Growing apart: The comparative political economy of income inequality and social policy development in affluent countries

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1 Introduction

1.1 Mind the gap

Over the past few decades, until the onset of the Great Recession, real disposable per capita incomes have grown steadily in OECD countries. The benefits of this income growth, however, were not equally shared amongst households. On the contrary, most OECD countries witnessed a widening of the income distribution. Earnings grew more dispersed in particular (Morelli *et al.*, forthcoming). This was for a significant part due to increases in wage differentials between low- and high-skilled employees (OECD, 2008a; 2011a).

Only fairly recently, rising income inequality has returned to the political agenda as a major concern for policy makers and society at large. Piketty's thought-provoking premises of an increased concentration at the very top of the income and wealth ladder in his *magnum opus* 'Capital in the Twenty-First Century' (2014) has gained wide attention in academic and political discourse. The Great Recession has further fuelled the imperativeness to cope with policy issues stemming from rising levels of earnings dispersion and stagnating earnings at the bottom and middle of the distribution (Jenkins *et al.*, 2012; Salverda *et al.*, 2014).

Inequality is inextricably linked with ideological issues of fairness and equity. Inequality is a potential source of injustice when the income distribution is a result of rent-seeking behaviour, or when a lack of financial means inhibits people to pursue personal goals and realise their potential (Cingano, 2014). In the same vein, inequality can be deemed unfair from a perspective of equality of human beings and humanitarianism (Rawls, 1971). On the other hand, earnings differentials can be justified when they simply reflect personal choices in amount of effort, or productivity differences from which society at large can benefit (Mankiw, 2013).

I will refrain from taking ideological positions in this doctoral thesis. What should be core societal objectives and what level of inequality is defensible are normative questions. Conversely, what has caused such inequality, what effects it may have on economic and social wellbeing, and what policy strategies could be implemented in the case of public interference are more factual questions. The importance of analysing these issues looms large with a widespread widening of the income distribution. This doctoral thesis aims to contribute to such an inquiry. At the same time I emphasise the imperfections and limitations of the analysis presented here.

1.2 Untying a knot

The widespread trend of rising income inequality evokes a number of questions. To begin with, how can we explain this pervasive pattern of growing income disparities? Three explanations are regularly put forward, namely labour market institutions, international trade, and technological change (Atkinson, 2003; Brandolini and Smeeding, 2009; Oesch, 2013).

A first line of explanations for employment and wage variations are changes in labour market institutions (*e.g.*, Rueda and Pontusson, 2000; Mahler, 2004; Martin and Swank, 2012; ILO, 2015). Labour relations and the bargaining power of employers and employees can have an impact on the distribution of wages and other working conditions (Martin and Swank, 2012; Huber and Stephens, 2014). In particular the share of employees covered by wage bargaining agreements and the level of coordination of wage bargaining are often mentioned as important factors in shaping the wage distribution (Wren, 2013). Employment protection legislation might be another factor by protecting employees from being laid off, whilst it can also create a gap between insiders with a permanent contract and outsiders without one (Koeniger *et al.*, 2007; Rueda, 2007).

A second culprit often mentioned in comparative political economy and labour economics is international trade. The degree of international integration, in particular between developed countries and developing countries such as China, has increased substantially in the last decades. When imports substitute for the domestic production of goods, local labour demand will go down. Increased competition from for instance China could also reduce possibilities to export to foreign countries. The resulting employment and wage effects might not be equally shared across all skill groups. Given the relative abundance of low-skilled labour in developing countries, mainly low-skilled employees in exposed sectors in developed countries will be affected by increased levels of imports (Autor *et al.*, forthcoming).

A third prominent hypothesis is that current advances in information technology lead to substitution of routine work by capital, whilst occupations with abstract or interpersonal manual task structures are complemented or unaffected (Autor *et al.*, 2003; Goos *et al.*, 2014). Technological change will cause an increase in the demand for high-skilled labour to perform non-routine abstract work, which in turn leads to higher wages and better employment opportunities for highly educated workers. On the other hand, routine work that tends to lie in the middle and parts of the bottom of the wage distribution will be substituted by capital (Oesch, 2013). This will trigger polarisation of the wage structure and an increase in inequality.

Which of these three factors can be seen as the most important driver? Surprisingly perhaps, this question has not received much attention yet in the empirical literature. Studies in comparative political economy have mainly focused on changes in labour market institutions, whilst effects of technological change are not taken into consideration (*e.g.*, Pontusson *et al.*, 2002; Rueda and Pontusson, 2000; Oliver, 2008; Huber and Stephens, 2014). The opposite holds for studies in labour economics (Autor *et al.*, 2013; Balsvik *et al.*, forthcoming). Effects of international trade are addressed in both strands of literature. Yet, in particular in comparative political economy the analyses tend to be based on a country level approach, ignoring variation in exposure to international trade at a more detailed sectoral level.

Having introduced possible explanations for rising levels of income inequality, a second main issue addressed extensively in public policy debates is whether this rising dispersion has had economic and political consequences (IMF, 2007; OECD, 2011a; Stiglitz, 2012). Inequality can hamper growth by leading to more social unrest or by causing lower overall levels of human capital accumulation, as people who lack financial means are inhibited to invest in themselves (Cingano, 2014). Conversely, income differences could incite people to exert additional efforts as the relative benefits are greater. If the earnings distribution is deemed undesirable, welfare states can mitigate earnings by redistributive policies (Boadway and Keen, 2000). Yet, alleviating inequality by redistributing income might have effects on growth as well. The trade-off hypothesis that redistribution based on economic outcomes reduces marginal benefits to gain income figures prominently in economics (Okun, 1975; Aghion *et al.*, 1999).

In addition to effects on economic output, rising earnings dispersion might induce a change in attitude. In particular, it might incite people to increase their redistributive claims. Based on a median voter model where redistribution preferences of individuals are a function of material self-interest, we would expect greater market earnings inequality to produce greater political demand for redistribution (Meltzer and Richard, 1981). Individuals might also favour social protection as insurance when they are exposed to an increased risk of job or wage loss. Since these forms of social security are redistributive (*e.g.*, Nelson, 2011), individuals exposed to occupational risks of technological change or international trade might show an increased preference for redistribution (Iversen and Soskice, 2001; Rehm, 2009).

Political and economic consequences of income inequality have been subject of much inquiry, but there are still a number of caveats. First, in an ideal world, when analysing the effects of inequality on growth we would take into account the effects of policies that were put in place to cushion dispersion as well, as these might have distinctive effects on growth. Moreover, the type of inequality might matter too. For instance, inequality across the population might impact human capital accumulation, whilst a rise in top incomes could be more important for levels of savings and investment. Regarding political consequences, international trade and labour market institutions have received wide attention as possible factor in explaining redistribution preferences (*e.g.*, Rehm, 2009; Walter, 2010; Gingrich and Ansell, 2012), but the same cannot be said for technological change. Whether individuals in occupations exposed to risks of job loss due to automation increase their redistribution preferences has not been analysed so far.

A third main element of rising earnings dispersion pertains to possible policy responses that countries can use to mitigate inequality. In most OECD countries, transfers account for a larger part of the absolute income redistribution than taxes (OECD, 2008a; Immervoll and Richardson, 2011; Wang *et al.*, 2014b). Insight into what type of social policies governments choose to adopt contributes to our understanding of the bandwidth for possible policy strategies of affluent countries. There is a large body of literature looking into structural processes of welfare state development (Pierson, 2000). The two most prominent hypotheses are that countries converge to a common model by opting for more similar policy solutions or, on the contrary, that welfare states only adopt incremental changes and largely follow their institutional legacies (Esping-Andersen, 1990). Not much attention has been given to whether these two theories can explain how welfare states respond to urgent social matters.

1.3 Aims and research questions

This dissertation is a collection of five chapters aiming to provide insight into determinants and political and economic consequences of income inequality and social policy development in affluent countries. As this dissertation is based on papers, the chapters are loosely related and can be read independently of each other. Four of the chapters are written together with other scholars.

Chapters 2 and 3 look into determinants of earnings inequality, employment, and wages across sectors in developed countries over time. Two questions guide this first part of the analysis. The chapters aim to contribute to the comparative political economy literature on inequality by analysing simultaneously the effects of labour market institutions, international trade, and technological change. Moreover, they adopt a sectoral approach to account for the substantial variation across sectors in inequality patterns and their exposure to international trade and technological change.

> *Q1: What sectoral trends in levels of earnings inequality and employment can be delineated and can these trends be explained by differences in sectoral exposure to international trade, technological progress, or changes in labour market institutions?*

Specific attention is devoted to trade competition with China. The rapid rise of China on the global economic stage might have employment and wage effects that differ across skill groups given China's large volume of low-wage labour. China's surge has not received much attention in the comparative political economy literature on wage inequality. The analysis also looks at direct effects of Chinese imports and effects of Chinese competition on foreign export markets, a route neglected thus far in the comparative political economy literature.

> *Q2: What are the employment and wage effects of China's rapid rise as a trading partner for low and high-skilled groups in advanced industrialised democracies?*

Chapters 4 and 5 address the possible economic and political impact of rising levels of inequality and its determinants in developed countries. Chapter 4 aims to provide some clarification on theoretical and empirical relations between inequality, redistribution, and economic growth at the country level over time. Essentially, this chapter consists of a discussion on how the socio-economic objectives of attaining economic growth and restricting income inequality are related to each other. This is a primary problem for the contemporary welfare state and a question in which political science and economics collide (Pierson and Castles, 2006). Data that consistently distinguish between the income distribution before and after taxes and transfers are used, which is a precondition to discern between inequality as such and redistribution. Moreover, generic measures of inequality across the population are used where top and bottom coding is applied, as well as enrichment at the top, captured by top shares (Atkinson *et al.*, 2011).

> *Q3: How can we theoretically and empirically understand the linkages between inequality and economic growth on the one hand, and redistribution and economic growth on the other?*

Having introduced redistribution as a key element of this doctoral study, the next question is whether preferences for redistribution are affected by inequality or its drivers. Even though it is often mentioned as a key cause of rising earnings dispersion in the labour economics literature, technological change has not received attention in comparative political economy accounts of determinants of redistribution preferences. Current advancements in technological change are said to be capable of substituting routine work by capital (Goos *et al.*, 2014). Chapter 5 examines whether individuals in routine task intensive occupations favour higher levels of redistribution as a means of public insurance. Reintroducing the sectoral approach, the chapter also analyses whether this relationship becomes stronger for individuals working in sectors that are more exposed to technological change. By doing so, the analysis aims to bridge the gap between studies emphasising occupational risk exposure influencing redistribution preferences, and studies that underline differences in risk exposure across sectors. Moreover, the role of personal income in shaping redistribution claims is revisited. Personal income is allowed to have a direct negative effect on the level of preferred redistribution in the spirit of Meltzer and Richard (1981), whilst it can accentuate the effects of risks resulting from technological change on redistribution preferences as individuals have relatively more to lose from automation.

Q4: Do individuals in routine task intensive occupations prefer higher levels of redistribution as insurance against the increased risk of future income loss due to automation? Is this relation stronger for persons employed in sectors that are particularly exposed to technological change and for richer individuals who have more to lose from automation?

Chapter 6 deviates from the earlier chapters in that it addresses actual social policy development in welfare states rather than inequality per se. Moreover, it is more conceptual in nature and based on a qualitative empirical approach. Although structural processes of welfare state development have been examined frequently, there is a caveat in knowledge on reactive policy strategies. The chapter aims to fill this gap by examining the reactive policy strategies of three countries representing the main welfare state regime types, namely Germany, the UK, and Sweden. By doing so, it provides a test whether structural policy development theories, namely the convergence and path dependence theories, can explain the policy strategies followed by these countries in response to the Great Recession.

Q5: Do the social and unemployment reactive policies adopted in Germany, the UK and Sweden in response to the Great Recession in 2008 and 2009 differ systematically and if so, can we use long-term policy development theories to explain these differences?

1.4 Conceptual choices

In my dissertation I aim to provide insight into income inequality and social policy development. I confine myself to income when discussing inequality, rather than for instance wealth, consumption, or income accounted for in-kind benefits. Income is widely considered to be a measure of utility or welfare (Sen, 1992). Having income is a precondition for consumption in a capitalist system, though it clearly does not paint a full picture of social welfare.

Income is a flow variable; I will not devote any attention to its stock counterpart, wealth. While acknowledging the existence of wealth inequality – one only needs to consult Piketty (2014) to gain insight into highly skewed wealth concentration at the top – earnings and wealth inequality do not necessarily share the same trends, causes, or have a similar impact on growth or redistribution preferences (*e.g.*, Alvaredo *et al.*, 2013; Ansell, 2014). I will also not look into the distribution of consumption expenditures. The actual consumption of goods is arguably more directly linked with utility than income, or the means available for consumption. Yet, consumption contains a stronger personal element – an individual voluntarily fasting would be considered poor (Sen, 1992; Morelli *et al.*, forthcoming). Furthermore, I will ignore in-kind benefits, such as publicly available services, even though in-kind benefits have redistributive effects as well (OECD, 2008a; Paulus *et al.*, 2010). The main reason for excluding the distribution of wealth, consumption, and in-kind benefits in this thesis is the availability of comparable data across countries and time.

In Chapters 2 and 3 of this thesis I will focus on earnings inequality and wage differences across sectors and skill groups. Rising income inequality is mainly a consequence of growing disparities in earnings. This also explains why factors that likely affect earnings patterns are addressed, namely labour market institutions, international trade, and technological change. I broaden the income definition in my analysis on associations between inequality, redistribution, and economic growth. I apply both disposable and market income as well as their difference as a proxy for the absolute level of redistribution, since we might theoretically expect distinctive effects of these different income definitions and redistribution on economic growth (Kenworthy and Pontusson, 2005). For instance, the distribution of disposable income might negatively affect growth by leading to more social unrest. A more unequal distribution of market income could hamper growth when this leads to more demand and actual levels of redistribution, and when redistribution negatively affects growth (Perotti, 1996).

Having selected income as the locus of distribution, the next step is the selection of units holding a certain level of income. I will delve in particular into the distribution of earnings among individuals and households within sectors and within countries. I use individual earnings and wage shares across skill groups in the sectoral studies on determinants of inequality, since individual earnings can more accurately be attributed to sectors than household earnings. Moreover, sectoral relative employment sizes and shares of hours worked across skill groups are used as additional dependent variables. I correct for differences in household composition using equivalence scales when looking at household income.

I restrict my analysis to OECD countries between 1970 and 2012. Which countries and years are covered exactly differs per analysis and depends on data limitations. The analyses encompass a broad set of OECD countries with diverse political-economic institutions. In emerging countries other factors such as malnutrition or democratic stability might play a crucial role, and data availability and quality are of much greater concern. Moreover, the chosen time span covers the widespread increase in earnings inequality in the developed world, the gradual trend towards international integration especially with developing countries, and the revolution in information technology.

1.5 Empirical and methodological approach

Chapters 2-5 address determinants and consequences of income inequality that are all based on a quantitative design. Most fundamentally, I seek to move beyond generic country-level measures of the variables of interest by using a variety of approaches and data sources. First, sectoral data built from a micro time-series database are used. Moreover, sectoral data that differentiate between employment and wage shares across skill groups are employed. I also apply country-level information, for instance on top income shares, redistribution, and labour market institutions. I will use multiple inequality measures for the country-level inequality indicators to test for robustness, since each measure by mathematical definition is particularly sensitive to shifts at certain parts of the income distribution – or equivalently, since each inequality measure has implicit social welfare judgments. When addressing redistributive claims, occupational and sectoral information on risk exposure are combined.

A few words on the quality of the data seem warranted. Crucial to my comparative design is that the income definitions are standardised across countries and time. I use secondary cross-national datasets from the OECD, LIS, EU-KLEMS, and the Standardised World Income Inequality Database in which the income definition is made consistent as adequately as possible. Moreover, the LIS and EU-KLEMS data I use allow for a consistent identification of sectors. Nevertheless, their comparability has its limits. The aforementioned datasets try to cope with consistency, but are still constructed on the basis of country-specific surveys (Atkinson and Brandolini, 2001; Atkinson, 2008; OECD, 2012a). I try to minimise these issues by testing whether my results are sensitive to the choice of dataset, if possible. LIS data play the most prominent role, since in this dataset the country surveys are harmonised using consistent definitions and concepts (Morelli *et al.*, forthcoming).

I base my regressions on a pooled time-series cross-section design exploiting variation across countries and time. Such a design permits correction of unobserved heterogeneity. I employ multiple estimation techniques, depending on the nature of the dependent variable, the data, and the question at hand. In an ideal world, I would analyse effects and consequences of income inequality and social policy development in a randomised and controlled setting across sectors, occupations, and countries over time. Since this is not feasible, possibilities of reverse causality hamper a causal interpretation of the found associations. This specifically holds true for the analysis of 'grand' associations between income inequality, redistribution, and economic growth. I will further reflect on these issues in the specific chapters.

Chapter 6, in which I examine social and unemployment crisis response policies, makes use of a comparative country case selection. As my objective is explicitly country-specific – I examine whether the crisis responsive policies fit with the historical-institutional tradition of three archetypal country cases – a qualitative approach seems most appropriate. The three selected European countries, Germany, Sweden, and the UK, differ maximally in their institutional legacies, but all experienced a sudden shock to their GDP and employment levels in 2008 and 2009. Obviously, the fact that I examine the policy strategies of three non-representative countries to one crisis decreases the generalisability of the findings.

1.6 A READER'S GUIDE

The following two chapters focus on determinants of rising earnings dispersion in developed countries. Chapter 2, *Taking the sector seriously: Data, developments, and determinants of sectoral earnings inequality and employment*, co-authored by Chen Wang and Olaf van Vliet, maps trends in intrasectoral inequality across 8 OECD countries based on micro data, and relates these trends to differences in exposure to international trade, technological change, and labour market institutions. Chapter 3, *Competing with the dragon: Employment and wage effects of Chinese trade competition in 17 sectors across 18 OECD countries*, co-written by Olaf van Vliet, zooms in on trade competition with China, which might have distributive effects across skill groups given the country's large share of low-wage labour.

Chapters 4 and 5 move from determinants to possible economic and political consequences of rising levels of income inequality. Chapter 4, *Is it the income distribution or redistribution that affects growth?*, addresses linkages between income inequality, redistribution, and economic growth at the macro level. Chapter 5, *Technological change as a determinant of redistribution preferences*, co-authored by David Rueda, analyses whether individuals whose occupations are more exposed to risks resulting from technological innovations demand additional redistribution as a means of public insurance.

Chapter 6, *Falling back on old habits? A comparison of the social and unemployment crisis reactive policy strategies in Germany, the UK, and Sweden*, written with Heejung Chung, looks at the development of social and unemployment policies adopted by three countries in response to the Great Recession.

I end this doctoral thesis with a summary of the main results in Chapter 7, *Conclusions*. In this chapter I reflect on how these findings contribute to the academic literature and on their societal relevance in more general terms. Finally, I indicate a number of directions for future inquiries into inequality and social policy.