

== Chapter 1 ==

Introduction: Egalitarian Capitalism in the Late Twentieth Century

Must we give up on the vision of a dynamic and productive yet relatively egalitarian form of capitalism? This is the question I seek to address in this book.

Many people would prefer to live in a society that is not only affluent but also reasonably egalitarian. In 1999, for example, significant majorities of citizens polled by the International Social Survey Program (ISSP) said that income differences in their country were too large: 71 percent in Australia, 86 percent in Austria, 71 percent in Canada, 88 percent in France, 82 percent in Germany, 69 percent in Japan, 73 percent in Norway, 71 percent in Sweden, 82 percent in the United Kingdom, and 66 percent in the United States (ISSP 1999).

The principal argument for egalitarianism is that it is fair. Much of what determines people's earnings and income—intelligence, creativity, physical and social skills, motivation, persistence, confidence, inherited wealth—is a product of genetics, parents' assets and traits, and the quality of childhood neighborhoods and schools. These things are not chosen; they are a matter of luck. A nontrivial portion of earnings and income inequality is therefore undeserved, which makes institutions and policies that can reduce inequality attractive to many (Rawls 1971; Roemer 1997). Other arguments for equality focus on its consequences. Income inequality may contribute to higher crime rates, disproportionate political power wielded by the wealthy, lower levels of educational attainment, and perhaps even slower economic growth. Of course, few if any egalitarians favor perfect equality of outcomes. Complete equality would substantially reduce work incentives, undermining both economic growth and the principle of reciprocity (all who are able to contribute do so).

A sensible contemporary vision of an egalitarian capitalist society, in my view, would prioritize not only limited income inequality but

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also high living standards—particularly for those at the bottom of the distribution—and a high employment rate. There are other reasonable aims, such as reducing wealth inequality, improving access to basic material needs, and increasing mobility (Boushey et al. 2001; Gottschalk and Danziger 1998; Leisering and Leibfried 1999; Mayer and Jencks 1989; Wolff 1995/2002). Although I discuss these aims briefly in chapters 6 and 7, for the most part I set them aside in this book. The book is mainly about differences across countries, and data limitations make it much more difficult to draw comparative conclusions about wealth, material hardship, and mobility than about jobs, incomes, and income inequality.

Suggesting that equality should not come at the expense of the living standards of the poor is unlikely to be controversial, but why is a high employment rate important? One argument in favor of employment has to do with its social nature. Heightened geographical mobility, later marriage, and increased divorce have loosened neighborhood and family ties, and as a result, work is an increasingly important site of social interaction. Work has other intrinsic benefits: it imposes regularity and discipline on people's lives. However, the chief argument in favor of high employment is that it is increasingly critical to the goal of limiting income inequality.

This is true in two respects. First, employment affects the distribution of earnings across households. Half a century ago it was normal for many working-age adults to not be in the labor force. They were mainly women, and their husbands were employed. The fact that some adults were employed and others were not had little impact on the distribution of earnings among households because inequality of employment occurred mainly within, rather than between, households. That is no longer the case. With women increasingly in paid work, inequality of employment occurs more and more between households. In other words, instead of having many households with one (usually male) earner and one (usually female) non-earner, a country with a low or moderate employment rate now is more likely to have many households with two earners and many with no earners (Gregg 1996; OECD 1998b). This increases inequality of earnings between households (Förster and Pearson 2002).

Second, employment is important for low inequality in its role in redistribution. Governments engage in redistribution in a variety of ways (Esping-Andersen 1990, 1999; Goodin et al. 1999). "Social democratic" welfare regimes in the Nordic countries provide benefits to most of the population, and those benefits tend to be relatively equal (flat-rate). This in itself alters the distribution of income—assuming taxes are not regressive, giving every household an equal lump sum reduces in-

equality (Rothstein 1998, 146–47). And redistribution is furthered through some targeting and inequality in benefit levels, as well as through taxing back part of the benefits paid to those who need them the least. (Social democratic welfare states also tend to offer extensive public provision of services, such as health care and child care. Though it does not alter the distribution of income, this too has an equalizing effect.) “Conservative” welfare regimes in the continental European countries rely disproportionately on social insurance programs in which benefit levels are determined by an individual’s former labor market status and earnings level. This type of program is not particularly redistributive in design, but because of some targeting and a relatively high overall *level* of transfers, continental welfare states nevertheless do tend to achieve a significant amount of redistribution. In the Anglo (English-speaking) countries, “liberal” welfare regimes provide minimal benefits that are narrowly targeted to the most needy (means-tested). This is the most efficient redistributive strategy; it achieves the most redistribution per amount of income transferred. But in comparative terms the level of transfers in these nations tends to be low, so relatively little redistribution is effected (Korpi and Palme 1998).

Welfare states in all affluent countries currently face a number of threats, of which two are perhaps most critical. The first is a demographic crunch. Most public pension systems are financed on a “pay-as-you-go” basis; benefits for retirees come directly from current taxes. With low fertility rates, limited immigration, and lengthening life spans, the cost of public pensions becomes ever larger relative to the tax base from which they are funded. Since pensions typically are the largest category of social expenditure aside from health care, this puts a severe strain on the welfare state.

The other threat is capital mobility. With investors now able to easily shift resources outside their home country, governments face increased pressure to reduce tax rates. Predictions of an all-out “race to the bottom” thus far have not been borne out, but tax rates have indeed been lowered in most nations. Such reductions are usually accompanied by a broadening of the tax base in order to minimize the reduction in revenues (Ganghof 2000; Genschel 2001). Yet revenues nevertheless have tended to fall. In every affluent nation aside from Norway and the United States, tax revenues as a share of gross domestic product (GDP) are lower than at their peak (typically in the late 1980s or early 1990s).

With tax revenue squeezed at the same time that welfare state costs are rising, something has to give. One option is to adjust the pension system—for example, by raising the retirement age a bit, reducing benefit levels somewhat, or taxing back the benefits of well-to-do retirees at steeper rates. But these measures may not yield enough cost savings.

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Another option is to increase immigration. But if many of the immigrants have limited skills, increasing immigration may end up adding to the cost of the welfare state, at least in the short or medium term. The best solution to the dilemma of the welfare state's rising costs and shrinking tax revenues is to increase the employment rate (Esping-Andersen 1999; Esping-Andersen et al. 2002; Ferrera, Hemerijck, and Rhodes 2000; Scharpf and Schmidt 2000). Doing so is doubly beneficial: higher employment yields an increase in tax revenues without an increase in tax rates, and to the extent that employment moves some recipients of government benefits into the workforce, welfare state costs are reduced.

Egalitarians thus should have three goals: low inequality, high living standards, and high employment. During the post-World War II "golden age" it was believed by many that these goals were not only compatible but mutually reinforcing. And through the mid-1970s a handful of countries—Sweden, Denmark, Germany, and a few others—succeeded in achieving all three. But the 1980s and 1990s are viewed by some as having called into question the extent to which low inequality remains an attainable goal and, more important, the extent to which low inequality is compatible with high and rising living standards and/or employment.

The End of Equality?

One concern is that egalitarianism itself may no longer be viable. In assessing this concern, it is helpful to think about inequality at three levels: earnings inequality among employed individuals (frequently referred to as "pay inequality" or "wage inequality"); earnings inequality among households; and income inequality among households when not just earnings but also investment income, taxes, and government transfers are included ("posttax-posttransfer income inequality" or "disposable income inequality").

Earnings compression among employed individuals has been threatened by an array of developments (Alderson and Nielsen 2002; Morris and Western 1999). Declining unionization levels and the decentralization of wage setting in many countries have weakened the major institutional force supporting wage compression. Growth in the supply of female and immigrant job-seekers has put downward pressure on wages at the low end of the labor market. The shift of employment from manufacturing to services has reduced the share of jobs in the sector where pay has traditionally been most compressed and increased it in the sector where it tends to be most dispersed. Heightened competition in various industries, a product of globalization and dereg-

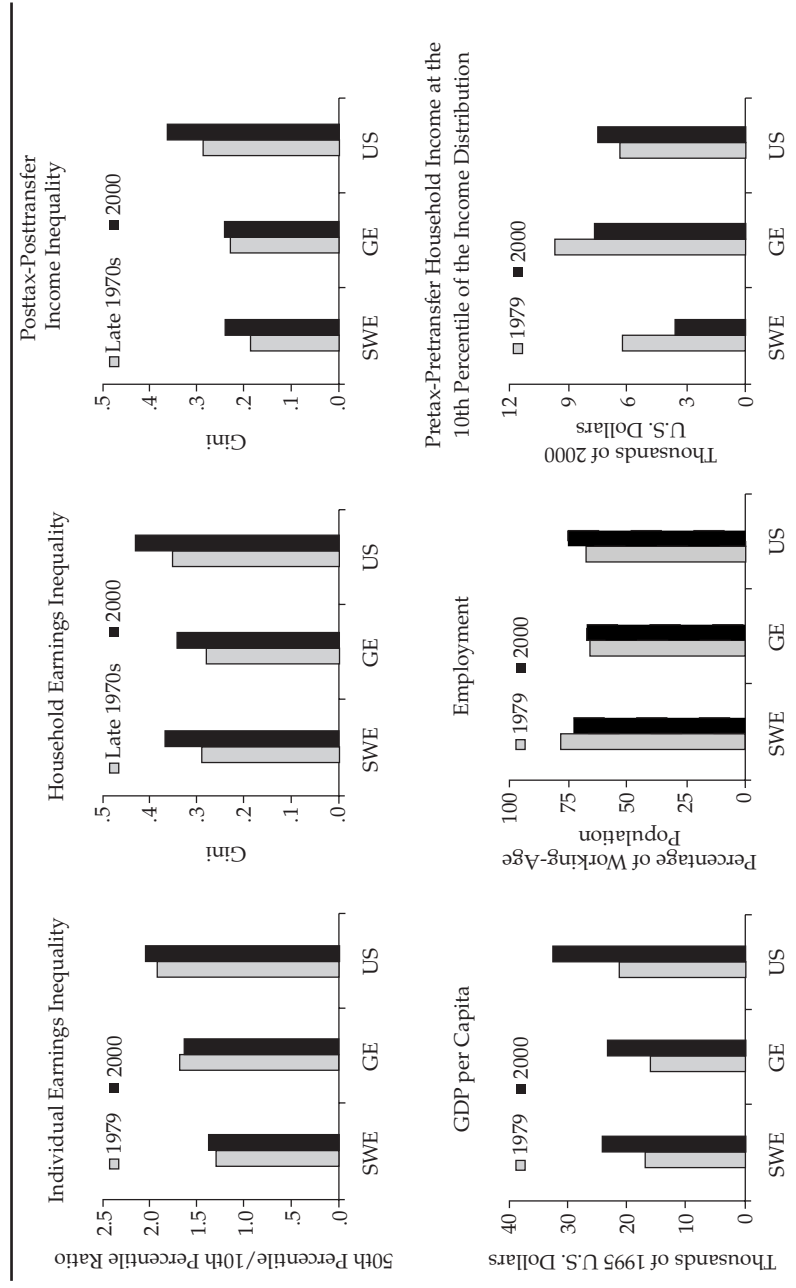
ulation, has encouraged firms to become more cost-conscious and thus intent on reducing pay levels—particularly at the bottom levels where employees are more replaceable. Enhanced ability to move factories and offices abroad has provided employers with additional leverage in making such demands.

There is good reason to suspect that earnings disparities have widened across households as well (Burtless 1999; Nielsen and Alderson 2001). The degree of pay inequality among employed individuals is a key contributor to earnings inequality among households; thus, if the former has increased, we should expect the latter to also have increased. Because non-employment tends to be distributed unequally across households, declines in employment that have occurred in a number of nations are likely to have increased interhousehold earnings inequality. The same is true of part-time employment (as a share of total employment), single-adult households, and marital homogamy, each of which has grown in many countries.

Finally, capital mobility has increasingly constrained the tax capacities of national governments, presumably restricting their redistributive capabilities. In other words, at a time when economic developments seem likely to have increased the degree of market earnings inequality, governments have faced heightened pressure to cut back on programs designed to compensate for such inequality. Indeed, almost all affluent nations instituted welfare state cutbacks at some point during the 1980s and 1990s, in the form of stricter eligibility requirements, reduced benefit levels, and/or shorter benefit duration (Clayton and Pontusson 1998; Gilbert 2002; Hicks 1999; Huber and Stephens 2001; Pierson 2001; Ploug 1999; Swank 2002).

Given these developments, can the comparatively low levels of income inequality achieved by the Nordic and some of the continental European countries be sustained? Figure 1.1 shows levels of earnings inequality among employed individuals, earnings inequality among households, and posttax-posttransfer income inequality among households in 1979 (or the closest year for which data are available) and in 2000 for Sweden, Germany, and the United States. These three countries are commonly cited as representative of the Nordic, continental European, and Anglo groups of nations, respectively. The years 1979 and 2000 were the peaks of the 1970s and 1990s business cycles, so they are suitable for purposes of comparison. (For reasons I discuss in chapter 2, different measures of inequality are used in this figure, but in each case larger numbers indicate more inequality.) The figure suggests that, with one exception (individual earnings inequality in Germany), the level of inequality did increase on all three dimensions in each of the three countries. On the other hand, the differences between the three

Figure 1.1 Inequality, Economic Growth, Employment Growth, and Real Income Growth in Sweden, Germany, and the United States, 1980s and 1990s



Source: Author's compilation; see appendix.

Note: Individual earnings inequality data refer to those employed full-time year-round. Posttax-posttransfer income inequality data are for households. GDP per capita and 10th-percentile household incomes are converted to U.S. dollars using purchasing power parities. Employment refers to the share of the working-age population that are employed. Data for inequality of household earnings and incomes and for 10th-percentile household incomes refer to working-age households. For variable descriptions and data sources, see the appendix.

countries did not diminish; Sweden and Germany remained considerably more egalitarian than the United States. In chapter 3 I explore this issue in greater depth across a larger number of affluent nations.

Potential Trade-offs

A second concern is that, even if egalitarianism remains viable, it may no longer be compatible with high and rising living standards. Hard-core advocates of free markets have long argued against “excessive” pursuit of equality (Friedman 1962; Hayek 1960). But in recent years even scholars with egalitarian sympathies have expressed some skepticism about the degree to which countries can effectively combine low inequality with a strong economy (Blau and Kahn 2002a; Boix 1998; Esping-Andersen 1999; Hemerijck and Schludi 2000; Iversen 1999; Pfaller, Gough, and Therborn 1991; Scharpf and Schmidt 2000; Streeck 2001). The chief concern has to do with potential adverse effects of pay compression (low earnings inequality among employed individuals) and generous social welfare programs on growth of economic output (GDP), employment, and real incomes.

An Equality-Growth Trade-off?

Debate about whether low inequality is compatible with a dynamic, productive economy has a long history. It has most commonly focused on the relationship between inequality and economic growth. The traditional view of this relationship, outlined famously in Arthur Okun’s 1975 book *Equality and Efficiency: The Big Trade-off*, holds that inequality is beneficial for growth. The mechanisms underlying this presumed effect are relatively straightforward. Investment, work effort, and skills are key sources of growth. The wealthy are the principal source of savings and investment in a capitalist economy, so the smaller their income share, the less investment there is expected to be. And absent the prospect of sizable financial gain, individuals may limit their work effort and skill development.

Others have suggested reasons why income inequality may instead be bad for growth (Birdsall, Ross, and Sabot 1995; Bowles and Gintis 1995; Kenworthy 1995, ch. 3; Perotti 1996). Since the wealthy tend to save a higher share of their income than do the poor, greater inequality may weaken consumer demand, which can be as debilitating for growth as low investment. High levels of inequality may be viewed by those at the middle and lower ranges of the income distribution as excessively unfair, thereby reducing worker motivation and workplace cooperation. High levels of inequality also may reduce the share of the

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population that can afford to invest in postsecondary education. In addition, the financial constraints and frustration generated by high levels of inequality may reduce trust, cooperation, civic engagement, and other growth-enhancing forms of social capital.

In the 1990s the traditional view was challenged on empirical grounds as a slew of analyses discovered that countries with more inequality tend to have slower rates of economic growth (see, for example, Birdsall, Ross, and Sabot 1995; Clarke 1995; Perotti 1996; Persson and Tabellini 1994). However, less-developed countries account for the bulk of the cases in these studies, so the findings may offer little insight into processes in affluent economies. Recently, several studies of rich countries have found evidence for a growth-enhancing effect of inequality, consistent with the traditional view (Barro 2000; Brandolini and Rossi 1998; Forbes 2000). The lower-left chart in figure 1.1 shows levels of per capita GDP in 1979 and 2000. At both time points the level in the United States was substantially higher than in Sweden or Germany, and the gap widened a bit in the 1980s and 1990s.

Is the traditional view correct, then? Is income inequality beneficial for economic growth once nations reach a certain level of affluence? I explore this question in chapter 4.

An Equality-Jobs Trade-off?

As suggested earlier, there is good reason to consider a high employment rate to be an integral component of the egalitarian vision, because high employment is increasingly likely to be a prerequisite for a generous welfare state. But might equality in fact constitute an impediment to high employment?

In many affluent nations the fastest-growing job sector, and the likely locus of much future employment growth, is private-sector consumer-related services—restaurants, hotels, retail trade, cleaning, child care, and the like. Because of productivity increases and low-wage competition from developing countries, manufacturing is unlikely to provide a major source of new job opportunities, and many new labor force entrants are unlikely to be qualified for high-skilled service positions. In most consumer service jobs, productivity levels are relatively low and difficult to increase. Firms therefore can pay high wages only by passing the cost on to customers. But if the market is reasonably competitive, customers will refuse to pay a higher price. Hence, many of the new consumer service jobs will pay relatively low wages. This in turn means that earnings inequality among the employed will rise. Alternatively, such employment could be created in the public sector. Government jobs are shielded from market competition, thereby per-

mitting above-market wages. But this increases the cost burden on the state, which is difficult to sustain in an age of capital mobility. Thus, for the Nordic and continental European countries, high employment may hinge on allowing lower wages at the bottom of the distribution, which implies greater pay inequality (Esping-Andersen 1999; Ferrera, Hemerijck, and Rhodes 2000; Iversen 1999; Scharpf and Schmidt 2000).

Indeed, a commonplace view holds that affluent countries face a trade-off between pay equality and jobs (Becker 1996; Blanchard and Wolfers 2000; Blau and Kahn 2002a; *The Economist* 1997; Iversen and Wren 1998; Krugman 1996; OECD 1994, 1996b; Siebert 1997). In the “U.S. model,” wages for those at or near the bottom of the labor market are relatively low. This makes it attractive for companies to hire such workers. The American labor market is thus characterized by low earnings for those at the bottom, but also by extensive job creation and high employment. In the “European model,” high relative wages at the low end of the distribution encourage companies to employ fewer workers. Countries in Europe therefore feature relatively high earnings for those at the bottom but little job creation and low employment. The lower-middle chart in figure 1.1 shows employment rates in Sweden, Germany, and the United States. At the beginning of the 1980s Sweden had the highest employment rate among the three countries, with Germany and the United States roughly even. But in the 1980s and 1990s employment declined in Sweden, was stagnant in Germany, and increased in the United States. By 2000 the United States had the highest rate among the three countries.

But allowing greater pay differentials hardly seems an ideal solution. Not only is a larger degree of pay inequality objectionable in and of itself; it also carries over to the distribution of household income. From an egalitarian perspective, a U.S.-style labor market, which features a high employment rate but a large number of low-paying jobs and consequently high inequality and poverty, is far from optimal. The question is: Can high employment be achieved with a low or moderate level of pay inequality? Is there a route to high employment that does not rely on extensive earnings and/or income disparities? I examine this issue in chapter 5.

An Equality-Incomes Trade-off?

If equality does impede the growth of economic output and/or employment, it may result in stagnant or falling real living standards for those at the low end of the income distribution. This, in my view, is the most important concern about potential incompatibilities between equality and other aims. There are good reasons to worry about the de-

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gree of separation between the rich and the rest of society, but the chief reason why most egalitarians favor limited inequality is because they presume that those at the bottom will be better off.

The well-being of individuals and households at the bottom of the distribution is most commonly studied by analyzing poverty. The central debate has concerned the impact of redistribution on poverty. To most supporters of the welfare state, one of its chief benefits is poverty reduction (Goodin et al. 1999). By redistributing income from the well-off to the poor, social welfare programs help to raise the incomes of households with low earnings. In contrast, many welfare state critics and even some supporters contend that, over time, generous social welfare programs reduce the growth of economic output and/or employment (Arrow 1979; Friedman and Friedman 1979; Lindbeck 1995; Murray 1984). As a result, the welfare state may increase poverty rather than reduce it.

To a large extent, proponents of these two views talk past one another. Welfare state supporters typically focus on *relative* poverty. A relative measure of poverty sets the poverty line for each country at a certain percentage (usually 50 percent) of the median income within that country. The poverty line thus differs across countries. Welfare state critics, on the other hand, focus principally on *absolute* poverty. An absolute measure of poverty uses the same poverty line (in converted currency units) for all nations. Across affluent countries, welfare state generosity is very strongly associated with low relative poverty (Brady 2001; Moller et al. 2003; OECD 2001e; Smeeding, Rainwater, and Burtless 2001). But there has been very little cross-country research addressing the possibility that redistribution may harm the poor in an absolute sense.

The lower-right chart in figure 1.1 shows real pretax-pretransfer household income levels (per equivalent person; see chapter 2) at the 10th percentile of the distribution in Sweden, Germany, and the United States. The 10th percentile is commonly used in studying the low end of the distribution (hence the frequent use of 90th percentile/10th percentile and 50th percentile/10th percentile ratios), since data for lower levels are more likely to suffer from measurement error. Consistent with the critics' argument, during the 1980s and 1990s the real income level at the 10th percentile fell in Sweden and Germany while it increased in the United States. Of course, what ultimately matters to people is income after taxes and government transfers are counted, and these three countries are not necessarily representative of all affluent nations. Still, these figures suggest a potential incompatibility between equality and real income growth for the poor. I explore this issue in chapter 6.

My Analytical Approach

For those who favor an egalitarian version of capitalism as well as those who do not, the issues and questions I have outlined here are significant. This book examines them from a comparative perspective. I focus on the world's richest nations, excluding a few with very small populations (such as Iceland and Luxembourg) and some others for which adequate data are lacking (Greece, Ireland, Israel, New Zealand, Portugal, and Spain). The countries included are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, and the United States. At various points in the book I refer to these sixteen countries as members of the three groups mentioned earlier: Nordic (Denmark, Finland, Norway, and Sweden), continental European (Austria, Belgium, France, Germany, Italy, the Netherlands, and Switzerland), and Anglo (Australia, Canada, the United Kingdom, and the United States). This draws on the typologies of political economies outlined by Jonas Pontusson (forthcoming) and Fritz Scharpf (2000), of welfare states by Gøsta Esping-Andersen (1990, 1999), and of families of nations by Francis Castles, Manfred Schmidt, and Göran Therborn (Castles 1993). I use this grouping simply as a heuristic device, to facilitate the exposition. Economic institutions and policies in Japan are such that it does not fit well into any of these groups; because of data limitations, Japan plays a limited role in the book in any case.

I examine the post-golden age period beginning in the mid-1970s, with an emphasis on the 1980s and 1990s. Much of the research on cross-country variation in inequality and poverty has focused on levels. My focus, by contrast, is chiefly on cross-country variation in *changes over time*. The 1980s and 1990s are viewed by many as a new and qualitatively distinct epoch for affluent economies. For some this distinctiveness is due to globalization, while others attribute it to heightened domestic competition, changes in policy orientations, demographic shifts, or some combination of these. Because economic institutions, policies, and performance patterns tend to change slowly, current cross-country variation in levels may be largely a product of determinants from an earlier era. Thus, in analyzing developments in the 1980s and 1990s, it is most useful to focus on cross-country differences in change during this period. For instance, differing levels of unionization may have had a sizable influence on cross-country differences in pay inequality in the 1950s, 1960s, and 1970s. As a result, unionization may continue to be an important explanatory factor in accounting for current cross-country variation in levels of pay inequality. But cross-country differences in changes in pay inequality in the 1980s and 1990s—

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and thus potentially in future decades—may be a product mainly of other factors.

The analyses in the book are largely quantitative. Yet for the most part they are relatively “low-tech.” I make extensive use of scatter-plot graphs and very simple regressions, owing in part to limitations imposed by the available data and in part to my interest in long-term processes and in separating analyses of levels from analyses of change over time (see chapter 2). This low-tech approach has the additional advantage of making the analyses accessible to those not well versed in sophisticated econometric techniques.

In chapter 7, I shift from comparative statistical analyses to country case studies in order to shed further light on the feasibility of egalitarian capitalism in the modern world economy. And in the book’s final chapter, I offer a set of suggestions for how affluent societies might most effectively reconcile equality, high living standards, and high employment.