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GROWTH, PROSPERITY AND THE GENERATION OF INEQUALITY

Review of *The State of Working America, 1998–99*, by Lawrence Mishel, Jared Bernstein, and John Schmitt, and *The State of Working Britain*, edited by Paul Gregg and Jonathan Wadsworth.

These two books share a common purpose—to bring together recent research on labor market conditions in an accessible form. Their aim is to inform those responsible for developing and implementing policy and those whose popular writings on economic issues help set the tone of the reform agenda. Writing in the Foreword to the Gregg and Wadsworth (GW) volume, Will Hutton emphasizes the importance of its attempt to close the gap between research and the views of politicians, pundits and policy advisors—views that are often informed "by little more than scraps of statistics, anecdote and prejudice." The underlying theme of both volumes is the growing inequalities experienced by different groups of labor market participants over the last twenty-five years or so. However, in taking on this admirable task of closing the gap between research and policy, a key determinant of success is the quality of presentation. It is therefore reasonable to judge the success of each volume against this benchmark, as well as in relation to content and scholarship.

It is difficult to think of two countries better than the United States and the United Kingdom in which to explore the dimensions and consequences of growing inequality since the 1970s. Although income inequality has been a striking feature of economic development in many industrialized countries over the last quarter of the twentieth century, the trend to inequality has not been universal across either time or place (Atkinson, 1996; Osberg, 2000). Yet widening income disparities have emerged or been anticipated in a wide range of countries at some point over the last three decades. The pattern has been sufficiently widespread that many have seen rising inequality as the inevitable price to be paid for restarting the engine of growth that stalled so fatefully in the 1970s.

Underlying the view that an increase in inequality is necessary to improve incentives, increase economic growth and raise living standards—at least in the minds of politicians and their policy advisors—is the idea of a trade-off between equity and efficiency made popular by Arthur Okun (1975). This presumed trade-off was the rationale for the economic policies of the Reagan/Bush and Thatcher/Major Governments, both of which pursued policies that deliberately increased inequality in order to improve incentives. Yet by the time these policies were coming into full effect, academic economists—inspired by the new theories of endogenous growth—had rejected the trade-off idea in favor of a new orthodoxy

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in which growth and equality were positively related (Osberg, 1995; Scarth, 2000). Reviewing the vast literature on inequality and growth, Aghion, Caroli, and García-Peñalosa (1999, p. 1656) conclude that; "when capital markets are imperfect, there is scope for redistributive policies which are also growth-enhancing." Even so, many governments continue to base their policies on the 1970s notion of an Okun-style trade-off between growth and inequality.

Clearly, the insights of academic economists in the 1990s seem to have had little impact on policy, at least in the short-term. This may in part be due to the fact that the economic ideas that are influential among the current generation of policy-makers were acquired when they were studying, typically two decades ago or more. But it may also be the result of the failure of economists generally to present their ideas in ways that policy-makers can understand and assimilate. Whatever the cause, the attempt of these two volumes to speak the language of contemporary economic research to a wide audience is to be welcomed. Although economic ideas will always have to compete with other factors that determine policy choices, making new ideas widely available can at least challenge those whose actions are influenced more by ideology than by sound research, rational argument and informed reflection.

Recent distributional research is supported by a wealth of new data, and a powerful array of analytical techniques and computer firepower. A new generation of economists has highlighted how the various dimensions of inequality have changed, identifying winners and losers in the distributional struggles that have accompanied the recent phases of capitalist development. Although there are still some who regard rising inequality as an inevitable consequence of growth, many others see the degree of inequality as something that societies must choose for themselves. This choice involves determining how much, and what forms of inequality accord with notions of social justice and balancing distributional outcomes against other economic and social goals.

Policy makers—particularly in Anglo-Saxon countries, led by the US and UK—have often seen "incentives" as the engine of growth. Economic and public policies have thus been shaped by a deregulatory environment in which the focus of tax and welfare reforms has been on reducing effective marginal tax rates, whatever this implies for effective average rates and income distribution. The trickle down theory characterized by Galbraith as the view that "in order to make the poor richer, it is first necessary to make the rich richer" is obviously still alive and well in some quarters.

But is this theory true? Faced with the dual challenges of trade and technology, do industrial countries face a stark choice between increasing their own competitiveness and increasing inequality, or protecting existing patterns of equality through tax and welfare state programs that erode competitiveness and contribute to unemployment? Atkinson (2000) has recently characterized this presumed trade-off as the "Transatlantic Consensus." It provides a seemingly powerful explanation of how the US and UK have chosen a small government scenario characterized by low unemployment and increased inequality, while Europe has preferred to hold economic differentials more or less fixed in a context of high unemployment and substantial government intervention. In fact, Atkinson argues that the theoretical and empirical basis for the Transatlantic Consensus is weak and that other factors, specifically the role of social institutions, are also important.

In general, it is important to know if the fact base supports the "received wisdom" of policy makers. The attempt of these two volumes to penetrate the policy discourse is thus of considerable significance. Both books focus on documenting the trends in inequality that have emerged in the two countries that, according to the best available internationally comparative data, have experienced the largest increases in income inequality since the 1970s (Atkinson, Rainwater, and Smeeding, 1995; Smeeding, 2000). Although the two studies differ in emphasis and presentation, each provides a comprehensive and authoritative account of changing inequality and the role of the labor market (and its consequence, the level of unemployment) in affecting the overall picture. While neither sets out to resolve the issues of cause and effect summarized above, they do paint a picture of the costs in terms of increasing inequality that have accompanied the economic growth recently experienced in the US and UK.

The American study by Mishel, Bernstein, and Schmitt (MBS) is the latest in a biennial series undertaken by the Economic Policy Institute. Like its predecessors, its main aim, identified at the outset, is to "examine the impact of the economy on the living standards of the American people." It is clearly the result of an extensive and meticulous research effort but is written and presented with a broad audience in mind. The authors are to be praised for the admirable quality of their analysis and the excellence of its presentation. The results, while often derived from complex manipulations of official data (primarily based on the Current Population Survey, CPS) are always presented with economy and clarity. There is an excellent (twelve-page) Executive Summary followed by an Introduction and a brief description of data and methodology (expanded on in a series of Appendices) so that those wishing to just get the "bottom line" story of great and growing disparity in the economic fortunes of Americans need not plough through a myriad of tables and figures to get it. But there is also plenty of "meat on the bones" to satisfy those who wish to immerse themselves in the detail and enrich their understanding.

The detailed analysis begins with a summary of trends in the level and distribution of family income, followed by chapters devoted to the role of taxes, wages and jobs. In between there are specific chapters on the distribution of wealth, poverty, regional inequality and international comparisons. The focus of most of the analysis undertaken by MBS is on the period 1989–97, although it is noted that the economy improved markedly in 1998. Data for the first half of 1998 show real wage growth and declining unemployment (to 4.5 percent), both reversing the trends experienced in the seven years to 1996. What has happened since then will have a major impact on how history judges American economic performance over the period.

Between 1989 and 1997, there was a modest rise (by 0.6 percent) in (real) median family income although real income declined for the bottom two-fifths of families. There was also a significant increase in income (but not consumption) inequality, the income gini coefficient rising by almost 7 percent. Most of the increased inequality occurred at the top of the income distribution, although the authors note the impact of changes in top-coding of the CPS data, a point also emphasized by Smeeding (2000). Interestingly, the authors argue against adjusting income by an equivalence scale, on the grounds that part of the decline in family size has been a *response* to declining family income, implying that the equivalence adjustment would provide an unjustified gloss to the distributional trend. There is a brief discussion of income mobility, in which PSID data show a low but constant degree of income mobility across the quintiles.

The overall extent of inequality can be judged by the fact that, by 1995, the average *weekly* after-tax income of the top 1 percent of families was greater than the average *annual* after-tax income of the bottom 20 percent of families. Furthermore, in 1997 the average American CEO earned almost 116 times as much as a "typical" worker, implying that it would take a CEO around two working days to earn the annual wage income of the typical average worker. Despite the substantial impact of federal tax cuts at the top, wage inequality has made a greater overall contribution to inequality over the period. To quote the authors: "Most of the rise in inequality and the fall in living standards . . . reflects what employers are putting into pay-checks, not what the government is taking out."

In overall terms, the distributional impact of changes in the US tax system were modest in the 1979–95 period. Changes in after-tax income were thus driven by changes in before-tax income. However, one of the most breathtaking aspects of US distributional change concerns the impact of tax changes on the incomes of those at the top of the distribution. Between 1977 and 1995, under the Reagan and Bush Administrations, average after-tax real family income increased by around $840 a year, or 2.4 percent. However, whereas the average incomes of families in the bottom four-fifths of the distribution fell by $1,400, those of the top one-fifth increased by over $16,000. Over this period, the *average* after-tax incomes of the top 1 percent of Americans rose by $208,000 or almost 90 percent. Had the after-tax income share of the top 1 percent remained at its level in 1989, it would have been possible to increase the average incomes of *all other families* by around $2,100 (1997 dollars). This would have been sufficient to convert the income losses for the lowest 40 percent into modest real gains. The distributional story of the period is thus one of enormous gains by those at the very top in an era when most other families were experiencing a modest decline in their real disposable income. The key question is how long will it take (if ever) for these income gains to trickle down to fertilize the barren soils in which the incomes of the majority of Americans have remained static or declined?

Although unemployment has played less of a role in income inequality in the US than in Europe, wage inequality has been a very important factor. While real wages among low-paid men fell by around 18 percent between 1979 and 1997, and the median male hourly wage fell by more than 15 percent, the top 10 percent of male wage earners experienced a slight increase in real wage rates over the period. For women, the trends were different, with those at the bottom doing better than their male counterparts (though still experiencing a decline in real wage rates) and those at the top doing much better. In real terms, the median female wage increased by over 6 percent. The result was a narrowing of the gender wage gap after 1979, around two-thirds of it attributable to the declining real wages of men.

Further evidence of widening US inequality is provided in the analysis of wealth and poverty. Wealth inequality increased dramatically during the late 1980s and through the 1990s, primarily driven by the gains in the stock market. Although stock ownership has widened somewhat, the great majority of US citizens still own few shares, and gain little income from them. In contrast, the rising US stock market brought huge gains to the richest 1 percent of households, who received more than 42 percent of the total benefits. At the other end of the scale, poverty increased between 1979 and 1997 and the fate of the poor became increasingly disconnected from that of the economy generally, as Haveman (2000) has observed (bringing into question the "trickle down" theory on which much of the economic policy of the period had been based). The poverty trend is robust with respect to variations in the poverty line and when the income measure is broadened to include estimates of the market value of food and housing benefits. With both male and female wages at the 20th percentile below the poverty line for a two-child couple family since 1989, there has been little prospect of the poor being able to work their way out of poverty, at least on a single income.

Glennester (2000) has noted that although US studies of inequality rarely look abroad, the leadership role of American scholars such as Smeeding and Rainwater in the Luxembourg Income Study is opening up a new global dialogue. Refreshingly, unlike the insularity of other US studies, MBS devote a chapter to reviewing the international evidence and comparing US economic performance and inequality with that of other OECD countries. Appropriately sub-headed "less-than-model-behavior," the chapter documents how far the US differs from other OECD countries in terms of economic inequality. The authors conclude that those who look just at the US experience will "miss a great deal" and that, along with the rest of the book, the comparisons "illustrate the many shortfalls of the 'US model' as a potential solution to the broad range of problems facing the OECD economies." Unfortunately, it appears that these words will have little impact on US policy that now seems focused after the election of President Bush on yet another round of extensive (and expensive) tax cuts for the rich.

The volume edited by Gregg and Wadsworth (GW) was inspired by the MBS volume and is also foreseen as a vehicle for "passing judgment and offering insight into labor market developments at regular intervals." The normative position of the editors is made clear in the Introduction, where reference is made to "exaggerated pay rises for those at the top of the earnings distribution" and to "rampaging wage increases for the better off only." Yet the extent of these increases falls far short of what has happened in the US, and one can but wonder what the rhetoric would have been like had the UK mirrored the US experience! Unlike MBS, the GW volume restricts its coverage to the labor market and does not explore systematically how labor market outcomes affect family incomes and living standards. This is a pity, since an important part of the living standards story concerns how the labor market experience of *individuals* has or has not been replicated within *families*. There are hints to what has happened throughout the GW volume, for example in its discussion of the impact of wives' earnings on family inequality and on the correlation between unemployment among spouses. But there is also a need for a systematic overall assessment of this issue, along the lines of that developed by MBS.

The period covered by GW is from 1977 to 1998, during which the unemployment rate rose from 6 to over 11 percent in the mid-1980s, fell and then rose to 10.4 percent in 1993, before declining steadily back to 6 percent in 1998. The pattern is similar to that for the US reported in MBS, although the US rate was about 2 percentage points lower through the 1980s and 1990s. Overall, the contributions to GW provide a comprehensive and authoritative account of how the UK labor market has changed, and with what consequences. It begins, like MBS, with a chapter that goes to the heart of the subsequent analysis, in this case with a description of trends in unemployment (rather than, as in MBS, with an overview of trends in family income). Subsequent chapters deal with the circumstances of older men and youth generally, the extent and impact of training, the rise of workless households, changes in gender roles and outcomes, wage inequality and poverty. There is a coherent structure to the book, but it suffers from the differences in style and nuance that are inevitable in a volume consisting of a series of differently authored chapters. Although it is more than a conference volume, in that the chapter topics are closely related and key findings are given prominence within an overall theme, future editions would benefit from sticking closer to the style developed so well in the MBS volume.

Data differences make it problematic to compare trends for the two countries. However, it appears that the US tendency for the 50/10 wage differential to decline after 1986 for both men and women did not occur in the UK, where a clear upward trend is apparent. (This, however, may be affected once the UK's new minimum wage system starts to bite—which would be another example of the importance of political choices and labor market institutions.) However, up to 1998, there is a common trend across both countries to increased incidence of low pay. Both countries are at the upper end of the scale in terms of the proportion of low-paid workers relative to other OECD countries, with the US higher than the UK. In an interesting analysis, Stewart shows that in the UK, both individual and job characteristics matter in determining who is low-paid and that movements out of low pay are sluggish and often out of employment altogether—a "low pay–no pay" cycle. He also demonstrates that low-paid jobs are more likely to act as blind alleys than as steps up the wage distribution. Both the growth in low pay itself and its dead-end nature pose serious questions for programs that encourage (in the limit, mandate) the unemployed to accept whatever work they can, in the optimistic belief that any form of engagement with the labor market is the most effective poverty relief strategy for those out of work.

The GW volume is distinguishable from MBS in its greater use of longitudinal data to explore the extent and impact of income and other transitions through time. Many of the authors in GW utilize the range of panel data now available in the UK to study mobility issues. The evidence on wage mobility presented by Dickens, for example, casts doubt on the conventional view that the UK is becoming a more mobile society. In fact, the evidence shows that wage mobility is rather low, even over long periods. There are differences of view concerning the factors behind the increase in wage inequality. While the MBS volume attributes an important role to increasing trade (and immigration) in the US, Machin argues that trade has been a less important factor than technology in the UK. However, both volumes agree that the decline in the coverage and influence of trade unions has been a factor behind the increase in wage inequality in both the US and the UK. This is fertile ground for further research in both countries.

Although neither of these two volumes is explicitly concerned to analyze the impact of policy, both provide many examples of how policy can be, and has been effective, particularly in its distributional impacts. Reference has already been made to the consequences of the increasing incidence of low pay for the success of "welfare to work" strategies. Unfortunately, because of their timing, neither volume is able to address the impact of recent tax reforms (the expansion of EITC in the US and introduction of the Working Families Tax Credit in the UK) that have been designed to make the welfare system more work-focused. Of course, the US income distribution trends show that tax reform can be extremely effective in influencing the incomes of those at the top of the distribution; but can tax policy produce similar effects for the poor? There is strong evidence for the UK that education and training reforms can have powerful labor market effects. Thus, the introduction of a new school examination has played a dominant role in increasing the numbers staying on at school after 16. At the same time, however, Green argues that off-the-job training in the UK, though very low overall, is also very unequally distributed. As a result, it has the potential to exacerbate inequalities in labor market outcomes in future years, rather than serving to equalize opportunity.

There is a wealth of data and analysis in the GW volume and it will serve as a valuable contribution to knowledge about the structure and impact of the UK labor market. However, the volume as a whole does not achieve anything like the same impact as the US volume. In part, this is a matter of structure and in part a matter of presentation. However much the UK authors were instructed to work to a common template, the end result still reads like a collection of essays that differ somewhat in style and presentation. Some chapters have footnotes while others do not, some present just new material, while others combine this with reviewing the literature, and others again simply review and report available research. As good academic researchers, the UK authors cannot resist the temptation to delve into what are often side issues and/or refer to competing explanations in ways that detract from their main message.

In contrast, MBS keep to the "main game" of describing what has happened and worry less about trying to explain it. This approach may be less appealing to some academics, but it provides readers generally with a much more integrated account of what has happened, leaving it to others to ask "Why?," but providing them with the statistical armoury to come up with answers. Overall, the GW volume is lacking in coherence and sorely misses the excellent Executive Summary and lengthy Introduction that catch the attention and draw the reader into the MBS volume.

The experience of the US and the UK through the last two decades is of more than just academic interest. These two countries have been leading the way towards a new economic prosperity for a few founded on small(er) government, individual responsibility and market liberalism. These two books provide an initial (though possibly premature) assessment of what this new approach has meant for living standards and inequality in each country. They confirm what the international evidence has revealed, that the increase in inequality has been dramatic in both countries—particularly in the US, where the extent of increased inequality at the top of the distribution has been little short of remarkable. Has it been worth it? It probably depends on who one asks, although there is surprisingly little comfort here for the vast majority who occupy the lower and middle ranges of the income distribution. For these people, support for "more of the same" in policy terms can only rest on the (unsubstantiated) view that they or their offspring may one day join the small band of extremely wealthy families who reside at the very top of the income distribution. On the evidence reported here, it is only these few who have clearly gained from the policies and reforms of the last two decades.

Aside from matters of content, the MBS volume sets new standards for accessibility and presentational excellence. It is difficult to think of a recent book on income distribution and living standards that outperforms it in terms of comprehensiveness, rigor and interest. The authors of the UK book would do well to consider changing their format to more closely resemble that produced from the other side of the Atlantic. Both countries have a very interesting distributional story to tell, but so far the US are far more expert in the telling.

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