

Commentary: How Can Economic Policy Strike a Balance Between Economic Efficiency and Income Equality?

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I'm going to begin with the very wise words of my former student who spoke yesterday, Larry Katz: "It's hard to disagree with a wise person making wise comments." This is especially true when the wise person making wise comments is Professor Lindbeck who has played an important role in my own intellectual development. He probably isn't aware that I've been a careful reader of his work over time. His work kept me interested in comparative and institutional economics and with developments in Europe. There is not much I disagree with in Professor Lindbeck's paper. I will reinforce some of his points and relate them to my experience as a one-time policy-maker.

The data that have been presented here in the last two days suggest an increasing problem of income and wealth inequality in the United States at least through the 1990s. Professor Lindbeck begins his argument with a basic concept, one that we teach in introductory economics, and that is the importance of the tradeoff between equity and efficiency in economics. But while you can describe the basic concept in 15 minutes in an Economics 1 lecture, it is actually very difficult to apply in practice. How a distribution affects efficiency and growth depends on how the distribution comes about. For example, Professor Lindbeck notes that if there's a more equal distribution of human capital, it is quite possible that you will end up with greater equality, greater efficiency, and greater growth. Whereas if there's a

more equal distribution of disposable income through a high level of taxation and subsidy, it's quite likely that the more equal distribution will lead to less efficiency and less growth.

Professor Lindbeck does not address the issue of how sensitive growth and efficiency would be to a high-taxation and subsidy system. I remember talking about this a lot as a policymaker. I think we should admit, as economists, that we have a tremendous amount of disagreement over how sensitive are personal incentives to save to a change in a tax and subsidy policy. There is also a tremendous amount of disagreement as to how sensitive are personal incentives to work to a high degree of taxation and subsidy policy. Professor Lindbeck doesn't tackle that econometric or empirical debate. But policymakers weighing the benefits of various tax and subsidy policies mitigating some increasing inequality in income need to know exactly how large is the tradeoff. Unfortunately, the literature doesn't indicate clearly how large the tradeoff is. This is partly because, as Professor Lindbeck notes, there is the issue of norms. When you introduce a policy, it is quite possible that over time that policy will change the norms, for example, in people's attachment to work. The perceived value of work in a given decade may depend on the policies of taxation and subsidy that were introduced a decade ago. So the hippie culture that Professor Lindbeck talks about or the welfare queens, which we talked about in the United States in the 1990s, were the result of changing norms. Populations learn as policies change and that, ultimately, may lead to a bigger efficiency and growth effect than one would have predicted because one didn't factor into the equations a change in norms.

Professor Lindbeck also notes that the relationship between efficiency and equity is not invariant over time. Efficiency and equity are indeed indigenous variables. That is nowhere clearer than as evidenced in the U.S. economy over the last 50 years. We had our growing-together periods, the 1950s, 1960s, and through the mid-1970s, when the U.S. economy was growing relatively fast, productivity growth was relatively strong, and the income distribution was more equal. Since, we have had our growing-apart decades, in which both the economy and productivity growth slowed

noticeably and the distribution of income became more unequal. If you were giving a lecture on the tradeoff between efficiency and inequality, it would be hard to explain how we grew together quickly and then grew together more slowly. You have to look at all the other variables that affect growth and affect the distribution in order to.

This slowdown in productivity growth in the United States has been not adequately explained. Professional economists have not developed a significant hypothesis that explains movements in inequality. Instead, we've focused on why inequality has become more pronounced. This topic was well discussed yesterday, and the evidence is mentioned again in Professor Lindbeck's paper. The prime determinant of the change in inequality patterns in the United States is most likely the change in the demands of technology or the growth in the demand for skilled labor coming from technology's outpacing the growth in supply of skilled labor coming from increasing levels of education. This observation is consistent with the fact that the earnings of more educated, more skilled, and more experienced workers, in fact, has risen relative to those of less educated, less skilled, and less experienced workers. This is true in all occupational categories and in all sectors in the U.S. economy. We also have seen a tremendous growth in the wage premium of college-educated as opposed to high-school-educated workers. What Professor Lindbeck refers to as the Tinbergenian view—income inequality being driven by earnings inequality of the labor force, being driven by a race between technology and education—is what most professional economists believe is the primary source of the increasing inequality in the United States.

I will quibble a little bit with Professor Lindbeck, at the risk of being debated more actively by Professor Lawrence, on the issue of globalization. Professor Lindbeck mentions globalization as a possible factor in the increasing inequality in the United States and notes that this factor has not been demonstrated to be a dominating force. I agree that it has not been demonstrated to be a dominating force and I do not believe it is a dominating force. But the recent literature on the United States suggests that the forces of global competition have had a moderate but discernable effect on wage inequality by depressing

the wages of low-skilled workers, particularly those who do not have a high school degree.

Professor Lindbeck notes that the demand and supply balance for low-skilled workers in the United States appears to have deteriorated much more than it has in Europe. Why might that be the case? Why has the erosion of the earnings of low-wage workers been so much greater in the United States than in Europe? There are probably several factors at work here. It may very well be the case that information technologies, which have driven skill-biased technological change, have diffused more rapidly in the United States than in continental Europe. The evidence may support the case that the forces of globalization are more powerful in the American economy than in Europe. If you look at trade patterns in the United States, you will see that we tend to be more subjected to the forces of wage competition. The distribution of human capital at the bottom in the United States is more uneven than it is in Europe because educational opportunities in the United States, particularly at the primary and secondary school levels, are more unevenly distributed than they are in continental Europe. In the United States, both the financing of education and educational standards are controlled at the local level, which it is now recognized to contribute to unevenness and weaknesses in the distribution of human capital opportunities.

Finally, I want to mention an issue that has not been raised much in the discussion. In the United States, there is compelling evidence that the erosion of the minimum wage in real terms and the decline in unionization, which has been continuous and dramatic, have contributed to the increasing dispersion of earnings among workers. The evidence on the minimum wage suggests that the falling minimum wage in real terms may have reduced the real earnings of the lowest quintile of American workers by about 20 percent. Researchers have concluded that the decline in unionization may explain about 20 percent of the increase in wage inequality among men. A recent study on the difference in the variance of the wage distribution in the United States and Canada suggests that two-thirds of the difference between these two Anglo-Saxon countries is due to variations in the degree of union protection and variations in the minimum wage. The United

States protects the bottom quintile of workers much less effectively through its unionization and minimum wage laws. I agree with Professor Lindbeck that such institutional factors are an important complement to the demand and supply factors in explaining the erosion of the income position of low-wage workers or the increasing inequality in the wage distribution in the United States.

Let me turn to family income distribution because it gets at some policies Professor Lindbeck mentions, including single-parent households headed by women or by men. In the United States, the family income distribution has widened more dramatically than the wage distribution. Families at the top have done very, very well relative to families at the bottom. What factors account for this change? Larry Katz mentioned them yesterday. First, there has been a growing correlation between the income of husbands and wives in the United States. Second, there has been a dramatic and unexplained increase in single-parent households, especially since the 1970s. According to a recent study by David Elwood, single parents earn less than half the income of families with two parents at every level of education. As a result, single-parent families headed by persons in the highest education group in the United States have lower incomes than husband-and-wife families in the lowest education group. It is extremely difficult to be in a single-parent household in the United States, even if you are a highly educated man or woman, and yet this rise in single-parent households is largely unexplained. It has occurred at all income and education levels. One cannot make the case in the United States that Professor Lindbeck makes for Europe—that the increase in single-parent households is the result of very attractive child-care packages and pro-family packages. In fact, one of the interesting things about the growth of single-parent households in the United States is that although single-parent households have grown at all income and education levels, the fraction of men married and living with their spouses has fallen. The decline has been much faster for men in the bottom two-thirds of the wage and salary distribution than for less educated men. This suggests that the erosion in the income-earning prospects of low-skilled workers who have been moving out of the labor force may be, in fact, a contribution to the erosion of the traditional family structure in the United States.

Since I am running short on time, rather than talk about single-parent households, let me mention one thing on education and then go on to talk about policies. I agree completely with the emphasis in Professor Lindbeck's paper on the importance of human capital as a way to handle the income distribution issues over the long term. My greatest concern is that in the United States, we have a large fraction of children, perhaps as many as 20 percent, living in poverty. And there is clear-cut evidence that the probability that a child will go to school and stay in school, go to college and get a college degree is greatly affected by the income level of the household that child grows up in. We do have a problem here of college degrees becoming more and more important as a return. Everyone agrees that is a good thing, but also it's the case that the entire increase in college education in the United States is accounted for by children in the top 60 percent of the income distribution. So we have a problem of how to increase opportunities for getting a college education for children growing up in households in the bottom of the income distribution.

Let me quickly turn to a policy point. Professor Lindbeck emphasizes, and I agree with him completely, that policies aimed at equalizing income distribution should boost the earnings of low-wage workers to encourage them to work and boost their opportunities for development. This policy perspective was very important in the first term of the Clinton administration, and resulted in a very large increase in the Earned Income Tax Credit (EITC). Adjusted for inflation, the maximum subsidy for a working mother with two children has increased by about 210 percent between 1989 and this year. Low-income workers in the United States have benefited both from a huge expansion of the EITC and an increase of about 19 percent in the real value of the minimum wage. Larry Katz, I, and others argued throughout the first term that an increase in the minimum wage in that range would not have a noticeable effect on employment. The evidence so far has borne us out. The combined effect of the increases in the minimum wage and the EITC, which is a tax benefit available only to workers, is that between 1989 and 1997 a single mother with one child, working full time, experienced a 27 percent increase in earnings. Over the same period, a single mother with two children, working full time experienced a 42 percent increase in

earnings. Both groups of women now earn disposable incomes that place them and their families above the poverty line. We have come up with a policy package that succeeded in identifying one group of outsiders and bringing them in.

We have had much less success on the training side. We have training programs for public-assisted recipients, and they work for single mothers fairly well, but the effects are small and they tend to die quickly over time. The real issue in the United States is not the training issue, but it's more the access-to-education issue that I mentioned earlier and the very great unevenness of preparing kids in primary and secondary school to make it at the community college and college level.

It is interesting to have this conversation at this point in time. The economy is doing very well, monetary and fiscal policy are working together in the United States, but strong macro performance does not resolve certain kinds of problems. If you look at trends in wealth and income distribution in the United States, we see that in the 1990s the trends of increasing inequality, at least in income distribution, appear to have halted. We do not see any signs at this point of a reversal. We have very low unemployment rates, we see an increase in people moving into the work force who we thought we had completely lost; so that is very good news. But I still think we have a problem of working through the minimum wage, the EITC, training, and better human capital opportunities needed to bolster the income-earning prospects both of low-income workers and their families. I think we should pay attention to all the insights of Lindbeck's paper as we continue to explore these issues.