



Institute for Policy Research
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Christopher “Sandy” Jencks

**“Economic Inequality:
How Much is Too Much?”**

Malcolm Wiener Professor of Social Policy,
Kennedy School, Harvard University

Economic Inequality: How Much Is Too Much?

Christopher Jencks
Harvard Kennedy School

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Three questions

 Why do some rich democracies have more economic inequality than others?

 What do we know about the costs and benefits of economic inequality?

 What do the answers to these two questions imply about how much inequality a rich democracy should regard as “too much?”

Economic inequality in rich nations

- **The Luxembourg Income Study (LIS) provides the most comparable measures of economic inequality in rich nations.**
- **I focus on 17 rich western democracies that participated in LIS and had per capita GDP of at least \$20,000 at PPP in 2000. (US = \$35,000)**
 - **I omit Luxembourg**
 - **I weight all nations equally but sometimes separate large from small nations.**

The LIS income measure

- **Total household money income from all sources, minus payroll and income taxes.**
- **Income is adjusted for differences in household size by assuming that “need” is proportional to the square root of household size.**

Households of four with \$60,000 therefore have the same “equivalized” income as households of one with \$30,000.

- **Adjusting for size and taxes lowers the US Gini coefficient by about a fifth.**

The 90-10 ratio

- If we rank households from poorest to richest,

$$90-10 \text{ ratio} = \frac{\text{Income at the 90}^{\text{th}} \text{ percentile}}{\text{Income at the 10}^{\text{th}} \text{ percentile}}$$

- In my 17 LIS nations the 90-10 ratio correlates 0.98 with the Gini coefficient in 2000.
- The 90-10 ratio correlates about 0.7 with the share of total income going to the top 1% in the nine nations with tax data on the latter.

I divide the 17 rich democracies into four groups

Scandinavian:

Denmark, Finland, Norway, Sweden

Franco-German:

**France, Germany, Austria, Belgium,
Netherlands, Switzerland**

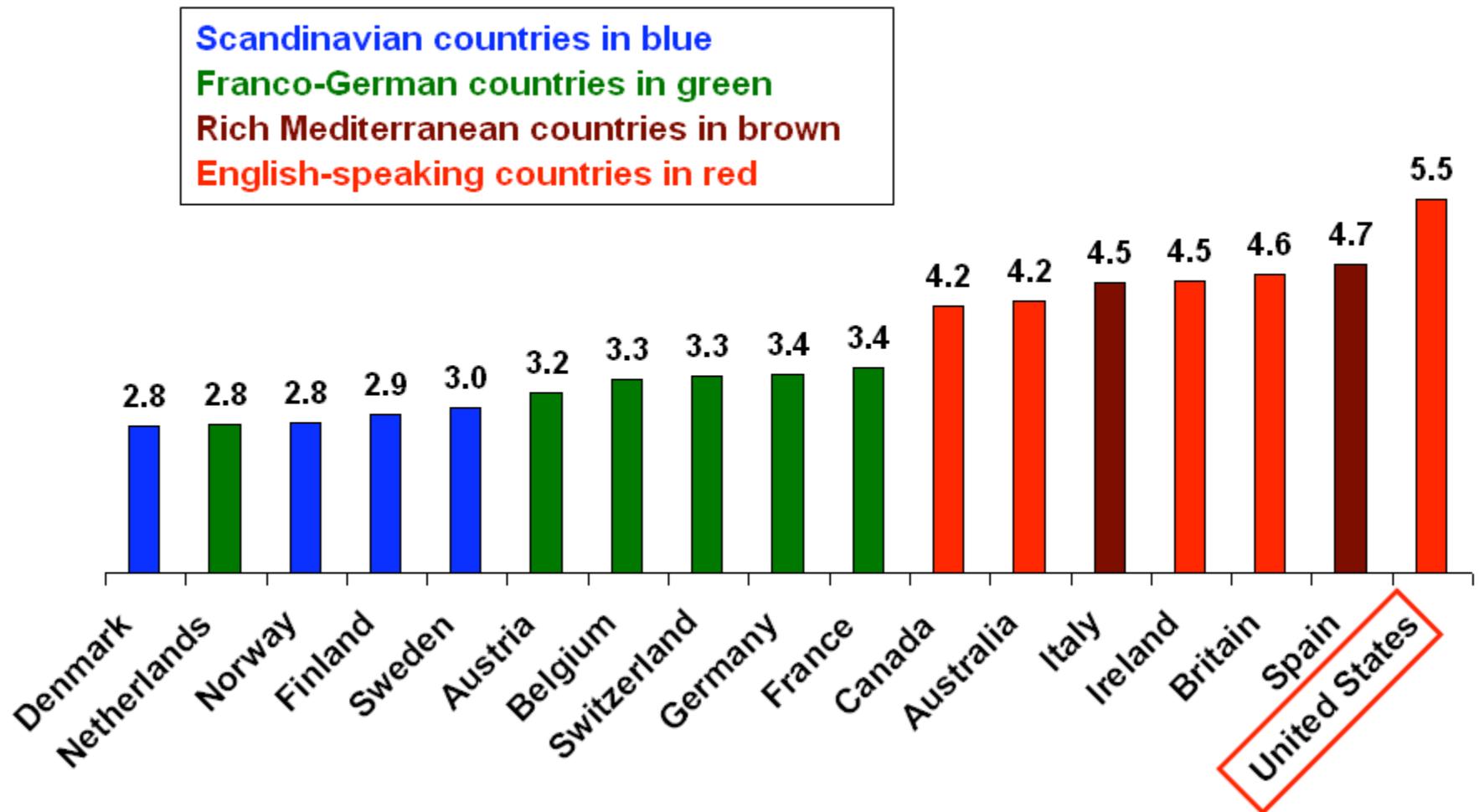
Rich Mediterranean:

Italy, Spain

English speaking:

Australia, Britain, Canada, Ireland, United States

The 90-10 ratios for the 17 rich western democracies are strongly related to a their location or language group



Source: LIS estimates for 1999-2001.

Politics: More unequal nations tend to have:

- Less regulated labor markets
- Decentralized wage bargaining
- Less financial regulation
- Two-party political systems
- A relatively successful “pro-market” party.

Human capital: More unequal nations tend to have:

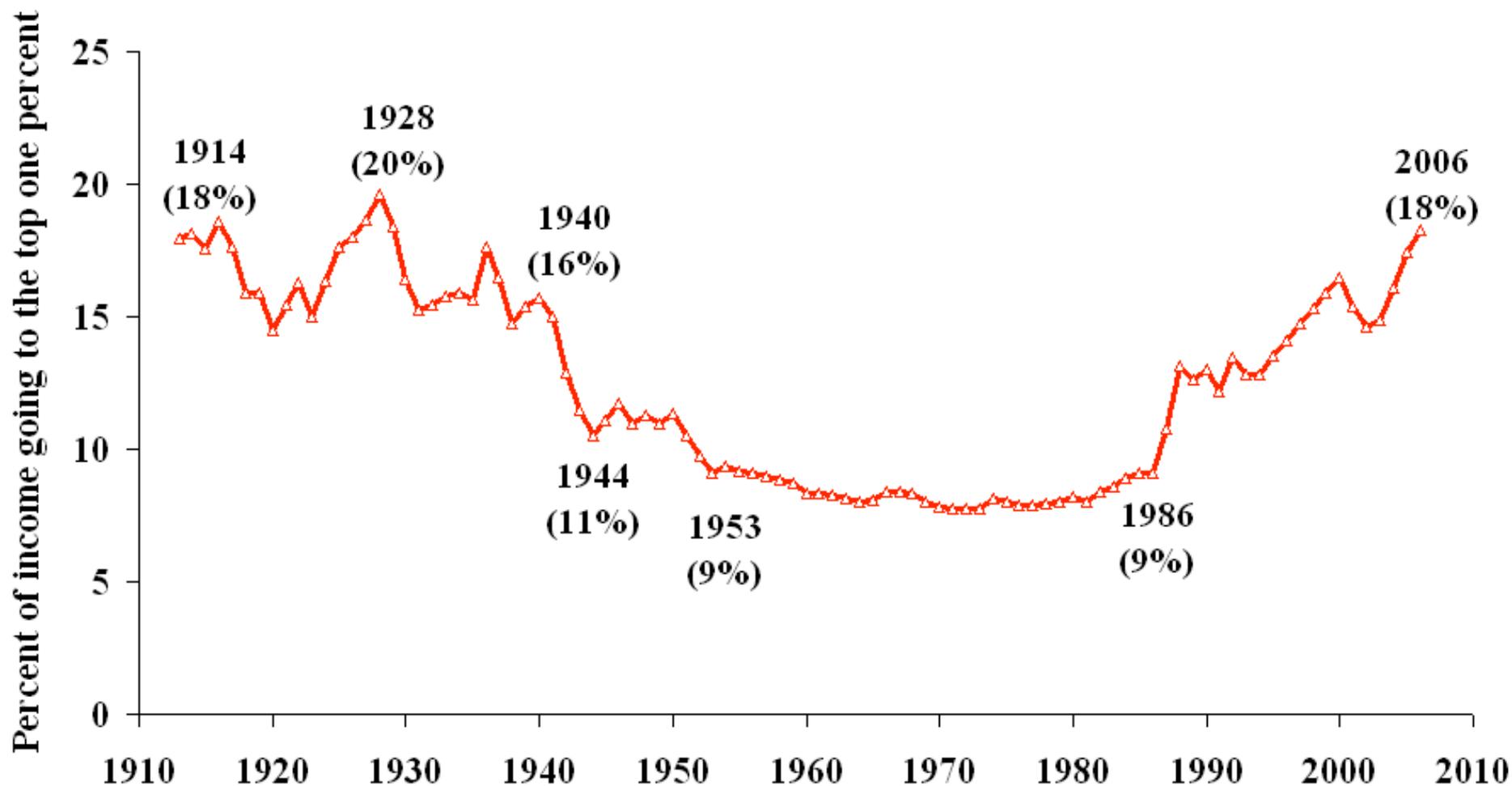
- Slightly more unequal test scores (could be a result of income inequality, not a cause)
- But **not** a more unequal distribution of schooling (in years)

Inequality also varies over time

In most large western democracies, economic inequality:

- **Was high before 1929**
- **Fell between 1929 and 1950**
- **Stayed low from 1950 to 1980**
- **After 1980 inequality rose in some countries but not others.**

In the US the top one percent's share of pretax income was cut in half between 1928 and 1953, was fairly stable from 1953 to 1986, and doubled between 1986 and 2006.



Source: Emmanuel Saez,

Change in the 90-10 ratio for 11 rich democracies with LIS data around 1980 and around 2000

Countries, from most to least unequal	90-10 ratio		Absolute change	Log change
	1979-83	1999-2001		
Britain	3.53	4.57	1.04	0.26
United States	4.67	5.46	0.79	0.16
Sweden	2.43	2.96	0.53	0.20
Germany	2.89	3.37	0.48	0.15
Spain	4.37	4.69	0.32	0.07
Australia	3.93	4.25	0.32	0.08
Canada	4.05	4.19	0.14	0.03
France	3.40	3.45	0.05	0.01
Norway	2.76	2.80	0.04	0.01
Switzerland	3.39	3.34	-0.05	-0.02
Netherlands	2.94	2.78	-0.16	-0.06
Source: LIS Key Figures.				

Ad hoc explanations

Germany: The LIS increase coincides with German reunification and its aftermath. No change from 1994 to 2000 in LIS. No LIS data since 2000.

Sweden: The 1981 estimate is the lowest ever recorded in Sweden -- or any other western democracy. It was either an error or not politically sustainable.

Sweden's 90-10 ratio was 2.73 in 1978, 2.71 in 1983, and 2.86 in 2005.

Implication: little change in Sweden since 1978.

A more general explanation

- **Inequality is highest in nations that do the least to limit the effects of unregulated market forces.**
- **Britain did less after Thatcher (1979) and the US did less after Reagan (1980).**
 - **Less regulation of labor markets:**
 - **Less legal protection for labor unions.**
 - **Less enforcement of labor law.**
 - **US raised minimum wage less than inflation.**
 - **Less regulation of financial markets since 1990.**

Budgetary changes

- **Demand for US college graduates rose at about the same rate after 1980 as from 1910 to 1980, but the supply of graduates grew more slowly after 1980 (Goldin & Katz, 2008).**
- **Cheap public universities became a lower budgetary priority at both the national and state level. Tuition rose faster than incomes, financial aid rose slower, and expansion slowed.**

Effect of budgetary changes

- **The supply of college graduates in both the US and the UK also grew less than in Western Europe.**
- **The wage gap between college graduates and high school graduates is also much larger in the US.**

Causes of inequality: A summary

- **It's mostly about politics**
- **Part of the story is about the choices that politicians made in the countries that grew more unequal.**
- **Most of the story is about the choices that politicians made in the countries that didn't grow more unequal but refused to make in the countries that did grow more unequal.**

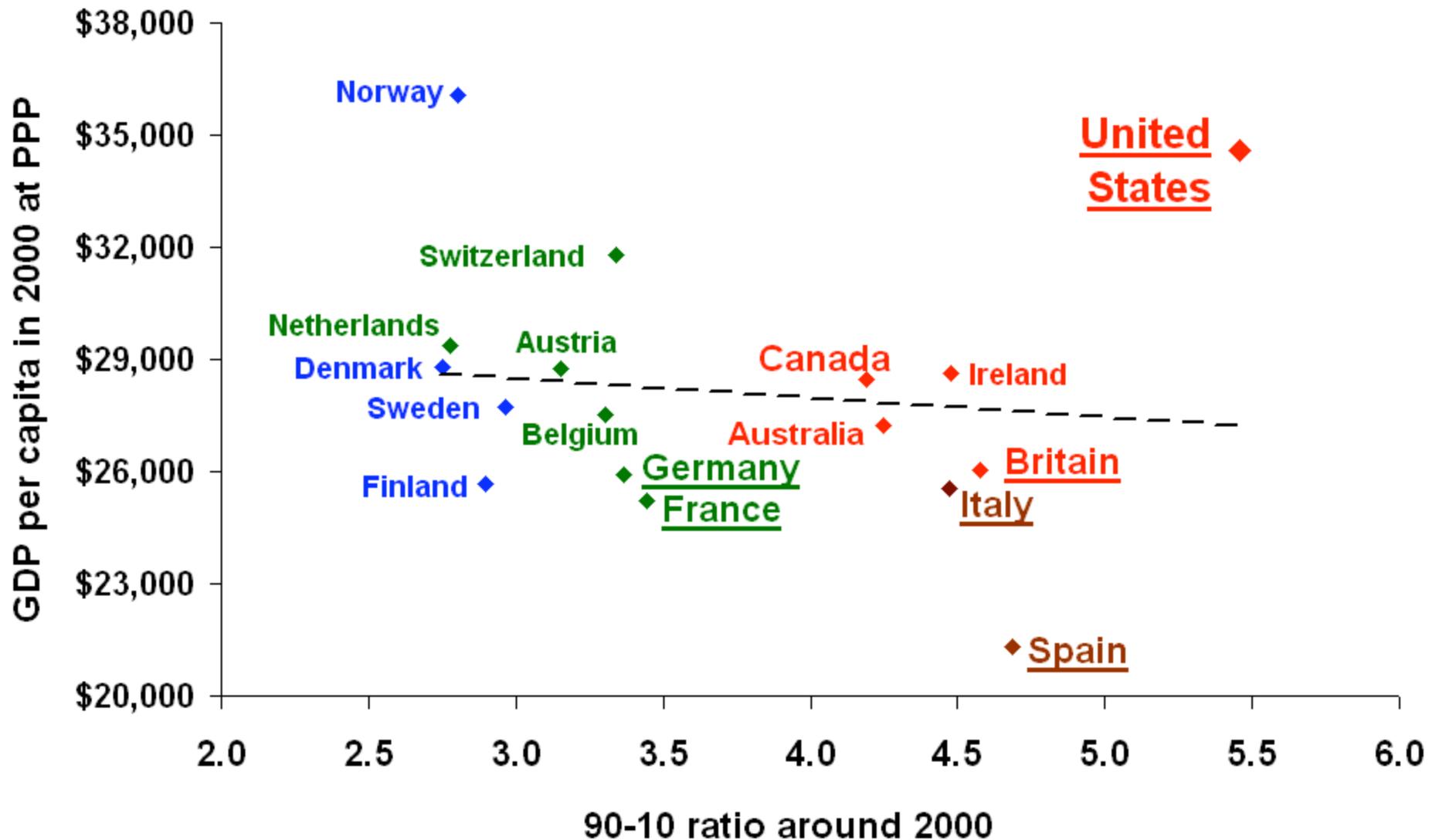
The case *for* economic inequality

Free market enthusiasts usually claim that efforts to reduce economic inequality have four costs:

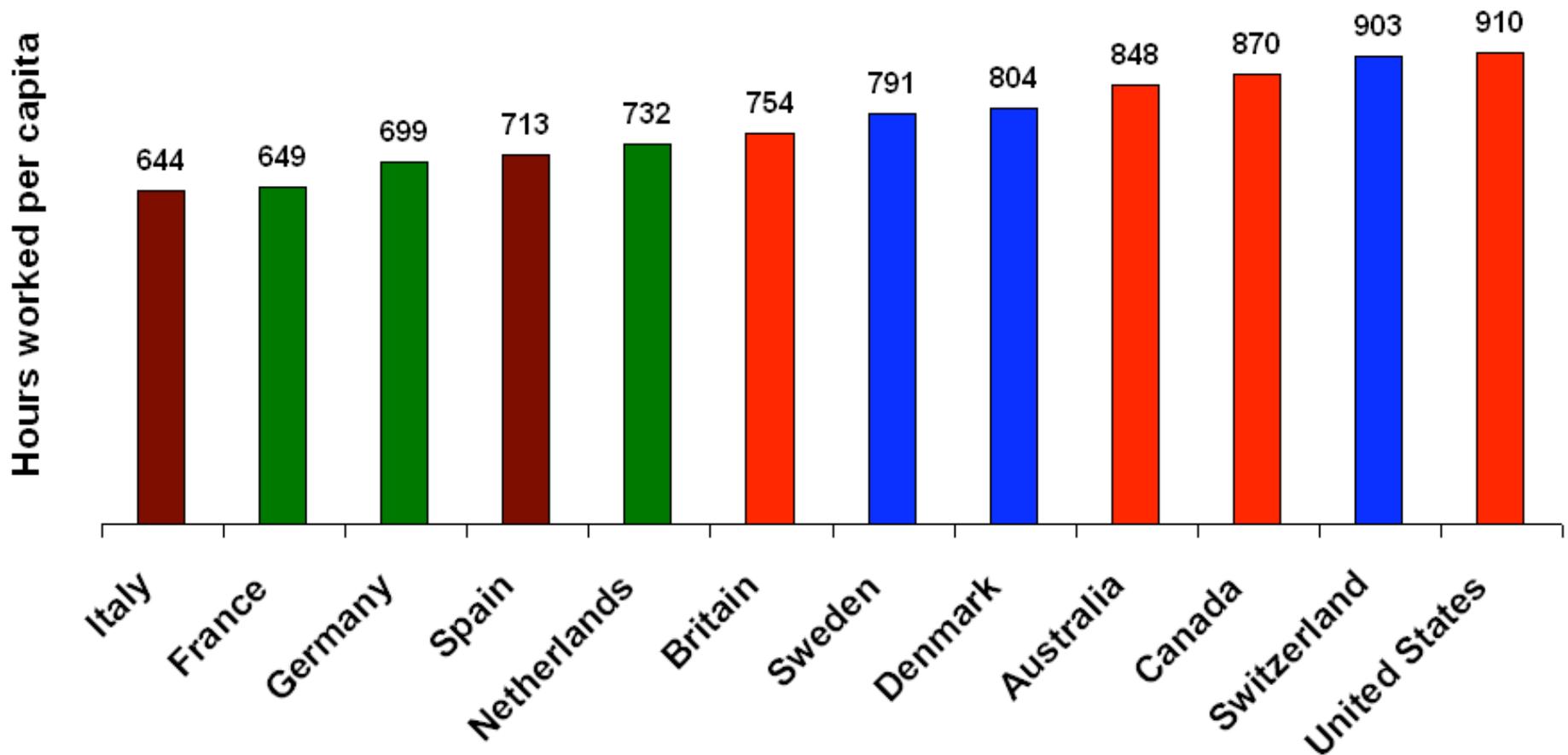
- Lower living standards (GDP per capita)
- Slower growth (change in GDP per capita)
- Less efficiency (GDP per hour worked)
- Fewer jobs (higher unemployment, lower employment)

But while the US is both rich and unequal, the overall correlation between inequality and per capita GDP in the rich world is negative.

The US is an outlier, suggesting that its GDP is high for other reasons.



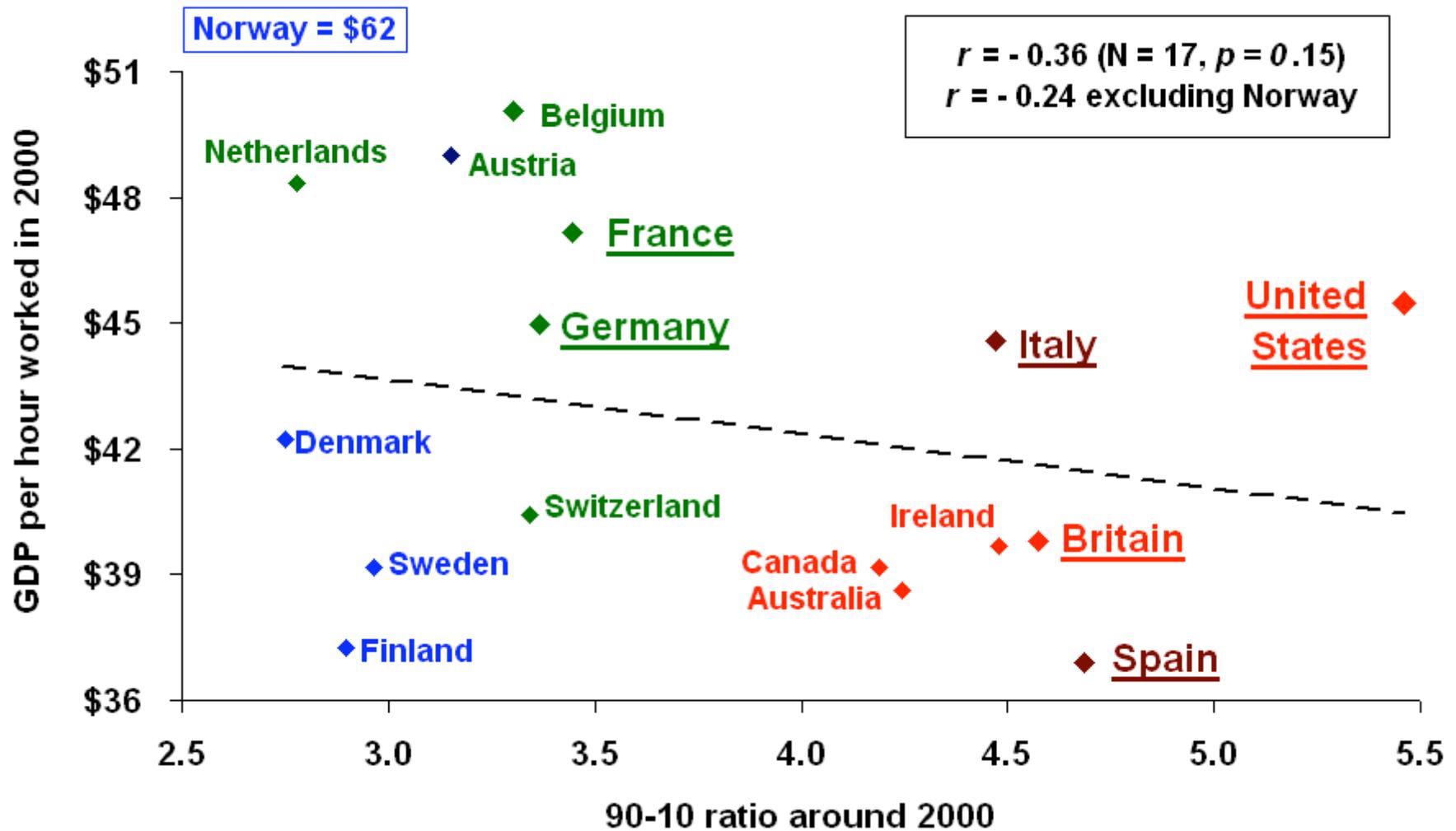
The view from Europe: Americans are only richer because they spend so much time working.
(More hours per capita in 2000 than any other rich country)



Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database, September 2008, <http://www.conference-board.org/economics/>

Do egalitarian policies lower output per hour?

GDP per hour is slightly lower in more unequal rich western democracies



Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database, September 2008

But this relationship may not be causal

- **Raising wages at the bottom makes employers less willing to hire unskilled workers.**
- **Generous unemployment and disability benefits also encourage unskilled workers to leave the labor force.**
- **Those who continue to work in egalitarian nations are therefore likely to be more skilled than those who work in laissez faire nations.**

Panel studies find a small **positive** effect of inequality on growth in rich countries

- Kristen Forbes (2000) found this using changes in the Gini coefficient within countries.
- Using tax data on top income shares, Andrews, Jencks, and Leigh estimate that a one percentage point increase in the top decile's share raised growth by 0.12 percentage points.
- **Implication:** For the bottom nine deciles, it takes 13 years for the benefits of faster growth to offset the cost of getting a smaller share of total income.

Inequality and unemployment

- From 1950 to 1980 unemployment was generally **higher** in the US than in more egalitarian nations.
- From 1990 to 2007 the pattern was reversed.
- But the US is unusual in combining high inequality with relatively low unemployment.
- If we compare all 17 rich western democracies, a 90-10 ratio of 4.0 rather than 3.0 is associated with a 1.7 point **increase** in unemployment ($p < 0.10$).
- **Direction of causation is unclear, since joblessness causes inequality as well as vice versa.**

Inequality and the economy: A summary

In more unequal nations:

- **GDP per capita is slightly lower**, but that could be chance.
- **GDP per hour worked is slightly lower**, which could also be chance.
- **GDP growth is a little faster**, but the bottom 90% do not benefit for a long time.
- **Average unemployment was higher from 1980 to 2007**, but there was no relationship in large nations.

The egalitarian case *against* economic inequality

 Worse health and lower life expectancy

 Fewer opportunities for poor children

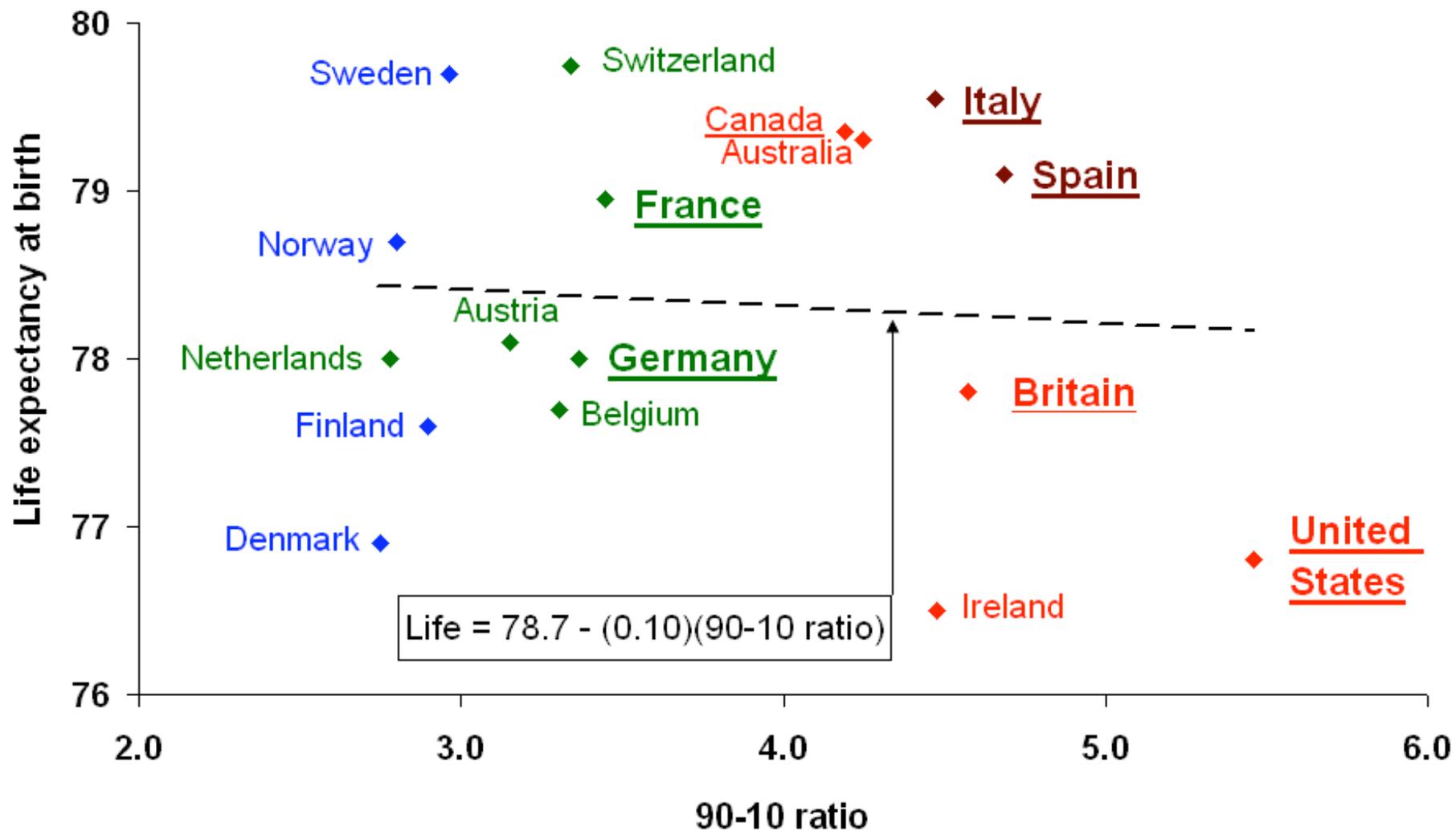
 Greater disparities in political influence

 Higher crime rates

 Erosion of social norms that derive from feeling that we live in a just society with reciprocal obligations to one another

I will discuss only the first three points.

Predicted life expectancy in 2000 was 3 months lower if a rich democracy had a 90-10 ratio of 5.5 rather than 3.0



What about SES disparities?

- Mackenbach *et al* (2008) report that the mortality gap between the most and least educated adults in eight West European countries is slightly **smaller** in nations with more income inequality ($r = - 0.3$, not significant).
- The mean mortality gap between the most and least educated is slightly smaller in the UK and France than in Scandinavia.
- The mortality gap between men in manual and non-manual jobs is also slightly smaller in more unequal countries ($r = - 0.3$, not significant).

Inequality and intergenerational mobility

 The inheritance of educational advantages (r_I) is somewhat higher in nations with more inequality ($p < 0.10$)

 The estimated intergenerational elasticity of earnings is also higher in more unequal nations. Some of these elasticities rest on shaky assumptions, **but the US elasticity is higher than the other reliable estimates.**

 No evidence on whether **changes** in income inequality lead to **changes** in mobility.

Income inequality & political inequality

- **The distribution of political influence always favors the more affluent:**
 - **Politicians are affluent themselves.**
 - **They spend most of their time with others who are affluent.**
 - **They need rich contributors.**

For details, see Larry Bartels, *Unequal Democracy*.

Income inequality & political inequality -- 2

- Rational choice theorists argue that when incomes become more unequal, politicians will be more likely to adopt “soak the rich” policies that reduce inequality. **Evidence for this is weak, at least in the short to medium run.**
- The more unequal the distribution of income, the larger the income gap between the median voter and the contributor of the median dollar.
- As a result, contributors’ preferences are more likely to distort legislators’ behavior.

Income inequality & political inequality -- 3

- From my perspective the changes in American politics between 1980 and 2008, when the income share of the top one percent doubled, support the view that money had more influence after 1980 than it had had from 1950 to 1980.
- But no one has yet devised empirical measures that persuade resolute skeptics that money has any influence on politics, much less that its influence has increased.

What do these facts imply about how much inequality is “too much?”

The two non-political effects of rising inequality in the US that worry me most are that:

 It may make children’s opportunities less equal. **Evidence for this is not yet conclusive.**

 It could undermine our feeling that we live in a just society and that we have reciprocal obligations to one another. **I have not yet looked for evidence on this possibility, and I’m not sure there is any.**

What do these facts imply about how much inequality is “too much?”

But my biggest worry is that rising economic inequality could alter the American polity in ways that made the trend almost irreversible.

At some point, the political influence of the rich may become such that it becomes impossible to construct a political coalition committed to reducing inequality unless there is another Great Depression like the 1930s or another war with domestic repercussions like 1941-45.

- **Until last year I thought the US might already have passed that point. Now I am a little less pessimistic. But not much.**
- **The Democrats may be stop the increase in inequality, but without 60 votes in the Senate they will not be able to **reduce** it significantly.**
- **Nor does history suggest that the Democrats will pick up more Senate seats in 2010.**
- **Nor is there any sign so far that the conservative wing of the Democratic Party sees anything wrong with one percent of American households getting a sixth of the nation's income.**

The End