

**The Political Economy
of Inequality**
U.S. and Global Dimensions

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The Political Economy of Inequality

Introduction

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The only true and sustainable prosperity is shared prosperity.

—Joseph Stiglitz

Inequalities in our society abound, across space, over time, and in numerous other dimensions. While income inequality attracts considerable attention in academic and policy arenas, there are many other aspects of social inequality that also deserve to be studied and addressed, such as wealth (assets), ability to borrow, education, employment, health care, political representation, and legal matters. In a sense, all of these can be generally characterized as inequalities of access or of opportunities. And all of them, if not resolved or mitigated, bear potentially serious consequences of economic instability and political and social unrest. Many of these inequalities are also interrelated, making them vexing and difficult to combat.

But for policymakers to do so, they must understand the extent of these inequalities, their trends, and, more precisely, how they correlate. What are the underlying root causes of these inequalities? What are plausible policies that could mitigate their impacts? These questions were recently addressed by six eminent scholars who were invited to provide insights and views from their respective areas of expertise through Western Michigan University's 54th Werner Sichel Lecture Series, which took place during the 2017–2018 academic year. These experts' presentations form the basis of this volume and cover the challenges of different inequalities in several countries, including the United States, member nations of the Organisation for Economic Co-

operation and Development, and developing countries in Africa and Latin America.

We briefly summarize each of the six chapters in this introduction.

Chapter 2, “The New Inequality: The Distribution of Retirement and Older Working Time in OECD Countries,” by Teresa Ghilarducci, the Bernard L. and Irene Schwartz Professor of Economics and Policy Analysis at the New School for Social Research, indicates that income and wealth inequality has been on the rise for years in rich nations. The chapter by Ghilarducci addresses inequality’s economic harms: inequality skews production toward what the rich want and away from public spending on education and health. Ghilarducci also notes that inequality skews political power to the rich, who use that power to create and preserve economic rents, also known as monopoly rents. An economic rent is any payment to a factor of production that is more than what is needed to induce that factor to engage in production. Ghilarducci’s chapter addresses a third kind of inequality—paid retirement time—and its potential damage to workers’ retirement. Retirement is the period after a lifetime of work and before death when people can exercise greater control over the pace and content of their time and construct a personal narrative about the meaning of their lives.

As nations grew richer, Ghilarducci says, voters and workers expanded paid time off, including retirement, widely across socioeconomic classes. But in the late twentieth century, OECD policy shifted to emphasize austerity and finance-based retirement income, leading some in the elderly population to work more hours and longer years. More work at older ages is associated with higher poverty rates and greater retirement-time inequalities among the elderly. The first part of the chapter defines retirement time and explores the lopsided distribution of American retirement time. The second section describes changes in retirement time in the rest of the OECD countries. The third section discusses how rich nations changed their pension designs toward less social insurance and more financialization. The fourth section shows how pension financialization is correlated with increases in older people’s labor-force participation and how nations with higher elderly labor-force participation also have higher rates of old-age poverty. The fifth and final section offers a conclusion.

In Chapter 3, “The Economics and Politics of the Fall and Rise of Income Inequality in the United States,” Charles L. Ballard, professor

of economics at Michigan State University, explores the issue of how income inequality in the United States has increased dramatically since the 1970s. Ballard notes that the U.S. economy actually experienced an equally dramatic *equalization* in the 1930s and 1940s. He argues that, consequently, if we are to develop a complete understanding of the evolution of the U.S. income distribution, we must analyze the earlier “Great Compression” or “Great Convergence,” as well as the more recent “Great Divergence.” In this chapter, Ballard begins with a review of the facts of the changes in income inequality over the past century in the United States. He then discusses and evaluates the economic explanations for those trends. However, the economic trends cannot be understood fully without reference to political factors. He argues that both the Great Compression and the Great Divergence are primarily the result of deliberate political choices made by the party in power. Furthermore, he points out that race is the most important of the many factors leading to the political shifts that have, in turn, contributed to the Great Divergence of the past 40 years. Many whites, especially in the South, reacted to the Civil Rights movement by switching their allegiance from the Democratic to the Republican Party, and this has contributed substantially to the adoption of more antiegalitarian economic policies. The best starting point for a discussion of long-term trends in U.S. income inequality, he says, is the journal article “Income Inequality in the United States, 1913–1998,” by Piketty and Saez (2003). Their original paper contains data through 1998, as the title indicates, but they have updated the data annually so that we now have a complete series covering a full century, from 1913 to 2015.

Piketty and Saez (2003) use tax-return data, and this allows them to produce extremely detailed estimates for the income shares of the very top income strata. The data reveal that the shares of the top groups fell from the late 1920s to the early 1970s, and especially sharply in the early 1940s. Specifically, the share of the top 1 percent plummeted from 15.7 percent of total income in 1940 to 10.5 percent in 1944 because of various public policies implemented, which are detailed in Ballard’s chapter. But then, following a decline through the early ’70s, the top income shares surged upward in the 1980s, almost as dramatically as they had fallen in the early 1940s. And over the past 10 years, the share of the top 1 percent has hovered around 18 percent of total income, which is higher than the average was in the first 15 years of the twen-

tieth century. Thus, by some measures, the income distribution in the United States today is more unequal than it was a century ago. Furthermore, the disequalization since the 1970s has been extremely top-heavy. A majority of the gains in the share for the top 5 percent went to the top 1 percent. In turn, a majority of the gains in share for the top 1 percent accrued to the top one-tenth of 1 percent. Finally, about half the gains in share for the top one-tenth of 1 percent accrued to the top one-hundredth of 1 percent. While Piketty and Saez's paper focuses exclusively on the top 10 percent, Ballard notes that there have also been changes in the income distribution below the top 10 percent. Census data analysis shows that, since the 1970s, the income of the typical household at the 90th percentile rose by substantially more than the income of the household at the 80th percentile.

Chapter 4 is titled "America's Unequal Playing Field: The Gaps between Poor and Rich Children's Resources." In it, Mary E. Corcoran, professor emerita of public policy, political science, and women's studies at the Gerald R. Ford School of Public Policy, University of Michigan, explores the phenomenon that growing up wealthy in the United States commands wide and profound advantages over growing up poor, and these advantages do not just involve the extra discretionary money that rich parents possess to spend on their children. Corcoran notes that, on average, children of the rich are more likely to avoid the disruption and trauma, both emotional and economic, from absent fathers due to out-of-wedlock births, divorce, and paternal incarceration. The rich children's home environments are more likely to be educationally enriching. These children are more likely to have parents who are college graduates and less likely to have parents who are high school dropouts. They are more likely to be raised in safe neighborhoods with good schools. Rich parents have more money, time, and social capital to invest in their children.

As a result, it is hardly surprising that rich children fare better economically as adults than do middle-income and low-income children. Corcoran refers to two recent books, *Whither Opportunity?* and *Dream Hoarders*, and warns that the economic and noneconomic advantages of being raised by wealthy parents are increasingly bundled together and are growing rapidly in ways that could imperil the American ideal of fair opportunity (Duncan and Murnane 2011; Reeves 2017). Since the 1980s, changes to the economic and demographic landscape and

to the criminal justice system have widened the gaps between the economic resources and social capital of affluent parents and those of middle-income and low-income families. Corcoran further notes that over the same period, a college degree has become increasingly important to children's adult economic success. And at the same time that investing in children's education has become more important for their economic mobility, gaps have widened between affluent parents and the middle- and low-income parents in their financial capabilities to make such an investment. The recent academic admissions scandal is indeed a perfect case in point. "This," Corcoran says, "leads to a very real worry: is the cherished U.S. norm of a level playing field—i.e., that a child's economic origins do not determine his or her economic future—at risk?" Corcoran's paper is organized as follows: she begins by presenting a stylized picture of the associations between family income and children's adult incomes, followed by a comparison of the rates of intergenerational economic mobility in the United States to those in other Western industrialized countries. It is evident that the United States comes off poorly in these comparisons. Corcoran then delineates how economic trends, demographic trends, and changes in the criminal justice system since the 1980s have altered the distribution of resources and social capital available to children in low-income, middle-income, and high-income families in the United States. She also documents how returns to a college degree have increased since 1980 in the United States.

Corcoran next reviews studies showing that parental income more strongly predicts students' achievement-test scores, college attendance, and college graduation today than it did in the past. She concludes by speculating on how the trends and evidence reviewed in this chapter might affect equal opportunity in the United States. She further elaborates on how the background advantages of children from affluent families vis-à-vis children from middle-income and low-income families have risen significantly. And she notes that college education affects a child's adult economic attainments more strongly now than in the past, and that a child's chance of acquiring a college degree is more tied to parental income now than in the past. She concludes by posing the following questions: Does this inevitably mean that the United States will become more stratified by income? What policy strategies might weaken the link between parental income and children's adult success?

In Chapter 5, “Why Has Income Inequality Increased while Education Inequality Has Decreased in Many Developing Countries?,” David Lam, professor of economics at the University of Michigan, points out that there is a great deal of concern about trends in income inequality around the world. On the domestic front, rising wage inequality in the United States has been a focus of attention for the past two decades. In addition, trends in income inequality in developing countries and in the world as a whole have been analyzed by the World Bank and a large number of researchers. However, less focus has been given to inequality in schooling. Lam’s chapter argues that inequality in schooling is a vital area of research, given the importance of education in affecting a wide variety of outcomes. Inequality in schooling is also important because it is integrally connected to income inequality. Several studies rely on the detailed data that are available on the distribution of schooling for a good number of low-income and middle-income countries. Comprehensive analysis of these data demonstrates that the distribution of schooling demographically changes in fairly regular patterns as the mean level of schooling increases. The standard deviation in years of schooling, which is shown theoretically to be an important driver of earnings inequality, tends to increase with mean schooling at low levels of schooling, eventually reaching a peak and then falling as mean schooling reaches higher levels. This has important implications for trends in earnings inequality. The coefficient of variation in schooling, a standard mean-invariant measure of schooling inequality, tends to fall steadily as mean schooling increases, a result of the “compression” in schooling that occurs with the rising mean. Given the strong relationship between schooling and earnings, this compression in the schooling distribution should be expected to reduce income inequality. However, data from several countries reveal a rather puzzling phenomenon: a number of African and Asian countries have seen increases in income inequality while at the same time experiencing significant declines in schooling inequality.

In this chapter, Lam explores several reasons for this disconnect between falling schooling inequality and rising income inequality in those developing countries. One important factor is the convex relationship between schooling and earnings, as implied in the standard Mincer (1974) earnings equation, in which log earnings are a nonlinear function of schooling. Another important factor is rising returns to

schooling, especially at the top of the schooling distribution. Lam's paper reviews the evidence on trends in income inequality and poverty for a variety of countries. The paper then looks at the theoretical relationship between schooling and earnings. Data from a large number of countries from the Demographic and Health Surveys (DHS) program are then used to look at how the schooling distribution changes as mean schooling increases. These data show a consistent tendency for schooling inequality to decline as mean schooling increases. Lam concludes his chapter with a detailed analysis of schooling inequality and earnings inequality in Brazil and South Africa, the two countries with extreme earnings inequality and high-quality labor-market survey data that can be used to look at schooling inequality, returns to schooling, and earning inequality over several decades.

In Chapter 6, "Institutions, Structures, and Policy Paradigms: Toward Understanding Inequality in Africa," Howard Stein, professor of Afroamerican and African studies and of epidemiology at the University of Michigan, states that the trajectory of development in sub-Saharan Africa remains puzzling to mainstream economists. Poverty stays stubbornly high, growth has been uneven, and life expectancy has continued to lag relative to other regions despite governments' adopting active policies inspired by neoclassical economists. Economists have offered a host of extraneous explanations for "Africa's tragedy," including ethnicity, geography, colonial history, slave trade, poor governance, and poorly developed social capital. Stein notes that the number of variables purportedly correlated with growth grew dramatically over time in the literature and reached, by one count, a rather implausible 86 regressors by the year 2000. His chapter deals with new concerns about income inequality, and how orthodox economists have tried unconvincingly to explain the pattern of income distribution in Africa.

Contrary to Kuznets's hypothesis that regions with low industrialization and a high reliance on agriculture should have more equitable distribution of income, sub-Saharan Africa has had high income inequality, which has been worsening in recent decades, despite evidence of deindustrialization and most of its population living in rural areas. As argued by Stein, part of the problem with relying on Kuznets's formulation is its reliance on the faux naturalism which is embedded in the neoclassical theory of distribution, in which factors of production in a competitive market are supposed to be paid according to their mar-

ginal contribution to production. The belief in a Kuznets curve follows the erroneous assumption that peasants received income commensurate with their land and labor in economies dominated by rural production. With industrialization, the divide between urban-based wage income and rural income will grow, and income inequality will worsen.

The neoclassical paradigm thus argues that only by shrinking the rural sector will equality be restored. But when this pattern is not observed, instead of questioning the underlying assumptions, neoclassical economists tend to search for extraneous factors in an attempt to explain why the paradigm does not seem to hold true. Stein argues that to understand income inequality, we need to transcend the faux naturalism of neoclassical economics so as to take into account the evolution of the institutions, related economic structures, and the way Africa has been integrated into the global economy—factors that really underlie the current and historical patterns of income distribution. Stein suggests that the core of explanation lies in the shifting structures of power which underlie the generation of disparities in material awards. Stein reviews the trends in income distribution in sub-Saharan Africa using Gini coefficients to measure inequality. His paper provides a critical alternative view to the mainstream view of distribution and its applications to understanding inequality in Africa, including its impact on policy formation, which has contributed to the exacerbation of distribution. The paper discusses the institutional approach to income distribution, which challenges the standard neoclassical economics approach and claims to offer a better understanding of the income distribution patterns that we have observed in sub-Saharan Africa.

Stein presents detailed evidence to make a strong case for the institutional theory of distribution. According to Stein, factors of production are integrated, and their ability to affect production is contingent and interactive. Resources, whether human or inanimate, derive their utility through their integration into a process dependent on many sub-processes. The power of production is found in systems, not in land, capital, and labor. Stein further argues that neoclassical economic constructs have been institutionalized and created the dangerous notion that people are paid according to the natural laws of the market and receive what is deemed worthy of their contribution. They are not a product of human agency but of forces beyond human control. In contrast, the institutional theory of distribution points to the need to understand

power and its relationship to the contesting of interests at the heart of the determination of the allocation of the shares of material rewards. Stein stresses that understanding the forces that select working rules and that shape and reshape the relative power of the parties involved in transactions should be at the core of an institutional understanding of the distribution of income in any society. Transactions are not simply among domestic players but involve international participants, and the rules of those transactions are affected by international institutions. So how does this explain the pattern of income distribution in Africa? The key, according to Stein, is in understanding the forces that shaped and altered the conditions and rules that affected the comparative power of direct producers in transactions over time. Stein provides comprehensive evidence to support the institutional perspective of inequality using his field studies in Tanzania, Kenya, Malawi, and Uganda.

In Chapter 7, “Income Inequality, Progressive Taxation, and Tax Expenditures,” the final chapter, James R. Hines Jr., Richard A. Musgrave Collegiate Professor of Economics at the University of Michigan, discusses the effect of progressive taxes and tax expenditures on inequality, alluding to the following four facts:

- 1) Income and wealth are unequally distributed in the United States, and annual incomes appear to have become significantly less equal over the past 40 years.
- 2) The United States has a progressive income tax system that imposes burdens based on ability to pay, with rates that rise sharply with income.
- 3) The primary function of the tax system is to raise revenue to finance the government, but in the process, the tax system also redistributes wealth.
- 4) The tax system can do quite a bit more on redistribution and should, but perhaps paradoxically this is possible only by maintaining and adding to tax expenditures (“tax loopholes”) for the affluent. In explaining the effect of progressive taxes, which can reduce inequality, Hines asserts that the prevailing tax system includes certain preferences, such as deductions for mortgage interest, charitable contributions, and state and local taxes that mitigate tax burdens. These are known as “tax expenditures.”

Like so much else in the tax system these days, there is partisan bickering over these “tax expenditures.” Liberals are highly critical that tax expenditures have been going mostly to the rich—which they do. Only 30 percent of taxpayers itemize their deductions, and affluent taxpayers are more apt to claim itemized deductions than are the less affluent. Affluent taxpayers have bigger mortgages and more state and local taxes from which to claim deductions. On the other hand, conservatives feel that tax expenditures smack of social engineering by government and prefer lower tax rates instead. Thus, neither political side likes tax expenditures. Yet, as we will see, they are essential aspects of a progressive tax system. Hines explains who benefits from tax benefits in various ways. Tax reductions from income tax expenditures go mostly to high-income taxpayers: 13.6 percent of the total goes to the bottom income quintile, 61.6 percent of the total goes to the top income quintile, and 27.5 percent goes to the top 1 percent of income. But of course it is also true that, of the total amount of revenue brought in by taxes, most comes from high-income taxpayers. Only 0.8 percent of taxes is paid by the bottom-income quintile, whereas 68.9 percent is paid by the top income quintile. In fact, 27.9 percent of tax revenue is paid by the top 1 percent. Tax expenditures roughly track total tax liabilities.

In discussing the equality issues of the U.S. tax system, Hines uses the example of one tax measure: the child tax credit. This credit reduces the tax burdens of families with children as compared to otherwise-similar families without children. Is that a good thing to do? The political system has decided that it is. It is certainly true that a family with two children and an income of \$50,000 is less well off than a family without children and an income of \$50,000. But Hines points out that, after all, those couples chose to have children, so should we permit them to have a tax reduction on this basis? Reasonable minds might differ on answering this question, but the majority think that the answer is yes.

Hines also addresses a few issues associated with the effect of eliminating or significantly reducing taxes. He speculates that such a reduction would have mixed effects. As a case in point, he takes the flat tax, whose advocates offer a coherent, three-step plan:

- 1) Eliminate all deductions, credits, and exclusions.
- 2) Impose a flat tax at 19 percent, 23 percent, or some other figure.
- 3) Permit a zero-bracket amount so that the first \$30,000 or so is untaxed.

While the flat-tax objectors argue that it is not a very progressive tax system—in fact it is regressive—it can also be argued that the cost of tax progressivity is that it creates greater distortions by subjecting some levels of income to high tax rates. And the more progressive an income tax system is, the more important it is to be smart about designing the system efficiently. Hines indicates that this alternative to the flat-tax system requires lots of special deductions and credits, many of which are targeted at high-income taxpayers. Advocates will decry these special tax breaks as antiprogressive, whereas exactly the opposite is the case.

Hines makes it clear that what most voters want are these two things:

- 1) tax simplicity, to make the system easier to understand and prevent others from getting unwarranted tax breaks
- 2) lower tax rates

But with that said, still, many specific tax breaks have considerable political appeal. (In the United States, these would include owner-occupied housing, charitable contributions, employer-provided health care and pensions, and deductions for state and local taxes, among other things.) The reality is that governments need revenue, and it is never going to be popular to get that revenue through taxation. But our history suggests that governments are aware of the need for tax policies that are sensitive to individual situations and economic conditions.

Hines makes the following three important and provocative points:

- 1) There is no principle of efficiency or equity that implies that the best tax system taxes a very broad definition of income at relatively low rates.
- 2) Far from it: the prevailing theory is that taxation should be highly differentiated and individualized.
- 3) In fact, the most efficient and equitable system has a relatively narrow tax base with relatively high tax rates. Proposals (and there are some) to cap all tax deductions or reduce all tax deductions by a fixed fraction (say, by letting people claim only 80 percent) look odd through this lens. Hines concludes that good policy is messy and that we have no choice but to rely on governments to make it for us. That they have done so with many tax credits, deductions, and exemptions may not be

a bad thing, and we may need more of them. These governments may have much clearer appreciation of the nature of the tax problem than that with which we often credit them.

Social inequality is multifaceted and very complicated. The chapters in this volume can cover only a limited portion of these complexities. Nonetheless, they contain insightful analyses and viewpoints that are critical for illuminating different types of inequality and providing context for policies to address them. We invite readers to explore these insights and inform their own conclusions.

Note

<https://inequality.org/> is an online portal to data, analysis, and commentary on income and wealth inequality. There readers can find information and insights that can help them better understand our deeply unequal world and how we can work to change it through the efforts of a think tank called the Institute for Policy Studies, in Washington, D.C.

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