease* inequality in Mexico

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- But first return to inequality in U.S. (also U.K. and France)

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- $p\left(q\right) =$ proportion of workers having skill q

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(iii) different tasks *differentially sensitive* to skill

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  - so inequality between q-worker and $\frac{q}{2}$-worker can't increase

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$$\text{implies } q_m > q_s$$

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– equality if $\pi^*(q,q') > 0$ (no profit in equilibrium)

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$\pi^*(M,M) = 0$ from (1)

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- Notice $\frac{\partial w^*(L)}{\partial M} > 0$ $\quad$ $\frac{\partial w^*(H)}{\partial M} < 0$

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- Notice $\frac{\partial w^*(L)}{\partial M} > 0$ $\frac{\partial w^*(H)}{\partial M} < 0$

  Proposition 1: Starting from low skill dispersion, $H < \sqrt{2}\,L$, increase in median skill *reduces* inequality in wages (and raises mean and median wage)

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and if either *L*-workers or *M*-workers not self-matched, at least one equality strict

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then mean-preserving spread in distribution *increases* segregation index ρ

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- intuitively, B rises as weight in tails increases

Return to globalization and Mexico

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  - but Mexico trades much more than Malawi with U.S.

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- production $\text{output} = q_s q_m^2$
- before globalization (i.e., in autarky), workers can match only *domestically*
- after globalization, *international* matching possible

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Proposition 3: If D-workers have sufficiently low skill, i.e.,

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then globalization *increases* inequality in poor country

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- $w_g^*(C) \geq w_a^*(C)$ because of possible matching with *B* or *A*
- Hence, $w_g^*(C) - w_g^*(D) \geq w_a^*(C) - w_a^*(D)$ - - globalization causes rise in inequality

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Case II $\quad p(D) < p(C)$

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Case II $\quad p(D) < p(C)$

- $\pi_a^*(C,C) > 0 \quad \Rightarrow \quad w_a^*(C) = \dfrac{C^3}{2}$

$$\Rightarrow w_a^*(D) = \max\left\{\frac{D^3}{2}, DC^2 - w_a^*(C)\right\}$$

- $w_g^*(C) \geq w_a^*(C)$ - - at worst C-workers can self-match
- $w_g^*(D) = \max\left\{\dfrac{D^3}{2}, DC^2 - w_g^*(C)\right\} \leq w_a^*(D) = \max\left\{\dfrac{D^3}{2}, DC^2 - \dfrac{C^3}{2}\right\}$
- Hence, again $w^*(C) - w^*(D)$ rises with globalization

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- workers in Malawi have very low skills $\Rightarrow$ no international matching opportunities

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  - role for investment by *third parties*
    domestic government
    international agencies, NGOs
    foreign aid
    private foundations