SESSION 1: Drivers and consequences of growing inequalities

Richard Freeman
Professor of Economics at Harvard University, USA

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Tackling Inequality | Lutter contre les inégalités

Welcome to the New World of Inequality

"It was the most unequal of times, it was the most equal of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of markets, it was the epoch of policy interventions, it was the season of Light, it was the season of Darkness, it was the spring of hope, the winter of despair. Perfect markets were leading us to heaven. Deregulated markets were sending us in the other way" – (A Tale of Two Economies)

Richard B. Freeman, Harvard and NBER, LSE CEPI
"Drivers and consequences of growing inequalities".
OECD Policy Forum, Paris, May 2, 2011

Introduction

The issue: The triumph of globalization and market capitalism has improved living standards for billions while concentrating billions among the few. It has lowered inequality worldwide but raised inequality within most countries.

The three questions for this talk:

1. Why has inequality changed so much?
2. What are the consequences?
3. Where will it all end?

Starting Point: divergence of global and local inequality.

More rapid economic growth of developing countries, particularly China and India, than of advanced countries – amplified in the Great Recession and recovery – has reduced **global** income inequality in relative terms and has begun to reduce it in absolute PPP terms even as inequality has risen locally in developing and advanced countries.

The decomposition of the variance of ln incomes (σ^2) shows the consistency of the divergent trends

$$\sigma^2 = a\sigma_1^2 + (1\text{-}a)\,\sigma_2^2 + a(1\text{-}a)(M_1\text{-}M_2)^2,$$

where a is share of population in advanced countries, σ_i^2 is variance of ln incomes and M_i is the mean ln income, where subscript 1 refers to advanced countries and 2 to developing countries.

Decreases in M_1-M_2 has dominated the increases in the σ^2

The rising inequality within advanced countries

- Falling share of wages in business sector value added (OECD, 2008) with magnitude affected by profit-sharing, stock options, etc. – 10 point drop for OECD-15, falls in 16 of 16 countries
- Large increase of inequality in labor earnings: decile ratio ($9^{th}/1^{st}$) rises in 14 of 18 countries in 2000-2008 by 0.17 points (~0.2 per year)
- Hollowing of “middle class” jobs
- Huge increase of inequality between very top and others
- Differing magnitudes of change among countries.
- Fractal rise of inequality in at least some high inequality countries.

Inequality of Salaries of Faculty Working at Doctorate-Granting Institutions, 1973–2006, Selected Fields: Gini Coefficient

Gini Coefficient	1973	1985	1995	2006
Engineering				
Assistant	.072	.079	.106	.164
Associate	.064	.082	.118	.152
Full	.091	.110	.159	.220
Math and Computer Science				
Assistant	.071	.115	.119	.164
Associate	.079	.095	.143	.184
Full	.102	.113	.157	.193
Physical Sciences				
Assistant	.070	.099	.132	.142
Associate	.091	.104	.141	.146
Full	.121	.127	.167	.225
Life Sciences				
Assistant	.091	.098	.190	.228
Associate	.088	.115	.168	.223
Full	.120	.128	.206	.250

Paula Stephan, tabulated from Survey of Doctorate Recipients, for forthcoming HUP book

Inequality within developing countries

- Associated with large informal sector that has not declined with development
- China with huge urban/rural and regional variation as well as increased urban inequality
- Surprising decline in inequality in Brazil and some other high inequality Latin American countries.

The World's Billionaires-- Forbes March 2011

Rank		Name	Net Worth	Age	Source	Country of Citizenship
1		Carlos Slim Helu & family	$74 B	71	telecom	Mexico
2		Bill Gates	$56 B	55	Microsoft	United States
3		Warren Buffett	$50 B	80	Berkshire Hathaway	United States
4		Bernard Arnault	$41 B	62	LVMH	France
5		Larry Ellison	$39.5 B	66	Oracle	United States
6		Lakshmi Mittal	$31.1 B	60	Steel	India
7		Amancio Ortega	$31 B	75	Zara	Spain
8		Eike Batista	$30 B	54	mining, oil	Brazil
9		Mukesh Ambani	$27 B	54	petrochemicals, oil & gas	India
10		Christy Walton & family	$26.5 B	56	Walmart	United States

Surprised at the patterns?

- Factor price equalization from “great doubling” --> increased inequality from globalization in advanced but free trade message was that human capital and technology would save the day. Trade specialists downplayed factor price equalization
- Magnitude of increased inequality in transitional and developing countries, continued informal sector with development, Latin America turnaround
- Development of global billionaire elites
- Great Recession devastating employment and social protection in some countries

1. Why has inequality changed so much?

Problem of assessing “big changes” – rarely find single cause and must deal with exceptions to generalizations

Exceptions offer insight but create difficulty if configurations (same factor can operate differently in different settings) matter.

Generalizations have failed in past – which is why we are surprised.

What we know about drivers

Globalization – contributed but in more complex ways than initially posited. Different effects for capital flows, trade flows, immigration.

The missing gorilla in globalization – knowledge transfers

Weaker labor institutions – uniform effect is that unions/govt labor interventions reduce inequality, but need to explain why they have weakened

Financialization – increased income at extreme top has been big enough to contribute substantially to overall inequality, associated with leveraging in finance, payment via capital-related earnings.

Deregulation – supposed to have improved competition but in finance → banks too big to fail, with huge payouts and leverage, lobbying power of business, wealthy,

Technology – favored explanation with little evidence, connected to trade, regulations. Hard to link to country differences.

Structural changes – age, marital status, ethnic diversity

Tax changes that give incentives for top executives to use dominance of corporate governance to reward themselves.

Curious Case of the US: fragmentation of earnings distribution

How should a competitive labor market respond to major recession?

With price/wage adjustments. Big loss of jobs and rapid jobs recovery when recession ends.

In industries, Salter model most appropriate, with firms as wage-takers so that demand increases produces big gains in employment. Market sets similar wage changes to similarly skilled workers.

Increased dispersion of pay among establishments, even within firms

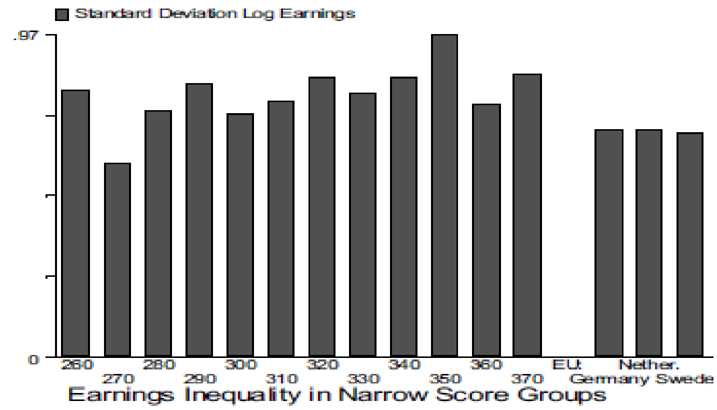
Depending on years and controls and specific measures, from 74% to 100% of rise in variance of ln wages for individuals associated with rise in variance of ln average wages among establishments

Rise in variance of ln average wages is in multi-establishment firms (which have greater choice and may be less market-constrained):

	1977	2002	2007	
Single establishment firms	**0.34**	**0.39**	**0.40**	**.06**
Multi establishment firms	**0.29**	**0.47**	**0.51**	**.22**

Huge Wage Variation Within Skill Groups in US

Figure 3: Wage inequality in Narrow US Score Groups



Source: National Adult Literacy Survey for US; International Adult Literacy Survey for other countries. We break the NALS sample of US workers into groups based on test score. For example, group 260 includes all persons with a score of 258-262. The average number of observations in each group is 286. We compare earnings inequality within each group to earnings inequality of each country. The average standard deviation of log earnings in these twelve groups is .79. The comparable figure for the four countries is Germany .68, Netherlands .67, Sweden .68, and US .86 (in the NALS, or .93 in the IALS).

Huge gains at the very top

Share of pretax income earned by top 0.1% increased over last 30 years from 2.7% to 12.3%

By contrast, rest of upper 1% increased their share from 5.3% to 5.7%

“could have had” a 10% increase in income for all other persons, including 90% of those in the upper 1% if share of upper 0.1% had been constant.

What occupations are in the top 0.1%?

IRS data for 2005 (Bakija, Cole, Heim, 2010, table 3)

Executives, managers, supervisors	42.5%
Financial professions + real estate	21.7%
Lawyers	7.3%
Medical	5.9%
Arts, media, sports	3.0%
Computer, math, engineering	2.9%
Professors and scientists	0.9%

Changes in shares of occupations gained in top 0.1%, 1979-2005

Executives, managers, supervisors	-5.6 pct points
Financial professions + real estate	8.9
Lawyers	--
Medical	-2.0
Arts, media, sports	0.8
Computer, math, engineering	0.6
Professors and scientists	0.1

High Return to Skills but enrollment into higher education stagnates

- Virtue of inequality is that in a well-functioning economy it directs investments so that inequality self-destructs.
- One puzzle in US is that among men college-stagnated despite high returns (tuition fees? Risk because of high dispersion of returns?)
- Second puzzle is that despite student flow into MBAs and Finance, returns have not been driven down.

What explains divergence between US labor outcomes and competitive model?

H1: The Invisible Hand is more mysterious than naïve economists think. Mysterious dark matter – unmeasured skill differences, economic conditions, technological change – account for patterns.

H2: US is not competitive market at all, especially at the top where large firms greatly influence govt decisions through lobbying and contributions → crony capitalism.

H3: The Invisible Hand needs help to establish socially desirable outcomes. Model requires social institutions.

2. What are the consequences of increased within-country inequality?

Normal economic consequences

- Bad effects of joblessness, insecurity
- Poverty

Non-market consequences – more speculative

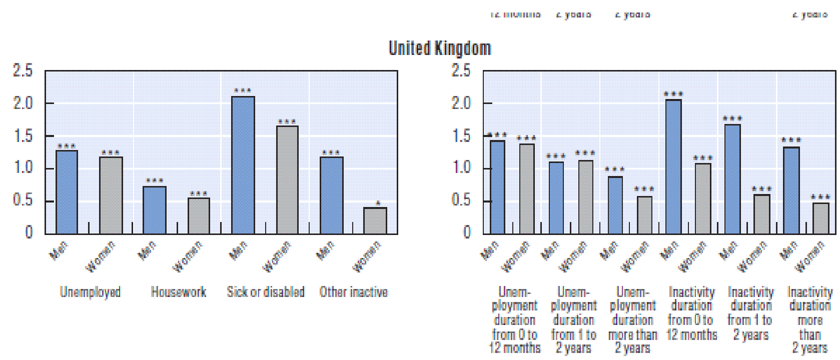
- Social cohesion and trust → scapegoating
- Political effects
  - Developing countries – social disorder, regime change
  - Advanced countries – new economic feudalism

Costs of joblessness: Mental health

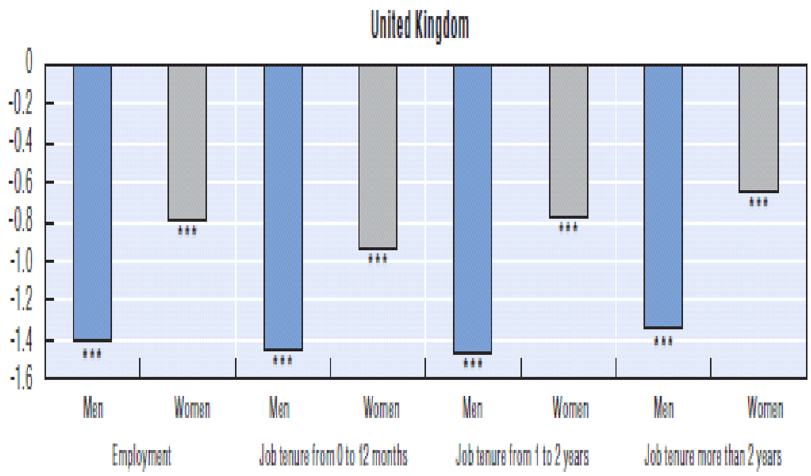
(OECD, Employment Outlook, 2008, chapter 4, panel study)

- *Mental health suffers when individuals move from employment to unemployment or inactivity.* The panel analysis for individual workers in five countries shows that non-employment is detrimental for mental health. The estimated impact of time spent in non-employment on mental health differs across countries and by gender. In some countries, individuals suffer in terms of mental health in case of long-term unemployment, while in others they do not, perhaps because of habituation to being unemployed or because of the structure of unemployment benefits.

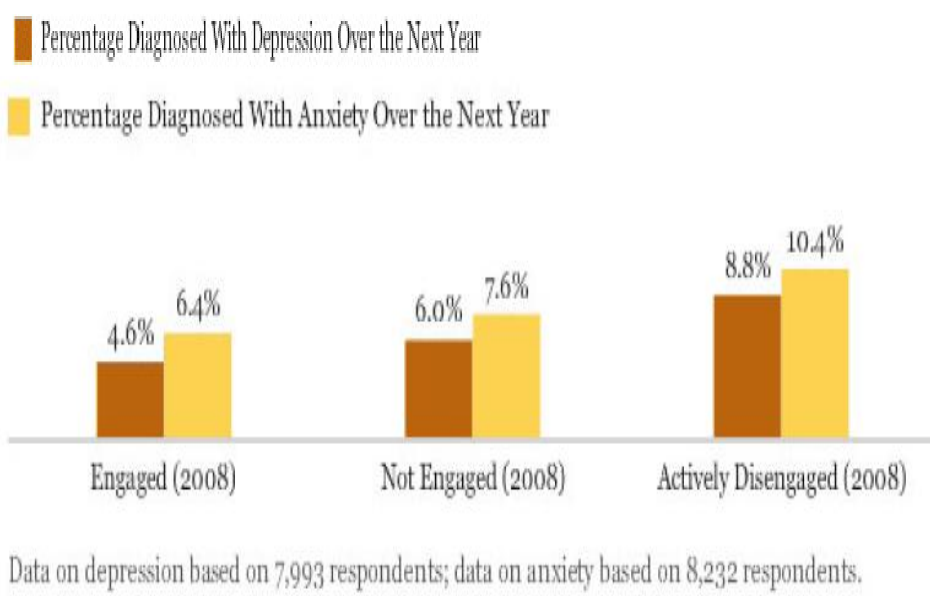
Loss of employment to … raises mental health distress



Movement to Job reduces mental health distress

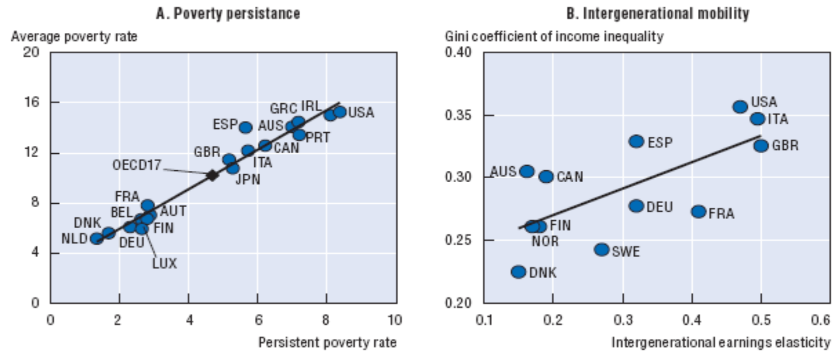


Gallup Poll on US workers suggests worse depression among those working in "bad jobs"



Long term poverty and reduced social mobility?

Figure 11.3. **Static and dynamic measures of poverty and inequality**

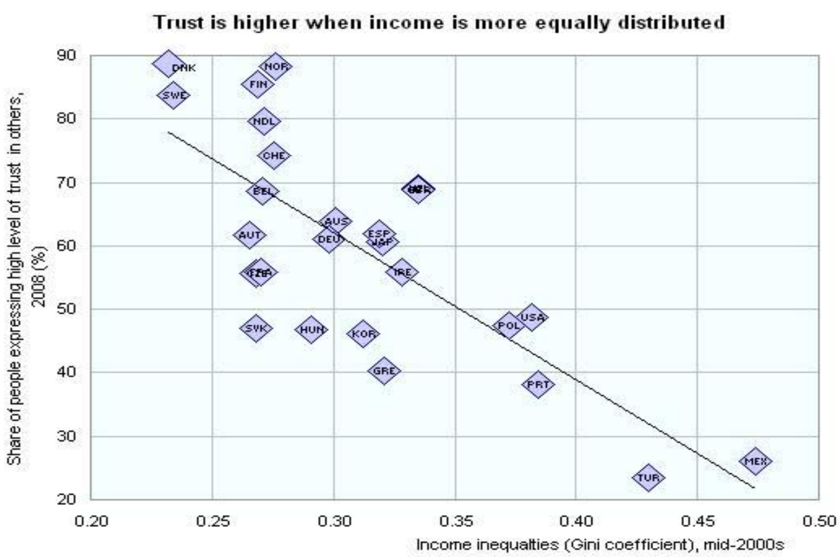


StatLink http://dx.doi.org/10.1787/424352834355

Note: Panel A: Dynamic measures of income-poverty rates based on a threshold set at half of median equivalised household disposable income. OECD-17 is the simple average of the countries shown except Japan, for which estimates are based on an income definition (household income before taxes and after public transfers) that differ from the disposable income definition used for other countries. The "always poor" poverty rate is the share of people with income below the poverty threshold in each of three consecutive years; data refer to the early 2000s. Panel B: The intergenerational earnings elasticity is a measure of the extent to which the earnings of sons are correlated to those of their fathers at a similar point in their life-cycle, meaning that high elasticity levels reflect low mobility. For further details on both sets of data, see Chapters 6 and 8.

Source: Detailed sources are provided in Chapters 6 and 8.

Social Consequences: loss of trust?



Politics and Rent-seeking in the New Inequality

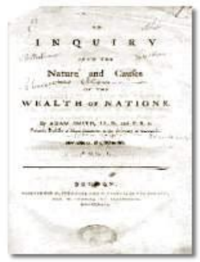
Two Machiavellian principles → stable equilibrium of high inequality, rent-seeking

- He who has the gold gets to rule
  - He who rules gets the gold

Political pressures to cut unemployment benefits … educational spending … infrastructure … R&D on climate, energy. US current effort to end collective bargaining in public sector introduced in nearly every state in the country ... privatize social security … cut pay of everyone but those at the top.

New Economic Feudalism?

"We rarely hear, it has been said, of the combinations of masters,though frequently of those of workers. But whoever imagines, upon this account,that masters rarely combine, is as ignorant of the world as of the subject." The Invisible Hand as told to Adam Smith (Wealth of Nations) (book 1, chapter 8)



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