Rising incomes and modest inequality: the high-employment route

Lane Kenworthy

During the period between the Second World War and the mid-1970s, the US enjoyed rapid economic growth, rising incomes for households across the distribution and a decline in income inequality. Since then, growth has continued, albeit at a slower pace. But, as Larry Mishel and Heidi Shierholz document in Chapter 1.1, the incomes of households at the middle and bottom have risen much less rapidly, both in an absolute sense and relative to the incomes of those at the top.

This presents a challenge to social democrats. If growth no longer secures rising living standards for low- and middle-income households, is there anything else that can be done to ensure that these families thrive in the modern economy? In this chapter, I first explore why strategies that worked in the past – namely, wage growth – may no longer work in the future. I then recommend an alternative: high employment. High employment would both raise household earnings and shore up the financing of redistributive government transfer programmes. High employment is not, however, a silver bullet, and I conclude by highlighting other policies that would complement and reinforce its benefits.

The broken link between economic growth and wages

During the early post-war decades, much of the growth in incomes for working-age Americans came from rising wages, which increased more or less in line with the growth of the economy. As Mishel and Shierholz (Chapter 1.1) show, that link has been severed for those in the lower half of the wage distribution.[1] Since the 1970s, real wages in the bottom half have barely budged.

The key to rising wages during the post-war golden age was that many US firms faced limited product market competition, limited pressure from shareholders to maximise near-term profits and significant pressure from unions (or the threat of unions) to pass on a 'fair' share of profits to employees. Each of these three institutional features is gone, and it is unlikely that they will return. Moreover, a host of additional developments now push against wage growth: technological change, stagnant educational attainment, the shift of employment from manufacturing to services, a more general trend away from middle-paying jobs, a rise in less-skilled immigration, growing prevalence of winner-take-all labour markets, a shift towards pay for performance and minimum wage decline.

The story is somewhat different in the UK. Real wages in the lower half rose between 1977 and 2003. But after that, the increase stopped, despite strong economic growth up to 2008. Resolution Foundation analysis suggests that the wages of a typical full-time male worker in the low- to middle-income group would be lower in 2020 than at their peak in 2003, even assuming that the economy returns to steady economic growth after 2017.[2] Will the UK's pay trend replicate what has happened in the US? It is too soon to tell, but given the similarity in labour markets and other economic institutions, it would not be surprising to see patterns in the US mirrored in the UK unless policymakers deliberately seek to alter the current trajectory.

Rising market inequality

The US and the UK have both experienced sharply rising income inequality, with more and more of the economic growth going to those at or near the top.[3] Although this trend is not unique to these two countries, it has been especially pronounced in them.

There are a number of factors at play here. As Figure 1.1.4 in Chapter 1.1 shows, inequality in the distribution of wages has been rising for some time now. This is extended and accentuated by family trends. Delayed marriage and frequent divorce result in lots of single-adult households. There is also evidence in the US and the UK of increasing 'marital homogamy' – higher-skilled, higher-earning people coupling with others like them. The net effect of this is to create many households with two earners and many with no earners or just one, and that in turn results in greater inequality of earnings and incomes between households. At the top, shifts in corporate governance, deregulation, financial innovations, rising stock prices and other developments have contributed to outsized growth in pay and capital gains. Some of these causes of rising market inequality are potentially amenable to policy intervention, but an appropriate and workable fix is far from straightforward.

Redistributive mechanisms are under increasing pressure

A key strategy for tackling rising market inequality in recent years has been to redistribute money to households. Indeed, many developed countries have increased the amounts of redistribution through their taxation and transfer systems.[4]

However, for the majority of countries, this increase has not been sufficient to offset the rise in market inequality, so post-tax, post-transfer inequality has increased too. And despite their increasingly important role in supporting the household incomes of low earners, redistributive measures face new pressures. Both taxes and transfers can redistribute. But, as the first chart in Figure 1.2.1 shows, in practice, transfers do most (if not all) of the work. In most rich countries, the overall tax system is roughly proportional: people at various points in the income distribution pay a similar share of their market income in taxes. In the US, for instance, taxes on personal and corporate income are progressive, but they only represent 14% of gross domestic product (GDP). Their progressivity is largely offset by regressive consumption and payroll taxes, which total 12% of GDP.

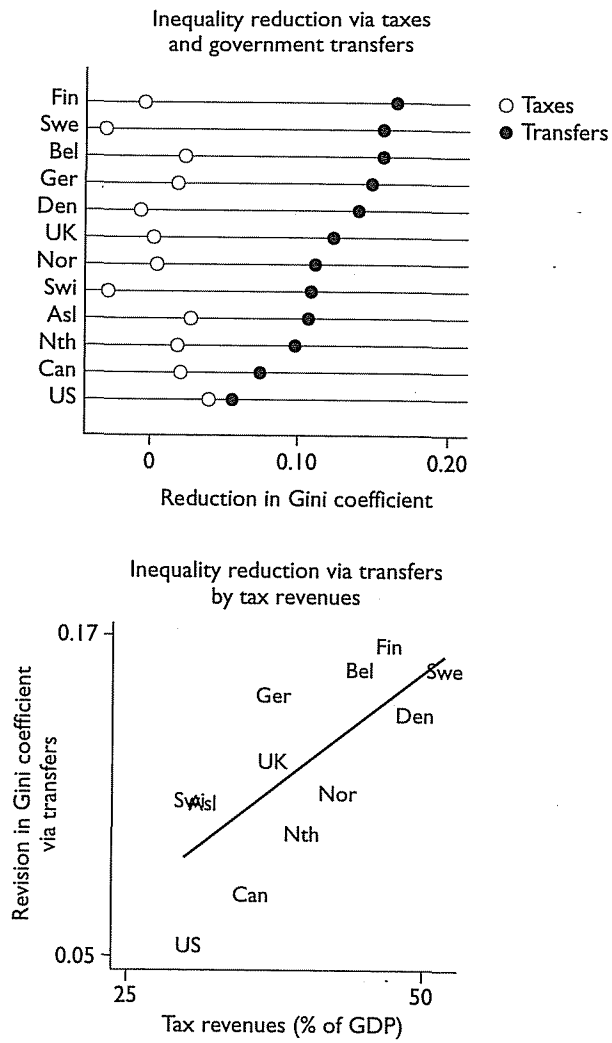
Taxes, though, provide the funds for the transfers that achieve the bulk of the inequality reduction. The second chart in Figure 1.2.1 shows a strong positive association across countries between tax revenues as a share of GDP and the amount of redistribution achieved via government transfers.

The problem is this: the economic recession has strained government finances in a number of rich countries. For example, the UK government's austerity programme has led to £2.5 billion of cuts to tax credits for low- to middle-income families in 2012/13. Population ageing will prove an even bigger challenge, raising the costs of pay-as-you-go pension systems and government-funded health care. A growing share of government revenues will need to go to the elderly, leaving less available for countering wage stagnation and rising market inequality.

A high-employment route

If government revenue from taxes will be stretched to meet the growing demands of an ageing population, where will the additional money come from to boost the incomes of low- and middle-income households? In the 1960s and 1970s, the standard response would have been to increase tax rates. The US has ample room to raise tax rates. In 2007, US tax revenues were just 28% of GDP, and total (tax plus

Figure 1.2.1: Taxes, transfers and inequality reduction, circa 2000



Source: L. Kenworthy (2011) *Progress for the Poor*, Oxford: Oxford University Press, Figures 8.3 and 8.4, using Luxembourg Income Study and Organisation for Economic Co-operation and Development (OECD) data.
Key: Asl = Australia; Bel = Belgium; Can = Canada; Den = Denmark; Fin = Finland; Ger = Germany; Net = Netherlands; Nor = Norway; Swe = Sweden; Swi = Switzerland; UK = United Kingdom; US = United States

non-tax) government revenues were 34%. Indeed, as Tamara Draut notes in Chapter 3.1, tax rates in the US have dropped over the last half-century, with tax revenues holding constant as a share of GDP only because the tax base has been widened. In the UK, tax revenues

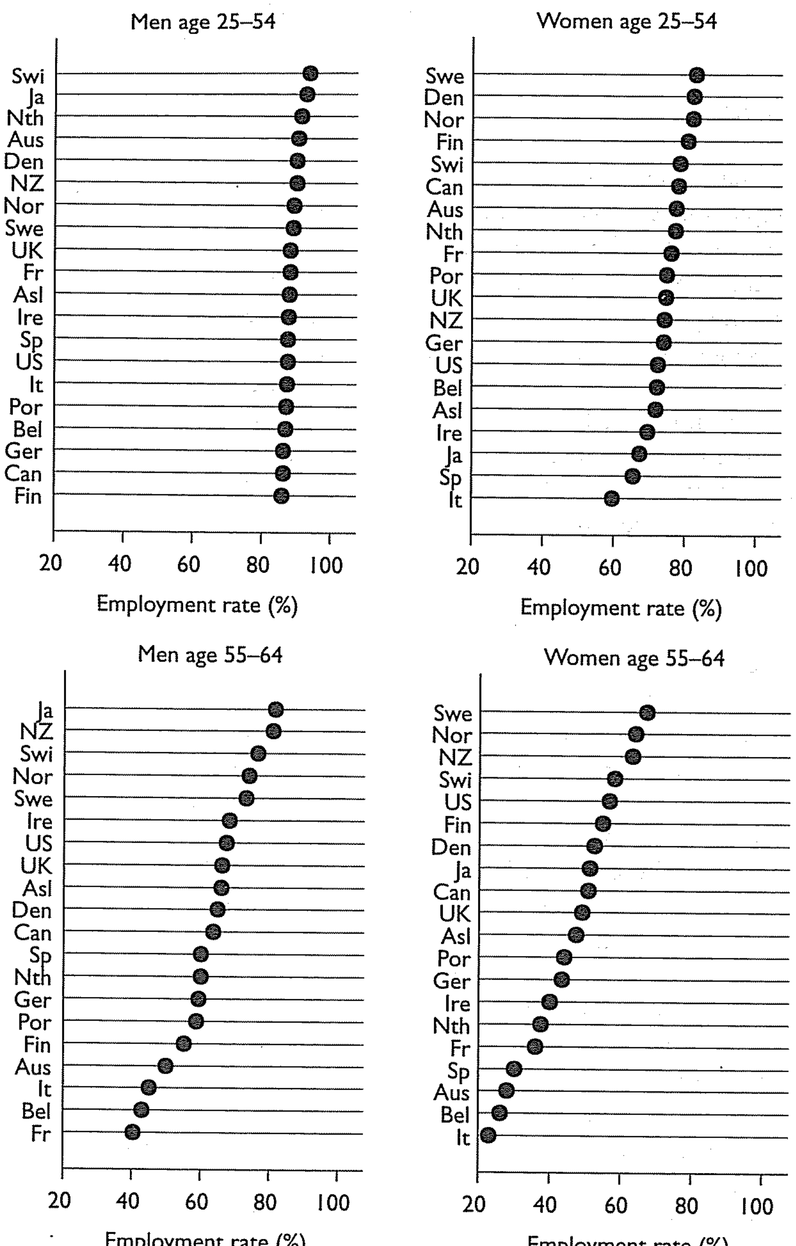
were 36% of GDP in 2007. This, too, is well below the levels of a number of other rich nations. In Denmark and Sweden, for instance, tax revenues in 2007 were 48–49% of GDP and total government revenues were 54–55%. This does not appear to have damaged these countries' economies.[5] However, capital mobility and public receptivity to anti-tax rhetoric make the politics of raising taxes extremely challenging. This is where employment comes in. Beyond its benefits to individuals,[6] employment can contribute to rising incomes and modest inequality.[7] First, people who move from government benefits into work tend to improve their income, at least in the long run. That helps with income growth. Second, because earnings from employment are taxed, a rising employment rate increases tax revenues without requiring an increase in tax rates. High employment can thereby help to generate the revenues needed to fund transfers that offset stagnant wages and rising market inequality. Third, high employment also eases the fiscal crunch by reducing the number of people fully or heavily reliant on government benefits.

How to do it

The UK came through the depths of the recent recession with employment rates remaining higher than expected given previous experiences during the 1980s' and 1990s' downturns.[8] That said, it may be some time before employment returns to pre-recession levels. And there is no guarantee that the UK will continue its upward trajectory. Indeed, it could well slip into the kind of employment stagnation that befell the US from 2000 to 2007, with growing numbers forced into underemployment. Furthermore, as Figure 1.2.2 shows, US and UK employment rates were well below those of the leading affluent countries even before the economic crisis hit in 2008. Employment rates for prime-working-age (25 to 54) men probably cannot go up much further. But among prime-working-age women and particularly among the near-elderly (55 to 64), both male and female, there is considerable room for increase.

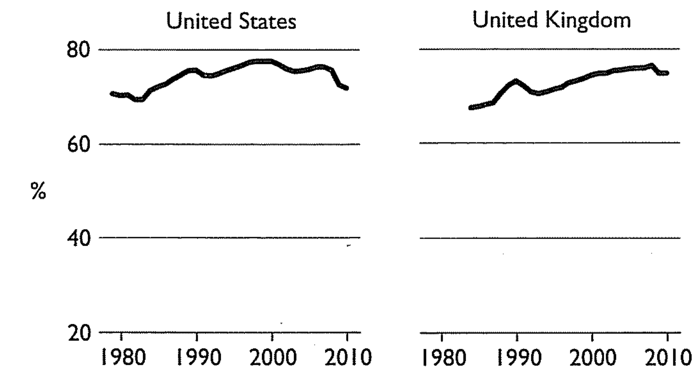
For several decades now, the US has pursued a market liberal approach to employment growth: a low wage floor, very limited labour market regulations, relatively stingy government benefits, comparatively low taxes, steady deregulation of product markets and limited support for retraining, job placement and work–family balance. Up to the turn of the century, the 'great American jobs machine' was comparatively successful, with the US one of the rich world's leaders in raising its employment rate. But in the 2000s, the bloom fell off the rose, as

Figure 1.2.2: Employment rates by sex and age group, 2007



Source: Author's analysis of OECD data
Key: Asl = Australia; Aus = Austria; Bel = Belgium; Can = Canada; Den = Denmark; Fin = Finland; Fra = France; Ger = Germany; Ire = Ireland; It = Italy; Ja = Japan; Net = Netherlands; Nor = Norway; NZ = New Zealand; Por = Portugal; Sp = Spain; Swe = Sweden; Swi = Switzerland; UK = United Kingdom; US = United States

Figure 1.2.3: Employment rates, age 25 to 64, 1979–2010



Source: Author's analysis of OECD data

Figure 1.2.3 indicates.[9] The early years of recovery after the 2001 recession featured feeble job growth, and things did not improve much after that. By the peak year (2007), the employment rate had not yet recovered to its 2000 level.[10]

During the debate surrounding the OECD's early-1990s' 'jobs study',[11] the virtue of the American model was seen as its ability to create lots of jobs. Whether that success was confined to a specific historical period or was always something of a chimera, it now seems clear that more is needed.

First, adequate demand is essential. Once it finally emerges from the aftermath of the great recession, the US may struggle in the absence of a 1990s- or 2000s-style stock market or housing bubble to fuel consumer spending. Rising living standards in developing nations should help by boosting exports, and government job creation can enhance domestic demand (see later); but this is a significant question mark going forward.

Second, early education is a clear winner. It has been shown that lowering the cost of childcare produces a significant increase in the employment of married mothers, with even larger effects for single mothers.[12] Beyond this economic case, evidence is mounting that good, affordable childcare contributes to equality of opportunity, improved life chances for those at the bottom, social mobility, and perhaps also equality of outcomes.[13]

Historically, social policy has been developed around an assumed male breadwinner/female carer model, with the result that social service provision for children or the elderly was underdeveloped. The Nordic countries began to prioritise family services in the 1970s, whereas governments in the US and the UK preferred to stimulate the market and subsidise care provision through tax deductions. The Labour administrations of 1997–2010 did much to address market failures in childcare, but their legacy is fragile. The new Coalition government reduced support for childcare in 2011 and it remains the case that childcare provision in the UK is patchy, expensive and inflexible. Still, it is much better than in the US.

Third, improvement in elementary, secondary and tertiary schooling is needed.[14] Just three-quarters of a typical American cohort complete high school, and the share getting a four-year college degree has risen only slightly since the late 1970s. Fourth, the US should sharply expand provision of individualised assistance for those who struggle in the labour market. This is expensive, but it helps.[15] Fifth, government can subsidise private sector job growth and create public sector jobs. One candidate is green jobs.[16] Another is helping/caring services, including the provision of information. Sixth, efforts to make low-end jobs pay well enough to be attractive have been inconsistent. Key tools include the statutory minimum wage and the Earned Income Tax Credit.[17] I discuss these later.

The New Labour governments embraced several of these approaches – childcare, reform of schools, individualised assistance in training and job search, and making work pay – albeit on a somewhat limited scale. Those efforts were a clear step in the right direction, and they made a difference.[18] Continuing, enhancing and improving them is likely to boost employment further. But as we have already seen, New Labour's positive legacy is threatened on several fronts as a result of the new government's decision to eliminate the public deficit in a single parliament.

How much additional revenue?

Can higher employment really generate enough tax revenues to fund the government transfers needed to ensure decent incomes and moderate income inequality? It is impossible to be certain, but I think there are grounds for optimism.[19] When a person shifts from being non-employed or a benefit recipient or employed off-the-books to a job in the formal sector, income and payroll tax receipts increase. Consumption tax revenues may also rise. And some people will move up to higher-paying positions, generating further additional tax revenues.

Here is a back-of-the-envelope calculation for the US: in 2007, just before the recession, taxes on income and payroll totalled about 18% of GDP. If the US were to increase its employment-to-population ratio[20] by about one sixth, from 62% to 72%, revenues from income and payroll

taxes might rise by two or three percentage points of GDP. That could finance a very large expansion of the Earned Income Tax Credit (see later); or it could fund a Nordic-style family policy.[21] If there were additional revenue from consumption taxes and reduced spending on some types of transfer payments (unemployment compensation, social assistance, disability), the fiscal benefit would be even larger.

A future of lousy jobs?

In an ideal world, everyone would have high-quality, well-paid employment. That, however, is not going to happen. Even if more and better education helps to push the quality mix of new jobs in a favourable direction, we must accept that a significant share of employment growth will be in low-end services. These are jobs that require limited schooling and in which productivity improvement is difficult – cleaning, caring, assisting and so on. We ought to embrace low-end service employment and figure out how to make it better.

This brings me back to wages. Despite the breakdown of the relationship between pay and economic growth, we should not abandon efforts to increase wages. Here, I see five complementary solutions. The first is high employment itself. A tight labour market – low unemployment, often referred to as 'full employment' – tends to push wages up. We can see this in the one and only period since the 1970s in which real wages in the bottom half of the US distribution have increased: the late 1990s. The key factor seems to have been an unemployment rate that got as low as 4%.[22] A high employment rate does not guarantee a low unemployment rate, but it makes it more likely.

It would be good to repeat the late 1990s' experience. But while it is within the power of policymakers to achieve full employment, there is a good chance they will not do so. If and when the US gets near 4% unemployment again, I suspect the Federal Reserve will be less willing than it was in the late 1990s to resist stepping on the brakes. The Federal Reserve chair at that time, Alan Greenspan, held interest rates low despite opposition from other Federal Reserve board members, who were concerned about potential inflationary consequences of rapid growth, rising wages and the internet stock market bubble. Greenspan took this stance in part because his belief in the self-correcting nature of markets led him to worry less than others about the bubble. In light of the painful consequences of the 2000s' real estate bubble, I doubt that the Federal Reserve will take that approach again for some time.

A second solution for wages is unions. Unionisation is a tried-and-true strategy for improving pay. Unions have been slow to organise low-end services, but there have been some successes, as Eileen Appelbaum and Carrie Leana show in Chapter 2.1. It would be good to see more of this kind of work in both countries.

A third solution is public employment. Public sector jobs tend to have better pay than comparable private sector ones. This has been a key element of the Nordic countries' success in bolstering the incomes of people in low-end service positions. Expansion of childcare, early education, care for the elderly, the ill and the disabled, and a host of other low-end services can occur partly via public employment.

A fourth solution is subsidies to boost household incomes. Here, the UK and the US have existing programmes, the Working Tax Credit and the Earned Income Tax Credit, on which to build (discussed by Daniel Gitterman in Chapter 2.4).[23] In the US, the Earned Income Tax Credit currently boosts the incomes mainly of households near the bottom of the distribution. There is a good case for expanding the credit to reach those further up the scale. In the UK, the greater generosity of out-of-work benefits means that the work incentives of the Working Tax Credit, particularly for second earners, can be rather weak. Despite the government's commitment to make work pay, it appears that the newly designed Universal Credit will not significantly improve work incentives for second earners and may, in fact, make things worse for many families.[24]

A fifth solution is the statutory minimum wage. The US ought to follow the UK in establishing an independent commission to determine when and by how much the minimum wage should be increased. In the US, the federal minimum wage is too low, and state-mandated levels, though they help, in many instances do not suffice to bring it up to where it ought to be. Even in the UK, the minimum wage has not fully kept up with inflation. In real terms, today's minimum wage is lower than it was in 2004.[25]

In Chapter 2.2, Francoise Carré and James Heintz draw our attention to the importance of work conditions alongside pay. Will a high-employment strategy help shore up the welfare state, secure decent incomes for the bottom half, maintain an acceptable level of inequality and yet leave a significant portion of the population working in drudgery? It need not turn out that way. There is a limit to the amount of stimulation that some low-end jobs will ever be able to provide. But most could do better, and efforts to figure out how and to push firms in that direction are well worth undertaking. Indeed, there is good reason to favour direct action to improve working conditions in *all* jobs,

instead of assuming that higher-skilled, better-paying positions – the kind we surely would like to have more of – will necessarily feature a decent quality of work life.

One piece of the puzzle

A generation ago it was fairly common on the centre-left to view freedom from work ('decommodification') as an integral element of the good society. In the 1990s, the tide began to turn in favour of employment, activation and the social investment state. Now, in the aftermath of rising inequality, stagnant relative poverty rates and a severe economic crisis, this in turn is itself facing questioning and criticism.[26]

That is healthy. It is always wise to rethink and re-examine. My own view, though, is that the case for a high-employment path is stronger than ever. The obstacles to rising incomes and modest inequality are formidable. High employment is only part of the answer. But it is an important part.

Notes

[1] See also Mishel, L., Bernstein, J. and Shierholz, H. (2009) *The state of working America*, Washington DC: Economic Policy Institute; Plunkett, J. (2011) 'Growth without gain? The faltering living standards of people on low-to-middle incomes', Resolution Foundation, available at: http://www.resolutionfoundation.org/media/media/downloads/Growth_without_gain_-_Web.pdf; and Whittaker, M. and Savage, L. (2011) 'Missing out: why ordinary workers are experiencing growth without gain', Resolution Foundation, available at: http://www.resolutionfoundation.org/media/media/downloads/Missing_Out.pdf

[2] The Resolution Foundation (2012) *Essential guide to squeezed Britain: The annual audit of low to middle income households*, London: The Resolution Foundation.

[3] Atkinson, A.B., Piketty, T. and Saez, E. (2009) 'Top incomes in the long run of history', Working Paper 15408, National Bureau of Economic Research.

[4] Kenworthy, L. and Pontusson, J. (2005) 'Rising inequality and the politics of redistribution in affluent countries', *Perspectives on Politics*, vol 3, no 3, pp 449-71.

[5] Kenworthy, L. (2011) 'Is heavy taxation bad for the economy?', Consider the Evidence. Available at: http://considertheevidence.net/2011/05/22/is-heavy-taxation-bad-for-the-economy

[6] Employment imposes regularity and discipline on people's lives. It can be a source of mental stimulation. It helps to fulfill the widespread desire to contribute to, and be integrated with, the larger society. It contributes to identity and self-esteem. With family and neighbourhood ties weakening, it is an increasingly important site of social interaction.

[7] Ferrera, M., Hemerijck, A. and Rhodes, M. (2000) 'The future of social Europe: recasting work and welfare in the new economy', report prepared for the Portuguese Presidency of the European Union, http://www.zoot.unifi.it/relazioni-internazionali-studi-europei/upload/sub/Ferrera_Hemerijck_Rhodes.pdf; Scharpf, F. and Schmidt, V. (eds) (2000) *Welfare and work in the open economy*, Oxford: Oxford University Press; Esping-Andersen, G., Gallie, D., Hemerijck, A. and Myles, J. (2002) *Why we need a new welfare state*, Oxford: Oxford University Press; Kenworthy, L. (2004) *Egalitarian capitalism*, New York, NY: Russell Sage Foundation; OECD (2006) *Employment outlook: boosting jobs and incomes,* Paris: OECD; Kenworthy, L. (2008) *Jobs with equality*, Oxford: Oxford University Press; Kenworthy, L. (2009) 'The high-employment route to low inequality', *Challenge*, vol 52, no 5, pp 77-99.

[8] Gregg, P. and Wadsworth, J. (eds) (2010) *The labour market in winter: the state of working Britain,* Oxford: Oxford University Press.

[9] Freeman, R.B. and Rodgers, W.M. (2005) 'The weak jobs recovery: whatever happened to "the great American jobs machine"?', Federal Reserve Bank of New York, *Economic Policy Review*, vol 11, no 1, pp 3-18; Gordon, R. (2010) 'Okun's Law and productivity innovations', *American Economic Review Papers and Proceedings* vol 100, pp 11-15; Kenworthy, L. (2011) 'The late American jobs machine', Consider the Evidence, available at: http://considertheevidence.net/2011/09/13/the-late-american-jobs-machine

[10] Rising employment is particularly important for those at the low end of the labour market. Here, too, the 2000s' upturn was a disappointment. In working-age households in the bottom quartile of the income distribution, average employment hours failed to rise at all. See Kenworthy, L. and Bentele, K. (2011) 'How trickle down can fail: the U.S. case', in Kenworthy, L. (ed) *Progress for the poor*, Oxford: Oxford University Press, ch 3.

[11] OECD (1994) *The OECD jobs study,* Paris: OECD.

[12] Blau, D. (2001) *The child care problem. an economic analysis*, New York, NY: Russell Sage Foundation.

[13] Kenworthy (2008), op cit, ch 10; Esping-Andersen, G. (2009) *The incomplete revolution,* Cambridge: Polity Press; Cunha, F. and Heckman, J.J. (2010) 'Investing in our young people', Working Paper 16201, National Bureau of Economic Research; OECD (2011) *Doing better for families,* Paris: OECD.

[14] Kenworthy, L. (2011) 'Two and a half cheers for education', in Cramme, O. and Diamond, P. (eds) *After the third way: the future of social democracy in Europe,* London: I.B. Taurus.

[15] Ben-Galim, D. and Sachraida Dal, A. (eds) (2009) 'Now it's personal: learning from welfare-to-work approaches around the world', Institute for Public Policy Research. Available at: http://www.ippr.org/publications/55/1797/now-its-personal-the-new-landscape-of-welfare-to-work

[16] Apollo Alliance (2008) 'Creating green-collar jobs in America's cities', Center for American Progress and Center on Wisconsin Strategy. Available at: http://www.americanprogress.org/issues/2008/03/pdf/green_collar_jobs.pdf

[17] Kenworthy, L. (2009) 'Reducing inequality: boosting incomes in the bottom half', Consider the Evidence. Available at: http://considertheevidence.net/2009/04/16/reducing-inequality-boosting-incomes-in-the-bottom-half

[18] Waldfogel, J. (2010) *Britain's war on poverty*, New York, NY: Russell Sage Foundation, ch 2; Finn, D. and Schulte, B. (2008) '"Employment first": activating the British welfare state', in Eichhorst, W., Kaufmann, O. and Konle-Seidl, R. (eds) *Bringing the jobless into work?,* New York, NY: Springer.

[19] For a fuller discussion, see Kenworthy (2009), op cit, pp 289–91.

[20] All employed persons as a share of the total population. This is different from the data shown in Figure 1.2.3, which are for employed persons age 25–64 as a share of the population age 25–64.

[21] The difference between what the US currently spends on child payments and allowances, parental leave benefits, and child care support versus what Denmark and Sweden spend is 2–3% of GDP. See OECD (2011) op cit, Figure 1.11.

[22] Bernstein, J. and Baker, D. (2003) *The benefits of full employment*, Washington D.C.: Economic Policy Institute.

[23] See also Kenworthy (2008), op cit, ch 7; Kenworthy, L. (2011) *Progress for the poor*, Oxford: Oxford University Press, ch 5.

[24] Hirsch, D. (2011) *Tackling the adequacy trap: earnings, incomes and work incentives under the Universal Credit*, London: Resolution Foundation.

[25] Manning, A. (2012) *Minimum wage: maximum impact*, London: Resolution Foundation.

[26] Morel, N., Palier, B. and Palme, J. (eds) (2009) *What future for social investment?*, Stockholm: Institute for Futures Studies; Cantillon, B. (2010) 'Disambiguating Lisbon: growth, employment and social inclusion in the investment state',

Working Paper 10-07, Centre for Social Policy, University of Antwerp; McTernan, M. (ed) (2011) *Social progress in the 21st century: social investment, labour market reform, and intergenerational equity*, London: Policy Network.

THE SQUEEZED MIDDLE

The pressure on ordinary workers in America and Britain

Edited by Sophia Parker