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Das Kapital - how the German elite are winning from globalisation

Globalisation is the scapegoat for a litany of economic ills, but one of the most persistent complaints against it is that in developed countries, the integration of world markets brings bumper rewards for those at the top of the income scale, while punishing less skilled workers at the bottom.

Two new CEPR Discussion Papers show that unlike many of the charges against globalisation, this one has some justification - the first study by empirically investigating changing wage disparities in Germany; and the second by constructing a model of the way globalisation shapes managerial pay.

Germany is often seen as the most powerful example of a distinctive European economic model, its workers insulated from the worst pressures of globalisation by collective bargaining, union consultation and norms of social solidarity. A new study of income distribution in Germany from 1992 to 2001 suggests that, at least as far as financial rewards are concerned, there are close parallels with Anglo-Saxon capitalism.

After a short-lived reconstruction boom, the decade following German reunification was one of slow growth and rising unemployment for the world's third-largest economy. Overall income inequality, as measured by the Gini coefficient, rose only slightly over the decade, supporting the argument that, unlike the US, Germany has not seen a sharp widening in the gap between rich and poor.

But by analysing tax returns, and matching them to the results of Germany's Socio-Economic Panel survey, CEPR Research Fellow **Giacomo Corneo** and his co-authors **Stefan Bach** and **Viktor Steiner** uncover a very different story. For households in the middle of the income distribution, 1992-2001 was a tough decade. Partly as a result of increasing joblessness, income for the median earner slipped from €12,915 in 1992, to €9,790 by 2001, as the number of people on zero or very low incomes increased.

Echoing a phenomenon commentators in the US have dubbed 'middle-class squeeze', the share of total earnings accruing to households at the centre of the income distribution shrank markedly. Those in the fifth decile took home 4.6% of total income in 1992, for example, but that had slipped to just 3.1% by 2001.

The explanation for the falling share taken by those in the middle can be found right at the top of the income ladder, among a group the authors define as the 'economic elite'. This select group of around 650 people - the top 0.001% of the income distribution - have seen their incomes rocket. Their share of the nation's total income increased by a third over the decade, and their median income shot up by 35%, to almost €15m, 1,500 times the income of the average earner. Luckier still are the 'super-rich' - the top 0.0001% of the population, who have seen their average income rise by more than half over the decade, to €48m.

There are still marked differences between the characteristics of the economic elites in the Anglo-Saxon economies and Germany. More than half of the top 0.001% of earners in Germany are entrepreneurs, making most of their money from business income, instead of taking home a bumper salary, like the star CEOs of the US. Just 4% of this elite group are managers or employees, making 90% or more of their income from wages. Thus most of the top earners in Germany remain classic 'capitalists' - owners of business assets, rather than company employees, perhaps because Germany has not seen the explosion of lucrative stock options used to reward top managers in the US; and the presence of union representatives on supervisory boards may help to constrain the pay of top executives.

There are signs of change, however: over time, the importance of wages in the income of the richest has increased, suggesting that Germany may be becoming more similar to the Anglo-Saxon model. The top 0.1% made 22.9% of their income from wages in 2001, up from 15% in 1992. Data for more recent years is not yet available, but the authors suggest the process of wage

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polarisation is likely to have accelerated.

In the US and other Anglo-Saxon markets, a rapidly increasing concentration of incomes at the very top of the scale has become known as 'winner-takes all' economics. The more constrained European model had been thought to avoid some of the worst excesses of 'greed is good' capitalism, but Bach et al. show that just like their American cousins, the German super-rich are grabbing a rapidly increasing slice of the pie.

The second paper, by CEPR Research Fellows Hans Gersbach and Armin Schmutzler, illustrates how the process of globalisation may help to create the wage disparities revealed by Bach et al. in Germany. By using a matching model, the authors show that when both product markets, and the labour market for managers, are globally integrated, the result tends to be wider variation in managerial wages.

More intense competition means firms are better rewarded for greater efficiency; they thus have more incentive to seek out more effective managers. At the same time, they are competing to hire staff in a global labour market - so the price of a good manager tends to increase.

The emergence of a breed of 'superstar' CEOs, with once-unthinkable earning power, is an example of this phenomenon; and the increasing riches of the German economic elite may also be partly explained by this process.

For managers unable to deliver the efficiency gains their firms demand, globalisation is less beneficial. In fact, Gersbach and Schmutzler suggest the wages for less effective managers actually fall as a result of globalisation. They find themselves forced to compete in an international labour pool, at the same time as their companies are punished more harshly for inefficiencies by a competitive global product market. The average wage for managers may fall as a result of globalisation, despite the rich rewards won by the high-fliers.

Both of these papers suggest that the process of globalisation may be reshaping the income distribution in dramatic ways, with potentially enormous social and political implications - not only in the US, the home of untrammeled Anglo-Saxon capitalism, but at the very heart of the European model.

DP 6251 From Bottom to Top: The Entire Distribution of Market Income in Germany, 1992-2001 by Stefan Bach, Giacomo Corneo and Viktor Steiner

DP6222, Does Globalisation Create Superstars? by Hans Gersbach and Armin Schmutzler

The blessings of bad geography in Africa

Mountainous terrain is tough to farm, costly to traverse, and often inhospitable to live in; yet in Africa, countries with a rugged landscape tend to perform better than their flatter rivals. To explain this paradox, CEPR Research Fellow **Diego Puga** and his co-author **Nathan Nunn** reach back more than two centuries - to the slave trade.

Geographical characteristics affect economic outcomes directly - making life harder for landlocked countries, for example - and indirectly, by altering the path of history.

In Africa, between 1400 and 1900, four simultaneous slave trades, across the Atlantic, the Sahara Desert, the Red Sea and the Indian Ocean, led to the forced migration of as many as 18m people. The economies they left behind were devastated: political institutions collapsed, and societies fragmented.

For African people fleeing this slave trade over the centuries, rugged terrain was a positive advantage. Enslavement often took place through raids by one group on another, and hills and mountains provided plenty of lookout posts and hiding places (caves, for example) for those trying to escape. In general, countries with flatter, more passable terrain lost more of their population to the traders.

Today, however, that same geographical ruggedness is an economic handicap, making it expensive to transport goods to port; raising the cost of irrigating and farming the land; and simply making it more expensive to do business. This contemporary effect of geography applies across the world: in general, mountains are not good for growth.

Because the long-term, positive effect of ruggedness, through fending off the slave-traders, is concentrated in African countries, where the trade took place; while the immediate, negative effect is universal, Nunn and Puga are able to test which effect is stronger.

Using data from the US Geological Survey, they define 'rugged' terrain, by calculating the average uphill slope for each country. They then study the relationship between ruggedness and income per person; and rule out other ways ruggedness could have an effect - by being correlated with natural resource deposits, or proneness to tropical diseases for example.

Even today, more than a century after the slave trade ended, Nunn and Puga find that the benefits of ruggedness in protecting the population in Africa still outweigh its contemporary economic disadvantages. In fact, the benefits of sloping terrain during the half-century of the slave trade continue to skew the distribution of the African population today, because waves of mass migration into the hills in the path of

the slave traders have never been reversed. By comparing ruggedness, population density and the vulnerability of different areas to slave exports, it is possible to show that hundreds of years of flight from the slave trade has left the African population disproportionately concentrated in hilly areas.

Unfortunately, as the authors have shown, the direct, contemporary effect of living in rugged terrain is negative: the high costs of agriculture, transport and industry tend to depress income per head. So the slave trades left a doubly toxic economic legacy in Africa: not only did they devastate the population in many areas, with long-lasting impacts which still persist centuries later; they also left the African population concentrated in areas which make contemporary economic development harder.

The impacts of geography on economic development are therefore complex and long-lasting. Some economists, such as Harvard's Jeffrey Sachs, have suggested increased aid flows and investment could help to overcome the contemporary handicaps created by geography; but the existence of the longer-term, indirect effects revealed in this paper suggest this may not be enough to level the economic playing field.

DP 6253 Ruggedness: The Blessing of Bad Geography in Africa by Nathan Nunn and Diego Puga

Spiralling oil prices: the (un)shocking truth

Oil shocks have a chilling reputation for wrecking economies: memories of fuel rationing and recession in the 1970s mean a sudden jump in the price of a barrel of crude is assumed to have a singularly disastrous effect on GDP growth today. Yet while the cost of energy in the US rose an extraordinary 68 per cent in real terms between January 2002 and July 2006, the US was booming, and the global economy achieved one of its strongest periods of sustained growth for three decades.

CEPR Research Fellow **Lutz Kilian** and his co-author **Paul Edelstein** use a meticulous analysis of energy prices and consumer spending in the US from 1970 to 2006, to unpack exactly how changes in the oil price affect the economy, and discover that the declining size of America's once-mighty auto sector has actually helped to contain the effects of an oil shock on the wider economy.

After a year, a 1.5% increase in energy prices causes total consumption to fall by an average of 2.3% in real terms. Given the small share of energy in total consumption, that's a bigger change than could be explained simply by the 'discretionary income effect' - the impact of consumers finding that more expensive energy leaves them less money to spend on other things.

Edelstein and Kilian's analysis shows that as energy prices rise, two more effects are at work: a 'precautionary savings effect' and an 'operating cost effect'. They use evidence from the Michigan University consumer confidence survey to show that shocks to spending power tend to leave consumers feeling less confident, and expecting higher unemployment, and lower income: in other words, they tend not to feel it's a great time to go shopping. Instead, they squirrel extra money away, in case things are about to get worse.

At the same time, consumers begin to change their spending patterns to adjust to the higher energy price. In what the authors call the 'operating cost effect,' they may opt for more energy efficient fridges or washing machines, for example, and buy a smaller, energy efficient car instead of a gas-guzzler.

Predictions of widespread economic damage following an oil shock are often based on the assumption that changes in spending patterns like these lead to an indirect, 'reallocation effect': as households switch away from energy-intensive goods - critically, cars - US industry is forced to adjust, causing a disruptive shake-up, with potential for further knock-on effects in lost jobs and income.

The operating cost effect on the car market is large: the authors calculate that an oil shock of the size that followed Hurricane Katrina could knock out 10% of demand for domestic cars, as consumers switch to foreign models, which tend to be more efficient.

Comparing the sales of different types of vehicle confirm that it's energy efficiency - operating costs - driving the switches in spending. While the total number of vehicles sold is roughly the same, demand for trucks, including gas-guzzling SUVs, falls by as much as 11.2% after a Hurricane Katrina-type price-rise. And since trucks account for a large chunk of the output of Ford, Daimler-Chrysler and GM, the impact on the industry would be considerable.

In the 1970s, when the US auto industry was much larger, and produced few energy-efficient models, leaving that end of the market to the Japanese, the economic effects of such a sharp switch in spending would have been much larger; but today, the car manufacturers account for just 1 per cent of US employment, and 1 per cent of output. Their relatively small size helps to contain the reallocation effect, and thus to limit the damage done by oil shocks today.

As well as thinking about the energy efficiency of their car, consumers respond with a myriad of tiny economies, as they trim their day-to-day spending in

response to rising prices. Using the detailed spending data, Edelstein and Kilian are able to detail these smaller changes. Families spend less on eating out, for example, and more on eating at home; less on private travel and more on public transport. They tend not to let their insurance policies lapse as their fuel bills go up - but they do cut back on car repairs.

Dissecting the impact of an energy price shock in this way also helps to solve a puzzle. When Opec, the oil producers' cartel, collapsed in 1986, and oil prices plunged, there was no resulting economic boom, despite the extra cash in consumers' pockets from falling energy bills. This is often regarded as evidence that the response to oil shocks is asymmetric, with price rises being unambigously bad, while falls have more complex effects. However, none of the mechanisms uncovered by the analysis - the precautionary savings effect, the discretionary income effect, and the operating costs effect - are asymmetric. Just as consumers increase their savings when prices are rising, they feel safe to spend more when prices are falling.

By re-examining the 1980s episode using the detailed consumption data, the authors find that in fact spending did pick up sharply, but there was no boom, because rising household consumption was offset by a sharp decline in business investment, perhaps caused by a completely unrelated piece of legislation, the 1986 Tax Reform Act. Just as oil price rises are damaging, falling costs can tempt consumers back to the shops. As the experience of the past five years suggests, the idea that a sharp increase in energy prices - an 'oil shock' - has a unique, devastating power over the whole economy is simply a myth, based on a misreading of the past.

DP 6255 Retail Energy Prices and Consumer Expenditures by Paul Edelstein and Lutz Kilian

Corporate governance: virtue is its own reward

Since Enron, WorldCom, Parmalat and a series of lesser scandals from 2001 onwards exposed the vulnerability of investors and workers to corporate malfeasance, governments have stepped in to tighten legal constraints on corporate governance - and shareholders have become increasingly focused on influencing the way firms are run.

'Compliance' with these new pressures has become an increasingly onerous part of the day-to-day running of big businesses, and many companies complain about the costs of tightening up their procedures. Two new CEPR Discussion Papers provide evidence that it's worth their while: better corporate governance means a higher stock market valuation - and healthier financial performance.

CEPR Research Affiliate Luc Laeven and his co-author Vidhi Chhaochharia examine the rewards that accrue to companies prepared to go farther than the laws or common corporate practices of their home market require.

They construct a 'governance index', using data collected by investor group Institutional Shareholder Services. It includes eight criteria about a firm's constitution, including whether it has an unfair dual-class ownership structure, with some shares carrying weaker voting rights; whether the board can use 'poison pill' arrangements to block a potential takeover; and whether shareholders have the power to demand special meetings.

Using data from 2,300 firms, across 23 countries, the authors calculate the average corporate governance standard for each country, and compare the market valuations of companies which fall above and below that hurdle.

There are wide variations across countries. Firms listed in Israel and Luxembourg had the highest average score on the governance index, at 7, while companies based in the Cayman Islands had the lowest, at 2. Only in the US and France do firms attain the top score, of 8 - although variation within those countries is wide.

Notwithstanding these differences, across the 23 countries as a whole, firms that show their commitment to corporate governmance by adopting higher standards than the average within their home country tend to have higher stock market valuations than their below-average peers. The authors suggest these firms may get access to cheaper finance, by signalling their intent to be better than the rest of the pack; or their stricter constitutions may be a credible commitment device, showing investors the firm will force itself to stick to the rules.

Not only do firms with stricter-than-average by-laws tend to have higher market valuations; they also offer stronger performance. The ISS data covers three years, from 2003 to 2005, making it possible to trace the performance of companies over that period. Chhaochharia and Leaven find that buying a portfolio of firms with an above-average score on the governance index for their country in 2003 would have generated a 19% return over the following two years. A

portfolio of firms with below-average scores would have returned just 13%.

Chhaochharia and Laeven believe their results suggest that the 'invisible hand' of the market has a role to play in encouraging better corporate governance standards, and punishing firms that refuse to bring their behaviour up to the standards of their peers.

Few governments are willing to leave corporate governance to the invisible hand alone, however, and CEPR Research Fellow Paola Sapienza and her co-authors Yael Hochberg and Annette Vissing-Jorgensen have studied the impact of a particular piece of US legislation, the hugely controversial Sarbanes-Oxley Act, which was aimed at improving transparency and ensuring that a firm's board could be held responsible for any financial misreporting.

Sarbanes-Oxley was passed in July 2002, as a direct result of Enron, WorldCom and other high-profile scandals. After the Act was passed, the job of drafting and implementing it was handed to the market regulator, the Securities and Exchange Commission, which began a consultation process, to ask the opinion of investors and corporations.

By examining the hundreds of letters sent to the SEC during that process, supporting or condemning elements of the Act, the authors identify which firms lobbied against the strictest implementation of it - and therefore which were likely to be most affected by the change in the law.

These 'anti-Sarbanes Oxley' firms generated cumulative returns 10 per cent higher than the rest of the market in the four and a half months running up to the legislation's being passed. Hochberg et al say that's because investors were able to tell which firms would be most affected, and bet on their performance improving once they were forced to comply.

After the legislation was implemented, there was no difference between the performance of lobbiers and non-lobbiers, suggesting that the costs of complying with the new law didn't swamp its benefits.

For firms feeling the pinch of stricter corporate governance standards, the findings of both these papers offer some comfort. When new rules bite, investors expect there to be financial benefits, and favour the firms most affected; and for companies prepared to take the moral high ground and go farther than the law demands, there are rewards in the form of higher valuations, and better performance.

DP 6256 The Invisible Hand in Corporate Governance by Vidhi Chhaochharia and Luc Laeven

DP 6201 A Lobbying Approach to Evaluating the Sarbanes-Oxley Act of 2002 by Yael Hochberg, Annette Vissing-JOrgensen and Paola Sapienza

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