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Wage inequality and welfare in developing countries: Privatization and reforms in the short and long run

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ABSTRACT

The impacts of privatization on wage inequality and welfare are considered for developing countries. In the short run, privatization can narrow wage inequality but reduce output of public firms. However, the favorable effect of privatization on lowering wage inequality vanishes in the long run due to the excessive entry of public firms. Thus, a policy recommendation for privatization would be: to avoid rising wage inequality, entry regulation of public firms should be imposed in the short run, and to mitigate the output contraction, complementary structural changes or policy reforms are needed in the transitional period of privatization.

1. Introduction

Income inequality is an important issue both in advanced and developing countries. According to a recent report by anti-poverty charity Oxfam International (2015), the rich are getting richer and the world's richest 1% will control over 50% of global wealth next year. The widening wage gap between the rich and the poor creates social conflicts and undermines economic growth and regional stability. U.S. president Obama plans to increase taxes on the wealthy while a rich tax policy has already been implemented in other countries, like France.

Many studies in labor economics and international trade have investigated the reasons for worsening wage inequality between skilled and unskilled labor in advanced countries.[1] The analysis on skill premium mainly focusses on the rising skilled wages by skilled-biased technologies,[2] while the declining unskilled wages can be attributed to globalization and demand for less unskilled labor domestically through importing unskilled labor-intensive goods and services or shifting unskilled jobs abroad.[3]

On the other hand, for developing economies, in addition to the above two reasons, rising wage inequality has been primarily due to market distortions, factor movements and trade restrictions. Davis (1998) considers unemployment as a factor that reduces unskilled wages, while this reduction is attributed to immigration in Kar and Beladi (2004) and to foreign investment by Marjit, Beladi, and Chakrabarty (2003). Recently, political and institutional factors have been included as important sources for rising wage inequality in developing economics. For example, Ghosh and Sen (2012) consider privatization as a reason for lowering wage income in developing countries. However, they are unable to discuss the problem of rising wage inequality because the workers are homogenous in a full-employment, monopolistically competitive model.

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[1] The early literature on the widening of wage inequality between skilled and unskilled workers can be found in Wood (1995) and Leamer (1998).

[2] Francois and Nelson (1998) analyze the effect of technological progress on the wages on unskilled and skilled workers.

[3] See Feenstra and Hanson (1996) who show that international outsourcing can cause a wage disparity between skilled and unskilled labor.

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Using an oligopolistic framework for an open, dual developing economy with urban unemployment, this paper investigates the issues arising in Ghosh and Sen (2012): Does privatization worsen wage inequality between skilled and unskilled workers and consequently lower welfare of the developing economy? If yes, are there complementary policy reforms that could mitigate or reverse the detrimental impacts caused by privatization during the transition period to a market-based economy? We consider a dual developing economy model with skilled and unskilled labor, while skilled workers provide managerial services and unskilled workers produce goods. We find that in the short run with entry regulation of urban public enterprises, increased privatization towards profit maximization can lower the wage gap between skilled and unskilled labor but at the expense of a contraction in the production of goods and services. However, the bonus of narrowing wage inequality by privatization vanishes or is even reversed in the long run with free entry/exit of public firms. This implies that the excessive number of public firms is a main source of rising wage inequality in developing economies during the transition to privatization. Therefore, a policy recommendation would be that to avoid rising wage inequality, entry regulation or even closure of public firms should be imposed in the short run, and then accompanied by complementary policies in structural changes or policy reforms, such as downsizing managerial teams, freer inflows of foreign capital or skilled labor, to mitigate the loss from output contraction during privatization.

We consider China as an example to illustrate the above points on privatization. China opened her door to foreign countries in 1979, and then followed by massive privatization in her state-owned enterprises (SOEs), with a guideline to "retain the large, release the small." During the process of privatization of SOEs, increasing wage gaps between skilled and unskilled labor has been identified as one of the many problems facing China, especially in the recent years (Appleton, Song, & Xia, 2014). One of the main reasons for such wage inequality was that privatization has led to a shortage of skilled labors and a drastic retrenchment of (unskilled) workers in those enterprises. Even though there has been a massive migration of workers from rural to urban areas seeking better employment opportunities, those migrants were mostly less educated and could only join the unskilled labor pool, which mainly supplied workers for private firms rather than SOEs. Worker retrenchments in SOEs and rural-to-urban migration have, therefore, dampened wage inequality in China. Indeed, wages in the state sectors in China started to surpass that in the private sector in 2003 and the trend has since then been on the rise (Yang, Chen, & Monarch, 2010).

Between 1995 and 2001, the number of SOEs in China fell from 1.2m to 468k, while the number of urban jobs in SOEs dropped by 36m or from 50% to 32% of total urban employment.[4] During the transitional period of privatization, some central public enterprises were transformed or closed, while other provincial or city new companies were created. Although the direction of privatization by reducing the number of public firms was in general appropriate, China could perform even better economically if the size of big public firms were trimmed or inflows of foreign investment and skilled labor were increased.

To help better understand the process of development in a globalizing world, we look at the issue of privatization in developing economies. In general, in those countries where there has been a push towards privatization by the central government, there has been, at the same time, a pushback to establish more control at the province or regional level. Therefore, it is useful to identify the players and discuss the motivations and constraints on the central and local government leaders. One of the main motivations of the central government in developing countries to privatize is the escalating government expenditure relative to GDP growth. This fiscal revenue reform can be combined with pension portability and opening up the services sector (especially in urban areas) to soak up the excess labor. Local governments in China will be keen to support privatization of their SOEs if they can guarantee themselves higher fiscal revenues and retention of their private benefits from the privatized firms. So, for the economic policy to be effective, the central government must obtain the cooperation of the SOE managers (usually local government officials) for compensating the workers (either through wages, unemployment insurance or relocation) and other things, such as guaranteeing payments of existing bank loans after the restructuring (Liu, Sun, & Woo, 2006).[5]

The phenomenon in which economic reform and privatization of SOEs have resulted in wage inequality and social welfare consequences is not unique to China, but has also been observed in other newly emerging economies, especially those in the Asia Pacific region. Take Vietnam, an economy with an impressive average annual GDP growth of 7.3% during the period 1990–2010, as an example (Vietnam Development Report, 2012). Vietnam started the process of economic reform in 1986 under the famous program called *Doi Moi* in which privatization of SOEs was among the priorities. According to the World Bank, thanks to *Doi Moi*, Vietnam has moved from a low income country and has now joined the lower middle income group.[6] However, similar to China, Vietnam has suffered from the skilled labor shortage and, consequently, increased wage inequality during the process of SOEs' privatization.[7] For instance, McKinsey Global Institute (2012) reports that the shortage of qualified engineers and middle managers in Vietnam appeared to be more challenging than in other Asian economies. Local media also reveals that Vietnam had some 53 million workers in 2012, of whom over 83% were manual laborers without any vocational certificates.[8] As such, Viettel, a state telecommunication company, had to pay its CEO and experts more than ten times the average salary of its employees, a phenomenon which could never happen prior to *Doi Moi*.[9]

[4] See "Privatization in China: Capitalism Confined," *The Economist*, 3 September, 2011. http://www.economist.com/node/21528262/print.

[5] Historically in China, and other developing economies, SOEs have provided a buffer against adverse shocks by hoarding excess labor instead of laying off workers during downturns. They favored gradual adjustment through relocation buyouts and severance pay. See Lam, Liu, and Schipke (2015).

[6] See http://data.worldbank.org/country/vietnam.

[7] As with other countries, SOEs in Vietnam utilized most of the country's capital and fixed assets (such as land) and created most jobs. Between 2000 and 2009, due to privatization, the number of SOEs reduced by 40%, while the SOEs' share of capital and fixed assets in the country reduced from 68% to 39% and from 55% to 45%, respectively. However, the SOEs' total employment reduced more drastically, from 59% to 19% (Vietnam Development Report, 2012). Improvements in productivity (partially due to worker retrenchment) and relaxation of the government's payment policy, which allowed profit-based bonuses, have enabled the SOEs to pay high salaries for their management positions (McCarty, 1999; Migheli, 2012).

[8] See http://www.thanhniennews.com/business/shortage-of-skilled-workers-hinders-fdi-in-vietnam-537.html.

[9] See http://english.vietnamnet.vn/fms/business/80701/the-companies-top-for-payroll-in-vietnam.html.