General Discussion:
How Can Economic Policy Strike A Balance Between Economic Efficiency and Income Equality?

Chair: Alice Rivlin

Ms. Rivlin: Thank you very much, Laura. We now have time for comments and questions.

Mr. Katz: I greatly enjoyed Assar's paper and largely agree with almost everything he said. I have a couple of points I want to make. The first is, while I think he does an excellent job of saying what we think policy should be, I think some of the political economy worries and whether we will have them, actually are related to something he talked about—the growing intergenerational potential conflict among these policies. That is, if the right strategy is more human capital investment in younger people, but more and more of the budget is going to transfer payments to a larger and larger share of an older group, that is a worrisome sort of trend. And there is interesting evidence for the United States. Claudia Goldin and I have done some work on this. It used to be in the first half of the century if you looked across states or school districts, areas that had a lot of elderly people actually spent more on schooling. There was some sense of a link among generations and a view that this was a well-off area, and was actually positive.

In the postwar era, as Jim Poterba has shown, there's now a strong negative relationship. The higher the growth in the share of the elderly in your state, the less you spend on schooling, the less you spend on children in general. And I haven't seen cross-country work on that, but I think that's going to be an issue of whether we're going to be able to take the right sorts of investment steps.

The second point I'd like to make is this: I'd like to reinforce what Assar said about the role of norms and thinking about these connections. If you think about it, we have a lot of individualistic estimates of elasticity responses to incentives. They may greatly underestimate the potential of changing the return to going to work, to any extent that their spillover affects the work in the same direction. While it's very hard to prove spillover effects from the data, I think common sense suggests something about the last few years' experience in the United States with the change in the earned income tax credit (EITC), with a somewhat more work-oriented welfare policy, and much, much larger increases in employment among single women than you would have ever predicted from any of the elasticity estimates. And we have seen an almost 50 percent rise with this sort of 40 percent increase in assorted pay. So I suspect that has to do both with a tight economy and with some of the changes in norms and spillovers. And, obviously, when you look at the type of work William Julius Wilson has done in inner-city areas of the United States, whereas if you look at working-class areas in Britain, persistent joblessness in areas greatly affects things in ways beyond individual elasticities. And changing the incentives is not the only thing we have to be concerned about—there are spillover effects—but there are also intergenerational effects we have to think of in the long run. And that's why I think policies focused on work are so important in the long run.

Mr. Budd: I'd like to relate one of Professor Lindbeck's policy proposals to Dennis Snower's paper, yesterday. I think this is also a point that Laura Tyson made. Professor Lindbeck proposes education and training, including vocational training, as a policy that can improve both efficiency and equity. Yesterday, Dennis Snower presented his very interesting account of the organizational revolution, and that emphasized the value of multiple skills together with versatility across tasks and the ability to learn new tasks. If that is true, we do have to be very careful about the kind of training that is provided. I suspect that in the United Kingdom, for example, there is an over emphasis on vocational training, which is narrowly defined. It doesn't fit people for Dennis Snower's new world. So I would suggest that's not just a question of training, but if Dennis is right, it's a question of thinking very carefully about the wider type of educational skills that are needed in this new organizational world.

Mr. Blinder: I'd like to just make a remark, which I think is going to lead to something that's been talked around and seems to me the biggest distributional question of the day. It unites the question of the previous session with this session. The question in the previous session was this: Why should economists care?

In Joe's very interesting paper, he left out the most obvious reason, I think, simply because it's just too obvious. It's this: If the social welfare function is concave, that is to say, we like equality and not inequality, then social welfare can be thought of as depending on both average income and its dispersion. The average is a good and the dispersion is a bad, and the question is striking a balance.

Now here is what seems to me to be the issue of the day, certainly in the United States, and I suspect in many other countries as well: If you have a period of time—and think of the 1980s and into the early 1990s as this period of time—where market forces, not necessarily government, are doing anything or causing a disequalization, how should the government respond? That is to say, should it increase its efforts to equalize? Should it do nothing? Should it decrease its efforts to equalize? From my point of view, it seems like such a situation creates a prima facie case to increase efforts to equalize. I furthermore think it's arguable that during the short distributional history of the United States from the early 1980s to the early 1990s, we did just the reverse.

Mr. Barnes: One of the changes in the U.S. pay structure in recent years has been the growing use of options as part of compensation packages, particularly in the high-tech sector. This increased usage of incentive-based pay in the most dynamic, fastest growing sector of the economy may have increased inequality but perhaps has also been associated with more efficiency and faster growth. Most of the studies of inequality presumably don't cover this period where use of options has become more prevalent. I was just wondering what your thoughts on this issue are.

Mr. Kaufman: As a general theory, Alan Blinder's statement I think is somewhat dangerous. And I would agree that we have to move ahead with education, with specialized training to take care of those who are incapable of participating in the system.

But let's assume that we all meet again 50 years from now and have accomplished that task. And there is still inequality of income. Will we then say that a doctor's income is too low and that a dentist's income is too high? And the Wall Streeter is getting too much? Or are we willing to accept the inequality that then exists, having eliminated the issue of the poor? I think no one really wants to come to grips with the difference in capabilities in society of human beings. We all believe that somehow we will equalize that capacity over a period of time. I think that issue still sits here. And, therefore, I would disagree with Alan Blinder's idea of rushing to take care of the inequality.

Mr. Eisenbeis: Reflecting on the empirical evidence provided so far in the conference, I remain unconvinced that income inequality, in and of itself, is a problem. All you have to do to see this is to look at Chart 3 in Joe Stiglitz's handout. Look at the various countries and compare the states of their economies today. Ask yourself which ones you would like to live in and which ones you wouldn't like to live in. I'm sure you would lop off the top half of the chart at this point, which has a low-income distribution inequality and relatively high growth. I don't think anybody would follow their model today. You could certainly delete the countries on the right hand side of the chart as places you would like to live. This forces you into the middle part of the chart. I'm sure that conditions and income disparities are more different between Switzerland and India than is suggested by the chart as a whole. Given this disconnect, I don't really know what to make of this chart, and I really haven't heard much at the conference so far that has helped to clarify the issue of why income disparity is a problem.

I distinguish this issue from the question of whether there's a problem with people at the low end of the distribution. There clearly is a problem of the poor and how to deal with people who have demonstratively low value of marginal product. This concern is even more interesting, given the Snower paper yesterday. It suggested that in today's more complex organizational structure, there's a greater demand on people to not only be highly skilled, but also to have even broader-based skills in order to have a high value of marginal product. In such environments, income disparity is going to increase just because the disparity in skills will increase, as will the value of these marginal products.

It seems to me that we are left with education as the main way to help people at the low end of the income scale. This would seem to be the only way to leverage up those with low-value marginal products.

Ms. Malmgren: Actually, following that same line of thought, I was very struck by Laura Tyson's reference to the period in the United States up until the early 1970s, where productivity was clearly increasing and inequality in incomes was decreasing, and since the early 1970s, as productivity has not done as well, inequality in incomes has increased. It seems to me that we have a question before us. If productivity gains are the essence of improving wages and income, then how much of our time and attention ought to be focused on how to improve productivity versus how much of our time and attention should be focused on how to redistribute income? Let's say it is better to enlarge the pie rather than argue about how to divide it up.

Mr. Makin: I'm struck by two things. First, as Laura Tyson reports, the efforts to address income inequality in the United States have been more focused on the elderly rather than on the young population. Going back to what Henry Kaufman said, shouldn't policy be focused on ex ante income inequality rather than ex post? Why have we gone the other way?

Second, I've been hoping to hear about experiments on dispersions of relative wages in groups that are homogeneous—that is, in terms of all the things that we can understand, they seem to have the same qualities. You do observe very large dispersions in relative incomes among apparently homogeneous people in terms of the things you could measure. Having spent a little time on Wall Street, I've come to that conclusion to console myself, if for no other reason.

What that tells me is that we have a large empty set about what we know about what determines relative compensation. And, of course, if we really don't understand what ultimately determines relative compensation—leaving aside the minimum standard problems—why do we have such aggressive policies to address it?

Ms. Rivlin: Let's take one more and then we'll give Assar and Laura a chance to riposte.

Mr. Mussa: Yes, I wanted to answer Henry Kaufman's question. If all of us meet here 50 years from now, we have surely paid our doctors too little.

There's some substance in that remark. I mean, there is a notion that people do earn their incomes. And some people may deserve higher incomes on the basis of their contributions to society. And there I wanted to agree with Henry and disagree a little bit with Alan, and really agree with Assar and Laura.

I really like Assar's approach that one wants to identify where there are problems in the income distribution rather than being concerned with the overall income distribution and whether it's becoming more dispersed or less dispersed. But are there problems specifically with the poor, with single mothers, with the elderly? Where are the problems and what policies may be appropriately directed to deal with those problems without creating worse concerns rather than a generalized effort to narrow the income distribution per se?

I would note in this regard two things: One of the most important and visible public policies has done a great deal to widen the income distribution and that is the nationwide spread of lotteries. More people participate in lotteries than vote in elections. And lotteries are surely a mechanism to widen the dispersion of income. People enjoy it, and I don't think we should reject it as a social phenomenon. The second thing is I thought Laura was a little rapid in dismissing the impact of public policies in terms of the disintegration of American families. It's now more than 30 years since Daniel Patrick Moynihan wrote on this subject. And I think that his predictions about the impact on those types of social policies did indeed prove accurate. And while I must say that I have been surprised by how well the increase in the minimum wage has worked, with no measurable impact in reducing employment, I've also been surprised at how well the welfare reform has worked. And I was concerned about what the social consequences of that would be, but so far at least, it seems to be functioning quite well with very large increases of employment and without many of the dangerous impacts on families that a number of us feared.

Ms. Rivlin: Tight labor markets may have helped. I said that was the last question, but I didn't realize that Alan Greenspan wanted to speak. I think my Chairman deserves the last word.

Mr. Greenspan: John Makin raises an interesting question, which I think raises a still broader question, which I would be curious to get a general response to. We look at the dispersion of income within presumably very narrow cells categorized by occupation, age—any of the characteristics by which we try to classify the cells. It is also obvious that how long a period one is choosing to define the income of the individual units in that cell will clearly influence the degree of dispersion that we observe. Obviously, it is an unrealistic assumption that over a 10-year period or a five-year period everyone within the cell has the same income. Random variation through the five-year period will create evidence of dispersion to the extent that one chooses time periods in which to measure it that are significantly less than, say, the five years. Obviously if you choose a two-month time frame to measure, you'd get exceptionally high dispersion.

This raises a question, which I don't recall having been directly addressed previously. What do we know about the extent to which the degree of income concentration may be reflecting greater instability in earnings and presumably, the possibility—as Dennis

Snower raised yesterday—that the changing structure is creating changing dispersions? That would show much less increase in Gini coefficients if we were able to get adequate data over much longer time frames. In other words, clearly the degree of income inequality is less the longer the time frame. But has that relationship changed over time in any way that would significantly alter the perceived trends?

Mr. Katz: There has been a fair amount of work trying to assess that question, using the three different data sets we have available to do that. That is, with the Panel Survey of Income Dynamics, we can follow people for the last 28 years. From the current Population Survey, we can do year-to-year comparisons by matching them. And from the National Longitudinal Survey, we can follow people over the last 15 years. And what you see is that the year-to-year instability of earnings has gone up significantly.

But basically what's happened is that the transitory and the permanent component of earnings and equality have increased proportionately the same. So you do exaggerate the increase in the Gini coefficient in absolute terms when you include the transitory stuff. But proportionally, if you do a 10-year average of earnings for the 1980s versus the 1970s, it's the same amount of increase as when you look at the level. So they're strikingly similar in all three of these data sets. What that means is the amount of earnings mobility between quintiles has not changed, but the consequences of that are greater because the gaps are greater.

Mr. Greenspan: You did mention it yesterday and I was just curious whether, in fact, you have enough observations in that particular set of data to draw a generic conclusion, which you're now drawing effectively.

Mr. Katz: You have enough observations to do that for everybody and to do that for broad education groups. You can't do that for a cell, like an individual occupation, age cell. You couldn't say, among doctors what's happened or among Harvard graduates what's happened. You can say for college graduates, as a whole, in the United States, that's the pattern. You have enough observations. Those panels only have about 10,000 each. So once you started breaking it beyond four groups, you can't really say much.

Ms. Rivlin: Okay, Assar, would you like to respond?

Mr. Lindbeck: Let me make a few comments. I tried to ask the question: Suppose that we want to equalize the distributions of income with the lowest possible economic costs, what are the alternatives?

I did not ask whether it was good to do it or not. And I did not ask whether governments are able to do it or not. I am more skeptical about what governments can do than, for instance, my friend Joseph Stiglitz, who has a tendency to assume that markets are grossly imperfect and governments are perfect. I don't have the opposite view exactly, but more in that direction.

One issue I did not deal enough with in my oral presentation was social norms. In my various papers about social norms I have argued that before the welfare state was established, you could not survive without working and without saving. Then the welfare state came. To begin with, people did not change their behavior very much. Why? Because there was a social norm. You should work; you should save. Otherwise, you were not a respected citizen.

But after a while, some entrepreneurial people discovered that you could utilize the system. You could take early retirement—and 12 percent of the Dutch people are taking early retirement because of assorted disability, 8 percent in Sweden. When more and more people start to exploit the system, social norms in favor of work start to fade away. And that is my point about the importance of social norms. And then, after a while, you get much stronger effects on behavior than is thought originally. If you subsequently try to go back to the previous situation, it takes time to reestablish the social norm. You run the risk of overshooting the welfare state by neglecting these adjustments of social norms.

I did not say much about the *quantitative* effects of various disincentives. The reason is that I have followed this literature for 30 years and it is extremely difficult to quantify these effects. What I would like to emphasize is the pervasiveness of effects. It's not only the choice between leisure and work that is influenced. There are effects on do-it-yourself work, on barter, tax evasion, geographic mobility, investment in human capital, and so forth. Each one of these effects might be small. But if you add them, they might come up to very much. So I believe we have to rely heavily on circumstantial evidence illustrating thousands of effects. But I cannot add them to an aggregate. That's why I was unable to quantify this issue.

Another question that was asked was how to explain the apparent increase in the dispersion of the distribution of income among apparently homogeneous groups. My hunch is that idiosyncratic factors take a much greater role. The typical worker today is not Chaplin in "Modern Times," working at the conveyer belt and screwing bolts. He was completely replaceable by other persons. But today, when firms are reorganized, as has been described in various papers by Dennis and me, individuals are given many more responsibilities. Social competence, cognitive skills, and personality become much more important for performance and reward. All these factors play a much greater role for success in the labor market.

Lotteries are an interesting aspect on the distribution of income because the whole idea about lotteries is to make the income distribution more uneven. You take small amounts of money from many people and give a lot to the few, as Mr. Mussa pointed out. And governments are involved in lotteries. So governments pursue distribution policy both ways—first, by equalizing it and then by expanding lotteries to make the distribution more uneven. How do you explain this? Could the explanation be that lotteries are fair in the sense that the chance of getting rich is equal ex ante? Everybody has the same chance. So if you become rich by randomness, it's all right. But if you do it by ability, it's bad.

Ms. Rivlin: Thank you. Laura, is there anything you would like to add?

Ms. Tyson: I only want to say a couple of things. First of all, this is a brief mea culpa. I think that probably our welfare policies had some effect on family formation but the important thing about it is that the disintegration of the traditional family structure occurred across all income groups. And it also occurred at a time when in real terms the value of the welfare program was declining. So it's pretty hard, although I think there is some truth to what Senator Moynihan said, I don't think it goes very far to explaining the breakdown in the structure. I would refer you instead to Akerloff and Yellen who talk about things like the development of birth control methodology and the breakdown of the change in the bargaining status of women and men.

Let me go on to just the income and equality thing. I would say clearly, my sense of the conversation is that the right way to think about this problem is really worrying about the bottom and targeting certain groups.

I was very compelled yesterday by the Saw-Hill analogy. Think about it this way: If we really do have an apartment building in which the penthouse is getting more and more luxurious and the basement floor is getting more and more rat-infested and we have no change in the degree of mobility—that is, we have a certain amount of mobility, which has been constant since this has been happening. But we have a lot of people and their children who are going to get stuck for a long period of time in the rat-infested basement. So we need to do something about the rat-infested basement. All the things we are talking about here—increasing the minimum wage, EITC, welfare-to-work training policies, and education policies to get that 40 percent of the population whose kids are not going on to college in increasing numbers into that system—that's what we should do.

Finally, within-cell inequality, I think that—you know I said in my comments, that we understand a lot about inequality, but we don't understand everything—and actually within-cell inequality may account for as much as 50 percent of the income inequality we are observing.

The question before us is to what extent is within-cell inequality increasing as a result of our better ability to measure differences in personal productivity? And to what extent is it varying because, in the new organizational structure that Snower talked about yesterday, differences in multitasking and other capabilities are becoming more and more important so we are rewarding them differentially?

And then, frankly, one thing we haven't mentioned at all here is, and this is where I'll end, is to what extent is within-cell inequality increasing because our own norms of what is fair and what is not fair are changing? We have social norms about the distribution of income, too. We have social norms about what is fair. How much should one worker get vis-à-vis another worker in the same cell? How much is fair for one CEO to get relative to another CEO if they're in the same cell? And I think those norms are changing in the United States toward a greater acceptance of greater inequality.

Ms. Rivlin: You have all earned a 25-minute coffee break and we will reassemble after that.