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DO EGALITARIANS HAVE A FUTURE?

Review of *Inequality and the State* by John Hills
(Oxford University Press, Oxford, 2004) and
Egalitarian Capitalism: Jobs, Incomes and Growth in Affluent Countries
by Lane Kenworthy
(Russell Sage Foundation, New York, 2004)

Can capitalist economies also be egalitarian? Skepticism has been a common reaction to this question among the fans of capitalism as well as its critics. For Marx, the capitalist system was a marvelous economic growth machine. Capitalism's dynamism, however, was built upon rising levels of exploitation and deepening inequalities between the owners of capital and the direct producers. However, Marx has scarcely been alone in his skepticism. Following a brief interlude of postwar optimism, gloominess has made a comeback for both empirical and theoretical reasons. Empirically, we have witnessed a surge in inequality in many of the advanced economies reinforcing theoretical claims that market economies face "inevitable" tradeoffs between growth and equality (Okun, 1975) or between jobs and equality (OECD, 1994). We can have lots of growth/jobs *or* lots of equality, so it is claimed, but not both at the same time.

John Hills and Lane Kenworthy, egalitarians both, could be characterized as gloomy optimists: there are many dark clouds on the horizon but also rays of hope. They take comfort from the fact that opinion polls continue to exhibit strong egalitarian preferences among contemporary publics. Hills shows that as income inequality has risen in the U.K. so too has the share of the British population saying that the income gap between the rich and poor is too large. And even in the United States, Kenworthy reports, the majority of Americans support generous social welfare programs if they encourage employment among the able-bodied.[1] Similarly, both authors are able to point to recent, and successful, policy initiatives that have countered emergent trends.

Few if any egalitarians would favor perfect equality of outcomes, Kenworthy argues. However, in Rawlsian fashion, he considers much of what determines people's earnings and income—intelligence, creativity, physical and social skills—to be a product of genetics, parents' assets and traits and the quality of childhood schools and neighborhoods. These things are not chosen; they are more a matter of luck than of merit. The principal argument for *limited* inequality, then, is that it is fair. But Kenworthy is not satisfied to sacrifice high living standards and high employment or otherwise kill the capitalist golden goose in the pursuit of equality. So the issues raised in these works are of interest to non-egalitarians as well.

[1]The two authors' optimism in this respect depends on whether public opinion is truly exogenous to the political process—i.e. whether public opinion shapes policies rather than the other way around—and this remains a contentious issue in political science. Nevertheless, a spate of research since the 1980s (see Burstein, 1998) does offer some reason for optimism on this count.

If nothing else, just how "limited" inequality can become without jeopardizing jobs and growth has been and remains a central and fascinating intellectual puzzle.

A major source of Hills' gloominess is the "information gap" between the public's egalitarian preferences and their understanding of inequality. A standard assumption of the neoclassical model is that market actors have "full information." The fact that information is often less than perfect is not especially troubling for the theory since departures from full information create interesting and, sometimes, solvable theoretical puzzles. However, the fact that that most professional writing in economics does little to enhance the "information" available to publics is troubling especially when it concerns core public issues like inequality and poverty. If there were a Nobel prize for enhancing public understanding of economic inequality, however, Hills' *Inequality and the State* would be near the front of the queue.

How society's resources are ultimately distributed, and how collective decisions through the state affect that distribution, Hills observes, are big issues. Even in the low spending U.K., policies that affect that distribution account for a quarter of national income and the lion's share of all government expenditure. Despite Iraq, welfare has replaced warfare as the major activity of the modern state. Yet, as Hills shows, people's knowledge about the distribution of income and their place in it is often extremely vague. Public understanding of how the income distribution has been changing and the forces driving those changes is even more rudimentary. Filling in the "information gap" is the main target of *Inequality and the State* and the result is a *tour de force*, nothing less than a well informed and data rich handbook of income distribution in the United Kingdom. Although Hills includes a great deal of comparative material, the main disappointment for readers from outside the U.K. will be that comparable works for their own nation are difficult to come by. Nevertheless, since the U.K., along with the U.S., has been leading the pack up the inequality ladder for the past thirty years, *Inequality and the State* merits a broad audience abroad as well as at home.

The novel contribution of Hills' work is implied by the title: it is about the *state* as well as the *economy.* Hills' consideration of the "state" goes well beyond the usual consideration of the distribution of income "before and after" transfers and taxes. He also examines the *policies* underlying the distribution and the *politics* that produce the policies. Indeed, Hills might well have called his book *Inequality, the State and Society*. He not only examines income distribution, taxation and spending in great detail but also what the public thinks of all three.

Part I covers what will be familiar ground to most economists. Chapters 2 and 3 provide lucid accounts of trends in inequality and poverty with excellent discussions of methodological issues in their measurement. Chapter 4 reviews standard explanations of trends in both earnings and household inequality while Chapter 5 on social mobility reviews what we have learned from dynamic, longitudinal, studies of these issues.

In Part II, Hills devotes three chapters to the "impact of policy" with chapters on social spending, taxation, and redistribution. The final section, "Where do We Go from Here," provides an up-to-date-review of the impact on employment and poverty of "New Labour's" policies under Tony Blair. The results have been surprisingly positive, especially in regard to child poverty. Under Blair, the top has

continued to move away from the middle but the bottom of the distribution has been moving back toward the middle.

In Part III, however, Hills also returns to the dark clouds on the horizon. He is skeptical about the future, in part because of emergent pressures on the public budget (e.g. from population aging) and in part because the poverty reduction strategies of the Blair regime have clear upper limits. Third Wayers, like Blair, have accepted a trade-off. The magic concept here is "social exclusion" which in practice means limiting differences between those in the middle and those on the bottom while allowing differences between the middle and the top to flourish. Third Wayers want to encourage the truly well endowed to develop their talents and to flourish—policy-makers everywhere would like their share of the Bill Gateses of the world—and so are reluctant to limit growing inequality at the top of the distribution with high taxes. But they are willing to compensate those who are truly unlucky. So the Blair government has taken major initiatives to limit inequalities at the bottom of the income distribution.

However, the strategies adopted until now—such as providing income-tested benefits to the poor financed with cuts to other parts of the state budget (e.g. defense)—cannot be used indefinitely. As income-tested benefits accumulate, so do the disincentive effects of high marginal tax rates. And cost-shifting from other parts of the state budget cannot go on forever. As Hills observes, the British electorate believes there is too much inequality in the U.K. But they would like to reach European levels of social protection with American levels of taxation. Politicians, he concludes, will have to be braver in laying out the choices involved. Hills worries a lot about the information deficit among the British public concerning both the scale and scope of trends in poverty and inequality and about the forces that have shaped their development. *Inequality and the State* goes a long way to eliminating this obscurity.

Egalitarian Capitalism picks up where Hills leaves off. Kenworthy moves the discussion forward to consider the options and trade-offs facing political leaders with egalitarian inclinations. Kenworthy also paints on a larger canvas: the 16 or so rich capitalist democracies of North America, Western Europe and Scandinavia. Like Hills, Kenworthy's analysis is data rich, pays close attention to key theoretical and methodological issues and the writing is remarkably lucid. He relies mainly on the Luxembourg Income Study (LIS) to study family level earnings and incomes and a data set compiled by the OECD to analyze individual level earnings. He uses cross-country differences in changing levels of inequality to ask about the main drivers of inequality (Chapter 3) and then turns to potential trade-offs. Is there an equality-growth trade-off (Chapter 4), an equality-jobs trade-off (Chapter 5), or an equality-incomes trade-off, especially for those at the bottom of the income distribution (Chapter 6)?

Kenworthy attends not only to the general or average "results" but also delves into country and period specific experiences. He shares an emergent skepticism about the search for a single "unified theory" of inequality trends in the rich democracies for theoretical as well as empirical reasons. Theoretical indeterminacy, he argues, characterizes many of the causal relationships in question (e.g. does income inequality enhance economic growth?). Rather than seeking to establish simply whether "X is positively related to Y," the aim is to determine in which

countries and time periods X is positively related to Y. Unlike "laws of nature," *social* mechanisms are best thought of as what James Coleman (1964, pp. 516ff.) once called "sometime-true-theories," general models that can adequately account for the results or regularities that obtain in *some* specific cases.

There are at least three sets of institutions one has to understand to make sense of the final distribution of income: labor markets (that shape the distribution of individual earnings), families (that shape the distribution of market incomes among families), and states (that shape the distribution of family income after transfers and taxes).

If you are an economist you are probably most at home with labor markets since labor markets are about prices, something economists know a lot about. If you are an economist in the U.S. or the U.K., you probably think that labor markets are the key to rising inequality since in these countries rising inequality in individual wages and earnings has been a major driver of rising inequality in family incomes. But as Kenworthy highlights, inequality in *family* earnings has been rising in virtually *all* rich democracies, including those where inequality of individual earnings has been relatively stable. In Sweden, for example, the Gini for *family* earnings inequality (i.e. before transfers and taxes) rose from 0.29 in 1981 to 0.38 in 2000 despite comparatively modest gains in individual earnings inequality.[2] In the same period, the Gini for family earnings inequality in Norway rose from 0.28 to 0.34 despite a *decline* in individual earnings inequality.

On average, the main driver of changes in *family* earnings inequality between the mid-1980s and mid-1990s, according to Kenworthy, was changing employment levels. Half a century ago, he points out, most employment "inequality" was *within* households: husbands were employed and wives were not. Now, most employment inequality occurs between households, between those with two, one and zero earners. Low-earning households, moreover, tend to be disproportionately affected by employment contraction. The employment effect is augmented by the fact that low earning husbands and wives tend to be married to one another (marital homogomy). Indeed, Kenworthy finds that the impact of changes in marital homogomy on household earnings inequality was as large as the impact of change in individual level earnings inequality over the period.

The focus on *family* earnings inequality is significant for two reasons. First, the usual standard for assessing the distribution of "welfare" is the post-tax/transfer distribution of *family* income so that the proximate challenge to welfare states arises from changes in the distribution of family, not individual, earnings. Second, if earnings inequality among *individuals* is not the only, or major, driver of earnings inequality among *families*, then, the policy menu for egalitarians may change substantially. If other factors (household size and structure, marital homogomy) contribute more to household earnings inequality, governments might be wise to rely more on tax and transfer programs than on pay compression to ensure a reasonably low level of household income inequality.

Like many before him, Kenworthy concludes that that it is very difficult to find strong empirical evidence for a trade-off between equality and economic growth. However, given the important role of high employment in sustaining "limited

[2]Here I rely on updated figures from Kenworthy and Pontusson (2005).

inequality," the jobs vs. equality conundrum posed by the OECD and many others is a key issue. Here he turns his attention from the household to the labor market and in particular to the employment effects of high wages at the bottom of the earnings distribution, the main suspect in many accounts of employment laggards such as Germany. Kenworthy finds little support for such an effect. Pay compression contributed to slower employment growth in the 1980s and 1990s but the effect was not terribly strong. He is more impressed, however, by the negative impacts of high payroll taxes and employment regulations that discourage employment.

These average effects, of course, do not tell the whole story. Thus far there is no "unified theory." In the United States and the U.K., where employment growth was comparatively strong, the chief culprits in the rise of household earnings inequality were rising earnings inequality among the employed, the growing prevalence of single adult households, and marital homogomy. And unlike countries where jobs were the issue, these effects were not offset by the tax-transfer system. In the final chapter ("Which Way Forward?"), Kenworthy provides a careful review of alternative strategies available to would-be egalitarians in the U.S. and the U.K. faced with a world of high employment and high earnings inequality.

The menu of options, he argues, is probably less circumscribed than often claimed by those who argue that there is a "tight coupling" between national economic institutions and available policy choices. Students of comparative political economy frequently conclude that the institutions and policies of particular countries or "families of nations" (e.g. the Anglo-Saxon) tend to cohere and complement one another in ways that make importation of "foreign" practices unfeasible or unlikely to produce the expected outcomes. He points out, however, that much of the success of countries such as Denmark and The Netherlands in limiting the growth of inequality in the 1980s and 1990s was due to a willingness of political leaders and economic actors to experiment with novel strategies.

These, and other "success stories," that Kenworthy documents are a major source of his optimism for egalitarianism's future. He concludes by reminding us of Martin Luther King's famous remark: "The moral arc of the universe is long, but it bends toward justice." I agree. But just when and where the arc will start "bending" remains an open question. In countries like the U.S. and the U.K. where the Gini of inequality is already out of the bottle, the time horizon for getting it back in again is probably a long one.

Consider first the changing "balance of power" in the labor market and the future of wage inequality. That a large measure of the surge in wage inequality in the U.K. and the U.S. has been driven by declining union coverage and, in the U.S., by falling minimum wages ("rent destruction") are well documented in the literature. In both instances, politics (Reagan, Thatcher) was, at the very least, the handmaiden of these developments. I am not at all familiar with the research literature on executive compensation. Nevertheless, my reading of the *New York Times* business pages makes me think there is a good *prima facie* case for rising rent extraction ("managerial power"), not markets, as the social mechanism driving runaway executive pay at the upper levels of the corporate world.[3] If

[3]See, for example, Gretchen Morgensen, "How to Slow Runaway Executive Pay," *New York Times*, October 23, pp. 3-1, 3-4, 2005. For a more comprehensive review, see Bebchuck and Grinstein (2005).

policy-makers want to nurture lots of Bill Gates clones, there is little incentive for them to counter this trend.

Some economists (e.g. Katz and Autor, 1999) have argued that these institutional changes, and the labor and tax legislation that made them possible, are not exogenous to market forces, i.e. that shifts in supply and demand may be the *cause* of changing preferences and the erosion of equality enhancing institutions such as minimum wages and collective bargaining. But in either case, reversing these trends or finding new labor market institutions to replace them are unlikely in the intermediate term. Institution building and reform are almost by definition *long term* projects.

The second source of concern has to do with families and households. High levels of marital instability and marital homogomy that produce inequalities in both the quantity and quality of labor that households have available to sell on the market are more or less permanent features of postindustrial societies and not easily amenable to social intervention. Even if governments were to implement cross-class dating services to encourage university graduates to marry high school drop-outs, they are unlikely to succeed.

One popular strategy is to equalize the distribution of human capital by pushing up skill levels at the bottom of the distribution with high quality early childhood education (Esping-Andersen *et al.*, 2002). But this too is a long term project. The cohorts now entering the labor force with their accompanying skill profile will make up the core of our prime age work force well into the 21st century. If we agree with the current consensus that the basic skills distribution is shaped early in life, further opportunities for "life-long learning" will likely alter their skills profile only on the margin.

In the intermediate term, we are left with two rather conventional strategies: maintaining high employment levels along with a robust and responsive tax-transfer system for those with little (or low quality) labor to sell. The case for progressive financing of both cash benefits and services is at least as strong in our postindustrial world as it was for our industrial age predecessors. The two distinguishing features of the postindustrial life course are postponed adulthood that results from more years in school and increased longevity. The highly educated and well paid, however, are experiencing the greatest longevity gains. As a result, they will absorb a disproportionate share of future pension and health care costs just as they absorbed a disproportionate share of education costs when they were young.

Political leaders in democratic polities, however, require strong incentives to pursue novel experiments of any sort and egalitarian ones in particular. Both Hills and Kenworthy highlight the fact that public opinion in the affluent democracies continues to be marked by strong egalitarian sentiments. Incentives from a public that wants European levels of protection but American levels of taxation, however, are likely to be weak. Public opinion is rarely enough if it is not mobilized. It is not coincidental that the two major periods of social reform in the United States were associated with the mass turmoil of the Great Depression and the black revolts of the 1960s. Such legislative moments rarely occur in the absence of movements from below—labor movements, moral and religious movements—that set the public agenda (Heclo, 1995). An interesting thought experiment would be to

imagine contemporary American politics had the political base for the new religious right been mobilized around their economic rather than their socio-moral concerns (Frank, 2004).

Can intellectuals contribute? To my mind, the key to successful egalitarian projects in capitalist economies is to identify positive-sum solutions to what are ostensibly negative-sum tradeoffs within specific historical contexts. This was the essence of the U.S. New Deal and, especially, of the Rehn–Meidner plan that provided the foundation for the postwar Swedish model. Identifying positive-sum solutions for producing a dynamic capitalism and greater equality in the current economic environment may be more difficult than it was in the 1950s. But as Rehn, one of the two architects of the Swedish model, once observed: "Well, if things are tougher, I guess you'll just have to work harder." A good dose of the "protestant ethic" or its functional equivalents may be just as salutary for egalitarians as it was for the proto-capitalists described by Weber.

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