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Inequality and Public Policy

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Inequality and Public Policy

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Abstract

This paper addresses a set of inter-related questions about inequality: why public policy should be concerned with inequality, how differences across countries in the extent and nature of income inequality can be explained, how Ireland's ranking in those terms can best be characterised and explained. It then seeks to draw out implications for public policy and how it is debated and framed. It concludes that modest reductions in income inequality are achievable within the framework of Ireland's current socio-economic model. However, achieving a level of income inequality much below the (EU or OECD) average, much less one close to the levels of the best performers, would require such a significant enhancement in the Irish Welfare State, and its corollary of substantially higher taxation, as to represent a radical departure from our current socio-economic model. Recent events in the financial markets and the extremely challenging economic environment to be faced over the next few years provide an opportunity to debate fundamental questions about the role of the State, in particular the extent and nature of social provision and its financing.

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[1] This paper was presented as an Inaugural Lecture in October 2008.

Introduction

In this paper I pose and address the following questions:

- Why should public policy be concerned with inequality?
- How can we explain differences across countries in the extent and nature of income inequality?
- How can we best characterise and explain Ireland's ranking in those terms?
- What are the implications for public policy and how it is debated and framed?

Why Should Public Policy Be Concerned with Economic Inequality?

Inequality should be a concern for public policy for a number of reasons, and it is worth distinguishing between them. The first is that inequality is something about which many people have strong views. The second, on which there is now a substantial research literature, is that inequality may be a key factor in producing or exacerbating a wide range of social ills such as educational disadvantage, health inequalities, intergenerational immobility, and crime, and may undermine social cohesion. The final reason, which is only recently receiving the attention it deserves, is that inequality and economic performance may be intimately related, but in a much more complex fashion than a simple trade-off between growth and inequality. So those framing and debating public policy need to focus on and understand inequality – and, as I will conclude by arguing, those who care about inequality need to focus on and understand public policy.

Explaining Income Inequality

Having started by talking in terms of "economic inequality", from here on I am going to focus on inequality in terms of household incomes. Income inequality is of course only one facet of economic inequality, but it is a central one, about which we have more information than, for example, wealth. Overall income inequality reflects the complex interaction of various factors: the way earnings are distributed among individuals, the extent and nature of labour force participation, how earners and non-earners are grouped together in households, the distribution of wealth and the returns to it, and "factor shares" – the division of returns between capital and labour. All these influence the shape of the distribution in one country versus another. However, what appears to be the single most important factor underlying differences among rich countries – and the one that is most amenable to influence via public policy – is the extent and nature of the Welfare State.

The first and most obvious way that the Welfare State influences income inequality is through redistribution via income transfers and direct taxes – income tax and social insurance contributions. There are striking differences across EU and OECD countries in the measured difference between inequality in income from the market versus disposable income, when transfers are included and direct tax deducted. For example when one goes from market to disposable income the Gini coefficient - the most widely-used summary measure of inequality - is reduced by less than 30% in the case of Italy, Spain and Portugal, compared to 45-50% in Austria, Denmark, Belgium, France and Sweden. This overall redistributive impact can be decomposed into the separate effects of income

transfers and direct taxes on inequality, and broadly speaking there is more variation across EU or OECD countries in the effects of transfers than taxes.

However, the impact of the Welfare State goes beyond income support to encompass social provision much more broadly. Overall "welfare effort" is often measured by aggregate public social expenditure, which also includes healthcare and housing subsidies. Relating summary inequality measures to total social protection spending as a percentage of national income, low spenders generally have high levels of income inequality and vice versa, but social protection spending alone is not a very good predictor of income inequality. (This is clearer if the set of countries examined is the EU-27 or the OECD rather than the narrower EU-15.) Quite a few countries have much lower inequality than their social spending would predict – e.g. Finland or Slovakia – and others have much higher – e.g. Portugal and Italy. Variations in social spending do not suffice to explain where countries rank in terms of inequality, nor is higher social spending guaranteed to produce low inequality.

The Welfare State remains central, though, because in addition to the direct effect of social protection spending it encompasses education and training, the way the labour market is structured and how it interacts with social protection. This is where the notion of welfare "regime" is helpful, with the now-customary categorisation into:

- Social Democratic - Denmark, Finland, Norway, Sweden
- Corporatist - Germany, Belgium, France
- Liberal - UK, USA, Australia, New Zealand, Canada

- Residual/“Southern” - Spain, Portugal, Greece, Italy.

These groupings are distinguished not just in terms of how much their social security systems rely on means-testing versus contributory or universal payments, but also on the basis of social rights independent of the market, social stratification, and the public-private mix. There are clear and consistent differences between these groupings in terms of levels of income inequality, with inequality lowest for the social democratic countries, higher but still relatively low for the corporatist ones, above average for the liberal regime with the USA an outlier, and as high or higher for the “Southern” regime, with Portugal again an outlier. (The former Communist countries of Eastern Europe cannot be placed in this schema and cover a very wide range in terms of inequality, from the Czech Republic at the low end to Lithuania at the other.)

Characterising and Explaining Income Inequality in Ireland

Against this background, where does Ireland fit comparatively in terms of income inequality, how should we characterise and explain Ireland’s ranking? When the most widely-used summary inequality measures are calculated from household survey data, Ireland ranks:

- 10-12th. within the EU-15
- 17-18th. within the EU-27
- 18-20th. within the OECD

Within the enlarged EU the Gini coefficient ranges from 0.24 to 0.38; the average is 0.30 and the median 0.29. The latest figure for Ireland is 0.32, so Ireland is clearly above average, but at a level that is similar to 8 other countries (e.g. Spain, Italy, UK, Poland)

and markedly below two – Portugal and Lithuania. Among OECD countries the picture is quite similar, with Australia, Canada and New Zealand also around Ireland's figure.

So Ireland is perhaps best described as "among the rich countries with significantly above-average levels of income inequality". We regularly read, in the media and in scholarly publications, that Ireland is "(one of) the most unequal countries in the industrialised world". Is my formulation making a distinction without a difference, just being pedantic? The definition of pedantic includes "a narrow, often tiresome focus on … learning and especially its trivial aspects", but also "an academic insistence on precision". It matters whether we see Ireland as *sui generis*, one of a kind, with a distinctively high level of inequality attributable to some specific features of our society, or as one of a group of countries that share a set of institutional features that – however great the differences between them – underpin their relatively high levels of income inequality.

Turning to trends in inequality for Ireland over time, there is some variation across the available surveys, but broadly speaking summary inequality measures have been rather stable going back to the late 1980s. (One can contrast this with the increase in inequality seen in the UK and the USA: from about 1980 the US Gini rose by 17%, while in the UK it went up by over one-third.) Summary measures may mask important changes occurring in different parts of the income distribution, so we can also look at decile shares – the share of total income going to those in the bottom 10%, next 10% etc. We do see some increase over the boom years in the share going to the top 10%, but with a decline for others in the top half rather than further down the distribution.

How would one reconcile this with the common belief that inequality has increased sharply over the boom? The first point is that household surveys may not capture the full picture, and may have particular difficulty right at the top of the income distribution where the most pronounced effects from an economic boom might be felt. Data produced by the Revenue Commissioners can be used to estimate the share of total income going to the top 1%, and my estimates show this rising from about 6% to 10% over the 1990s. Even larger increases in top income shares in countries such as the USA and the UK have been widely commented on. In the Irish case, though, it is particularly difficult to disentangle the effects of changes in reporting behaviour vis-a-vis the tax authorities from changes in actual incomes – both are probably contributing.

Another factor is that even if the distribution is not changing in relative terms – if everyone experienced the same proportional increase in their incomes, which would leave conventional inequality measures unchanged – widening absolute gaps in incomes could dominate popular perceptions. (There is some experimental evidence that perceptions or views about inequality often focus on absolute gaps rather than just on shares.) When incomes are rising as rapidly as they did during the boom, such widening gaps will be particularly striking.

As far as shares are concerned, though, some of the effects of economic growth may be less obvious than others. The impact via profits towards the top may be more obvious than the no less real impact of much lower unemployment towards the bottom. Another

important feature of the boom was the increase in married women's labour force participation. While in some countries this has been concentrated among women married to higher-earning men, my research with Bertrand Maitre showed that in the Irish case it was as common for those married to lower-earning men, and thus did not have a disequalizing effect on the household income distribution. It also seems that at least up to 2000 the boom was not accompanied by the pronounced increase in earnings inequality and widening gap between high versus low levels of education seen in the USA and the UK. Strong demand for low-skilled employees kept up their returns, while increasing numbers of highly-educated leaving college and returning from abroad kept theirs down. An IRCHSS-funded project with colleagues here and in the ESRI is currently investigating whether this was very different after 2000. As far as social welfare is concerned, rates initially lagged behind average earnings but subsequently made up much of the ground, although not increasing by as much as average household income boosted by increasing numbers at work.

So Ireland's relative position in terms of income inequality has been quite stable over time, despite substantial variation in social spending as a proportion of national income. We are used to seeing Ireland rank lowest in the EU-15 in terms of social spending as a share of GDP. That includes profits repatriated abroad, however; expressed as a proportion of Gross National Income Ireland is one of the low spenders but not such an outlier. When social spending is plotted against summary inequality measures, for the EU or the OECD, Ireland is right on the regression line: our level of inequality is pretty much exactly what you would predict given our current social protection spending.

Focusing on income transfers to and direct taxes on households, their “redistributive impact” in the Irish case to reduce the Gini coefficient for market income by 32%. This is substantially below the EU average and similar to Greece and the UK, but as we saw earlier countries such as Italy, Spain and Portugal reduce market inequality by less. When this overall redistributive impact is decomposed into the effects of income transfers versus direct taxes, it is the former that is particularly modest for Ireland. This relates in particular to the limited redistributive impact of public pensions, reflecting their flat-rate nature with reliance on private pensions for an earnings-related component, as in the UK but unlike many other EU countries. More broadly, in terms of welfare regimes Ireland’s structures fit us in the Liberal regime, and it is not then surprising that we have a level of income inequality similar to most of the other countries in that grouping. This has fundamental implications.

The Implications

This focus on welfare state institutions highlights not only the importance of adopting a comparative framework, but also of a historical perspective on understanding how we have arrived here, how core features of our institutional landscape have evolved. A key question then is the extent to which we must regard ourselves as constrained by this institutional legacy. A widely-used phrase during the financial crisis has been “we are where we are”: the older Irish tag is “if I wanted to go there, I wouldn’t start from here”. Is Ireland locked into a relatively high level of inequality by institutional legacies and choices made in the past?

Posing the question that way of course begs what might be seen as a logically prior one: perhaps we are where we are because that is where we want to be? Depending on what you believe about the way the political system translates voters' preferences into public policy, that could be simply a tautology: what we see must reflect at least the majority's preferences. Some cross-country research on inequality does see it as simply reflecting differences in attitudes, values and preferences, with voters in some countries being much less concerned about inequality than others - the question of interest then becomes why attitudes differ. Without dismissing this entirely, it seems simplistically reductionist, for at least two reasons.

The first is that the path from attitudes and values – and their distribution among different groups in society – to public policy and institutional change is a long and tortuous one: while most economists are still happy to infer individual preferences from what people do and spend, it seems quite a stretch to infer societal preferences from outcomes as complex and multifaceted as inequality. The second is that attitudes, values and preferences are not independent of context – they cannot simply be seen as exogenous. One illustration is the fact that many Americans are suspicious of "socialised medicine" but are as attached as any European to the public old-age pensions (what they call "social security") which Roosevelt's New Deal succeeded in embedding during the (previous?) Great Depression. So while there may be deep-seated differences across countries in general attitudes towards the State and "Big Government", when it comes to the more specific areas in which policy is actually made there is a dynamic relationship between

attitudes/preferences and institutions/policies: attitudes do not simply shape and constrain institutional change, they also reflect it.

Does it make more sense to see societies as choosing different combinations of inequality and growth – different points on a stable underlying growth-equality trade-off curve? This is certainly a significant ingredient in the way public policy is debated. The first objection that will be raised to most social expenditures is that they will have a negative impact on economic growth and employment, either directly because they interfere with the free functioning of markets, or via the distortionary impact of the taxation required to finance them. Both in debate and in reality this is intimately tied up with our economic growth/development model – captured in the "Boston or Berlin" way our choices have been framed. In simple textbook models of supply and demand, taxes and transfers produce deadweight losses, which hinder economic growth. However, Peter Lindert's magisterial cross-country study of social spending and economic growth since the 18th. century finds little evidence for such a negative relationship. Recent research has highlighted the scope for social spending to itself be a "productive factor", underpinning economic growth in a variety of different ways. This is most obvious in its impact on the health and productivity of the labour force, but extends well beyond that to include, for example, the provision of income security allowing economic agents to take risks, and helping create an environment where trust and social cohesion are high which in turn facilitates investment and growth. This awareness has now percolated through to the way in which the role of social spending is debated at EU level, including currently by its Social Protection Committee.

The broader relationship between inequality and economic growth has also been the subject of recent theoretical and empirical research, which has brought out the numerous transmission channels through which inequality may affect growth. As Voitchovsky's contribution to the forthcoming Oxford Handbook on Economic Inequality brings out, this literature suggests that inequality can both facilitate and retard growth, and that inequality towards the top may have a different impact to inequality towards the bottom. What is clear is that some countries have sustained low levels of inequality with impressive levels of economic growth – indeed, they include some of the richest in the world in terms of income per head.

But realizing that the welfare state may in some circumstances and respects underpin economic performance does not mean we can go to the other extreme and believe with Dr. Pangloss that "all is for the best in the best of all possible worlds". Just labeling something as "social investment" does not mean it will have a net positive impact on economic performance. Poorly-designed welfare institutions and policies, and financing them, *can* damage growth and jobs. Countries that spend more on welfare policies, Lindert suggests, take greater care in designing efficient taxes and transfers. What matters then is evidence – about what works and what doesn't, about whether we are going in the direction we want to go in terms of key outcomes, and about underlying structures and causal forces.

This brings us finally to the way public policy is debated and framed. The notion of "evidenced-based policy-making" suggests a technocratic exercise, where the facts are carefully sifted by experts and the best option among a clearly-defined set selected and implemented. This is not the way public policy is made anywhere, even in countries where policy-relevant research is most developed and the policy-making process best equipped to absorb it. Economists tend to hanker after something like the Bank of England's Monetary Policy Committee (MPC), where experts debate the evidence and arrive at a view on how the policy lever should be pulled. It is instructive that even there the correct course of action is often hotly debated, because the available evidence is partial and open to different interpretations – as it always will be – and those involved have different priors, prejudices and objectives – as they always will. One former member reported in a recent article in the Financial Times the view of a senior politician that the independent MPC was a mistake because technocrats would underperform politicians in a crisis, being more likely to be out of touch or bogged down in doctrinal disputes. But specific decisions by policy-makers, and perhaps even more so broader public debate and societal choices, can only be improved if the evidence base is wider and deeper than we currently have available.

There is then the question of what constitutes evidence, and how it is communicated and absorbed. Both quantitative and qualitative research are needed to inform policy, but serious questions remain about how best to assess quality in seeking to carry out meta-analyses and reviews, as well as how to synthesise the findings from different types of study. Some argue that the methodological and philosophical differences between the

‘positivistic’ and the ‘interpretive’ traditions are so great that seeking to synthesise the evidence is philosophically impossible and scientifically meaningless. In this context it is worth quoting from the foreword to a recent study by the UK’s Health Development Agency: “The HDA cannot detain itself with what, in our view, is a misrepresentation of the philosophical issues. ….. the characterisation of the debate as an irresolvable one between positivism and interpretivism is disingenuous in our view. It is a device that obscures more than it reveals. … the label ‘positivist’ is usually misused in a stereotypical and stigmatising way, which does an injustice to the original ideas of positivism and, more importantly, labels some very serious science as if it were in some sense second-rate. …. the methodological debate is completely unhelpful from a point of view of trying to bring about reductions in inequalities in health, does nothing to help develop policy and practice, is a gross oversimplification of vast amounts of important scientific work in a range of methodological traditions, and – as a final shot – is a misrepresentation of the philosophical principles which supposedly are the origins of the so-called divide.” (HAD, 2004)

In the heath area the method of investigation accorded most weight is the randomized control trial (RCT), where outcomes for a randomly-selected treatment group are compared with a control group, and this approach is now also employed on occasion to evaluate potential public policy interventions. The results of such studies can have a level of precision not available from alternatives, and can be particularly powerful in convincing policy-makers of the value of a specific intervention. That does not mean we should always aspire towards a general model of policy formation where a set of options

is carefully delineated, pilot projects are scientifically evaluated via RCTs, and the most cost-effective are mainstreamed. Not only would this be unrealistic – decisions cannot always wait for such evaluation and other political and bureaucratic factors will always influence them – but if the pilot interventions are framed too narrowly it could incorporate a bias towards rejection and doing nothing. Other types of evidence are key, not least in deciding what options to consider in the first place and how broadly they may need to be framed. In that context a comparative perspective, looking at what does and does not seem to work in other countries, seems particularly valuable – while taking into account that the broader institutional setting in which specific policies are embedded may be crucial.

The capacity of policy-makers to absorb the lessons from research has implications for the training they need, and for the professional skills which the public service needs to recruit and utilize. It is equally important for those producing social science research to grasp the complex web of forces that affect how public policy is actually made, in order to be able to communicate their findings to the policy community but more fundamentally in order to be able to understand key facets of the society we study. That perspective underpins the cross-disciplinary doctoral programme in Public Policy recently launched here in UCD.

Conclusion

Let me return in concluding to the core question raised earlier: is Ireland locked into a relatively high level of inequality by institutional legacies and choices made in the past? What does the evidence suggest? My assessment would be that modest reductions in

income inequality are achievable within the framework of Ireland's current socio-economic model. Spending more on social insurance pensions, for example, and probably introducing an earnings-related element to those pensions, could be an important element on the spending side, while a modest increase in the redistributive impact of direct taxes should also be achievable. While such a strategy could in all probability bring us down towards or even to the EU or OECD average in terms of conventional income inequality measures, it would in all likelihood have great difficulty bringing us much further. Recent British experience is instructive in that context: significant redistributive efforts under New Labour – albeit by stealth rather than trumpeted from the rooftops – have had some impact on poverty but have not even held income inequality stable at the level inherited in 1997, much less reduced it towards pre-Thatcher levels.

The EU its social inclusion process and elsewhere often uses the achievements of the best-performing countries as a point of reference for others. Achieving a level of income inequality much below the (EU or OECD) average, much less one close to the levels of the best performers, would require such a significant enhancement in the Irish Welfare State, and its corollary of substantially higher taxation, as to represent a radical departure from our current socio-economic model. Given recent events in the financial markets and the extremely challenging economic environment that we face over the next few years, this may seem like an issue for another day. In another way, though, once the most immediate needs of the situation are met, like the mid-1980s this context may provide an opportunity to debate fundamental questions about the role of the State, the extent and nature of social provision and its financing, and the type of society we aspire to. For those

who want to see greater equality, the State is “the only game in town”, and public policy is the central arena.