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**ACT HAMILTON ELECTORATE**

**THE THIRD WAY: NEW PACKAGING,  
OLD PRODUCT?**

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**HAMILTON  
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## **THE THIRD WAY: NEW PACKAGING, OLD PRODUCT?**

The search for a middle way is often a perfectly sensible approach to public policy. An objective of simply 'downsizing' government, for example, would be just as silly as the old socialist objective of public ownership of the means of production, distribution and exchange. The interests of New Zealanders are best served if the division of functions between the public and private sectors is determined according to their relative efficiency. The proper goal is to 'right-size' government. There is nothing novel about this idea – it has been a principle followed in many areas of economic policy reform in New Zealand during the 1980s and '90s.

Paradoxically, however, the 'third way' has come to be associated with a particular set of views that are not consistent with establishing sensible boundaries between the public and private sectors. Advocates of this 'third way' argue for an increase in the role of the public sector, despite analysis that suggests it should be reduced in the overall community interest. I might have said 'further reduced' but that would hardly be accurate given that, for example, government spending on social welfare has continued to increase – from 11.6 percent of GDP in 1983 to 13.5 percent in 1998 – so that it is now more than double its level in the early 1970s (6.2 percent of GDP in 1972).

In New Zealand the idea of a third way was resuscitated last year by the visit of the former US labor secretary, Robert Reich, at the invitation of the Labour Party. During his visit Reich made some good points. One was that globalisation should be accepted, not just because the costs of resisting it are high but because of the beneficial effects of wider markets. Another was that with increased international mobility of capital, a nation's future well-being depends more heavily on the productive capacity of its people – which is partly determined by investment in education and training. In this context he argued for education vouchers at the compulsory education level and for funding tertiary education largely through student contributions – sound ideas which have not yet been taken up by his hosts.

However, the part of Reich's message I want to challenge is his view that in order to maintain social cohesion, the governments of wealthy countries need to adopt a long-term strategy which involves "active market interventions that seek to widen the circle of prosperity and enable more people to be full participants in a global economy". The basic problem, as Reich perceives it, is that "global forces are pulling our societies apart".

Are they really? Would the policy solutions proposed by Reich actually help people who are hurt by globalisation? If available evidence suggests the answer to these questions is 'no', why would anyone think Reich's 'third way' is either necessary or desirable.

### **Trends in income inequality**

Robert Reich's view that global forces are pulling our societies apart is based on a revival of the old idea that the rich are getting richer while the poor are getting poorer.

Over the past 200 years, that claim is obviously wrong. In all the industrial countries, living standards have increased more than at any other time in history. The average citizen today lives better than all but a privileged few less than 10 generations back. Just in the past 50 years, the populations of Japan and some other countries in Asia have risen from poverty to levels of income that exceed New Zealand's. A rising tide lifts all boats, if not at the same time and speed. General economic growth is far more important than changes in the share of national income between different groups in improving material living standards.

Moreover, in the successful parts of the world the trend has been towards greater equality in incomes. Many former third world countries have greatly narrowed the gap with the living standards of the West. Within advanced countries the gap between rich and poor has narrowed over the past century. Today's beneficiary has a better standard of living than the average worker 50 years ago. The rich have grown richer but the poor have grown richer faster.

To be sure, those trends have not been at work in all countries at all times. Poverty alleviation and reduced income gaps have been most clearly associated with relatively open, competitive economies – Taiwan, for example, has enjoyed rapidly rising incomes and one of the most even distributions of income in the world. Centrally planned and socialist economies have suffered from stagnant and often very unevenly distributed incomes: Trotsky reported that in 1939 the top 11-12 percent in the Soviet Union accounted for around 50 of total income – a far higher proportion than anywhere in the West. I think a focus on improving the position of the poor is much more important than a concern about income gaps – there is no obviously 'right' distribution of income. But as the attached chart shows, it so happens that freer economies are associated over the long run with more evenly distributed incomes.

In New Zealand, the evidence suggests that some of these long-run trends have been interrupted over the past 15 years. Statistics New Zealand has recently traced what has happened to the distribution of New Zealanders' real disposable incomes (adjusted for household composition) over the period from 1982 to 1996. It finds that there has been an increase in inequality, with most of the increase occurring between 1986 and March 1991 (ie during the Labour government's term of office and before the 1991 benefit cuts). This increase is primarily due to those at the top of the income distribution becoming relatively better off, those in the middle becoming slightly worse off, and the income share of those at the bottom remaining unchanged. Thus, contrary to popular opinion, the poor did not become poorer during this period; policies aimed at safeguarding their position were successful.

A key factor affecting pre-tax market incomes in the 1980s was the action of the Labour government in embarking on a major programme of industry restructuring while failing to address the problems of New Zealand's rigid labour markets. As a result, many thousands of workers were condemned to unemployment, which is always a major factor in inequality and hardship. The Statistics New Zealand research shows that in the early 1990s the deteriorating trends were arrested with the freeing up of the labour

market and the rapid fall in unemployment which was helped by a more consistent policy framework and general economic growth.

It should also be remembered that the population in the bottom income deciles (or any others for that matter) is not static. The Statistics New Zealand research refers to broad income shares. A large number of those who were in the bottom 10 percent 10 years ago will have improved their position (and some in the top bracket will have moved down). For most people the prospect of moving up the income ladder is more important than the rung they occupy on it at any point of time.

With the weakening of the policy framework since 1993, especially the loss of fiscal discipline, and the damage done by the Employment Court to labour market flexibility, unemployment has been on the rise since 1996. The most distressing statistic and testament to poor policy is a Maori unemployment rate which has gone back up to nearly 20 percent again. High unemployment also puts downward pressure on the wage rates of the working poor. Although the recent tax cuts and increases in family assistance will have benefited many at the low end, it would not be surprising if some trends in income are going in the wrong direction again.

As in New Zealand, trends in income data in other countries need to be interpreted with care. In the United States, the idea that the poor got poorer as the rich got richer during the 1980s and early '90s is based on income data which is averaged over several different types of family structure. The picture looks different if the data is disaggregated to enable the incidence of poverty among groups with particular types of family structure to be observed. Bill Cline, an economic researcher who has undertaken a major study of income distribution and trade in the United States for the Institute for International Economics, has commented as follows:

The striking feature of the more disaggregated data is that they show the incidence of poverty has been about constant or declining in almost every major category in recent years, except for white families with female head of household and no husband present. This means that the increase in overall poverty has come to an important degree from a shifting composition of the population toward those categories with higher poverty incidence, rather than from a generalised deterioration

within each category.<sup>1</sup>

In recent years it appears that the US economic boom of the 1990s has lifted incomes in practically all categories, but some of the problems of the so-called underclass remain deep-rooted.

### **Why advocate minimum wages?**

Many people associated with welfare organisations and churches – people who are genuinely interested in reducing poverty – have tended to support labour market interventions including regulations governing hiring and firing, minimum wages and other regulatory interventions that make it harder for people to obtain work. It is puzzling how anyone could advocate minimum wage regulations, as Robert Reich does, as part of a package of policies which is meant to be an alternative to what he describes as "the mythic contest between the free market and government intervention". The regulation of minimum wages has all the characteristics of the old interventionist approach of attempting to achieve desired outcomes by imposing crude and counter-productive government controls.

The limitations of statutory minimum wages as an anti-poverty device are apparent when it is realised that:

- people who earn low wages do not necessarily come from poor families; and
- wage rates set at levels higher than the productivity of young and low-skilled workers in particular simply exclude them from the labour market.

A recent OECD study shows that there is not much overlap in OECD countries between people who are low paid and those who are in low income households. The results indicate that a high proportion of low paid workers are in households that earn

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<sup>1</sup> W Cline, *Trade and Income Distribution*, Institute for International Economics, Washington DC, 1997, p 8.

moderate to high incomes in all 13 countries included in the study. The lowest proportion is in the United States, where 62 percent of low-paid workers come from households which earn moderate to high incomes. Even Robert Reich acknowledged in 1997 that "most minimum wage earners are not poor".

The study also shows that there is a low incidence of low paid workers among families that are in poverty. The highest incidence of low paid workers among persons aged 16 and over in families in poverty was 13 percent. That figure relates to the United States – the percentage in most other countries was substantially lower. The OECD comments on the reasons for this result as follows:

The biggest reason ... is the large number of individuals who do not work at all. The low incidence rates make it apparent why minimum wages cannot be considered – and are not designed to be – a tool to reduce poverty across all families: unless workers are present in a household, higher wages cannot affect that household's income.<sup>2</sup>

What this amounts to is an acknowledgment by the OECD that minimum wage policies are poor tools for reducing poverty. They are a cruel hoax on the most marginal workers, preventing them from getting a foot on the bottom rung of the income ladder. No pay is worse than low pay. Testifying recently before the US Congress, Federal Reserve chairman Alan Greenspan called for the US minimum wage law to be abolished. Those genuinely concerned about the appalling rate of unemployment among young Maori in New Zealand should be doing the same here.

### **What determines trends in wages?**

The fear that market forces are moving us toward a divided and less equal society is nothing new. Karl Marx was, of course, its foremost exponent. But even J K Galbraith, an author who has long been a strong supporter of increased government intervention in economic affairs, recognised in *The Affluent Society* that:

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<sup>2</sup> OECD, *Employment Outlook*, June 1998, p 52.

The first reason why inequality has faded as an issue is, without much question, that it has not been showing the expected tendency to get worse. And thus the Marxian prediction, which earlier this century seemed so amply confirmed by observation, no longer inspires the same depth of fear. It no longer seems likely that the ownership of the tangible assets of the republic and the disposal of its income will pass into a negligible number of hands ...<sup>3</sup>

Galbraith argued that "it has become evident to conservatives and liberals alike that increasing aggregate output is an alternative to redistribution or even to the reduction of inequality".<sup>4</sup> Robert Reich on the other hand maintains that while this "was probably the right advice at the time", a trend toward greater inequality has since emerged.<sup>5</sup>

Has there been a fundamental change in the functioning of economic systems during the past 40 years? Does recent experience suggest that Marx may have been correct after all in his argument that the labour-saving bias of technological progress would tend to result in a reduction in real wages and increased misery among workers?

The evidence suggests otherwise. Across the world, real wages are highest in the countries which use the most advanced technology and have the highest output per worker.<sup>6</sup> Over the decade to 1995 the relationship between real wage growth and productivity growth has remained strong even in countries with high initial productivity levels – the countries with relatively high productivity growth rates have tended to have relatively high real wage growth. The average rate of growth in real wages (measured by business sector labour costs) for the five OECD countries with the highest growth in labour productivity (measured as GDP per person employed) was 1.8 percent per annum whereas that for the five countries with the lowest growth in labour productivity was zero.<sup>7</sup>

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<sup>3</sup> J K Galbraith, *The Affluent Society*, Pelican Books, 1962, p 78.

<sup>4</sup> Galbraith, *op cit*, p 88.

<sup>5</sup> Robert Reich, 'America's Anguish', *Australian Financial Review*, November 6, 1998.

<sup>6</sup> See, for example, *The Economist*, September 20, 1997, p 42.

<sup>7</sup> There are 20 OECD countries included in the data set on which this calculation is based. Average annual real wage growth for each quartile ranked by productivity growth was as follows: 0

The OECD is projecting that rates of growth in the labour force of OECD countries will be substantially lower over the next 20 years, even if there is a trend towards later retirement. There has been a great deal of discussion of the implications of changing age distributions for dependency ratios. Perhaps more thought should be given to the possibility that lower labour force growth rates may result in more rapid growth in real wages in the future.

### **Is globalisation reducing wages of unskilled workers?**

There are sound economic reasons why globalisation – freer trade in goods and services and greater international mobility of capital – may have made some contribution to the widening margin between the pay of skilled and unskilled workers that has been observed in many industrialised countries since the early 1980s. It is an implication of the Stolper-Samuelson theorem – a basic foundation of international trade theory – that trade between wealthy countries, which are relatively well endowed with skilled labour, and poor countries, which are relatively well endowed with unskilled labour, will tend to reduce the price of unskilled labour and increase the price of skilled labour in wealthy countries. As *The Economist* puts it:

The effect of imports from poor countries is therefore akin to expanding the supply of unskilled labour in the West, which causes its price there to fall. If this is so, then trade with the developing world may make the advanced economies as a whole better off, but at the expense of lower pay for the unskilled.<sup>8</sup>

On the other hand, of course, unskilled labour in poor countries tends to benefit from these trends.

There has been a great deal of academic research on the effects of globalisation. A good survey of the relevant literature has been undertaken by Bill Cline, who argues that there are grounds to reject extreme estimates (both high and low) of how much of the observed increase in disparity between skilled and unskilled wages in the United States is attributable to globalisation. Cline concludes that "on a balanced reading of the

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<sup>8</sup> percent; 0.9 percent; 1.1 percent and 1.8 percent.  
*The Economist*, September 20, 1997.

existing literature, about one-fourth to one-fifth of the nearly 20 percent rise in the skilled/unskilled wage ratio over the past two decades has been from the influence of trade and immigration".<sup>9</sup>

Cline also makes the important observation that the increase in the skilled/unskilled wage ratio was the net effect of several factors. For example, in the absence of any other change, the increase in availability of skilled relative to unskilled labour in the United States over this period could have resulted in a fall in the ratio of skilled to unskilled wages of the order of about 40 percent. When account is taken of a whole range of factors, including labour-saving technological change, which are likely to have increased the skilled/unskilled wage ratio, Cline concludes that trade and immigration may have accounted for "only about one-tenth of the gross unequalizing forces".<sup>10</sup>

Cline makes several other points which help to put the effects of globalisation into perspective:

- Despite globalisation, a large sector of all economies is devoted to production of goods and services that are not traded internationally. This tends to limit the effects of free trade on the skilled/unskilled wage ratio.
- Even if all goods and services were traded internationally, the wages of both skilled and unskilled workers would remain much higher in industrial countries than in developing countries because of the higher technological efficiency of the former (and the relative absence of problems such as corruption and weak legal systems). Despite lower wages, the average labour cost per unit of output of manufactured goods is often higher in developing countries than in industrial countries.
- The impact of increased trade on the absolute wage levels of unskilled workers in the United States was substantially offset by its effect in reducing the prices of

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<sup>9</sup> *Op cit*, p 257.

goods purchased by these workers.

- Future moves toward free trade are unlikely to cause much change in wage inequality and are unlikely to cause absolute reductions in unskilled wages.

### **Would increased education subsidies reduce inequality?**

It is arguable that by increasing the supply of skilled labour relative to unskilled labour, further public subsidies for education and training could arrest further increases in the ratio of skilled to unskilled wages. There is some evidence which suggests that the increase in this ratio in the United States is partly attributable to the fact that "the supply of educated workers increased at a decreasing rate during the 1980s".<sup>11</sup> There is also some evidence that countries in which the supply of skilled labour has increased most rapidly experienced smaller increases in the ratio of skilled to unskilled wages.<sup>12</sup>

However, reducing the ratio of skilled wages to unskilled wages does not make much sense as a public policy goal. In terms of equity, it is not obvious what is gained by imposing high taxes in order to subsidise the tertiary education of people who come from high or middle income families. Moreover, given the increasing ability of skilled people to sell their services into a global market, it is even doubtful whether the training of increased numbers would have much effect in the longer term on the ratio of skilled to unskilled wages in some occupations.

Government subsidies to education also have important implications for the efficiency of resource use. It is likely that government subsidies tend to encourage some students to undertake studies which they would not otherwise undertake, even if they had access to long-term loans to cover fees. Given research findings that the benefits of higher education are very largely captured by the students themselves, in terms of their higher lifetime earnings, there must be a strong presumption that subsidies to higher education

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<sup>10</sup> *Ibid*, p 268.

<sup>11</sup> P Gottschalk and T Smeeding, 'Cross-National Income Inequality', *Journal of Economic Literature*, Vol XXXV (June 1997), p 650.

lead to a misallocation of human resources.

Public investment in education is a major plank of Reich's third way. He asserts:

What keeps and attracts private sector investment to any given place on the globe is the quality of public investment in education, job training and human capital in general.<sup>13</sup>

A moment's reflection indicates that this claim is nonsense. Russia has maintained quite high standards of scientific and technical education, but this advantage is of little avail in attracting investment in a general climate of lawlessness and weak institutions. There is plenty of evidence of the importance of human capital in the economic growth process, but none I am aware of that suggests higher public subsidies for education raise average wages – often they create gluts in the graduate labour market and lead to emigration of many of the most heavily subsidised.

The critical issue is how the efficiency and equity of existing arrangements for the provision of education services can be improved. The Business Roundtable's view is that the efficiency goal could best be met through a subsidy based on the public good element of courses. On average, this element is unlikely to exceed 30 percent of university tuition fees. The equity goal would be best met by targeting disadvantaged students rather than by universal subsidies.

When the introduction of a greater element of user pays in education is suggested, there is a tendency for some people on middle and higher incomes to raise the argument that they are already paying for the cost of their children's education through high tax rates. In fact, what they are paying for through high tax rates includes the provision of many different forms of state welfare for their own groups and substantial waste associated with inefficient use of resources, including the deadweight costs of taxation. A general move away from public provision and middle class welfare would result in a lower structure of taxes, providing more scope for self-reliance by people who do not really need government assistance.

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<sup>12</sup> Gottschalk and Smeeding, *op cit*, p 655.

## Defining the real problem

Robert Reich presents his third way as an alternative to what he sees as the rigid but cohesive societies of Europe with high levels of unemployment and the booming economy of the United States with exceptional rates of job creation but rising inequality. The third way is intended to generate jobs and promote equity.

This sounds like an attractive idea, but we have already seen that the part about rising inequality in the United States – to the limited extent that it has a factual basis – has more to do with family breakdown than with the effects of openness and economic growth. Likewise, the part about the cohesive societies of Europe also has a high fictional content. Does Reich really believe that a stagnant economy with high long-term unemployment – and a substantial proportion of the population dependent on welfare – is a recipe for social cohesion?

There are good reasons to think that there is a stronger basis for social harmony in a prosperous economy, where people form networks to engage in mutually beneficial economic activities and voluntary work, than in a stagnant economy where the redistribution activities of government are central to social cohesion.<sup>14</sup> The following points are relevant in this regard:

- Economic prosperity is generally associated with widespread opportunities. International comparisons show a high correlation between the rates of growth in average incomes of the bottom 60 percent of the income distribution and overall rates of economic growth.
- Rules of society which promote economic prosperity also tend to provide a strong basis for social harmony. These rules include respect for the property of others, observance of contractual obligations, and equal rights before the law

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<sup>13</sup> As reported in *The Listener*, 4 July 1998.

<sup>14</sup> These issues are further discussed in: W Bates, *The Links Between Economic Growth and Social Cohesion*, New Zealand Business Roundtable, Wellington, August 1996.

regardless of factors such as wealth, race and religion.

- The assumption by governments of major responsibility for income security involves what has been described as a 'quicksand effect'.<sup>15</sup> Rather than providing firm foundations for supporting people against poverty and uncertainty, the prevailing systems in many OECD countries have tended to give way when weight has been put on them. Increasing numbers of people have become entitled to public support, but as its cost has increased the political and economic pressures on governments to reduce support have also grown.

A lesson we should draw from the past century is the need for political parties to consider very carefully what their objectives are when they seek to redistribute incomes. A century ago there may have been some grounds for concern that wealth was unduly concentrated in the hands of a few people, who were able to exercise disproportionate political influence to protect themselves from competition. There is now much less reason for such concern. For example, it would be impossible to argue that Bill Gates, the wealthiest person in America, has been able to use his wealth to protect his firm from competition. And as Peter Drucker has pointed out, at the height of his fortune, J P Morgan could finance all of America's economic needs (except residential housing) for four months. Bill Gates's \$US100 billion would do the same job for perhaps a week. As Drucker says:

The rich no longer matter. ... The real capitalists are the middle-class people who put \$25,000 into a mutual fund – that's many trillions of dollars.<sup>16</sup>

Closer to home, it is simply wrong to assert, as some people do, that the wealthy have been the main beneficiaries of the economic reforms undertaken in New Zealand since the mid-1980s. The *National Business Review* has pointed out that "at \$6.285 billion, the wealth on the latest list is less in inflation-adjusted terms than the \$5.296 billion reported on the first Rich List in 1986". The wealth of many rich people declined during the 1980s as economic privileges such as protection, subsidies and tax concessions were removed.

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<sup>15</sup> D Snower, 'Challenges to Social Cohesion and Approaches to Policy Reform', in OECD, *Societal Cohesion and the Globalising Economy*, Paris, 1997.

<sup>16</sup> Peter Drucker, 'The Rich no Longer Matter', *National Business Review*, 27 March 1998.

It would be a good idea if New Zealand's political parties were to abandon the politics of envy and resentment which leads to the peculiar idea that achieving a more equal distribution of income is somehow a more desirable objective than reducing poverty. It is interesting in this context to revisit the work of Arthur Okun, published during the 1970s, which popularised the notion of a trade-off between equality and efficiency. Okun makes plain that the objective he had in mind was to reduce poverty:

I have stressed particularly the urgency of assisting the bottom fifth on the income scale and helping them into the mainstream of our affluent society. I believe that programs to help them rise would generate momentum through time and into wider ranges of the income scale. If those at the bottom receive the contents of the leaky bucket and are granted greater equality of opportunity, most will get on their own two feet.<sup>17</sup>

The leak in the bucket that Okun refers to is the waste of national product that occurs as a result of the effects of redistribution on the economic incentives of the rich and poor, and the administrative cost of tax collection and transfer programmes. The idea of a trade-off between efficiency and equality poses the question of how much additional waste is acceptable to achieve a further reduction in poverty. In the current New Zealand setting, this question hardly arises in a stark form. There is ample scope to achieve both greater efficiency and greater equality by restructuring existing programmes – to eliminate middle class welfare and to provide effective assistance to the poor to improve their income-earning potential. It is paradoxical that much government intervention in areas as diverse as education, health, conservation and the labour market actually tends to result in increased income inequality.

### **Concluding remarks**

The main attraction of Robert Reich's third way seems to be in the packaging rather than the product. His third way is differentiated from the utopianism and insularity that has characterised past collectivist approaches in many countries, including New Zealand. He accepts the reality of globalisation and open markets. But it still has a warm and

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<sup>17</sup> A Okun, *Equality and Efficiency: The Big Tradeoff*, Brookings Institution, Washington, DC, p 118

fuzzy feel about it that appeals to people who think that market forces are all about greed rather than mutually beneficial exchange.

The main problem is that the packaging is deceptive. Reich tells a good story, but it does not fit the facts very well. Many of his statistics and findings have been debunked by the US Employment Policy Foundation. When you open Reich's package and look inside what you find are tired old policies like minimum wages, education and training subsidies, and progressive income taxes. It is difficult to escape the conclusion that Reich's third way does not amount to much more than a way of making these policies seem relevant and consistent with wealth creation in an open economy.

Steve Maharey, who has been an advocate of a third way in New Zealand, is reported to have said: "The third way is an incomplete political theory. It's feeling its way for another answer to social and economic dogma. It is literally still being invented".<sup>18</sup> But in fact attempts to invent a third way between socialism and capitalism go back a long way. Former British prime minister Harold Macmillan wrote a book called *The Middle Way* in 1938. The failed Swedish experiment with a third way began around the same time. In the light of the repeated experience of such failures, the third way has been described as the fastest way to the third world.

In Britain today, the Blair government's talk of a third way is widely seen as a device for disguising the fact that it is largely following a path which Margaret Thatcher's governments marked out. Attempts to get to grips with the concept as expounded, for example, in the writings of Anthony Giddens, director of the London School of Economics, have been described by *The Economist* as "like wrestling with an inflatable man. If you get a grip on one limb, all the hot air rushes to another."<sup>19</sup> In short, the third way is several planks short of a framework. We would make more progress if politicians just spared us the hot air and discussed their policies without the ideological baggage and within the standard framework of modern economic and public policy

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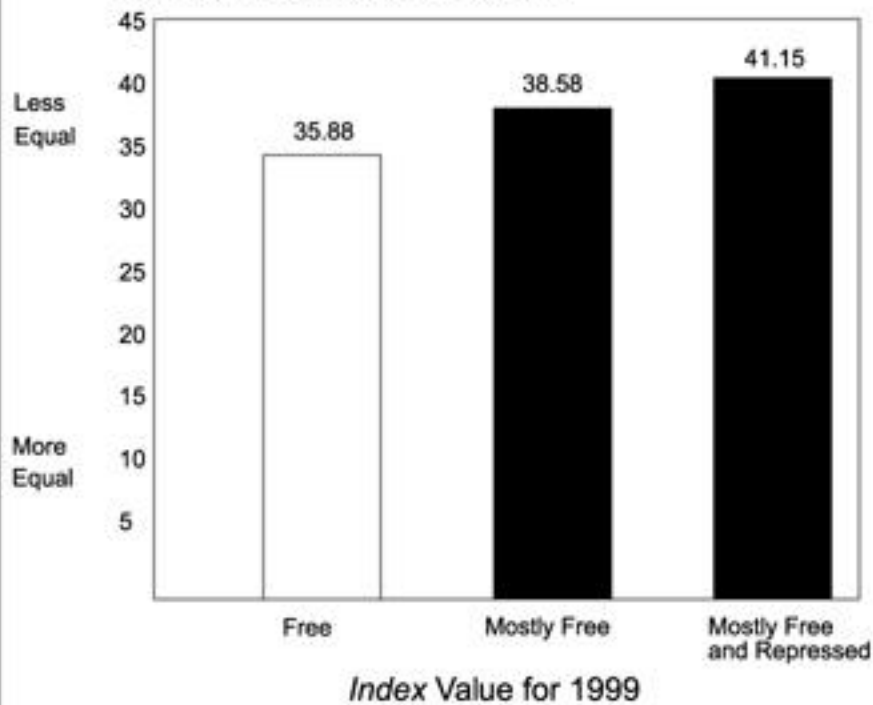
<sup>18</sup> *Waikato Times*, 17 June 1998.

<sup>19</sup> 'The Third Way: Goldilocks politics', *The Economist*, 19 December 1998.

analysis.

Chart 1.5

Freer Economies Tend to have  
More Equal Distributions of Income



**Note:** \*Gini data were available for 102 of the 161 countries studied in this year's Index. The Gini scale ranges from 0 to 100, with lower values representing greater income equality.  
**Source:** Gini data from Klaus Deininger and Lyn Squire, "A New Data Set Measuring Income Inequality," World Bank Economic Review, Vol. 10, No. 3 (1998)