The bigger, the less fair

The growing size of firms may help to explain rising inequality

***The Economist*, Mar 14th 2015**

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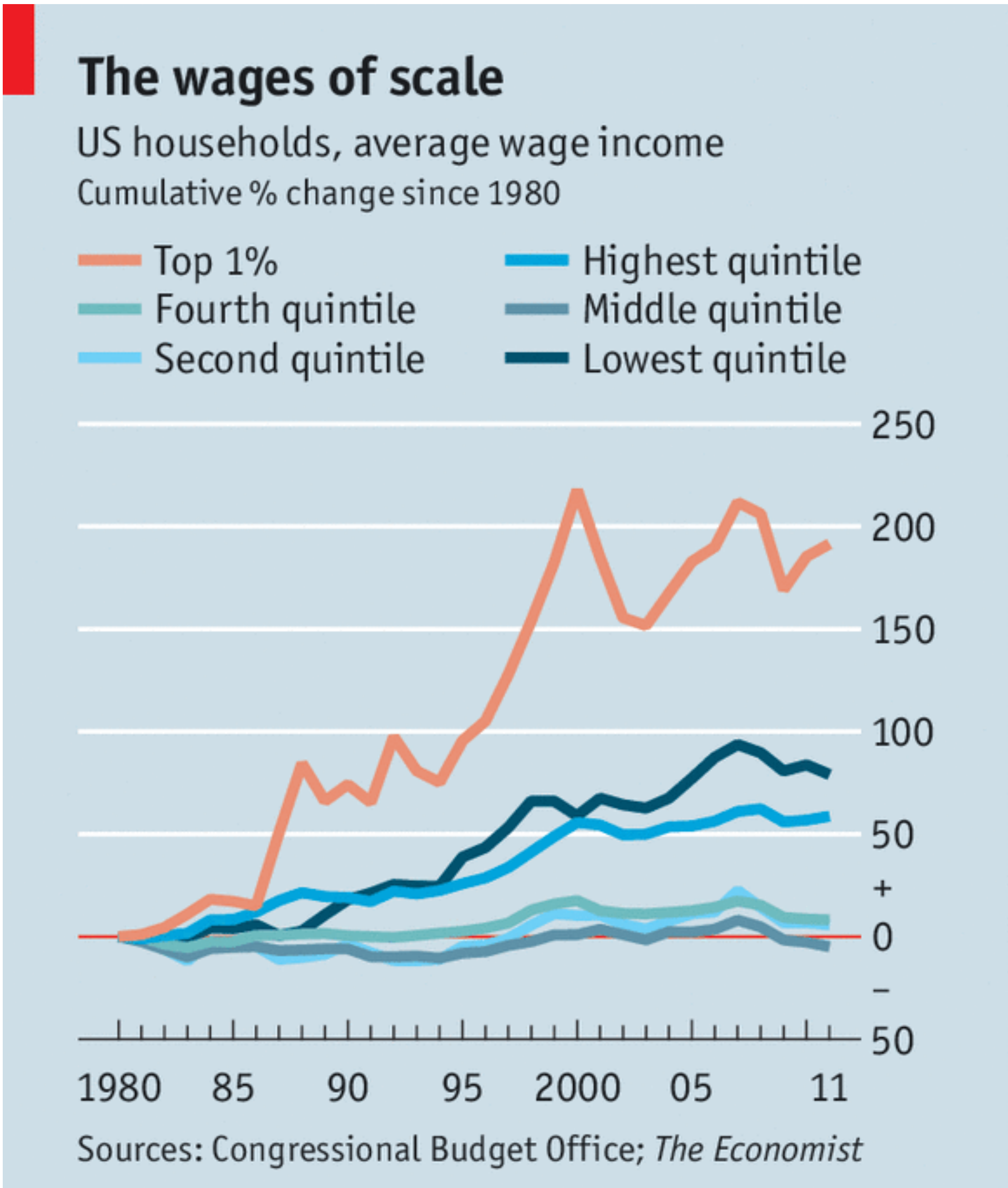

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SINCE its publication last year, Thomas Piketty's "Capital in the Twenty – First Century" has ignited a furious debate about inequality in the rich world. He focuses on the increasingly unequal distribution of wealth, and pays less attention to the growing disparity in wages over the past three decades. Yet that disparity is ballooning, too: in America, for instance, the best-paid 1% of workers earned 191% more in real (ie, inflation-adjusted) terms in 2011 than they did in 1980, whereas the wages of the middle fifth fell by 5%. Similar trends can be observed all over the world, despite widely varying policies on tax, the minimum wage and corporate pay.

The standard explanation says that technology plays a big role: modern economies require more skilled workers, raising the pay premium they can demand. A new paper* by Holger Mueller, Elena Simintzi and Paige Ouimet adds a new and intriguing wrinkle to this: the rising size of the average firm. Economists have long recognised that economies of scale allow workers at bigger firms to be more productive than those at smaller ones. That, in turn, allows the bigger firms to pay higher wages. This should not, in theory, cause a rise in inequality. If the chief executive and cleaner at a larger firm are both paid 10% more than their counterparts at a small firm, the ratio between their wages—and thus the overall level of inequality—should remain the same.

But the paper shows that the benefits of scale are not shared equally among all workers. Using data on wages at British firms, they divide workers into nine groups according to how skilled they are. Over time, they find that the proportional difference in wages between the groups grows as firms get bigger. This trend is driven entirely by a rising gap between wages at the top compared with the middle and bottom of the distribution. As the authors note, this is very similar to the trend in income inequality in America and Britain as a whole since the 1990s, when pay for low and median earners began to stagnate (see chart).

The authors suggest two possible explanations. First, larger firms should find it easier to automate tasks than smaller ones, and may therefore find it easier to resist demands for pay rises from relatively unskilled workers who could be replaced by machines. In addition, entry-level workers in the middle of the income distribution may be willing to accept lower pay from big firms since in the long run the chances of winning a promotion are greater than at small firms.

Top hogs

The benefits of size are thus enjoyed only by the most senior workers at a firm, who can extract a bigger premium for their skills and experience. A cleaner at a single shop does the same sort of work as those at a large chain. But managing a multinational firm such as Walmart requires a different—and much rarer—set of skills than that required to run a corner store. Over time this pushes up the salaries of the top brass at Walmart compared with corner-shop managers.

The authors find that the relationship between the growth in the size of companies and the level of inequality holds across the rich world. They looked at data from 1981 to 2010 on wages and the size of largest firms for 15 countries in the OECD, a club mostly of rich countries. The relationship between rising levels of income inequality and the size of firms was strong.

This effect is particularly noticeable in America and Britain, where firms have grown rapidly in recent decades. In America, for instance, the number of workers employed by the country’s 100 biggest firms rose by 53% between 1986 and 2010; in Britain the equivalent figure is 43.5%. On the other hand, in places where the size of firms has not changed much, such as Sweden, or where it has shrunk, such as Denmark, wage inequality has grown much less. Part of what is perceived as a global trend towards greater disparity in wages may actually be the result of the biggest firms employing a greater share of workers.

Another new paper**, which looks at manufacturing in America, China and India from 1982 to 2007, suggests that the trend towards bigger firms is only likely to accelerate. Big firms' higher productivity, it argues, raises the barriers to entry for new—and presumably smaller—competitors. Larger factories are more productive than smaller ones, so bigger firms can entrench their position over time. That will skew the income distribution even more. There is plenty of evidence across America and Europe that startup rates for companies are falling, allowing the biggest firms to get bigger unhindered by competition. Since the financial crisis, higher barriers to entry in the form of limited access to capital has caused the number of new businesses to collapse.

Not all economists see this as a dreadful thing. After all, bigger firms have much higher investment rates than smaller ones, which helps to fuel growth throughout the economy. The preponderance of small firms in such places as Greece, Italy and Portugal, seems to be one of the factors holding those economies back.

But if governments wish to reverse the inequality big firms foment, reforms to the labour market are unlikely to do the trick. Instead, they will have to spur competition by reducing barriers to entry for smaller firms, most notably by improving their access to credit. That should reduce income inequality and boost economic growth at the same time.

Voters dislike the growing inequality of incomes, and often agitate for redistributive policies to reverse it. Yet too much crude redistribution can be counterproductive in that it tends to dampen economic growth. The link between firm size and inequality suggests a better option. By boosting competition, policymakers can please both populists and economists at the same time.

* H. Mueller, E. Simintzi and P. Ouimet, "Wage inequality and firm growth", LIS Working Paper 632 (March 2015).

** A. Bollard, P. Klenow and H. Li, "Entry costs rise with development", SCID Working Paper 518 (December 2014).