Will the Middle Class Hold?
Two Problems of American Labor

Testimony of
Alan S. Blinder
Princeton University
to the Joint Economic Committee
January 31, 2007

Thank you for holding this hearing, Mr. Chairman. I'd like to use my brief time to focus on two broad-brush, long-term issues, one pertaining to income disparities and one pertaining to globalization. They are, of course, related.

Rising income inequality: First, do no harm

The first problem has been with us for so long that I fear we may be becoming inured to it. The plain fact is that America does a very poor job of caring for its poor, for its weak, and for its downtrodden—as was illustrated, for example, by the woefully inadequate response to Hurricane Katrina.

Although specific statistical measures of poverty and inequality can be--and have been--disputed, the basic outlines of the story are clear enough. Inequality in America was mostly falling for the 35 years or so from the end of World War II until the late 1970s, but has been mostly rising since. The one notable exception was the boom years of the second Clinton administration, when labor markets were extraordinarily tight.

This phenomenon has *not* been mainly a story of vast capital gains accruing to a tiny minority, nor of a massive income shift from labor to capital—although both of these have played roles in certain time periods. Rather, the basic story is that *earnings from work* have grown vastly more unequal over the last quarter-century. There are many ways to measure that change, but here is one that I find both dramatic and easy to understand. According to IRS data, in 1979 the average taxpayer in the top 1/10th of 1 percent of all wage and salary earners earned about as much as 44 average taxpayers in the bottom half.[1] By

[1] The unit of observation in tax data is the tax return, not the individual or the family.

2001, that number had risen to almost 160.[2] And we know from other data sources that inequality has gotten worse since.

What accounts for this alarming trend? Let me be clear: The main culprit has *not* been the government but the marketplace. While there are a number of competing theoretical explanations, the fact is that, starting sometime in the late 1970s, the market turned ferociously against the less skilled and the less well educated.

How should the government have reacted to such a development? One clearly *wrong* approach would have been to try to stop the market forces that were generating rising inequality. Such an effort would have produced undesirable side effects and would probably have failed anyway.

A more reasonable approach would have included using the tax-and-transfer system to cushion the blow, raising the minimum wage and the EITC, devoting more resources to compensatory education, making health insurance universal, etc. These are still useful ideas, and we should use them.

A Social Darwinist would have rejected palliatives like these in favor of letting the market rule and the chips fall where they may. (By the way, it strikes me as ironic that some of these Social Darwinists are not biological Darwinists.)

That may sound heartless. But, with a few notable exceptions, the U.S. government has followed an *even harsher* policy course for most of the past quarter century.[3] As market forces turned against the middle class and the poor, the federal government piled on by enacting tax cuts for the rich while either permitting or causing large holes to emerge in the social safety net. In football, that would be called “unnecessary roughness”--and penalized severely. It’s a policy direction that, in my view, needs to be changed—and fast. The first step is to stop piling on.

---

[2] These are my calculations, based on data in Table 7 (p. 104) of Ian Dew-Becker and Robert Gordon, “Where did the Productivity Growth Go?,” *Brookings Papers on Economic Activity*, 2005:2. 2001 is the last year for which comprehensive tax data were available at the time.
[3] The main exception was the Clinton administration’s huge increase in the Earned Income Tax Credit in 1993.

Offshoring: The sleeping giant

Let me now turn to an issue whose present importance has been greatly exaggerated, but whose future importance appears to be underappreciated: offshoring of service jobs. While no comprehensive numbers are available, scattered studies make it appear likely that fewer than a million U.S. service jobs have been lost to offshoring to date. A million may sound like a lot, but in a nation with over 140 million jobs, it is not even one month's normal turnover. No big deal, in other words.

However, I believe we have seen only the tip of a very big iceberg. Here's why. Only a minority of American workers—mainly manufacturing workers—have historically faced job competition from abroad. They haven't welcomed it, of course. But they have long understood that foreign competition is one of the hazards of industrial life, like bankruptcies and business cycles.

But most American workers, including the vast majority of service workers, have never had to worry about foreign competition. Until recently, neither low-skilled work like call centers nor high-skilled work like computer programming could easily be moved offshore. Now both can be. My point is that the share of American jobs that is potentially vulnerable to offshoring is certain to rise over time as the technology improves and as countries like India and China modernize and prosper. As this occurs, tens of millions of *additional* American workers will start to experience an element of job insecurity—and downward pressure on real wages--that has heretofore been reserved for manufacturing workers. It is predictable that they will not like it.

Many people have concluded that offshoring will be a particularly acute problem for less-skilled and less-well-educated workers--precisely the people who have been left behind for the last 25 years. I'm not so sure. As I see it, the key labor-market divide in the Information Age will not be between high-skilled and low-skilled workers, as it has been in the recent past, but rather between services that can be delivered electronically with little loss of quality and those that cannot be.[4]

Consider a few examples. It seems unlikely that the services of either waiters or brain surgeons will ever be delivered over long

[4] See Alan S. Blinder, "Offshoring: The Next Industrial Revolution?," *Foreign Affairs*, March/April 2006, pp. 113-128.

distance. On the other hand, both typing services and security analysis are already being delivered electronically from India--albeit on a small scale so far. These disparate examples illustrate two fundamentally important points. First, the dividing line between jobs that are deliverable electronically (and thus are threatened by offshoring) and those that are not does *not* correspond to traditional distinctions between high-end and low-end work. Frankly, I have no idea whether future offshoring will make the distribution of wages more or less equal. Second, the fraction of U.S. jobs that can be moved offshore is certain to rise inexorably as the technology improves. Despite all the fuss, it is pretty low now; but it will eventually be quite high. In some ongoing and still preliminary research, I have estimated that 22-29% of all (current) American jobs might potentially be *offshorable*, although only a fraction of those jobs will actually be *offshored*.[5]

What can or should the government do about all this? I don't have a laundry list of concrete proposals, but I think the appropriate governmental responses fall into two generic categories.

First, we need to repair and extend the social safety net for displaced workers. This includes unemployment insurance, trade adjustment assistance, job retraining, the minimum wage, the EITC, universal health insurance, and pension portability--plus other, newer ideas like wage loss insurance. If we fail to do these things or, perish the thought, turn again to Social Darwinism or piling on, a large fraction of the U.S. population is going to experience a great deal of anxiety and economic distress. These people will constitute a much larger, more vocal, and more politically-engaged group than the poor and uneducated. So it seems unlikely that they will just sit there passively and take their medicine. Rather, Congress will hear from them.

Second, we must take steps to ensure that our labor force and our businesses supply and demand the types of skills and jobs that are going to remain in America rather than move offshore. Among other things, that may require substantial changes in our educational system—all the way from kindergarten through college. And it will certainly entail a variety of steps to ensure that the U.S. remains the home of innovation and invention, for we will never compete on the basis of cheap labor. Nor do we want to.

[5] Alan S. Blinder, "Estimating the Potential for Offshoring in the United States," unpublished, Princeton University, December 2006.

Notice that I did not mention a third category of governmental response: trying to impede globalization in general or offshoring in particular. The U.S. government cannot hold back the tides of history, and it should not try. Mr. Chairman, you may remember a popular 1960s musical comedy called *Stop the World, I Want to Get Off*. I understand the sentiment. You hear it a lot these days. But we cannot stop, and we cannot get off. Instead, we Americans need to prepare ourselves for the future of globalization, whether we like it or not. There is much to be done.

Thank you.