Capital Mobility and the Threat to American Prosperity

Thomas I. Palley
Dept. of Economics
New School for Social Research
New York, NY 10003

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I Introduction

The nations of Western Europe and North America are beset today by persistent economic malaise. Abstracting from the swings of the business cycle, this malaise has manifested itself in the form of stagnant wages and higher average rates of unemployment. Conventional economics attributes the malaise to massive technological change which has caused job losses and obsolescing of skills, and claims that all will ultimately work out for the best. Given time, society will once again enjoy full employment with even greater prosperity supported by improved technology.

This article challenges this view, and argues that the crisis is not self-correcting. Instead, it is the result of adverse structural changes in the relative bargaining strength of capital and labor arising from increased "mobility" of both financial and physical capital. This has caused a deterioration in the distribution of income in favor of profits and executive pay, and reduced the share of wages. This in turn has diminished mass purchasing power, and contributed to the emergence of global excess capacities and unemployment. Moreover, this shift in the balance of economic power has not only been felt by workers, but has also been felt by national governments whose powers of sovereignty have been increasingly eroded by the power of capital.

Implementing new policies to confront and reverse these trends requires recognizing the causes of the crisis. In the absence of this, policy will continue to be driven by the damaging presescriptions of conventional economic theory. The stakes are enormous, the legacy of failure being a structure of political and economic imbalance that will continue into the next century.

II Theory before policy: characterizing the economy

An essential ingredient for good policy analysis is a sound analytical framework, and in this sense theory should always precede policy. This calls for a brief characterization of the economy, which is as follows:

(i) the levels of employment and output depend on the level of demand for goods and services. Shortages of demand tend to lower output and employment: brisk demand tends to produce inflationary pressures.

(ii) the level of demand depends importantly on the distribution of income between wages and profits, and a high wage share tends to stimulate demand owing to its effect on consumption.[1]

(iii) The distribution of income depends on bargaining between workers and firms. The relative bargaining strengths of workers and firms depends importantly on the state of the economy, with unemployment serving to weaken worker power. Worker power is also affected by the ease with which firms can replace existing workers, and by labor laws providing protections against employer sanctions.

(iv) Firms are driven by the search for profits, and will therefore shift production to sites earning the highest profits.

III Capital mobility, transactions costs, and the origins of the crisis

Within the above bargaining framework, the realized pattern of income distribution depends importantly on the ease with which firms can shift production and fire workers. This in turn depends on "transactions" costs which firms must incur in implementing different strategies. These costs are myriad in character. For purely financial dealings

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[1]. However, to the extent that wages reduce profits, they can adversely affect investment spending which reduces demand. These conflicting tendencies of higher real wages are examined in Bhaduri and Marglin (1990).

they include costs such as brokerage fees, commissions, and official taxes and charges such as stamp duties. With regard to the location of production, they include such costs as transportation (including shipping, breakage, insurance), and costs of co-ordinating production across geographically dispersed locations: in the context of international trade they also include tariffs, which are a cost incurred for transporting goods across national borders. Finally, with regard to replacement of workers, these costs include the value of production lost during the replacement period, as well as costs related to training new workers.

Why are these costs important? The reason is that these costs have an important affect on the relative power of capital since they affect firms' abilities to shift production or threaten employed workers with replacement by unemployed workers. To see how these costs impact economic outcomes, consider their impact on the working of financial markets. Suppose there are two types of investment of identical risk yeilding returns of R_1 and R_2. If there are no transactions costs, then market forces will equalize the two rates of return. The economic logic is that any time the returns differ, there will be an incentive for wealth owners to rearrange their portfolios by selling the low return investment and buying the high return investment. Now suppose there are transactions costs of C associated with buying and selling investments.[2] In this case, market forces will only ensure that the difference between the two rates of return is less than the transactions cost. The economic logic is that if the rate differential is less than the transactions cost, it is not worth incurring the cost to get the higher rate.

[2]. These costs are expressed as a rate per dollar.

Exactly the same logic applies to manufacturing firms and their choice of production location. Suppose firms can site production in two possible places: in site one they earn a profit rate of P_1, in site two they earn P_2. In the absence of transactions costs, market forces will tend to drive the profit rates toward equality. The mechanism for this is the traditional market mechanism: as firms relocate to the site with the higher profit rate, wages and other costs are driven up thereby reducing the profit rate. Correspondingly, as they exit the other site, wages and costs fall thereby raising the profit rate at that site. However, if there are re-location transactions costs, then market forces will only ensure that the profit rate differential is less than the transaction costs. The economic logic is exactly the same as earlier: if the profit rate differential at the two sites is less than the transaction cost, it is not worth incurring the relocation costs.[3]

Finally, the same logic applies to firms' decisions whether or not to replace their existing "insider" labor force with cheaper unemployed "outsider" workers. If there are no transactions costs, firms will replace insiders as long as outsiders are willing to work for less. However, if there are replacement costs, then firms may stick with the more expensive insiders because the wage savings from replacement do not cover the costs of replacement.

What has this to do with the current economic crisis? The answer is that transactions costs have a critical affect on bargainning power, and therefore affect the distribution of income. Though conventionally talked about in the politically neutral terms of supply and demand, the determination of wages involves a process that implicitly pits firms against

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[3].Once again the transactions costs should be interpreted as a rate per dollar.

workers: sometimes workers are collectively organized in unions, but more often they are not. Within this real world, transactions costs protect workers.

In the first instance, firms faced a decision about the siting of production: for example, should firms site production in the U.S.A., or should they site production in Indonesia where labor is cheap, and there are mimimal social insurance taxes, pollution mandates, and worker safety laws? Alternatively, should firms operating in high labor cost regions in the U.S. (such as the North-East) move to low labor cost regions such as the South-East? In both cases, moving production produces significant labor cost savings, yet this may not be sufficient because of transactions costs associated with uprooting production. If these transactions costs are sufficiently high, firms will not relocate: however, once these transactions costs fall below a threshold level, firms will relocate to take advantage of the lower labor costs. At this stage workers at existing plants will either be made redundant, or firms will use the credible threat of moving to extract wage concessions. In either case, the net result is that wages are reduced and profits increased.

The same issues arise in connection with firms' threats to replace existing workers with unemployed workers as a means of winning wage concessions. Now, transactions costs associated with replacement protect employed workers; these costs include production lost during the replacement period, retraining costs, and costs associated with having an alienated workforce. If these costs are sufficiently large, then replacement threats will not be credible, and firms will be unable to secure wage concessions. However, if these costs fall below a critical threshold, such threats become credible. At this stage existing workers must confront either being replaced by cheaper labor, or

accept a wage cut. Once again, the net result is a redistribution of income from wages to profits.

These examples illustrate the critical influence of transactions costs on the distribution of income. Applied to the problem at hand, the underlying thesis is that over the last twenty five years there has been a tremendous decrease in transactions costs, which has eroded workers' bargaining power. The result has been wage stagnation and a shift in the distribution of income toward capital. In the U.S., this redistributive process began to be visible in the 1970's when real wage growth ceased, and it then accelerated in the 1980's.

This redistribution of income has in turn had a depressing influence on demand for output because workers tend to spend a greater fraction of their income (i.e. save proportionately less) than do the wealthy. This has caused an on-going deterioration in the robustness of business conditions: though punctured by intermittent cyclical recoveries, the overall trend has been downward. Moreover, this process partakes of a vicious spiral as worsening income distribution has weakened demand for output, thereby putting further pressure on firms to reduce costs.

The sources of this decrease in transactions costs are manifold. One source is technological advance. Amongst financial firms, improvements in electronic communication and data processing have vastly reduced the costs of trading financial assets. The result has been quicker and cheaper adjustment of portfolios, and an increased ability to shift financial wealth between countries. In manufacturing, transactions costs have fallen because of technological developments that have facilitated management of production across multiple distant locations: thus, whereas the multi-national corporation was previously an organizational form restricted to the largest of business enterprises,

today it is widespread. Another source of lower transactions costs has been declines in shipping costs. This has facilitated production in sites that are geographically distant from core markets. It has also promoted a system of national and international sub-contracting in which production is sub-contracted to the cheapest producer. The role of the lead firm is thereby reduced to that of co-ordinating production, and assembling the components supplied by sub-contractors. The outcome is a low cost mobile production system that pits worker against worker across different regions and countries. Lastly, improved monitoring technologies have given management greater ability to observe workers, thereby reducing workers' abilities to threaten non-cooperation in response to wage stagnation.

Technological developments have undoubtedly contributed to substantial reductions in firms' transactions costs. However, another cause of reduced transactions costs has been government policy. In financial markets, the abolition of capital controls has facilitated the international movement of financial capital. National governments have also promoted the development of global securities trading in the hope of expanding employment in their own financial centers. In goods markets, governments have promoted free trade and reduced both tariffs and official red tape obstructing the international movement of goods.

IV Capital mobility and the power of government

In the previous section it was argued that government policies have actively helped reduce transactions costs. These policies have also affected government's relations with capital in regard to (i) the ability to tax capital income, and (ii) the ability to pursue independent national economic policies.

(a) Transactions costs and the taxation of capital income

Just as the reduction of transactions costs have hurt labor vis-a-vis business, so too they have hurt governments' abilities to raise revenues by taxing capital. This has forced governments to look for replacement sources of revenue which has meant that the burden of taxation has increasingly been shifted on to labor. This development has impacted every level of government in the U.S., from the Federal, to the state, to the municipal. The desire to create jobs in this era of unemployment, has pitted government against government in an auction of business tax exemptions and subsidies designed to attract businesses. A recent example (1993) of this was the bidding war that took place over the siting of Mercedes-Benz's proposed U.S auto-assembly factory, that was finally won by Alabama. Another example (1993) was the bargaining between United Technologies Corporation and the state of Connecticut over tax exemptions: in that case U.T.C. used the threat of re-locating production to either Georgia or Maine to win significant tax concessions. A similar tactic pitting Connecticut against New York was used by Travellers Insurance Company. At the national level, an example of this process has been the competition between member countries of the European Economic Community over siting of Japanese car plants. To the extent that tax concessions extorted in this fashion have produced revenue shortfalls, this has meant tax burdens have been shifted on to households. Falling transactions costs have therefore hurt workers by reducing wages and by raising the taxation of wage income.

(b) Transactions costs and sovereignty of macroeconomic policy

Another way in which reduced transactions costs have impacted government concerns the ability to pursue sovereign economic stabilization policies. In market oriented

economies with open international movement of financial capital, wealth holders will shift funds across countries so as to earn the highest rates of return (adjusted for risk differences): such behavior produces pressures for equalization of cross-country interest rates.

Where there are transactions costs, this equalization will be incomplete (as discussed in section II). From the standpoint of national economic policy, this is an enormous benefit since it potentially allows governments to pursue independent monetary and fiscal policies. In a world with no transactions costs, market forces imply that interest rates across countries must be equal, so that governments inevitably lose control over the level of interest rates. However, if there are transactions costs, this permits small cross country differences in interest rates that financial arbitrageurs don't find worthwhile responding to. Transactions costs therefore reduce the vulnerability of sovereign macroeconomic policy to international movements of financial capital.

V <u>The problem of capital mobility: what is to be done?</u>

The foregoing analysis reveals some of the ways in which reduced transactions costs, arising from both technological innovations and officially sanctioned economic policies, have served to increase capital mobility. This increase has raised the power of capital relative to both labor and government, and it has had adverse effects on both the distribution of income and the distribution of tax burdens. These effects are a principal cause of the current economic stagnation and economic insecurity that afflicts the industrialized world. This raises important questions concerning the appropriate policy stance to transactions costs, globalization of markets, and capital mobility. This focus on the significance of transaction costs is completely absent from the current policy agenda

which has been constructed exclusively on the basis of orthodox economic theory. The reason for this absence is that conflict and power are absent in the orthodoxy, so that the significance of transactions costs for power relations is moot.

The orthodox approach to transactions costs (the Chicago School) portrays them as a "friction" that inhibits the realization of the benefits of competition and trade. Orthodox theory therefore recommends that policy should be aimed at eliminating such costs. However, I have argued that these costs have important implications for the distribution of income, and for governments' ability to tax capital and conduct sovereign economic policy. Moreover, the distribution of income also has important effects on the level of aggregate economic activity.

All of these effects and linkages are completely neglected by orthodox theory which has dominated economic policy making. This has meant that policy has been directed toward reducing transactions costs as evidenced in the push for elimination of controls on international capital movements, the encouragement of multi-national production, and the movement to free trade. Recognizing that transactions costs are an important strategic variable with significant macroeconomic implications compels a reassessment of policy.

(a) Designing policy toward transactions costs

What is the best policy toward transaction costs? A good point of departure for addressing this question is to distinguish between domestic and international transactions. *Prima facie*, reduction of transactions costs such as transportation within an economy, would appear a good: this is because it reduces the resources needed for transportation, thereby freeing them for use in other activities. Similarly, increasing the mobility of production means that employment can potentially be moved to depressed areas, thereby

bringing them prosperity. However, though reduced transactions costs bring benefits, they can also have significant negative consequences. In particular, as it becomes easier to shift production, the bargainning power of capital increases since firms can now effectively pit workers from different regions in a competition for jobs. This adversely effects the distribution of income, with potentially damaging consequences for national prosperity. Indeed, since the great oil shock of 1974 this has been a significant feature of the U.S. economic scene, with workers from the sun-belt being pitted in struggle with workers from the rust belt as a means of extracting wage concessions.

What can government do about this, and what should government do?
The first step must be the establishment of a national policy toward transactions costs. This policy must start from the premise that transactions costs are important, and their elimination has effects on income distribution. In effect, transactions costs represent a form of property, so that officially changing these costs is tantamount to a redistribution of property. Sometimes such redistributions may be desirable, sometimes not.

One important area for transactions cost policy concerns labor markets and mandated employer contributions on behalf of workers. A recent adverse development that is part of the general move to sub-contracting, is the replacement of full-time workers with part-time and contract workers. For firms, the economic incentive is to avoid costs such as health insurance and pension contributions. Counteracting this incentive therefore requires that firms be mandated to pay contributions for all workers, including part-time and contract workers. Thus, health insurance reform that imposes this could actually provide a huge unintended structural boost to prosperity. Another recent adverse development is the massive increase in over-time work, which has meant that employed

American workers are working longer than ever at a time when unemployment and under-employment are up. Once again this increase is driven by firms' desires to avoid hiring additional workers, thereby avoiding additional social security and pension contributions. Indeed, there are many informal indications that much of this over-time work is involuntary, with workers facing a choice of work longer or be replaced. Confronting this trend requires that overtime hours be considered analogous to hiring a new worker, so that firms must start making fresh contributions on all time over forty hours. Whether or not one agrees with the specifics of these particular proposals, it is clear that transactions costs matter and a national transactions costs policy is urgently needed.

A second policy area concerns co-ordination of state government tax policy. Here, there is an urgent need to put an end to the auction of corporate tax exemptions and subsidies designed to attract new jobs. Considered as a whole, this is a zero-sum game: the only winner is the corporate sector, which ends up paying lower taxes. Thus, states that participate in such tax auctions simply syphon jobs from other states, and lower overall state tax revenues. Rectifying this problem requires formal co-ordination of taxation policies across states. This is the only way of resolving a situation which partakes of the prisoner's dilemma. Each state has an incentive to break ranks to make itself better off: however, the net result is that all states break ranks, making all worse off. Only co-ordination can prevent this outcome.

A third area that concerns the maintenance of policy sovereignty is the use of taxes to counter the effect of declining transactions costs in financial markets. Thus, placing a small tax on financial transactions involving U.S. assets could help reduce speculative

activity. However, it is important that the tax be a "title" tax levied exclusively on U.S. assets, and payable upon registration of new title. If it is just a trading tax, this would drive trading overseas which would harm employment without reducing speculative activity. Such title taxes might promote a shift to bearer bonds, but this could be mitigated by imposing a new issue tax on bearer bonds. Moreover, this step would have the added benefit of diminishing bearer issues, thereby reducing their availability for use in the international money laundering business.

(b) International trade policy[4]

Clearly domestic factors have played an important role in the worsening of income distribution, but so too has the growth of international trade and multi-national production. This growth has increased the threat posed to American workers by the abundance of cheap foreign labor, and it neccesitates a re-examination of trade policy.

From the standpoint of orthodox theory, increased international trade is an unambiguous good, so that lower international transactions costs and increased multi-national production are both seen as major sources of gain. Orthodox economists have therefore persistently pushed for free trade and the elimination of tariffs, and these policies have reinforced the secular reduction in transactions costs.

However, the conventional approach to trade draws no distinctions between types of trade. Instead, all trade is good, and the greater the diversity of the trading partners, the greater the benefits to trade. Thus, Americans supposedly have the most to gain from trading with countries like China, Mexico, and the Phillipines. Nothing could be further

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[4].This section draws on material contained in my article "The Free Trade Debate: A Left Keynesian Gaze," Social Research, 61 (Summer 1994), 379-94.

from the truth; instead, the benefits to trade depend importantly on who one is trading with. Without doubt trade can be enormously beneficial, and these benefits include: (a) greater product diversity, (b) lower prices attributable to economies of scale associated with larger markets, (c) lower prices attributable to the fact that some countries have climatic and natural resource advantages in the production of certain commodities, and (d) lower prices due to increased market competition.

However, trade ceases to be a good when it rests exclusively on wage differentials: in this case, it becomes an implicit instrument for battering down wages and raising profits. This forces a reconsideration of trade policy: where countries have similar wage structures, employee protection laws, and environmental protection laws, then free trade is desirable; where countries differ in these regards, we need to be much more cautious. Free trade predicated exclusively on wage competition is entirely unacceptable, and represents a major threat to popular prosperity in America and Western Europe.

In light of the above, trade policy must distinguish between trade liberalizations with high employment-high wage (northern) economies, and trade liberalizations with surplus labor-low wage (southern) economies. Where there are conditions of domestic monopoly or where countries have a natrural advantage in the production of goods, free trade is desirable: thus U.S. consumers have clearly benefited from the effect of Japanese automobile market competition, and so too it makes no sense for the U.S. to try and produce coffee when Colombia has a natural climatic advantage. However, where the only reasons for trade are poverty level wages, and lack of obligations regarding pollution abatement, worker safety standards, and health and social insurance costs, then free trade is unacceptable. Under such conditions, free trade will end up promoting a decline in the

wages of American workers as companies either transfer production overseas, or use the threat of doing so to extract wage concessions. Moreover, to the extent that the system of social and environmental protections becomes viewed as a source of cost disadvantage and job loss, this will unleash political pressures for its repeal. In the realm of free trade, market forces promote the lowest common denominator.

Given this, free trade is appropriate where the requisite criteria are satisfied: for instance, the acronym NAFTA should have stood for North Atlantic Free Trade Agreement. However, if the criteria are not met, countries should be subject to a "social" tariff designed to compensate for their exploitative economic conditions. As conditions in countries improve, this tariff can be lowered thereby providing an incentive mechanism for governments in under-developed countries to advance the welfare interests of workers. Moreover, the tariff proceeds could be used to provide aid for purchases of U.S. exports, thus helping both the U.S. economy and under-developed countries.

V Conclusion

This article began by laying out a simple theoretical framework for understanding the cause of the current economic malaise. Orthodox economists see this malaise as the temporary result of massive technological change that will ultimately contribute to even greater well-being. Though these may be difficult times, mass prosperity is not deemed to be endangered. This is a dangerous representation, that derives from a fundamental misunderstanding of the workings of the market system. In particular, it ignores the significance of power and conflict for income distribution, and blithely assumes full employment -- except when the black box of technology suddenly unleashes a wave of technical change. The reality is that the last twenty years have seen a progressive shift of

bargaining power away from workers and governments toward business and financial capital. This shift has occurred because of technological change and government policies, and it has adversely affected the distribution of income. The result has been an erosion in the robustness of business conditions that has undermined the foundations of mass prosperity.

Changing the way we understand our economy is of paramount importance. The stakes are enormous, for without such a change there is little likelihood of putting in place policies to reverse this decline. Indeed, the situation is worse than that: if we continue with the economics of orthodoxy, we will continue with policies that have already exacerbated a difficult situation. These policies will further entrench deep structural changes that will be difficult and perhaps impossible to reverse.