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The High-Employment Route to Low Inequality

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It's no secret that income inequality has been on the rise in the United States over the past generation. Less well known is that it has been increasing in almost all affluent nations. This is not a product of cuts in taxes or social programs; it is due mainly to rising inequality of market income.

Suppose we think it would be good for countries to try to maintain or move toward relatively low levels of inequality, something akin to the levels in contemporary Denmark or Sweden.[1] What's the best way to do that?

The Case for High Employment

Historically, limiting the dispersion of market (pretransfer-pretax) incomes has been key to keeping a lid on inequality. Reversing the rise in market inequality is thus one possible avenue. That's a tall order, though.

Figure 1 offers two ways of seeing the rise in market inequality that has occurred since the 1970s.[2] The first chart in the figure uses survey data on household incomes. These data are quite good in terms of cross-country comparability, but they don't fully capture income developments among those at the top of the

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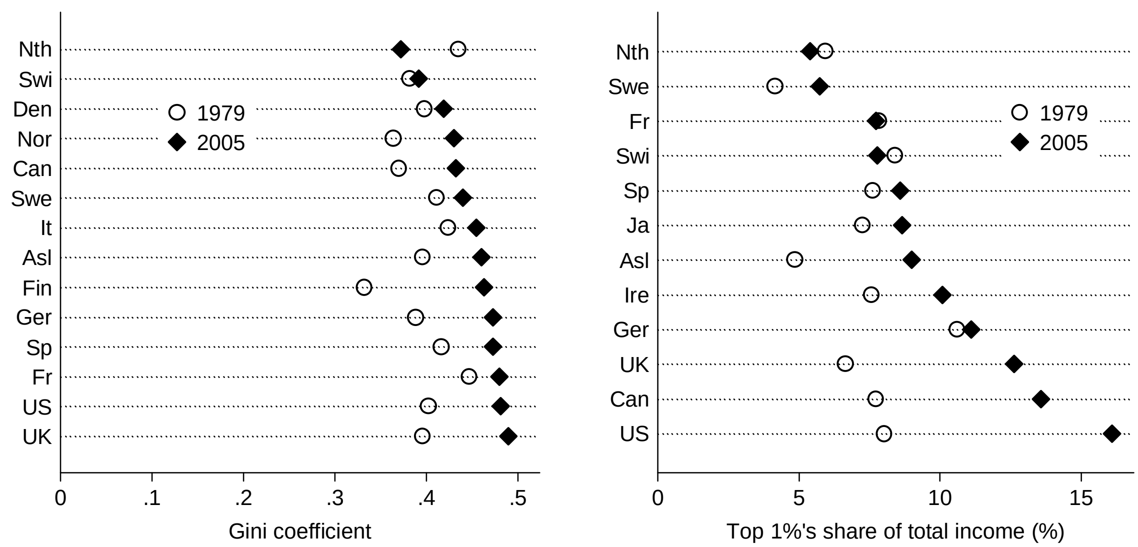
[1] See Kenworthy (2008, ch. 2) for arguments for and against this view.

[2] See also OECD (2008).

distribution. The second chart in the figure uses data from tax records to try to get at changes at the top. Both charts indicate growing market inequality in almost all countries, with the rise particularly pronounced in the United States, the United Kingdom, and Canada.

Figure 1. Trends in Market (Pretransfer-Pretax) Income Inequality, 1979 to 2005



Note: Actual years are the closest available to 1979 and 2005. Sources: Gini coefficients are author's calculations using Luxembourg Income Study (2009) data; top 1%'s share data are from Leigh (2007).

Part of the increase stems from declining manufacturing employment, part from shrinking unionization and fragmenting collective bargaining, part from heightened immigration and other aspects of globalization, and part from technological change. Some of these are potentially amenable to policy intervention, but an appropriate and workable fix is far from straightforward.

Social scientists don't yet have a good handle on the causes of the surge in incomes at the top of the distribution in the English-speaking countries. Hypotheses include changes in market competition, financialization, norms, labor power, government partisanship, tax systems, corporate governance practices, and the demand for entertainment, athletic, and English-speaking executive talent. Some suggest legislating a cap on earnings, but the logistics and merits of doing so are questionable (Frank 2009).

Even greater difficulties from a policy perspective are posed by another source of the rise in inequality: changes in household size and composition. Due to later marriage and more prevalent divorce, more and more households have just one adult, and hence only one potential earner. At the same time, coupling between people with similar education and thus similar earnings potential ("marital homogamy") has increased, and the share of highly-educated women who are employed continues to rise. The result of these developments is that many countries have more two-adults households with high earnings and more one- or two-adult households with low earnings than used to be the case. What policy makers can, or should, do to alter these trends is not at all clear.

The most effective lever for countering inequality's rise, then, may be redistribution. This runs contrary to current wisdom. Isn't taxation much more difficult in today's global economy with its ease of capital movement? And haven't rich countries been forced to trim their welfare states in recent years?

To understand recent trends in redistribution and its potential utility as a response to the inequality challenge, it helps to consider the components of redistribution separately. Let's begin with taxation. It is commonly believed that tax systems are a major source of income redistribution. In the United States, much of the political debate over government redistribution since the late 1970s has focused on tax policy. However, the conventional view is wrong. Taxation in affluent countries does little to alter the market distribution of income. This is because taxes on income and corporate profits — which are progressively structured, reducing the incomes of high-earning households by a greater percentage than those of low-earning ones — are only part of the tax system. Their progressivity tends to be largely offset by the regressivity of payroll and consumption taxes.[3] On average across the rich countries, taxes on income and profits total 15% of GDP, compared to 20% for taxes on payroll and consumption.[4]

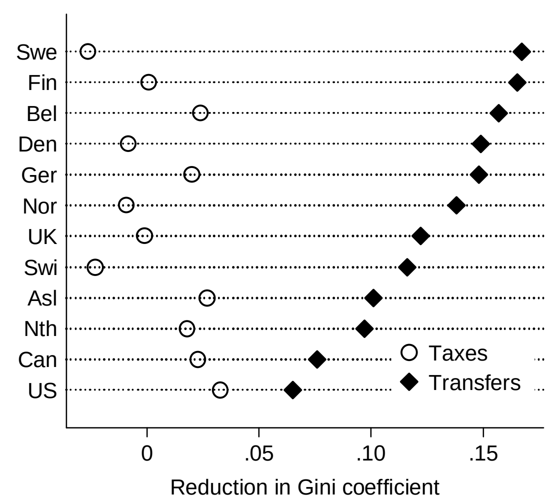
Redistribution, then, is accomplished mainly, and in some countries entirely, via government transfers. We can see this with data from the Luxembourg Income Study (LIS). The LIS database compiles comparable survey data on earnings and incomes in various countries and allows researchers access to the survey

[3] Payroll and consumption tax rates usually are "flat": the rate is the same regardless of individual or household income. Payroll taxes tend to be regressive because they apply to earnings rather than income, and wealthy households tend to get a smaller share of their income from earnings than do most households in the middle of the distribution. Also, payroll taxation often features a cap; in the United States, for instance, earnings above roughly $100,000 are not subject to the 7.65% payroll (Social Security and Medicare) tax. Consumption taxes apply to spending rather than income. They are regressive because lower-income households by necessity spend more of their income than their higher-income counterparts, so more of their income is subject to the tax. Exemptions for food and other basic needs can help to reduce the regressivity of a consumption tax, but only up to a point.

[4] My calculations for 2007 using OECD (2009) data.

microdata. We can begin by calculating income inequality using households' market income — their income before government transfers are added and taxes are subtracted. We can then do the same after adding transfers or subtracting taxes. Comparing the degree of inequality with income measured in these different ways tells us how much redistribution is achieved via taxation and via government transfers. Figure 2 shows this as of the mid-2000s for the nations for which this calculation is possible.[5] The larger the number, the more inequality is reduced by taxes or transfers — in other words, the greater the redistribution. The conclusion is clear: it is transfers that do most of the redistributive work.

Figure 2. Inequality Reduction via Taxes and via Government Transfers, 2005



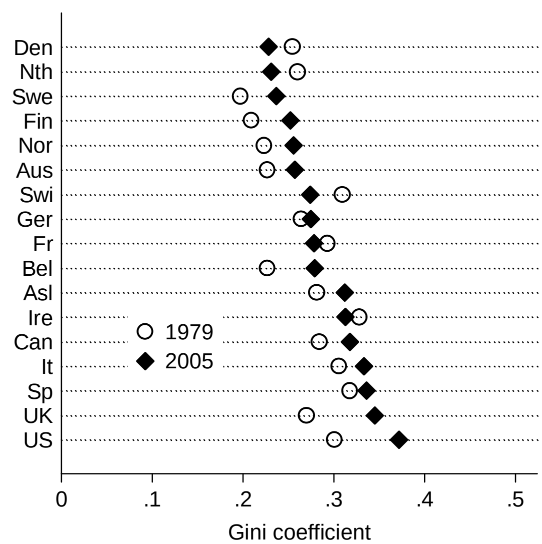
Source: Author's calculations using Luxembourg Income Study (2009) data.

Taxation is not irrelevant to redistribution, of course. Taxes provide the revenues that fund government transfers. Across countries, inequality reduction achieved via government transfers correlates strongly with tax revenues as a share of GDP (Kenworthy 2008, figure 8.3). From the perspective of redistribution, then, the key aspect of taxation is its quantity rather than its progressivity.

[5] Two caveats: First, the LIS data understate incomes at the top of the distribution, so they underestimate both the level of inequality and likely the amount of redistribution achieved via both transfers and taxes. Second, the LIS data do not include consumption taxes; this leads to an overestimate of the redistribution achieved by taxes.

So far, government transfers have been fairly successful at keeping a lid on rising inequality in most affluent countries. Figure 3 shows the increase in post-transfer-posttax (disposable) income inequality between 1979 and 2005 in the countries for which data are available. As figure 1 above indicated, market inequality increased virtually everywhere. But with the exceptions of the U.K. and the U.S., transfers were relatively effective in dampening this rise. If they can continue to do so, these nations may succeed in staving off a sharp jump in income inequality.

Figure 3. Trends in Posttransfer-Posttax Income Inequality, 1979 to 2005



Note: Actual years are the closest available to 1979 and 2005.
Source: Author's calculations using Luxembourg Income Study (2009) data.

But can they continue to do so? Several threats lurk. All of these countries have aging populations and generous pay-as-you-go pension systems, and most also have government-funded health care programs. Adjustments will be made: the retirement age will be raised, benefit levels will be reduced, benefits will be taxed back at a steeper rate, and co-payments will be increased. Nevertheless, a growing share of government revenues will need to go to the elderly, leaving less for working-age households and their children. Heightened immigration can help, and over the past decade it has been helping in the United States, Canada, Australia, and a number of formerly restrictive European countries. But it is unlikely to fully solve the problem.

A sustained increase in productivity would go a long way toward addressing the fiscal bind. That might happen, but it seems unwise to count on it.

Where, then, will the money come from to provide the transfers needed to offset rising market inequality as well as the needs of growing elderly populations? Until recently the normal response in these nations would have been to increase tax rates. But capital mobility has made this more difficult. Predictions of a race to the bottom in taxation have not proved accurate, but in most countries tax rates on income and corporate profits have indeed been reduced, with tax revenues holding constant (as a share of GDP) due to broadening of the tax base (Genschel 2002; Ganghof 2005).

Is there a way out? Possibly, yes, via an increase in the employment rate. Because earnings from employment are taxed, a rising employment rate increases tax revenues without requiring an increase in tax rates. High employment can thereby help to generate the revenues needed to fund transfers that offset rising market inequality. It eases the fiscal crunch another way, too, by reducing the number of people fully or heavily reliant on government benefits for income.

High employment can also help to reduce inequality in the market distribution of incomes. Half a century ago inequality of employment occurred mainly within households. But as more women enter paid work, inequality of employment increasingly occurs between households. 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. This increases inequality of earnings and incomes between households. To the extent high employment reduces the number of zero-earner households, it counteracts this development and thereby reduces market inequality.

Employment has other attractive features. With heightened geographic mobility, later marriage, and increased divorce, neighborhood and family ties have been dissipating, making the office or factory an increasingly important site of social interaction. Employment imposes regularity and discipline on people's lives. It can be a source of mental stimulation. It helps to fulfill the widespread desire to contribute to, and be integrated with, the larger society. And for many individuals, work contributes to identity and self-esteem. That isn't to say that all paid work is glorious. But it does have desirable features for many.

An additional reason to look favorably on employment as a key piece of a just and reasonably egalitarian society is that work has long been, and continues to be, central to the political and economic cultures of a number of OECD countries. This is easily visible and widely acknowledged in the United States, and to a lesser extent in the other English-speaking nations. Less well-known is that an orientation in favor of employment — "productivism," as it is sometimes called — is just as important in the Nordic countries (Korpi 2003; Huo, Nelson, and Stephens 2008). These countries don't just have the most generous safety nets among the OECD group; they also have the most extensive commitments to education and active labor market policy, the aim being to offer every citizen solid preparation for the labor market and to aid in rapid reskilling and reemployment if and when a job with a particular firm ends.

Finally, as women catch up to and surpass men in educational attainment, the societal loss from low or moderate rates of female employment increases. There is nothing wrong with highly-skilled women choosing to perform unpaid household labor. But if some or much of that work can be outsourced, the logic of comparative advantage suggests it is in society's interest to encourage or at least facilitate that. Moreover, institutions and policies that discourage female employment increasingly breed frustration, producing, among other things, low fertility. This in turn only worsens the fiscal barrier to enhanced redistribution (Esping-Andersen 2002).

This, then, is the case for the high-employment route to low inequality: Market inequality is increasing, and it will not be easy to reverse that trend. Redistribution, which has always been a critical component of egalitarian strategies, is therefore likely to increase in importance. As populations age, a growing share of government revenues will need to be allocated to the elderly. If so, and if greater redistribution is needed for working-age households in order to offset inegalitarian changes in the wage distribution and in household composition, where will the money come from? Steady welfare state expansion in the 1950s, 1960s, and 1970s was financed by rapid productivity growth and rising tax rates. But productivity growth has slowed, and capital mobility makes it difficult to raise tax rates. High employment offers a potential solution.

Are High Employment and Low Inequality Compatible?

Well and good, you may say, but isn't there a fundamental problem with this strategy? Don't institutions and policies that affluent countries typically rely on to limit income inequality tend to impede employment? How can high employment be the basis of a strategy for securing low inequality when there is a tradeoff between equality and jobs?

This view is now a bit dated. Compared to a decade ago, there currently is little consensus among researchers about whether such a tradeoff exists, and if so exactly which policies and institutions are implicated.[6] Even the OECD, which

[6] See, for instance, Blanchard and Wolfers (2000); Esping-Andersen and Regini (2000); Scharpf and Schmidt (2000); Blau and Kahn (2002); Howell (2005); Nickell, Nunziata,

gave the jobs-equality tradeoff notion considerable momentum with its *Jobs Report* in the mid-1990s (OECD 1994), now has a much more nuanced view (OECD 2006).

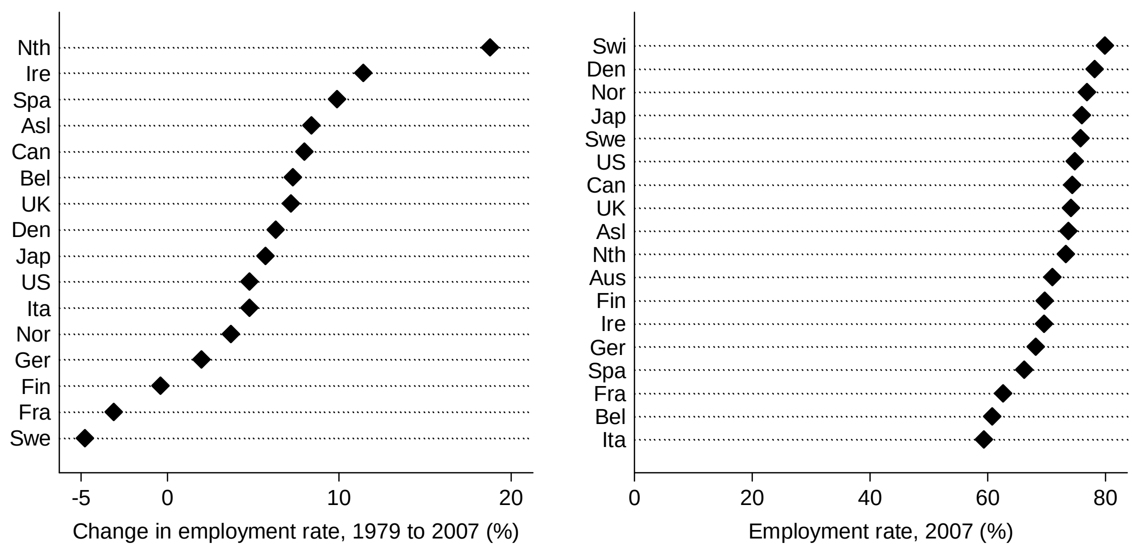
In a new book, *Jobs with Equality,* I explore the impact on employment performance of four inequality-reducing institutions and policies: wage levels at the low end of the labor market, employment protection regulations, government benefits, and taxes. My analytical strategy differs from that of other researchers in some significant ways. I won't go into the details here (they are discussed at length in chapter 4 of the book) except to note that the effects of these institutions and policies on employment performance in recent decades is best assessed by studying *changes* in employment rates. Many analyses have focused on current or recent employment rates as the outcome of interest. But employment rates change only incrementally, so the current rate in each country is partly a function of its earlier rate. A country with a high employment rate at the end of the 1970s will likely still have a comparatively high employment rate, even if the rate declined during the intervening years. Similarly, a country that started with a comparatively low employment rate but gained employment in the ensuing decades may still have a comparatively low rate. The economic environment for affluent countries has changed fairly dramatically since the 1970s: firms have faced heightened competition from both foreign and domestic sources, and technology has shifted in profound ways. These changes have reduced employer demand for less-skilled labor. As a result, inequality-reducing institutions and policies that had no impact on employment in the 1950s, 1960s, and 1970s may have become impediments in the 1980s, 1990s, and 2000s. We can best observe this by looking at changes in employment rates since the 1970s.

Do I find that employment growth in recent decades has been impeded by high low-end wages, stiff employment protection regulations, generous government benefits, and high taxes, as some claim? The comparative experience suggests that these institutions and policies may indeed have had an adverse effect, but its magnitude probably has been small.

Even better news is that there is a set of policies that appears to be conducive to *both* high employment and low inequality: so-called "women-friendly" policies, such as government-supported child care and early education, generous (but not too lengthy) paid parental leave, public employment, access to part-time jobs, and a tax system that doesn't discourage second earners within households. The comparative evidence suggests that these types of policies have likely contributed to higher rates of employment among women. The empirical case isn't a slam-dunk, but it leans in favor of this conclusion.

and Ochel (2005); Bassanini and Duval (2006); Baccaro and Rei (2007); Bradley and Stephens (2007).

Figure 4. Employment Performance, 1979 to 2007



Note: Employment rate = employed persons as a share of the population age 15 to 64. Source: author's calculations using OECD.Stat data.

There are multiple paths to successful employment performance. Figure 4 shows OECD countries rank-ordered from best to worst on employment outcomes. In the first chart the measure is change in the employment rate between 1979 and 2007 (both business-cycle peak years); in the second it is the employment rate as of 2007. The best performers include Denmark and Norway, Nordic countries that are heavy on many equality-promoting policies and institutions, from taxation to government benefits to wage levels in low-end service jobs. They also include Japan, the United States, Canada, the United Kingdom, and Australia, nations that tend to be much lighter on these policies and institutions. The Netherlands also is among the top performers. It's a continental European nation with a set of policies and institutions that, even more than the Nordic countries, is not conventionally viewed as conducive to a healthy employment outcome.

What these findings suggest is that there is no inherent conflict between equality-promoting institutions and policies and high employment. It is feasible to seek high employment as a means of securing low inequality while also attempting to reduce inequality through traditional policies and institutions.

What to Do?

What, specifically, should countries do if they wish to pursue this strategy? Table 1 offers a set of summary recommendations organized by country grouping. Here I adopt a fairly conventional classification scheme, grouping OECD nations into Nordic, continental European, and Anglo (English-speaking).

Table 1. Recommendations

Anglo Countries	
	Increase the generosity of the statutory minimum wage
	Increase the generosity of some government benefits, including employment-conditional earnings subsidy, social assistance, and social insurance
	Increase tax rates
Anglo and Continental Countries	
	Increase support for high-quality child care and preschool
	Increase support for activation: active labor market programs and (as "last resort") public employment
Continental and Nordic Countries	
	Soften employment protection regulations
	Shift tax revenues away from payroll and consumption taxes
	Reduce lengthy maternity/home care leaves (Fr, Ger, Fin, Nor)
	Allow wages to fall a bit at the low end of the distribution and tighten eligibility/reduce duration for some benefits
	Add an employment-conditional earnings subsidy and perhaps a statutory minimum wage

Note: This table simplifies in order to organize the recommendations by country group. Source: Kenworthy (2008, table 11.1).

The suggestions in the table, though, are pitched at a fairly general level. Each nation is different in its existing configuration of institutions and policies. The appropriate path therefore will vary not only among groups but also among countries within each group. There is *no one-size-fits-all reform package*.

Another key point is that there is *no silver bullet*. The experiences of rich countries over the past several decades do not reveal a particular policy or institution that is the obvious choice to focus upon for a country wishing to be a high-equality, high-employment society. Improvement may require changes to multiple policies and/or institutions.

Finally, there inevitably is considerable uncertainty regarding the best course of action for any particular country. Governments and other economic actors therefore have little option but to proceed by trial and error. Success requires learning from the experiences of other countries, learning from one's own past, and *continuous experimentation and adjustment*.

With this in mind, let me offer some concrete suggestions for three illustrative countries: Germany, Denmark, and the United States.

Germany

In 1979, as the 1970s business cycle peaked, Germany's employment rate was 66%. This was comparatively high. It was below those of the Nordic countries but similar to those of the Anglo nations. Among the 18 countries included in figure 4, Germany ranked eighth. In 2007, the peak year of the most recent business cycle, the German employment rate stood at 68%. This placed it fourteenth among the 18 countries. Over nearly three decades Germany achieved little progress on the employment front, and its comparative position slipped considerably.

One reason is unification with the former East Germany. The country absorbed a relatively poor nation with little sustainable employment base. In some respects the fact that Germany's employment rate is not now substantially lower than before unification is a significant achievement. But while unification clearly placed additional costs and strains on the German economy, the relevant question is how its institutions and policies have dealt with those costs and strains.

Germany has strong unions concentrated in manufacturing. Large manufacturing firms also must negotiate work conditions and hiring and firing procedures with firm-level works councils. In addition, codetermination laws stipulate that employees elect half of the board of directors in incorporated firms with more than 2,000 employees and one-third in firms with between 500 and 2,000. Perhaps these institutional "rigidities" have burdened manufacturing firms with excessively high labor costs and reduced their ability to respond quickly to changes in the competitive environment (Siebert 2004). Employment has declined in manufacturing. But that is true everywhere, and as of 2007 Germany continued to have a larger share of its working-age population employed in manufacturing (15%) than any other rich country. The source of Germany's mediocre employment growth is its comparatively slow increase in service jobs, particularly in low-end services.

The German model shifted markedly over the past decade. There are three important developments. First, the traditional wage-setting system has slowly crumbled. Germany's wage setting was never formally centralized, but there was considerable coordination; many firms followed the settlement in the metalworking sector, with minor adjustments for industry-specific conditions. That is less and less true, as separate industries, and to a growing extent individual firms, set wages with little or no regard to what happens in other sectors. Second, in 2003 the government created a new type of employment that is exempt from the heavy payroll taxes paid by firms and employers and from the collectivelybargained minimum wage. These "mini jobs" have since exploded. By one estimate they now account for 15% of German employment (Bosch et al. 2009). Third, the "Hartz Commission" reforms introduced in the mid-2000s reduced the duration and generosity of unemployment benefits. The result of these three changes has been a fairly sharp rise in inequality both of wages among employed individuals and of household incomes (figure 1 above; OECD 2008).

Germany would do well to adopt a statutory minimum wage in order to prevent wages for low-end service jobs from falling too much. This might be usefully complemented with an employment-conditional earnings subsidy along the lines of the U.S. Earned Income Tax Credit or the Working Families Tax Credit in the United Kingdom. These programs provide a tax refund to households with low earnings. If (as is often the case) the refund is greater than the amount the household owes in income taxes, the household receives the difference as a cash benefit. In order to encourage labor force participation, the amount of the tax credit increases with earnings up to a point, and then begins to decrease. The credit in the United States has existed since the mid-1970s, and most studies have concluded that it heightens labor force participation, effectively targets transfers to households most in need (moreso than a subsidy to low-earning individuals, since some such individuals may be in higher-earning households), creates minimal stigma, and has low administrative costs.

Over the long run, Germany would benefit from changing the structure of its tax system (Scharpf and Schmidt 2000; Streeck and Trampusch 2005). Payroll taxes are quite steep; employers and employees each pay around 20% of wages. Altering the system so that this revenue is generated from income and/or consumption taxes would reduce nonwage labor costs and thereby heighten both the supply of and the demand for low-end service employment.

Women-friendly policies are the other area where policy change is most urgently needed. The employment rate among prime-working-age German women has been increasing, but too slowly. Child care for children under three is undersupplied. Public preschool is available for children age three to six; but this schooling often is half-day, which poses a problem for parents in full-time jobs. Half-day schooling for six-to-nine year-olds forces many couples with even school-age children to keep one parent home during the heart of the working day. The maternity/care leave is too long. It encourages mothers to take a three-year break from employment, which increases the number who never return or who return only part-time. Moreover, eligibility for the leave is not conditional on prior employment, so there is no incentive for women who wish to make use of the leave to enter the labor market beforehand. There is little public employment and not much part-time employment. The tax system imposes a comparatively stiff penalty on households with two earners. The German pension system further reinforces the male breadwinner model: if a husband qualifies for a pension, the wife automatically does too. Improvements on all of these counts would help.

Particularly beneficial would be an improved supply of affordable, good-quality child care and early education along with a reduction in the incentive for women to take long post-birth leaves.

Demnark

Denmark is in many respects typical of the Nordic countries and their "social democratic" configuration of institutions and policies (Björklund and Freeman 1997; Goodin et al. 1999; Pontusson 2005). High employment is pursued through various means: the schooling system provides a solid education to the bulk of the population; active labor market programs such as retraining and job placement assistance improve the efficiency of the private-sector labor market, and the public sector employs a comparatively large share of the population; generous women-friendly policies such as government support for child care, paid maternity leave, support for part-time employment, and individualized taxation encourage female employment. Income inequality is contained in several ways: strong unions compress wages, so earnings inequality among those in paid work is low; high employment ensures that there are comparatively few zero-earner households; and generous social programs redistribute income from high-earning to low-earning households.

Unlike its Nordic counterparts, Denmark gives employers extensive freedom in hiring and firing. Rather than protecting workers' current jobs, the Danish "flexicurity" system permits high employment turnover but provides those who are displaced with generous unemployment compensation and with assistance in training for and finding a new job.

In the 2000s Denmark has enjoyed the type of iconic status held by Sweden in the 1970s, Japan and Germany in the 1980s, and the Netherlands and Ireland in the 1990s. It is the model *du jour*, the country widely viewed as having gotten the institutional and policy mix right — to be admired, studied, and emulated. As of the mid-to-late 2000s, Denmark was one of the best performers among the rich OECD nations on both employment and income inequality (figures 3 and 4). (It also is consistently near the top on the World Economic Forum's ranking of country "competitiveness"). Why, then, should the Danes consider changing anything? How could the country possibly do better?

One reason is that each of Denmark's predecessors on the economic pedestal eventually stumbled and fell out of favor. Sweden suffered a deep and protracted economic downturn in the first half of the 1990s, in which its employment rate dropped from 84% to 73%; Germany's troubles were reviewed in the previous subsection; Japan's economy barely grew during its "lost decade" in the 1990s; and Ireland now finds itself in the midst of a sharp downturn (Brown 2009). Denmark may be different, but there is no compelling reason to expect so.

Aside from generic worry about the tables eventually turning, however, what specifically about Denmark's institutional and policy configuration might be cause for concern? One question is whether taxation at roughly 50% of GDP will continue to be sustainable. Public support for the high-tax, generous-welfare-state, low-inequality regime might not continue to hold up. If it declines, Denmark may have to shift somewhat away from universalism and toward greater use of targeting in its transfer programs.

A second concern is whether Denmark can continue to sustain a high employment rate without extensive private-sector employment in low-end services. Employment in restaurants, hotels, and retail and wholesale trade is modest in Denmark (and the other Nordic countries). The nation has compensated with extensive public sector employment, but that strategy may have reached its limit. Further increases in the employment rate, and perhaps even maintenance of the country's current rate, will likely have to come in the private sector.

If so, what should Denmark do? There is little room for further improvement in women-friendly policy. Cutting back on the generosity of government benefits to low-income households might help, but it might also result in an increase in inequality. Relaxing employment protection regulations isn't relevant; Denmark's are among the most lenient in Europe. Nor would reduction of payroll taxes help; here too Denmark has little room for improvement.

This leaves low-end wage levels. One possibility might be for Denmark, and perhaps the other Nordic countries, to allow wages to drop a bit at the low end of the distribution. Why do that? First, it would likely increase private-sector employment. Second, there are people in these countries — not least, immigrants — who are willing to perform low-end service jobs at modest pay. And there are people who would like to be able to purchase such services. Third, policy tools exist that may be able to prevent widening individual earnings inequality from producing widening household income inequality.

What policy tools? The chief one is an employment-conditional earnings subsidy along the lines of the Earned Income Tax Credit (EITC) in the United States and the Working Tax Credit in the United Kingdom. Consider the earnings and disposable incomes of a typical low-wage worker, a hotel room cleaner, in Denmark and the United States. As of 2006, the hourly wage in Denmark was three times that in the U.S.: $16.36 per hour versus $5.15. But in Denmark income taxes take a significant chunk. In the United States income taxes on earnings this low are collected only by state governments, and they are relatively small. Payroll taxes (Social Security and Medicare) also reduce net income, but again by a fairly small amount. For a household with two or more children, the EITC payment boosts the household's income by more than $4,000. In the end the two households have similar disposable incomes despite the stark difference in wages (Kenworthy 2008, table 7.2).

There are important caveats. The heavy tax payments in Denmark fund government services such as health care and early education, which substantially boost living standards for low-income (and other) households. And Danish employees receive much more paid vacation than their American counterparts. The point of this comparison is simply to illustrate how helpful an employment-conditional earnings subsidy can be in a low-wage context.

Significant obstacles stand in the way of Denmark or any of the Nordic countries moving in this direction. One is that key political parties, unions, and many citizens in these countries do not want to embrace a U.S.-style labor market with a sizeable low-wage segment. Adoption of an EITC-style earnings subsidy is viewed as a movement in that direction. A second is that it is not governments but rather unions that determine the minimum wage level. And unions will likely be very resistant to an increase in wage inequality, not to mention an absolute reduction in wage levels at the low end of the distribution. Still, I suspect the appeal of this strategy may eventually win out.

The United States

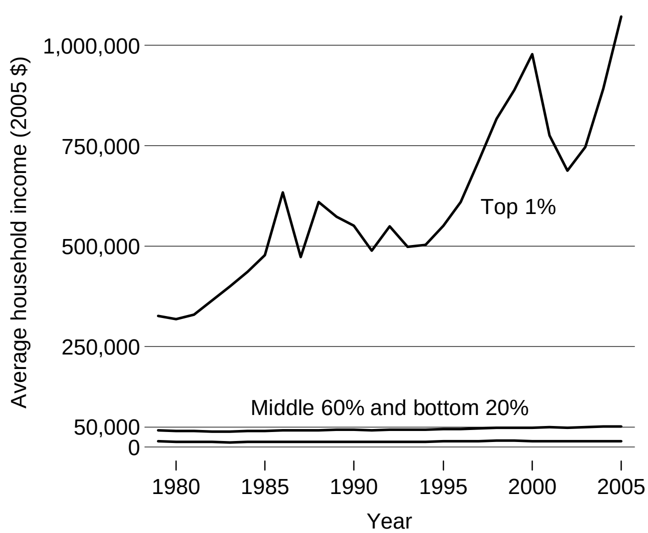
Inequality in America is the highest among the affluent countries. This is partly a result of market processes, which produce a high dispersion of wages and households incomes. But it's largely a product of limited redistribution. The U.S. employment rate is comparatively high (although it could be higher), so the fiscal basis for heavier redistribution exists. What has been lacking is political will.

Rising income inequality in the United States has two interrelated components. One is stagnation of earnings and incomes in the bottom half of the distribution. The other is a surge in earnings and incomes at the very top — specifically, in the top 1%. Economic growth in the American economy has been reasonably rapid during this period. But rather than benefiting households throughout the income distribution, that growth has gone largely to those at the top. Figure 5 shows this development.

What can be done? There are two main options for addressing the surge at the top, most of which has come from job-related earnings rather than investment income (Piketty and Saez 2006). One is some type of cap on earnings. Various proposals have been offered for limiting the pay of CEOs. This strikes me as logistically difficult. And I'm not sure about the merits of singling out CEOs while not limiting the pay received by other high earners, such as financial analysts, entertainers, and athletes.

The other option is to increase income tax rates. In the early 2000s, the Bush administration reduced the top federal income tax rate from 40% to 35%. That reduction will expire after 2010, and the rate will then return to 40%. This was the rate that obtained in the late 1990s. It helped then, and it will likely help again. I recommend gradually raising the top rate to 45%. This is far from confiscatory, and given the magnitude of incomes at that level, the adverse effect on incentives would not be large. If I have the opportunity to earn an additional $1 million, the fact that the federal government will now take $450,000 of it rather than $400,000 is not likely to discourage me.

Figure 5. The Rise in American Income Inequality, 1979 to 2005



Note: Posttransfer-posttax income. Source: Congressional Budget Office (2007).

What about at the low end? A reversal of the slide in unionization would likely help, but it would only help some. The lesson of the late 1990s, the only period in the past generation when low-end earnings and household incomes rose, is that an unemployment rate around 4% or lower seems to create a labor market tight enough to help drive wages up (Bernstein and Baker 2003). The most direct route for policy is via the minimum wage and the Earned Income Tax Credit. The minimum wage will be $7.25 as of mid-2009; it could be boosted a bit further and tied to inflation so that its real purchasing power doesn't decline. Without any adverse impact on work incentives and at modest cost, the EITC can be made more generous, particularly for adults without children. Finally, enhanced funding for good-quality child care and early education would help to increase employment rates among less-skilled women.

Reversing the rise in inequality is likely to prove more difficult in the United States than in other affluent countries, both because the magnitude of the increase has been larger and because the egalitarian strain in our political culture is relatively weak. Then again, evidence from public opinion surveys suggests that Americans do care about inequality and that they are amenable to government programs that work (McCall and Kenworthy 2009; Page and Jacobs 2009). The challenge for political leaders is to revise existing policies and create new ones that will push the country in a more egalitarian direction. Doing so will foster a political culture that supports future efforts.

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