Fall 2014

INSTITUTE FOR EUROPEAN STUDIES

Policy brief:

The Effects of Politics on Economic Inequality

By Dimitrije Tasic*

There is an almost unanimous consensus among scholars that economic inequality has been growing within most countries around the world. Some argue that rising economic inequality is inevitable given the major structural changes that occurred in the advanced industrial economies over the last several decades. For them, gaps between the rich and the poor are an economic phenomenon, a result of market forces. But if this explanation is correct, then one would expect to see similar trends of rising inequality in all advanced industrial countries. However, that is not the case. In many European advanced industrial countries that underwent similar structural changes to the US (and were consequently subject to similar development of market forces), the degree of rising inequality is not as notable as in the US. Therefore, the question arises- if structural changes were the main reason for rising inequality, why do similar advanced industrial counties have such different levels of rising inequality? I argue that though structural changes matter and some level of rising inequality can be explained with tools from economics, the reason for growing inequality lies elsewhere. ***Inequality levels are driven chiefly by factors related to national political systems and the policies they produce.***

Standard economic accounts examine shifts in demand and supply in labor markets to explain changing patterns of inequality in the last several decades. This type of analysis carries some truth if applied to understand major shifts in the US and EU labor market structures in the last several decades. In particular, in the last several decades, advanced industrial economies lost millions of jobs in manufacturing as a result of technological change, a process whereby advances in productivity in manufacturing outpaced increases in demand for manufacturing workers and caused unemployment in that sector. If markets function well, displaced workers can easily move to other sectors. Often, however, such mobility is impeded as the new job can be in another location or require different skills, which might trap workers in sectors with declining employment and leave them unable to find an alternate job. In addition to advances in productivity, shifting comparative advantage in manufacturing towards the emerging markets (such as China) increased the magnitude of this structural change.

These emerging markets gained comparative advantage in manufacturing as they invested heavily in education, technology, and infrastructure, and had a lower cost of labor. As a response, the share of global manufacturing shrank for the advanced industrial economies and many manufacturing jobs were lost and new non-manufacturing jobs were created. However, these new jobs were not as well-paid or as long lasting, as skills that made workers valuable and highly paid in manufacturing were of little value in their new jobs. As the displaced manufacturing workers looked for jobs in other sectors, wages in these sectors went down due to increased demand.

A second structural shift (so-called skill-based technological change) came from changes in technology. Technological change increased the demand for skilled workers and replaced unskilled workers with machines. Innovations that reduced the need for unskilled labor weakened their demand, and consequently lowered their wages. At the same time, innovations increased the demand for those who mastered the technology leading to higher wages, and made the gap between technology and non-technology equipped workers wider. Nevertheless, throughout the 20th century, there were multiple skill-based technological changes, and the outcome was not a vast rise in

*Dimitrije Tasic is an IU senior majoring in Political Science and an intern at the Insitute for European Studies for 2014-15.

economic inequality as in the example above. Instead, thanks to government involvement, supply and demand for skilled and unskilled labor has shifted in a way that did not vastly increase wage disparities.

For example, the GI Bill enabled many Americans to receive an education. This served to shift the supply of high-skilled workers to keep pace with increased demand and the overall growth of the economy[1]. As a result, workers with college degrees still received higher wages than high school graduates, but the wage ratio remained almost the same as before WWII, as diminished relative supply of unskilled workers pushed their wages upward. Still, despite this positive example of government involvement through education, the policy of educational attainment in the US stopped improving after 1980, especially relative to the other advanced economies. The relative supply of skilled workers increased more slowly from 1980 onwards than from 1960-1980, losing pace with the technological changes in the economy.[2]

The example above suggests that the level of inequality in a certain country is not an inevitable outcome of development of market forces, but that it can be altered by public policies. In addition, explanations provided for increasing economic inequality with the tools from economics - although helpful in explaining the way structural changes shape the labor market - fail to explain a type of inequality so particular to the US in the last several decades: an enormous increase in wealth at the very top of wealth distribution. Purely economic accounts also fail to recognize the extent to which policies ameliorate or exacerbate economic inequality. As we know, economic forces are global, affecting similarly situated countries similarly. However, the level of inequality, although rising everywhere, differs markedly across the advanced economies and is a function of differences in public policies, most notably social, tax, and education policy.

Inequality and Tax Policy

Table 1 (see appendix) shows the effect of government taxes and transfers on income inequality as a percentage reduction in income inequality produced by market forces in numerous advanced industrialized countries. In other words, the table shows pre-tax and pre-transfer income, (income determined by market forces) post-tax and post-transfer income, and the percentage of redistribution of income produced by taxes and transfers. The table shows that the US has the highest levels of inequality among the selected countries, both before and after taxes and transfers. It also shows that inequality rose sharply in the 1980s in all the selected nations except the Netherlands, confirming the effect of structural changes in labor markets explained earlier. Furthermore, the table shows that the trend of rising inequality is largely the result of shifts in pre-tax and pre-transfer income rather than changes in taxes and transfers.

However, the table also makes it clear that US taxes and transfers have done considerably less than taxes and transfers in other countries to offset the rise in inequality experienced by many countries during this period. Taxes and transfers in the US were not only considerably less than in all the other selected countries, but also decreased slightly during the observed period, a trend different than in a great majority of other selected countries. The United States, as Table 1 shows, has mean market-income inequality only slightly higher than that of the other countries, but significantly higher after taxes and transfers, reflecting the extent to which the tax and transfer system is less effective at reducing inequality than in other similarly developed countries. In addition to having a less effective tax and transfer system to reduce inequality, US social policy did not do much to reduce negative socioeconomic effects of the major labor market changes described earlier. The decreasing number of jobs in manufacturing was followed by rising levels of earnings inequality, growing instability of income, increased employment in part-time jobs and in the service sector, and increased structural unemployment. Figure 2 shows a dramatic increase in income inequality across families after 1980, and also reveals a growing instability (volatility) of income. All these changes suggest that a new climate of economic risks meant that social policy had to do more to secure past achievements. However, that did not happen in the US. Instead, unemployment insurance decreased in its reach, particularly for lower-income workers[3]. Similarly, employment-based health and pension protections among lower-wage workers significantly decreased and were only slightly offset by expansions of public health coverage under Medicaid and the new Children's Health Insurance Program of 1997 .[4]

Figure 3 suggests that total US social spending is not notably smaller as a share of the total economy than the levels found in the most generous European welfare states. However, in the US a much larger share of that spending is carried by the private sector; spending which is carried by the government elsewhere. And while the total of US social spending is not so different from other countries, the distribution of that spending is not, since private social benefits are distributed much less equally across different strata of society than public social benefits. There are several reasons for this- first, private benefits are generally distributed in rough accordance with pay; second, they are subsidized through exclusions and deductions in the tax code worth more to high-income tax filers; and finally, for more than two decades, the private side of America's hybrid benefit system has eroded as corporations eliminate and restructure benefits to cut costs and encourage self-reliance.[5] According to Hacker and his coauthors, this erosion has taken two forms- drops in benefit coverage and generosity, and changes in the character of benefits that have shifted risk from collective intermediaries, such as employers and insurers, onto workers and their families.

Tax policy is another type of public policy that can significantly affect the distribution of income and wealth in society. However, tax policy in the US has done little to reduce the huge increase of income at the top that has occurred during the last several decades. For example, in order to offset the fact that pre-tax household income rose by more than 50 percent between 1979 and 1997 in the top quintile (and by nearly 150 percent among the top 1 percent) while dropping by 4 percent in the bottom quintile, the effective tax rates would have had to increase massively, but they clearly did not. This is of course not to mention the effects of 2001 and 2003 federal tax cuts (also known as the Bush tax cuts) which were certainly a shift in distribution of taxes in a regressive direction.[6] It has been estimated that the ten-year cost of the 2001 tax cut was around $2.1 trillion and that it had a skewed distribution: 36 percent of that total was accrued to the richest 1 percent, 63 percent to the top 20 percent, and just over 20 percent to the bottom 60 percent.[7] Similarly, the 2003 tax cut was estimated to cost more than $1 trillion in the first ten years, and its benefits were even more concentrated among higher income taxpayers. For example, in the first year, the tax cut granted nearly $100,000, on average, to taxpayers making more than $1 million, while median-income households received an average cut of $217.43.[8]

State and local tax policies have also done little to redistribute income more equally. These taxes are, in fact, much less progressive than federal taxes as the largest share of revenue comes from state sales and excise taxes, which hit lower-income residents much harder than higher-income residents, as lower-income residents spend a larger share of their income on consumption goods. Finally, state and local tax share of total tax revenues has risen significantly since the 1970s, a trend that does not help in alleviating the problem of rising economic inequality.

Although the US appears as an outlier compared to other countries in Western Europe, such a response is not particularly surprising if we keep in mind the widespread view that Americans are skeptical towards explicit redistribution.[9] However, the US has also been known for being one of the pioneers in universal public education and for believing that education, rather than explicit redistribution, is the key to fostering economic equality (via equality of opportunity).

Therefore, one would expect education policy to have a big role in reducing the rising economic inequality in the US. After all, US spending on education not only ranks relatively generously compared to other advanced industrial countries, but there has also been significant growth in federal spending on education in the past few decades.

The Role of Education

At the level of higher education, for example, US education policy since the 1970s has showed strong commitment to provide educational opportunities to all its citizens. At the federal level, the Higher Educational Amendments of 1972 created a number of programs (i.e. Pell Grants) that enabled lower and middle-income citizens to go to college. State governments followed the federal government's initiatives, pouring extensive resources into higher education, particularly by expanding public universities and colleges.[10]

However, since the 1970s, public funding has failed to keep pace with the rise in tuition, and its role in expanding access to education has diminished sharply. According to a study by the Commission on National Investment in Higher Education, accounting for all sources of public aid, support per student has just kept pace with inflation, but real costs per student have grown by about 40 percent.[11] The number of Pell Grant recipients has grown steadily, reaching 8.3 million students annually in the 1998-99 academic year, but its value for individuals has diminished. The maximum value of Pell Grants per student, in 1999 dollars, peaked at $4,205 in 1975 then declined steadily to $2,500 in the mid- 1990s, rebounding only slightly in recent years. In 1975, Pell Grants covered about 80 percent of tuition, fees and room and board at the average public four-year institution and 40 percent at the average private four-year institution. By 1999, its share had fallen to about 40 percent and 15 percent, respectively.[12] On the state level, support for students declined as mounting fiscal pressures over the last two decades have increasingly strained spending.

College education has become less affordable precisely at a time when its economic value has become more pronounced.[13] In the mid - nineteenth century and through the 1970s, a college degree did not offer the promise of economic well-being much greater than that attainable through jobs requiring less education. During the 1980s, however, the value of a college degree grew tremendously. College graduates, between 1979 and 1994, witnessed a five percent increase in their weekly earnings, whereas high school graduates' earnings fell by 20 percent .[14] While enrollment in four-year colleges has grown sharply in recent years among individuals from high-income families, it has increased much less for those from middle-class families, and has actually declined slightly among those from the least advantaged families .[15]

Final Thoughts

As should be apparent, a certain part of rising inequality can indeed be attributed to major structural changes that occurred in the labor markets of advanced industrialized nations. However, it can also be seen that market forces do not exist in a vacuum - they are shaped by public policies. Therefore, escalating economic inequality is not simply an inevitable economic trend but is attributable to specific policy choices. For example, economic inequality in the US is greater than it is in other similarly developed nations mostly because US public policy is less oriented towards producing equality. In particular, US social, tax, and education policies have not changed to accommodate the increase in market generated income inequality that many nations experienced in past several decades, as policies in many other similarly developed nations have. Instead, US taxes and transfers have grown less distributive over the past several decades, as have other key areas of policy.

Endnotes:

1 Stiglitz, Joseph E. The Price of Inequality:

New York: W.W. Norton, 2012. Print.

2 Stiglitz, Joseph E. The Price of Inequality:

3 New York: W.W. Norton, 2012. Print.

General Accounting Office. 2000. Unemployment Insurance: Role as Safety Net for Low Wage Workers is Limited. Washington, D.C.: United States General Accounting Office.

4 Hacker, Jacob S. 2002a. The Divided Welfare State: The Battle over Public and Private Social Benefits in the United States. New York: Cambridge University Press.

5 Hacker, Jacob, et al. "Inequality and public policy." Inequality and American democracy: What we know and what we need to learn (2005): 156-213.

6 Hacker, Jacob, et al. "Inequality and public policy." Inequality and American democracy: What we know and what we need to learn (2005): 156-213.

7 Citizens for Tax Justice. 2002. Year-by-Year Analysis of the Bush Tax Cuts Growing Tilt to the Very Rich.

8 Greenstein, Robert, Richard Kogan, and Joel Friedman. 2003. "New Tax Cut Law Uses Gimmicks to Mask Costs: Ultimate Price Tag Likely to be $800 Billion to $1 Trillion Final Bill Both More Costly and More Regressive than Administration Plan." Washington D.C.: Center on Budget and Policy Priorities.

9 Esping-Andersen, Gosta. 1999. Social Foundations of Postindustrial Economies. New York: Oxford University Press.

10 King, Jacqueline E. 2000. 2000 Status Report on the Pell Grant Program. Washington, DC: American Council on Education

11 Benjamin, Roger W., and Stephen J. Carroll. "Breaking the Social Contract The Fiscal Crisis in U.S. Higher Education." Web.

12 King, Jacqueline E. 2000. 2000 Status Report on the Pell Grant Program. Washington, DC: American Council on Education

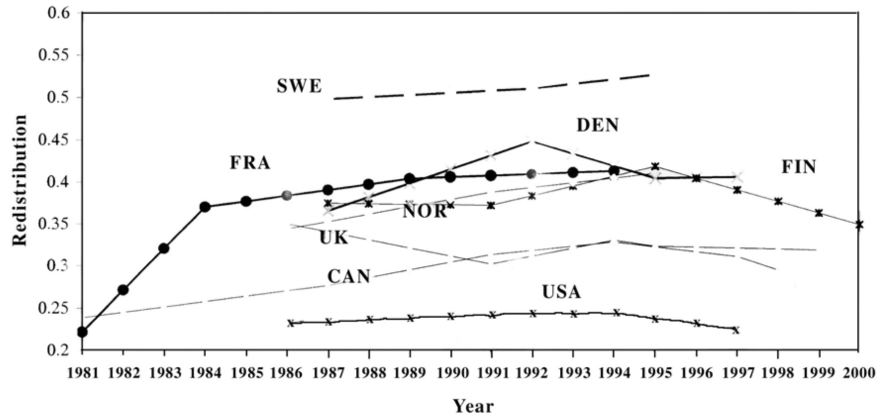
13 Hacker, Jacob, et al. "Inequality and public policy." Inequality and American democracy: What we know and what we need to learn (2005): 156-213.

14 Weir, Margaret. 2002. The American Middle Class and the Politics of Education. In Postwar Social Contracts Under Stress: The Middle Classes of America, Europe and Japan at the Turn of the Century, edited by O. Zunz, Leonard Schoppa, and Nobuhiro Hiwatari: Russell Sage.

15 Ellwood, David T., and Thomas Kane. 1999. Who is Getting a College Education? Family Background and the Growing Gaps in Enrollment. In Securing the Future, edited by S. Danziger and J. Waldfogetl. New York: Russell Sage Foundation

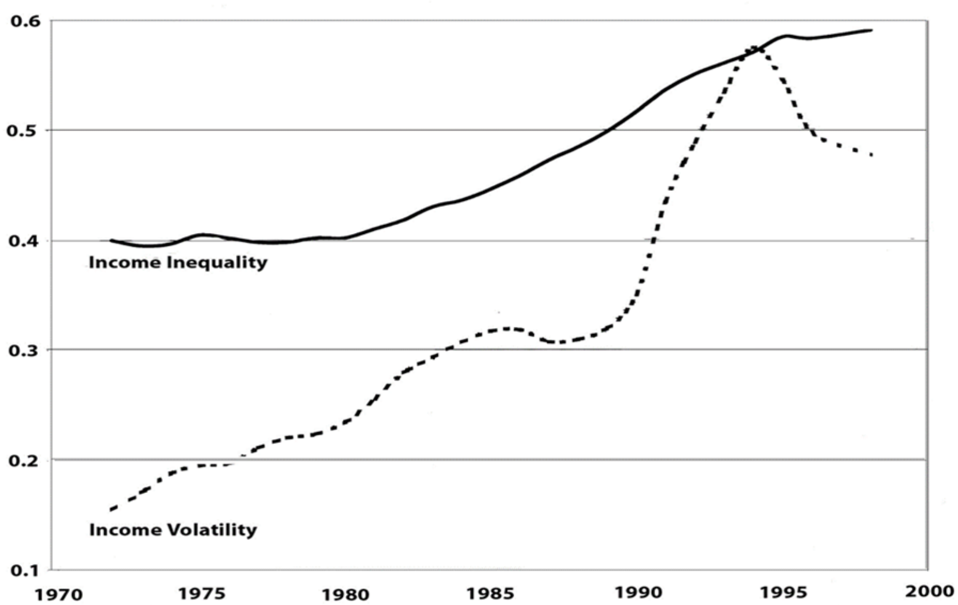
Country/ Year	Market Income Gini	Disposable Income Gini	Redistribution
Australia 1981	0.398	0.281	29%
1994	0.455	0.224	50
Mean (1981-1994)	0.426	0.275	36
Belgium 1992	0.452	0.224	50
1996	0.483	0.26	46
Mean (1992-1996)	0.4675	0.242	48
Canada 1981	0.373	0.284	24
1998	0.432	0.305	29
Mean (1981-1998)	0.408	0.288	29
Denmark 1987	0.4	0.254	36
1997	0.432	0.257	40
Mean (1987-1997)	0.425	0.252	40
Finland 1987	0.334	0.209	37
2000	0.379	0.247	35
Mean (1987-2000)	0.359	0.223	38
France 1981	0.37	0.288	22
1994	0.49	0.288	41
Mean (1981-1994)	0.454	0.290	35
Germany 1981	0.39	0.244	37
1994	0.445	0.261	41
Mean (1981-1994)	0.461	0.252	39
Italy 1986	0.424	0.306	28
1995	0.468	0.342	27
Mean (1986-1995)	0.433	0.312	28
Netherlands 1983	0.436	0.26	40
1994	0.423	0.253	40
Mean (1983-1994)	0.427	0.259	39
Norway 1986	0.355	0.233	34
1995	0.403	0.238	41
Mean (1986-1995)	0.378	0.234	38
Sweden 1981	0.411	0.197	52
1995	0.466	0.221	53
Mean (1981-1995)	0.444	0.216	51
United Kingdom 1986	0.466	0.303	30
1995	0.508	0.344	32
Mean (1986-1995)	0.490	0.330	24

Figure 1: Income Redistrubtion via Taxes and Transfers in Selected Nations, 1981-2000



Source: unpublished LIS data, kindly supplied by David Jesuit, Vincent Mahler, and Timothy Smeeding

Figure 2: Volatility and Inequality of American Family Income, 1972-1998



Source: Panel Study of Income Dynamics, adjusting for household size and average income growth. Calculations by Nigar Nargis, University of Dhaka. For additional information, see Hacker 2004 and http://pantheon.yale.edu/~jhacker/PSID_Data_NYT.htm.