feature article *lane kenworthy*

is equality feasible?

Is income equality possible in modern capitalism? Yes. Would it hurt the economy? No.

The principal argument for equality is that it is fair. Much of what determines people's earnings and income—intelligence, creativity, physical and social skills, motivation, persistence, confidence, inherited wealth, discrimination—is a product of genetics, parents' assets and traits, and the quality of one's childhood neighborhood and schools. For the most part, these factors are a matter of luck. A large portion of earnings and income inequality is therefore undeserved, which makes institutions and policies that can reduce inequality attractive. While few egalitarians favor complete equality of incomes, most would prefer less inequality than exists in the contemporary United States.

In the view of many economic analysts, equality comes at a cost. A high minimum wage reduces jobs. Generous government benefits discourage job searching. High taxes reduce incentives for saving, investment, and entrepreneurship. The result is low employment, stagnation, and mediocre living standards.

Are these claims true? Each of them is plausible, but we can also argue that equality might contribute to a healthier economy: it might boost consumer demand, spur productivity by enhancing perceptions of fairness, encourage the development of new skills by facilitating investments in college education by the poor, increase trust, and reduce crime and political conflict. Ultimately, the question of equality's effects can only be answered empirically.

the new economic environment

In some countries, such as Sweden and Denmark, many employees are unionized, and unions have strongly influenced wage patterns and government policy. Governments have enacted generous benefits to cover risks that individuals and households face in a market economy—low income, unemployment, sickness, disability, poor health, old age. In other countries, such as the United States and Canada, unions have been smaller, less cohesive, and less influential. Less of these nations' incomes is taxed from the wealthy and transferred to the poor.

Through the 1970s, comparatively equal countries grew just as rapidly as less equal ones, and employment tended to be higher in the former. Looking across these nations, we see no indication of a trade-off between equality and economic dynamism.

Then the economic environment changed. Heightened competition in various industries, a result of globalization and domestic developments such as deregulation, encouraged firms to become more cost-conscious and thus to reduce pay levels. Enhanced ability to hire foreign workers and to automate low-skilled tasks has given employers additional leverage. Declining unionization and decentralization of wage-setting have weakened the major institutional forces supporting decent wages for the less-skilled. Immigrant job-seekers have also put downward pressure on wages at the low end of the labor market. The shift of employment from manufacturing to services has reduced the share of jobs in the sector where pay traditionally has been most equal and increased the share in the sector where it tends to be most unequal. With later marriage and increased divorce, more households have just one adult and therefore only one potential earner. Because firms and investors can more easily move their plants or their money to other countries, governments feel pressure to reduce tax rates.

These changes threaten both the viability and the desirability of pursuing equality. The new environment has made it more difficult for countries to reduce income inequality, and many fear that there may be greater costs to doing so.

While I do not pretend to know what will happen in the next several decades, it is worth examining what has occurred so far. I focus on the experiences since the late 1970s of nineteen affluent countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

the end of equality?

Although most research has focused on unequal earnings among employed individuals ("pay inequality"), the inequality of income among households is more important because households typically pool their earnings. The

Contexts, Vol. 6, Number 3, pp 28-32. ISSN 1536-5042, electronic ISSN 1537-6052. *DOI: 10.1525/ctx.2007.6.3.28*

amount of income inequality in a country is commonly measured using the Gini coefficient, which indicates the proportion of a country's income that would have to be redistributed in order to achieve perfect equality among households. It ranges from 0 to 1, with larger numbers indicating greater inequality. As of 2000, the most recent year for which data are available for many countries, the Gini coefficient ranged from .25 in Sweden, Norway, Finland, and the Netherlands to .37 in the United States.

Since the late 1970s, household inequality has increased in most affluent countries. But the increase has been small, as government taxes and transfers have helped to offset rising market inequality. Only in the United States and the United Kingdom has the jump in income inequality been substantial.

an equality/incomes trade-off?

Even if equality remains viable, is it compatible with other desirable social and economic outcomes? Hard-core advocates of free markets have long argued against "excessive" pursuit of equality. In recent years even scholars with egalitarian sympathies have expressed skepticism about the degree to which countries can effectively combine low inequality and a strong economy.

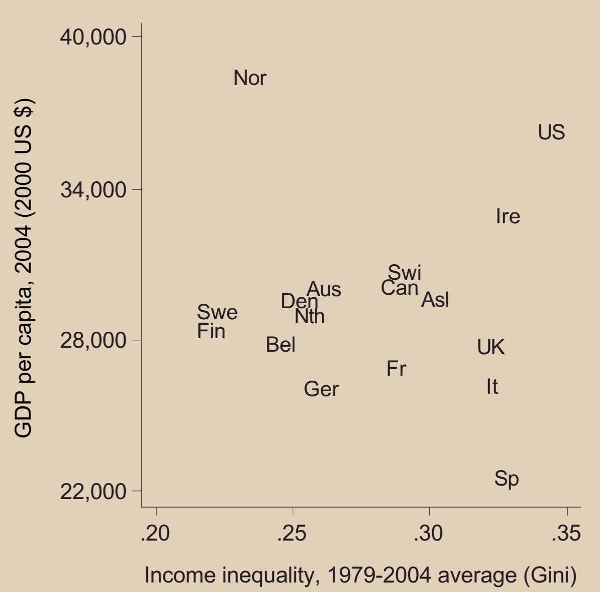
Debate about whether equality is compatible with a dynamic, productive economy has a long history. Much of it has focused on the relationship between inequality and economic growth. The traditional view of this relationship, outlined in Arthur Okun's 1975 book *Equality and Efficiency: The Big Tradeoff*, holds that inequality contributes to growth. Investment, work effort, and skills are key sources of growth. Those with higher incomes tend to save more of their income than do those with moderate or low incomes. The wealthy are thus the principal source of investment in a capitalist economy. Consequently, the smaller the income share of the rich (i.e., the less inequality), the less investment there is. Compressed earnings distributions and high taxes reduce the financial gain from hard work and skill development. This may cause people to reduce their work effort and investment in skills. And those with limited labor market prospects may be tempted to live off government benefits rather than work.

On the other hand, we can argue that income inequality may be bad for growth. Since the wealthy tend to save more of their income, greater inequality may weaken consumer demand, which can be as debilitating for the economy as low investment. Those in the middle and lower classes may regard high inequality as excessively unfair, reducing employee motivation and workplace cooperation. High inequality may also reduce the share of the population that is able to invest in higher education. And the financial constraints and frustration created by high inequality may decrease trust, cooperation, civic engagement, and other growth-enhancing forms of social support.

What does the comparative evidence suggest? Figure 1 plots levels of per capita gross domestic product (GDP) in 2004 (the most recent year for which data are available) by the average level of income inequality since the late 1970s. We see no indication that income inequality contributes to economic affluence. Figure 2 shows change in per capita GDP between 1979 and 2004 on the vertical axis. Here too the pattern does not support the view that high inequality is beneficial.

A thorough analysis of the impact of income inequality on economic affluence and growth would go well beyond the simple bivariate patterns shown in figures 1 and 2. It would be helpful to control for other factors. We might wish to measure economic growth in other ways—as change in GDP per employed person rather than per population, or as percentage change rather than absolute change. We might want to use the level of inequality at

figure 1: level of gdp per capita by income inequality



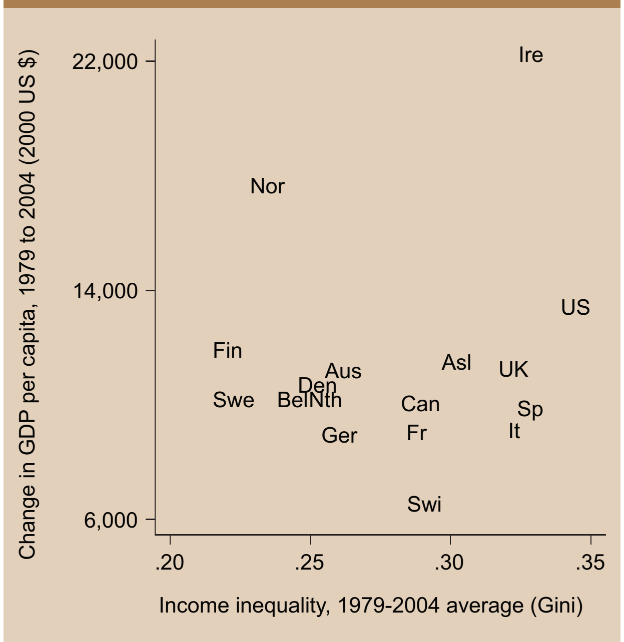
Note: Chart axes are truncated (do not begin at zero). Income inequality is for posttax-posttransfer household income, with income adjusted for household size. GDP per capita is converted into U.S. dollars using purchasing power parities. Source: Author's calculations using OECD and Luxembourg Income Study data.

Lane Kenworthy studies the effects of institutions and government policies on growth, employment, inequality, poverty, and mobility in affluent countries.

the beginning of the 1980s, rather than an average for the period, to ensure that there is no reverse causality. We might also change the starting and ending points or break this period into smaller subperiods. None of this, however, alters the conclusion that cross-country patterns since the late 1970s do not support the idea that pursuit of low income inequality impedes economic growth. There surely is some point at which the distribution of income in a country might be too egalitarian to be compatible with a desirable rate of growth. But the experience of the past two decades suggests that none of these countries has reached that point.

GDP per capita is thought to be a good indicator of a country's living standards. Across the affluent countries, GDP per capita is indeed strongly correlated with median household income—that is, with the income level of households in the middle (50th percentile) of the income distribution. But it is less useful as an indicator of living standards for households at the low end of the distribution. A better indicator is the income level at the 10th percentile of the distribution (below the 10th percentile there is more reason to worry about measurement error). These data suggest the same conclusion as those in figures 1 and 2: there is no apparent trade-off between low income inequality and high incomes at the bottom of the distribution or rapid growth of those incomes.

figure 2: change in gdp per capita by income inequality



Note: See the note to figure 1. Change is measured as 2004 GDP per capita minus 1979 GDP per capita, adjusted for inflation.

an equality/jobs trade-off?

In the past decade much of the debate about the effects of egalitarianism has centered on jobs. Here the concern is about pay equality rather than income equality—specifically, about the impact of high wages for those at the low end of the labor market. The equality/jobs trade-off view runs as follows. In many affluent nations the fastest-growing job sector, and the likely locus of future employment growth, is consumer-related services such as

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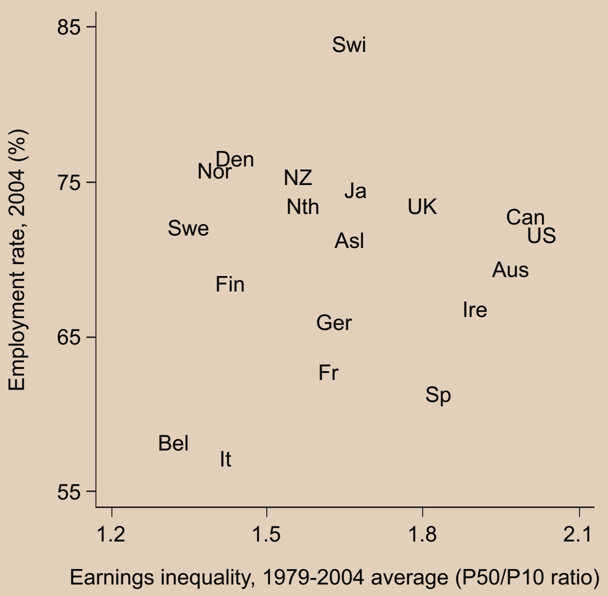
restaurants, hotels, retail trade, cleaning, and child care. In many consumer-service jobs, productivity levels are low and difficult to increase. In order to pay high wages, firms would have to pass the cost on to customers. But if the market is reasonably competitive, customers will refuse to pay a higher price. Unless wages for these consumer service jobs are low—which implies a high level of earnings inequality—the jobs will not exist.

Here too we need to look at the evidence. Figure 3 plots employment rates (employed persons as a share of the population age 15–64) in 2004 by the average level of earnings inequality among full-time employees since the late 1970s. There is no association. However, that could be a function of the period preceding the 1980s. Suppose that countries with less earnings inequality tended to have higher employment through the end of the 1970s (they did), but then around 1980 the economic environment changed so that low inequality began to harm employment. This development might take a long time to show up in an analysis of cross-country variation in employment levels. The sensible way to address this possibility is to look at change in employment, rather than levels of employment.

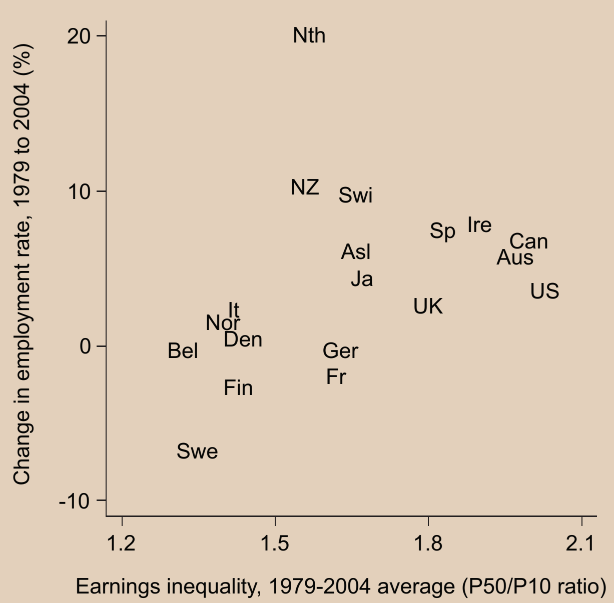
Figure 4 does that. It shows change in the employment rate between 1979 and 2004. Except for the Netherlands, there is a positive association between earnings inequality and employment growth. With the Netherlands excluded, the correlation between the two is .58.

Is the positive association between earnings inequality and employment growth spurious? A variety of labor marfigure 3: level of employment by earnings inequality



Note: Chart axes are truncated. Earnings inequality is for full-time employed individuals. Employment rate is employed persons as a share of the population age 15 to 64. To focus on earnings at the low end of the distribution, inequality for this and the following figure is measured using the ratio of earnings at the 50th percentile to earnings at the 10th percentile. Source: Author's calculations using OECD data.

figure 4: change in employment by earnings inequality



Note: See the note to figure 3. Change is measured as 2004 employment rate minus 1979 employment rate.

ket policies and institutions—including government benefit levels and their duration, tax structures, employment protection regulations, and wage-setting arrangements—tend to correlate fairly closely with levels of earnings equality across these countries. One or more of these might be the true obstacle to employment growth. My attempts to disentangle the effects of these various factors suggest that the adverse impact of low earnings inequality on employment growth has been smaller than that suggested in figure 4, but very likely real.

Is this apparent trade-off a cause for concern? Yes, for several reasons. Employment has intrinsic merits. With heightened geographical mobility, later marriage, and increased divorce, neighborhood and family ties have dissipated somewhat. As a result, work is an increasingly important site of social interaction. Employment also brings regularity and discipline to people's lives. It can be a source of mental stimulation. It helps fulfill the desire to contribute to and be integrated with the larger society. For many people, employment is inextricably bound up with identity and self-esteem.

Of perhaps greater importance for egalitarians, a high employment rate may increasingly be a prerequisite for greater household income equality. Higher employment can help to reduce market income inequality among households and to facilitate government redistribution.

How does it reduce market income inequality? Half a century ago it was common for many working-age adults to be out of the labor force. They were mainly women, and their husbands were employed. The fact that some adults were employed and others were not had little impact on the distribution of income among households because inequality of employment occurred mainly within, rather than between, households. That is no longer the case. As more women enter the labor market, inequality of employment occurs more and more between households.

In other words, instead of having many households with one (usually male) earner and one (usually female) non-earner, a country with a low or moderate employment rate now is more likely to have many households with two earners and some with no earners. This increases inequality of earnings and incomes between households. To the extent that it reduces the number of zero-earner households, high employment helps to counteract this development and reduce income inequality.

How does high employment facilitate government redistribution? The aging population will soon force a larger share of government revenues to go to the elderly. The ability of firms and investors to move funds across national borders makes it difficult for governments to increase tax rates in order to maintain or increase the generosity of redistributive programs for the non-elderly population. This poses a challenge for a government committed to equality. A rising employment rate increases tax revenues without an increase in tax rates. And to the extent that it moves some current recipients of government benefits into the work force, it reduces welfare costs.

Is it possible for countries to combine high employment with low pay inequality? Yes. Denmark, Norway, and Sweden have been able to do so by relying on high levels of public employment to offset deficits in private-sector, consumer-service jobs. Unlike most private firms, governments can pay wages that exceed productivity levels without having to raise prices. Employment rates in the Nordic countries continue to be high (figure 3). The question is whether this strategy is sustainable. Increasing capital mobility is a threat, but the main determinant will be whether citizens in these countries remain willing to be taxed at comparatively high rates.

Even if the Nordic approach proves to be sustainable, it is unlikely to be an option for countries that historically have had lower tax burdens. An alternative strategy is to allow relatively low wages at the bottom of the earnings distribution in order to stimulate private-sector employment. This implies more earnings inequality than there is in Sweden, though not as much as in the United States. However, it need not imply greater inequality of *household incomes*, which I suggested earlier should be of greater concern for egalitarians. To the extent that those who move into such jobs come from zero- or single-earner households at the low end of the distribution, the new earnings, even though relatively low, will pull up the income of the household. This will have the effect of reducing income inequality across households.

Moreover, low-income households can supplement their earnings with an employment-conditional earnings subsidy, along the lines of the Earned Income Tax Credit (EITC) in the United States and the Working Tax Credit in the United Kingdom. These programs provide a tax refund to households with low earnings. If (as often happens) the refund is greater than the amount the household owes in income taxes, the household receives the difference as a cash benefit. In order to encourage employment, the amount of the credit increases with earnings up to a point, then begins to decrease. The EITC has existed since the mid-1970s, and most studies conclude that it heightens labor force participation, effectively boosts the incomes of households most in need, creates minimal stigma, and has low administrative costs.

what to do?

Despite profound changes in the economic environment since the 1970s, affluent countries with egalitarian institutions and policies have so far been fairly successful at maintaining relatively high levels of income equality. And that success does not appear to have come at the expense of income growth for the middle class or the poor.

There may be a trade-off between earnings equality and job growth, but its magnitude appears to be modest. In any event, the existence of such a trade-off does not mean that high employment is incompatible with low income inequality. Countries unwilling or unable to collect sufficient tax revenues to pursue the Nordic strategy of extensive public employment may find it useful to allow more wage inequality than Sweden or Denmark. But the resulting higher employment can help to reduce income inequality among households, both by boosting the incomes of formerly zero- or one-earner households and by facilitating generous government benefits.

recommended resources

Francine D. Blau and Lawrence M. Kahn. *At Home and Abroad: U.S. Labor Market Performance in International Perspective* (Russell Sage Foundation, 2002). A useful statement and empirical assessment of the view that high wages at the low end of the earnings distribution are an impediment to high employment.

Robert E. Goodin, Bruce Headey, Ruud Muffels, and Henk-Jan Dirven. *The Real Worlds of Welfare Capitalism* (Cambridge University Press, 1999). Examines the impact of social policies on economic growth, inequality, poverty, and other outcomes in the United States, Germany, and the Netherlands.

Lane Kenworthy. *Egalitarian Capitalism* (Russell Sage Foundation, 2004). Assesses the causes and consequences of inequality in affluent nations in the 1980s and 1990s.

Lane Kenworthy. *Jobs with Equality* (Russell Sage Foundation, forthcoming 2007). Argues that high employment is crucial to the sustainability of generous redistributive programs and therefore to low income inequality, and analyzes the effects of institutions and policies on employment in affluent countries.

Fritz W. Scharpf and Vivien A. Schmidt, eds. *Welfare and Work in the Open Economy*. 2 vols. (Oxford University Press, 2000). Case studies and comparative analyses of what determines employment performance in rich nations.

An estimated 1,640,000 people have been killed in Middle East wars since 1945