CHAPTER 11

Lifting Living Standards in an Open Economy

The Danger of Front-Loading Income Inequality

Lane Kenworthy

Over the past decade, the American left has directed a growing share of its attention at income inequality.[1] Indeed, for some, reducing income inequality seems to have become the central goal.

There are compelling reasons to object to America's high and rapidly rising level of income inequality.

One is fairness. Much of what determines a person's earnings and income – intelligence, creativity, physical and social skills, motivation, persistence, confidence, connections, inherited wealth, discrimination – is a product of genetics, parents' assets and traits, and the quality of one's childhood neighbourhood and schools. These aren't chosen; they are a matter of luck. A non-trivial portion of income inequality is therefore undeserved.

Second, income inequality may increase inequality of other valuable things, such as education, health and happiness. Even if we think greater inequality in the distribution of income is acceptable, we may feel that greater inequality in the distribution of health, schooling and subjective well-being is not.

Third, a rise in income inequality contributes to slower absolute income growth for those in the middle and at the bottom.[2]

These, however, are not the rationales commonly put forward for worrying about income inequality. Instead, the most common arguments are that inequality is bad for the economy, overall health, opportunity and democracy. 'Of all the competing and only partially reconcilable ends that we might seek', writes Tony Judt in *Ill Fares the Land*, 'the reduction of inequality must come first. Under conditions of endemic inequality, all other desirable goals become hard to achieve.'[3]

Is that true?

Income Inequality and Economic Growth

In *The Price of Inequality*, Joseph Stiglitz suggests:

> We are paying a high price for the inequality that is increasingly scarring our economy – lower productivity, lower efficiency, lower growth, more instability – and the benefits of reducing this inequality, at least from the current high levels, far outweigh any costs that might be imposed.[4]

Stiglitz outlines some reasonable hypotheses about why income inequality is bad for economic growth. For instance, the rich spend a smaller fraction of their income than the middle class and the poor, so rising inequality may reduce consumer demand. And people may not work as hard if they perceive the distribution of pay and income to be unfair.

What does the evidence say? 'The US grew far faster in the decades after the second world war, when inequality was lower', Stiglitz points out, 'than it did after 1980, since when the gains have gone disproportionately to the top'.[5] However, there are many other differences between these periods that could account for the difference in growth rates. Better to compare the American experience with that of some other countries where inequality did not increase. Denmark and France are good candidates. Neither has had a noteworthy rise in income inequality. The top 1 per cent has not separated from the bottom 99 per cent, nor has the income gap widened within the bottom 99 per cent.[6] From 1947 to 1973, the heart of the postwar golden age, GDP per capita grew at an average annual rate of 2.4 per cent in the US, 3.3 per cent in Denmark and 4.4 per cent in France. Between 1979 and 2007, the growth rate averaged 1.8 per cent in the US, 1.8 per cent in Denmark and 1.5 per cent in France. In other words, economic growth slowed more in the more egalitarian countries. That is not what we would expect to see if inequality is a significant obstacle to economic growth.

According to Stiglitz: 'The bottom line [...] that higher inequality is associated with lower growth – controlling for all other relevant factors

– has been verified by looking at a range of countries and looking over longer periods of time.'[7] But in support of this claim he cites just one study, published nearly two decades ago. More recent research has reached varying conclusions about the effect of income inequality on economic growth in rich nations, with few finding that inequality is bad for growth.[8]

Faster economic growth would be a good thing (particularly if with it came a shift towards greener growth). But there is little evidence that the American economy will grow more rapidly if the US manages to reduce income inequality.

Income Inequality and the 2008 Economic Crisis

A related claim is that rising income inequality was a significant cause of the 2008 economic meltdown. Proponents cite three mechanisms, as summarised by Anant Thaker and Elizabeth Williamson:

> (1) sharp increases in debt-to-income ratios among lower- and middle-income households looking to maintain consumption levels as they fall behind in terms of income; (2) the creation of large pools of idle wealth, which increase the demand for investment assets, fuel financial innovation, and increase the size of the financial sector; (3) disproportionate political power for elite financial interests which often yields policies that negatively affect the stability of the financial system.[9]

It will be a while before the causes of the crisis are sorted out, but there are grounds for scepticism about income inequality's contribution.[10] Growing demand for loans by middle- and low-income households may have been driven more by the rising cost of homes and college, along with relaxed lending standards and the availability of second mortgages (home equity loans), than by slow household income growth. Risky lending may have been spurred by the creation of new financial instruments that appeared to spread risk and by an increase in pressure for profits in publicly owned investment firms. Finally, the Federal Reserve could have quashed the housing bubble, the proximate precipitant of the crisis, had it wanted to do so. That it chose not to arguably owed more to the ideological predilections of its chair, Alan Greenspan, than to the political influence of the rich.

Income Inequality and Health

A number of researchers, most prominently Richard Wilkinson and Kate Pickett in their book *The Spirit Level*, argue that income inequality is bad for life expectancy. Inequality is said to increase status competition, which increases stress, thereby shortening lifespan.

This hypothesis has been studied extensively, with the bulk of findings suggesting that income inequality is indeed associated with shorter life expectancy.[11] But virtually all of these studies are cross-sectional. They examine the association between the level of income inequality and the level of life expectancy across nations, regions, counties or cities at a single point in time.

A better approach is to analyse changes across countries.[12] None of the studies that have done so find evidence of a negative association between changes in income inequality and changes in life expectancy. Several relatively comprehensive reviews conclude that the empirical case for an effect of income inequality on life expectancy is very thin.[13]

Income Inequality and Other Social Outcomes

A similar conclusion holds for other social phenomena, including college completion, family stability, safety and happiness. Various claims have been made that income inequality is a key source of worrisome trends in these outcomes. But there is little supportive evidence.[14]

Income Inequality and Opportunity

Alan Krueger, Chair of President Obama's Council of Economic Advisers from 2011 to 2013, has suggested that rising income inequality in the US may have reduced intergenerational income mobility.[15] Krueger's inference is based on the fact that affluent nations with greater income inequality tend to have less mobility (they have a stronger correlation between the earnings of parents and their children). What does this cross-country association tell us about inequality's impact on mobility?

The goal is not high intergenerational mobility per se; it is low inequality of opportunity. Mobility serves as an indicator – not perfect, but not bad – of equality of opportunity. Money ought to be good for children's opportunity. Those growing up in households with higher incomes are more likely to have good health care, low stress, learning-centred pre-schools, good elementary and secondary schools, extracurricular activities that promote cognitive skills and earnings-enhancing non-cognitive traits, and access to a strong university. It would be surprising, therefore, if inequality of parents' incomes did not contribute to inequality of opportunity among their children.

But how large is the effect? After all, money is not the only thing that matters; our abilities and motivations when we reach adulthood also stem from non-monetary influences such as genetics, in-utero development, our parents' habits and behaviours, peers and schooling. In addition, there are diminishing returns to money; beyond a certain point, more parental income probably helps only a little, if at all.

The four Nordic nations – Denmark, Finland, Norway and Sweden – have low inequality and high mobility. At the same time, they have been providing affordable, high-quality early education to a substantial portion of children aged one to five for roughly a generation.[16] James Heckman and Gøsta Esping-Andersen, among others, argue that early education is perhaps the single most valuable thing a society can do to equalise opportunity.[17] The Nordic countries also feature late tracking (streaming) in K–12 schools and heavy subsidies to ensure that college is affordable for all. These public services, rather than low-income inequality, may be the chief reason the Nordic countries have such high intergenerational mobility. If we leave out the Nordic nations, the cross-country association between income inequality and intergenerational mobility remains, but it is quite weak.[18]

Income Inequality and Democracy

The most commonly voiced concern about income inequality in the United States is the fear that it has polluted our politics. Rising inequality is said to do four things: reduce trust in political institutions, reduce voter turnout, increase polarisation between the two parties and increase the influence of the rich on policy-making.[19]

The first two hypotheses do not square with the trends over time in trust and voting. According to data from the American National Elections Studies, trust in government and in the political process in the US began to decline in the 1960s and continued in the 1970s, but changed little during the period of rising income inequality since the 1970s. Voter turnout in presidential elections also declined beginning in the 1960s. But it reached a low point in 1996 and has increased since then. By 2008 it was back up to the level of the early 1960s. Voter turnout in off-year elections has not changed since 1974.

Party polarisation refers to the fact that elected Republican legislators have moved to the right on key economic issues while Democratic legislators have moved to the left. Here, too, the timing is a problem. According to the authoritative study of party polarisation, *Polarised America*, by Nolan McCarty, Keith Poole and Howard Rosenthal:

> In both chambers [the House and the Senate], the Republicans became more moderate until the 1960s and then moved in a sharply conservative direction in the 1970s. The pattern for the Democrats is almost exactly the opposite. Consequently, the two party means [average party positions] moved closer together during the twentieth century until the 1970s and then moved apart.[20]

But income inequality between the top 1 per cent and the bottom 99 per cent did not begin increasing until the 1980s.

What of inequality of political influence? Money clearly matters in American politics.[21] With the richest getting a larger and larger share of the country's income, it is sensible to hypothesise that they have greater success in swaying policy-makers to support their preferences. On the other hand, the influence of money in American politics occurs mainly via lobbying rather than campaign contributions, and lobbying is funded primarily by companies and other organisations rather than by individuals. The amount of money spent on lobbying has increased exponentially in the last few decades.[22] But much of that increase, if not all of it, might well have occurred in the absence of a rise in income inequality.

The most relevant evidence comes from studies by Larry Bartels and Martin Gilens.[23] For the period from 1989 to 1994, Bartels examined the association between senators' votes on proposed policy changes and the opinions of Americans in the lower third, middle third and upper third of income. He found that voting correlated much more closely with the views of those with higher incomes. Gilens extended Bartels' analysis by examining both the Senate and the House of Representatives, and by covering the presidencies of Lyndon Johnson, Ronald Reagan, Bill Clinton and George W. Bush. His finding echoes that of Bartels.

What we need to know, however, is whether this pattern of unequal influence has increased as income inequality has risen. According to Gilens, the association between affluence and influence was weak during the Johnson presidency, strong during the presidencies of Reagan and Clinton, and relatively weak during the presidency of George W. Bush. This is not what the inequality hypothesis predicts, though there may be some confounding factors, such as the 11 September 2001 terrorist attacks, that skew the pattern during the Bush years.

Now, this is by no means a full and complete test of the inequality hypothesis. After all, the well-to-do may exert their influence mainly by keeping proposed reforms from ever coming to a vote and behind-the-scenes shaping of legislation that does pass. It is possible that their growing income share has enhanced their ability to use these kinds of levers. But if this has in fact happened, it has yet to be effectively documented.

In their recent book *Winner-Take-All Politics*, Jacob Hacker and Paul Pierson detail a litany of policy initiatives since the mid-1970s that in their view have had a significant influence – some because they were passed, others because they were blocked – on the degree of income inequality in the US and on the living standards of ordinary Americans. But there is no indication in their account of a steady increase in the tendency of policy to favour the rich.

Reduce Income Inequality, but not Above All Else

I believe, as I said earlier, there are good reasons to object to the high and rising level of income inequality in the US. Yet I fear the American left's recent move to put income inequality reduction front and centre might be harmful rather than helpful. It may foster a conviction that the key to addressing America's social, economic and political problems is to reduce the top 1 per cent's share or the Gini coefficient. That could distract attention from more direct and effective efforts to address those problems.

Such efforts include fully universal health insurance; improvements in eligibility, duration and benefit level for various social-insurance and social-assistance programmes; wage insurance; early education; enhanced financial support for college; a minimum wage indexed to prices; an expanded earned-income tax credit indexed to average compensation; and monetary policy less tilted towards inflation avoidance. Policy changes like these would go a long way towards improving economic security, enhancing opportunity (and mobility) and ensuring shared prosperity in the US. Inequality of political influence could be lessened via direct reforms, such as reversal of the Citizens United decision, introduction of a strong transparency rule and public funding for congressional election campaigns.

Developments in the UK under the New Labour governments from 1997 to 2010 are illustrative. Among rich countries, the UK has one of the highest levels of income inequality, and inequality continued to rise under New Labour (though less rapidly than in prior decades). Yet, through a variety of new programmes and changes to existing policies, those governments achieved one of the best records of any affluent nation over the past generation in improving economic security, opportunity and living standards for middle-class and poor households.[24]

In the US, policy changes such as these will require more tax revenue. Here lies another troublesome consequence of a focus on inequality reduction: a sizeable portion of the American left has come to think of taxation solely in terms of its redistributive impact. The aim of tax reform, in this view, should be to reduce income inequality. The change many favour is higher tax rates on the top 1 per cent or 5 per cent. Yet while that may reduce income inequality, it will not provide the US government with anywhere near the money it needs to do the sorts of things I've just mentioned. Instead, the chief aim should be to increase revenues. In my estimation, the US ought to be thinking about how to get an additional 10 per cent of GDP in coming decades, and that cannot be done by increasing the taxes of just those at the top.[25]

Some of the programmes I've mentioned would help to reduce income inequality by boosting the incomes of households on the lower and middle rungs of the income ladder. Indeed, focusing on economic security, opportunity and rising living standards might be the most effective route to lessening income inequality. The American public has never shown much appetite for income redistribution. Even during the past three decades, as income inequality has shot up, the main detectable reaction among Americans has been a desire to expand programmes that focus on opportunity.[26] That does not mean it is impossible to take steps to reduce inequality in the market distribution or to increase redistribution. It means programmes that do this are more likely to be supported if they are not marketed as a means to achieve income-inequality reduction.

Other programmes I listed above are public services. Though childcare, schooling and health care do not reduce the measured degree of income inequality, since they do not change household incomes, they do reduce inequality of living standards.[27]

Income inequality is too high in the US. It would be good to reduce it. But it is a mistake, in my view, to put inequality reduction at the top of the agenda.

Notes

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