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## Inequality in the new knowledge economy

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*Robert D. Atkinson*

An imbalance between rich and poor is the oldest and most fatal ailment of all republics.

Plutarch

While the New Economy has brought renewed growth and dynamism, it has also brought a disturbing increase in economic inequality. Compared to the prior war mass production economy that provided a comparatively egalitarian labour market in which there was robust growth, widely shared, today the US, and a number of other advanced economies, enjoy growth, unevenly shared. Where tens of millions of poor and working families, even ones without much education, were propelled into the ranks of the middle class in the old economy, today we are creating relatively few middle class jobs. Where President John Kennedy could confidently proclaim, ‘A rising tide lifts all boats’, today a rising tide lifts the yachts much higher than the dinghies. Where a confident welfare state ‘leaned into the wind’ of the remaining income inequality with tax, spending and regulatory policies, today’s conservative policies make existing inequalities worse.

Such growing income inequality has not been confined to the United States, although the US enjoys the dubious distinction of having the highest income inequality among developed nations. As that old economy exhausted itself in the 1980s and early 1990s, most OECD nations experienced a marked increase in income and wealth inequality as protections for workers at the bottom eroded in some nations, as technical change led to both an increased demand for higher skilled jobs and reduced demand for middle skilled jobs, and

as robust competition in product and labour markets destroyed old egalitarian practices and expectations. On top of this, fiscal pressures and a growing mistrust of government led many nations to significantly trim the welfare state.

Within the United States, these trends, combined with a systematic set of plutocratic tax and spending policies from the Bush administration, have the potential to take America back to the kind of bifurcated society experienced before the New Deal. The stakes are not small. In his book *The Post-capitalist Society* business management guru Peter Drucker warned that ‘there is a danger that the post-capitalist society will become a class society unless service workers attain both income and dignity.’<sup>1</sup> Indeed, the US economy is evolving in the direction in which there are two classes, a prosperous class of knowledge workers and a struggling class of service workers.

While there is considerable agreement among economists over what has happened, there is much less consensus over why inequality has worsened, whether it is a problem and what, if anything, governments should do to address it. Many on the right see growing inequities as actually a spur to growth. Many on the left blame the New Economy’s dynamism and competition and pursue a Don Quixote-like effort to resurrect the old economy.

If we are to develop a third way on income inequality it will have to be based in the recognition that the New Economy has brought about fundamental new realities that can’t be ignored or reversed. It will require new kinds of pro-competition, pro-innovation policies that foster both greater growth and egalitarianism. But it will also require embracing policies such as more progressive taxation, a higher minimum wage, better skills training efforts, and labour law rules that level the playing field for workers engaging in collective bargaining. In short, we need an agenda that takes both growth and progressiveness seriously.

### **The growth of income inequality**

Before discussing this third way agenda, we need to first examine trends in income equality. While economists use a number of measures to assess changes in inequality, one common measure is to compare the changes in income for groups in different income deciles. For example, the 50–10 ratio compares the income of people in the 50th percentile of income to those in the 10th (the lowest). Likewise, the 90–10 compares the highest quintile to the lowest.

Within the United States the 50–10 gap began to grow significantly in the late 1970s and since the early 1990s has grown only slowly. In contrast, the 90–50 and 90–10 wage gaps have continued to grow since the late 1970s.<sup>2</sup> Because growth was slow and unevenly shared from 1979 to 1997, inflation-adjusted after-tax income declined for the lowest 20 per cent of households, increased just 5 per cent for the middle quintile, but skyrocketed more than 250 per cent for the top 1 per cent of earners.<sup>3</sup> One reason is that the earnings of the very wealthy (the top 0.01 per cent) went from fifty times more than the average worker's income in 1970 to 250 times by 1998. For example, the average compensation of the highest paid chief executives went from around \$1.25 million in 1970 to almost \$40 million in 1999. This 'winner-take-most' phenomenon has meant that the share of wage and salary income going to the top 10 per cent, 5 per cent and 1 per cent of taxpayers has not been higher since before the Great Depression.<sup>4</sup> As a result, for at least half the population, twenty years of economic growth have produced few gains, in part because over one-third of the total increase in US GDP over this period went to the richest 1 per cent of wage earners. Those lucky enough to be in the small elite group, whether they are chief executives, entertainers, sports figures, attorneys or doctors, have been able to increasingly live 'lifestyles of the rich and famous'. In fact, were the top 5 per cent of earners getting today the same share of national income as they did in 1978 and the economy were the same size, the average worker in America would enjoy earnings of \$6,100 more per year.

Growing income inequality is not confined to the United States; most OECD nations have seen increases.<sup>5</sup> Smeeding found that between the mid-1980s and mid-1990s inequality grew significantly in seven of eleven OECD nations.<sup>6</sup> Canada, Finland, Germany, Great Britain, the Netherlands, and Sweden all saw incomes get more unequal.<sup>7</sup> For example, in the United Kingdom the richest 20 per cent earned four times as much in 1977 as the poorest 20 per cent, but seven times as much by 1991.<sup>8</sup> The richest 0.1 per cent of earners did even better, seeing their share of income increasing from around 1 per cent in 1978 to 3.5 per cent in 1998. However, not all nations have seen increases. For example, income shares have remained relatively constant in France.

Not only has the distribution of incomes gone out of kilter, but so has the distribution of jobs, as the share of those with middle income wages has shrunk. Wright and Dwyer found that during the 1990s there was 'strong growth in the top tier of the employment structure, moderately strong at the bottom, and extremely weak growth in the middle'.<sup>9</sup> Of the 15 million full-time jobs added between 1992 and

2000 almost one-third were in the top quintile, only 6 per cent in the middle, and 20 per cent in the lowest. This contrasted significantly with job growth in the 1960s, where the fewest jobs were created in the lowest wage quintile and the most in the highest. However, starting in the 1980s the 'U' shaped pattern of job growth began to replace the prior 'stair-step' pattern, and it became more pronounced after 1992. As a result, during the 1990s the job pattern was one of polarized growth, albeit weighted towards better jobs.

Unfortunately, this pattern has gotten even worse in the 2000s. While the economy lost over 825,000 jobs from 2000 to 2003, 540,300 jobs in the lowest-wage quintile were added, while 451,400 jobs in the middle quintile and 560,800 jobs in the fourth wage quintile were lost. The top two quintiles also lost jobs, 358,000, but considerably fewer.

Great Britain has experienced similar trends. Goos and Manning found that between 1975 and 2000 there was an increase in what they call 'lousy and lovely jobs': the lovely, best paid jobs, mainly in finance and business service sectors, and the lousy, worst paid jobs in occupations such as waiters, porters, shelf-fillers and checkout operators. Together with a decline in the middle-level clerical and skilled manual jobs in manufacturing, both Great Britain and the United States have seen a rising polarization in the quality of jobs and increasing wage inequality.<sup>10</sup>

Apologists for the current structural trends argue that they are simply temporary results of an economic slowdown in the United States. Yet the US Bureau of Labor Statistics forecasts that these trends are likely to continue. Between 2002 and 2012, BLS projects that jobs in the highest two wage quintiles and the lowest wage quintile will grow the fastest, with jobs in the third and fourth quintiles – the working and middle classes – growing much more slowly. Of the thirty-nine occupational categories where BLS predicts a loss of 5,000 or more jobs, only one, sewing machine operators, is in the lowest wage quintile. None is in the highest. In contrast, of the projected fifteen fastest growing occupations, six are in the lowest quintile and three are in the highest. For example, BLS predicts that in 2012 there will be 454,000 more fast food workers making \$15,150 and 376,000 more operations managers making \$83,590.

### **Why has income inequality increased?**

Scholars have posited a wide range of factors for the increase in inequality. Indeed, there is considerable academic debate over the

causes. Because of the complexity of the issue, while there is some consensus on the causes, there is also considerable disagreement as well as some uncertainty as to the complete causes.

Within the United States, some of the growth in the 50–10 ratio, and to a lesser extent the 90–10 ratio, appears to stem from the decline in the real value of the minimum wage, although it does not appear to account for the continued growth in the 90–50 earnings ratio since those making median income are well above the minimum wage. Autor et al. report that a simple regression of the 90–10 log hourly wage gap for the years 1973 to 2003 on the real minimum wage yields an R-squared of 0.71, a strong and positive relationship.<sup>11</sup> While the US Congress regularly raised the minimum wage to keep up with inflation, it reached its peak (in constant dollars) in 1979 and fell 37 per cent during the Reagan and Bush I administrations as the 50–10 and 90–10 ratios increased. In contrast, during the Clinton administration increases in the minimum wage helped it regain some of its lost value and the rise in the 50–10 and 90–10 ratios slowed considerably. This is not to say that other factors did not also play a role in the 1990s. Clearly, the strong labour market and low unemployment rate during the Clinton administration helped raise wages at the bottom of the labour market, just as the weak labour market of the Bush administration has suppressed wages at the bottom and middle of the labour market. Moreover, the higher productivity growth rates of the Clinton administration, particularly the second term, compared to the relatively weak rates of growth of the prior fifteen years made it easier for wages to increase across the board. As Frank Levy notes, ‘the fast rate of average wage growth [in the 1950s and 1960s] was a safety net for change. By the time of the 1981 blue-collar recession, this safety net had disappeared.’<sup>12</sup>

The 50–10 and 90–10 gaps widened also because of the increasing wage gap between college educated and non-college educated workers. Since most low wage workers do not have a college degree, an increase in the college premium could contribute to increased income inequality. Starting in the 1980s there was a sharp slowdown in trend growth in college graduates, while the demand for college graduates continued to grow.<sup>13</sup> As a result, while the earnings premium for college graduates relative to high school graduates averaged around 25 per cent during the 1960s and 1970s, it rose steeply in the 1980s, reaching around 50 per cent for the first part of the 1990s and 70 per cent in 2000, and falling to 60 per cent in 2002.<sup>14</sup>

Yet, while the college premium thesis is appealing – it leads to a solution virtually everyone supports, more education – it alone cannot be the cause of the widening gap. If it were, then inequality among

college-educated workers would not have increased. Yet from 1974 to 1988 the 90–10 split among college-educated workers grew and then stabilized, while the 90–50 wage gap continued its upward trend. As Auter et al. note, changes in education levels played some role in the growth of 50–10 and 90–10 inequality, but almost no role in the rise of 90–50 inequality.<sup>15</sup>

If the declining minimum wage and the growing college wage premium do not account for this growing gap between the top and the middle (the 90–50 gap), or the significant increase in earnings going to the top 10 per cent, what does account for it? Most economists have looked to explanations involving variables that can be quantified and put into econometric models. One factor they have looked to is the increased use of technology in the economy. This skill-biased technical change argument is intuitively appealing, suggesting that jobs are getting more skilled because of computers and information technology, and therefore demand for skilled workers is going up. However, while technical change appears to be creating higher skill requirements for jobs at the top, it is also leading to a hollowing out of routinized middle wage jobs and an increase in low skill jobs.

Two factors, trade and technology, have helped create a job market that looks like a ‘U’, with lots of high and low wage jobs and fewer in-between. While trade has lowered prices for consumers, at the same time it has not only put downward pressure on wages in some trade-impacted sectors, but also led to the elimination of some jobs, particularly lower middle and middle wage jobs. The Progressive Policy Institute (PPI) calculates that, since the end of 2000, increased imports and decreased exports have contributed to the loss of more than 830,000 manufacturing jobs, with approximately 70 per cent of these jobs in the second and third wage quintiles.<sup>16</sup> The growing trend of companies to move information-based service jobs to low wage nations such as India will only exacerbate this trend. Of the 3.4 million US jobs Forrester Research projects to be lost due to offshoring by 2015, PPI estimates that only 10,000 will be in the lowest wage quintile; almost two-thirds will be in the middle three quintiles.<sup>17</sup>

Technology plays an even bigger role than trade. Looking back over the last four decades, the growth of manufacturing in the 1960s and 1970s played an important role in the creation of middle wage jobs, while its decline in the 1980s and 1990s led to fewer middle wage jobs.<sup>18</sup> Since the end of 2000, higher productivity in manufacturing has been responsible for the loss of 1.1 million factory jobs, most of them paying middle wages. Job loss from automation is not confined to manufacturing. The rise of the digital economy is leading to a new wave of automation – dramatically reducing jobs in certain industries

and occupations, particularly in the 34 million jobs that involve routine processing of information (such as insurance policy processing clerks) or human interactions (for instance, telephone operators). While the increase in service sector jobs in the 1980s helped create middle wage jobs to offset manufacturing jobs lost in that decade, in the 1990s growth in services was more polarized, with service jobs mostly created in high and low wage occupations as the IT revolution helped automate routinized middle wage jobs.<sup>19</sup> For example, this is one reason why the number of travel agent jobs declined by 6,580 in just three years, as more Americans booked their own trips. It's why the Bureau of Labor Statistics predicts that there will be 28,000 fewer telephone operators (average salary \$29,340), 57,000 fewer secretaries (\$26,390), and 93,000 fewer people in word processing jobs (\$27,830) in 2012.

Trade and technology can be a plus since they reduce costs and raise incomes, but they play a role in the increasing polarization of jobs. This is because, as jobs involving routine processing of goods and information are eliminated, two broad occupational areas are expanding. On the one hand the new IT-driven global economy is creating higher wage managerial, professional and technical jobs. Managerial and professional jobs increased as a share of total employment from 22 per cent in 1979 to 28.4 per cent in 1995 and to 34.8 per cent in 2003.<sup>20</sup> In the 1990s, the growth of high tech accounted for over 50 per cent of the increase in jobs paying in the top wage quintile, and business services accounted for approximately another 22 per cent.<sup>21</sup> On the other hand, low wage service jobs in such fields as health care, child care, food preparation and the retail trade are expanding. For example, the occupations with the largest predicted numerical increases over the next decade are cashiers, janitors, retail salespersons and waiters/waitresses, all lower skill, lower wage occupations. In fact, of the ten occupations with the fastest projected wage growth between 2002 and 2012, three are in the top quartile when ranked in median earnings, none are in the second quartile, two are in the third, and five are in the lowest quartile.<sup>22</sup> These jobs are growing in part because they are hard to automate and because many are in non-traded sectors where lower skilled workers in developing nations cannot do the work.

As more people gain high wage and low wage jobs, income inequality can be expected to grow. Goos and Manning find that within the United Kingdom job polarization explains between 33 and 51 per cent of the increase in the log 50–10 differential between 1976 and 1995 and between 54 and 79 per cent of the increase in the 90–50 differential.<sup>23</sup> Similar rates could be expected for the United States.

But even if job polarization is taken into account, it still cannot explain all the changes in income inequality in the US, particularly changes within occupational categories; the fact that the very top-level earners have seen their incomes go up so much; and the fact that wages at the bottom have declined as demand for low wage labour has grown. With regard to the latter, standard neoclassical economic theory suggests that if demand expands, so should price (in this case, wages). There are several reasons why wages at the low end have not increased faster than at the top. First, rapid immigration into the United States, particularly of lower skilled Hispanics, coupled with the rise of global production systems employing wage workers in developing nations has meant that the effective supply of low wage labour has grown. Moreover, the low minimum wage combined with reduced unionization makes it easier for employers to create low wage jobs.

Non-market and institutional changes – changes that are hard to quantify and put into models – appear to have played important roles in explaining top level wage inequality. In the last two decades changing social norms have increasingly legitimized more unequal incomes. When Michael Douglas's character Gordon Gecko proclaimed in the 1980s movie *Wall Street* that 'Greed is good' he was reflecting a changed social ethos that much larger and growing distributions of income were now acceptable, even desirable.

While a new ethos may have legitimized higher income inequality, the erosion of old rules and constraints and the rise of intense competition have been the key driver enabling it. The new economy's intensely competitive markets drive companies to pay more at the top and less at the bottom. The global marketplace means that competitors now contest firms in more markets.<sup>24</sup> Twenty-five years of government deregulation has boosted competition in a host of industries. Ever increasing pressure from securities markets to raise shareholder value has meant that maximizing shareholder value has become the overriding goal of most companies. As Michael Useem observes, in the old economy, 'Managerial capitalism tolerated a host of company objectives besides shareholder value. Investor capitalism does not.'<sup>25</sup>

This heightened competition means that organizations reward workers differently. During the era of managerial capitalism workers were usually paid on the basis of seniority, not on performance or marginal productivity. Moreover, there was little market pressure on companies to force down wages at the bottom, and considerable social pressure not to do so. Most individuals worked their way up organizations and organizations would usually look to within for top management talent, abiding by informal anti-raiding norms.<sup>26</sup>

Indeed, as late as the 1970s it was unusual for mid and upper level executives who were seen as ‘company men’ to ‘jump ship’ and go to work for a competitor. Moreover, higher levels of unionization and national, industry-wide bargaining patterns moderated wage differences between and within industries and occupations. Finally, high marginal taxes acted as a break on high salaries, since it was expensive for companies to reward top executives, because they would ‘lose’ most of it to the government. All these factors acted as brakes on too much inequality.

However, as the New Economy emerged, with its intensely competitive markets and self-interested ethos, companies increasingly sought to cut costs, including wages at the bottom, and the ‘market’ was willing to bear it. As competition increased, wages became increasingly based on the marginal productivity of workers, with more highly productive and valuable individuals getting higher raises and bonuses. Moreover, what were once internal labour markets became external ones, with companies willing to hunt for the best talent and bid up their compensation to get them.<sup>27</sup> Likewise, as the ‘organization man’ became replaced by the ‘free-agent man’, individuals have become much more willing and likely to leave organizations in search of the best deal.<sup>28</sup> Economists Robert Frank and Phillip Cook have termed this the ‘winner-take-all’ phenomenon. They argue that such winner-take-all (or more accurately ‘winner-take-most’) markets ‘have permeated law, journalism, consulting, medicine, investment banking, corporate management, publishing, design, fashion, and even the hallowed halls of academe’.<sup>29</sup>

Recent trends in one industry – the symphony orchestra industry – illustrate these trends. In the last decade, symphony orchestras have been under considerable competitive pressures, with audiences shrinking, recording contracts drying up, and government and private donations dropping. Because competition has gotten so intense, orchestras have embarked on intense competitive efforts to attract the best top level talent of orchestra executives and conductors. Not surprisingly, their pay has skyrocketed. The head of the Boston Symphony made \$349,923 in 2003, while the conductor of New York Philharmonic earned \$2.28 million in 2003 for just fourteen weeks worth of work, plus their annual tour. Star performers are increasingly sought in order to attract a shrinking audience, and because of this are able to command a significant premium. (Yo-Yo Ma, for example is said to pull down \$65,000 to \$70,000 per performance.) At the same time, since overall revenues are stagnant, the wages for the average performer have also stagnated and in some cases declined. The annual salary of the average violist will often not even top what a virtuoso

like Yo-Yo Ma might make in one night. Moreover, to make ends meet, some orchestras are implementing staff cutbacks and wage freezes, and increased use of part-time workers. While the orchestra industry represents only a small segment of the US economy, similar patterns can be seen in most US industries.

### **Is rising inequality a problem?**

While most observers across the political spectrum agree that the distribution of income has become more unequal, they don't agree on whether this is a problem or whether anything should be done about it.

Many conservatives blithely ignore rising earnings inequality, in part because they claim that as people move through the labour market, most spend only short periods of time in low wage jobs. Conservative economists Cox and Alm argue that 'annual snapshots of the income distribution might deserve attention if we lived in a caste society, with a rigid class line determining who gets what share of the national income – but we don't live in a caste society.'<sup>30</sup> They cite University of Michigan panel data showing movement. For example, only 5 per cent of individuals in the lowest income quintile in 1975 were there in 1991. However, there are two problems with their logic. First, a considerable portion of the movement of individuals from low wages to higher wages over the course of their lifetime occurs as students or workers in their first jobs gain higher wage work. Even chief executives started out making a lot less. Second, while there is some movement, it's not completely fluid. For example, of the individuals in the highest income quintile in 1975, fully 86 per cent were in the fourth or fifth highest quintile by 1991. This is not to say that there is not some movement of lower income persons into higher income quintiles, or that public policy should not encourage more movement. However, to blithely dismiss the problem of inequality as one that is really only about temporary stops at stages of life is to ignore the significance of the problem.

Conservatives also try to deflect concerns by claiming that while inequality might be unpleasant, it's inevitable. Cox and Alm argue: 'America isn't an egalitarian society. It wasn't designed to be.'<sup>31</sup> But it's absurd to argue as the right does that there are only two choices: a Communist society with perfectly equal distribution, and our capitalist society with whatever distribution happens to be in effect. Of course there are and should be inequalities – high wages reward the

acquisition of high skills. The real question is whether they should be as extreme as they are today.

The right says large gaps in income fuel growth as they motivate people to work hard and take risks. They argue that ‘in developed nations . . . economies have tended to do better when inequality is higher.’<sup>32</sup> Moreover, they warn that efforts to redistribute incomes may ‘undermine economic growth and create an authoritarian government that opposes our freedoms’ (such as the freedom to be taxed less).<sup>33</sup> Yet the link between higher levels of inequality and higher levels of economic growth is tenuous at best. If they were linked, why did the US economy grow faster in the 1950s and 1960s, when income inequality was lower, than in the 1980s and 1990s, when it was higher? Why did the economy grow in the 1990s after Bill Clinton restored the top marginal income tax rates back to their higher 1980s levels, lowering after-tax inequality?

Finally, even if inequality spurred growth, there might still be cause to question the high levels in the United States. While there is no doubt that strong economic growth is a precondition for progressive outcomes, it is not always enough. In this regard it’s worth comparing Germany and the United States. During the last half of the 1980s and the first half of the 1990s, average incomes went up 15.5 per cent in the United States and just 10.4 per cent in Germany. But looking at median hourly income reveals a different story. US median hourly income actually went down 2 per cent while German median income went up 14.7 per cent. In other words, Germany saw less growth, but a significantly greater number of people benefited from it.

If the right celebrates the new inequity in an almost Panglossian way, many on the left reject the New Economy and its accompanying inequalities and instead try to resurrect the old postwar economy with its greater stability, more equal incomes and more egalitarian policies, even if it means sacrificing growth. The left’s focus on stability and equity even at the expense of growth grows out of a long liberal tradition. Within the United States it is perhaps best articulated by the late John Rawls, a Harvard social philosopher. Rawls’s influential 1971 book *A Theory of Justice* sought to establish bedrock principles that people could agree would lead to a just society. One of them was the principle of ‘original position’, where Rawls postulated that we should judge the ethical value of a particular economic arrangement based on no knowledge of our own individual economic or social position. In this position, Rawls argues, a reasonable, moral and self-interested person would support an economy that led to two people getting \$1,000 more and that this outcome would be just. What if one person gets \$1,000 more and the other only half, \$500? Would this be just?

Rawls answers that it would be, since both parties benefited. What if one person gets \$1,000 more and the other, nothing. To Rawls, this is an unjust outcome even though society as a whole is \$1,000 better off and the allocation of that \$1,000 is based on chance. Rawls's philosophy is a cornerstone of liberal democratic thinking and the source of their focus on distribution, for it sees income growth as bad if it leads to inequality.

Robert Reich reflected this philosophical position when he led a discussion with some college students when he was Secretary of Labor in the Clinton administration. He stated:

I am concerned about the direction that the country is heading with regard to inequality. Let me ask you for a show of hands. Let's assume that I could offer you a deal, and I want to know how many of you would accept [it] . . . 'You have a choice either between the current economy, with all the good news and all the problems it has . . . or I will offer you a deal in which the top fifth of income earners get a 25 percent raise and the bottom fifth get a 10 percent raise.' Now the net result is more inequality than we have today, but everybody is better off . . . How many like that deal? Put up your hands. Have the courage of your convictions. Hands high in the air. This is a learning experiment here. OK. There are twenty-eight. How many of you do not like that deal? That's interesting. Sixty-three.<sup>34</sup>

Sixty-four, if Reich's vote is counted. In other words, even though low income Americans are better off today than they were in 1970, this is not an acceptable outcome because upper income Americans are even richer. Clearly Rawls's first choice, both groups getting the same amount, is the best. However, to reject an economy where everyone gains but where those at the bottom gain less is to lose sight of the fact that the progressive goal should be to raise incomes of the less advantaged. Again, this is not to suggest that the current unequal distribution of incomes and wealth is fair or even necessary – it is not. However, being ambivalent about growth is not the answer.

### **What should we do?**

Many conservatives will say that if we intervene to make society more egalitarian we will only reward laziness and penalize hard work. Many liberals will say that equality is more important than growth, and thereby call for measures, such as trade and other job protections, that would slow growth. In contrast to conservatives, third way centrists believe that high levels of income inequality are a burden on

economic growth. We believe, to paraphrase John Kennedy, that a rising tide is needed to lift all boats, but unless everyone has solid boats a rising tide may lift yachts the highest. In contrast to liberals, we believe that a robust growth agenda that supports high levels of market competition is a core component of an agenda to reduce income inequality.

When confronted with a labour market that has become more unequal, the default position of many across the political spectrum is to favour policies to help low wage workers improve. The right attributes income inequality to a lack of motivation and work ethic and suggests that improvements in character would solve the problem. The left argues that institutionalized racism and sexism keeps low wage workers down. All sides agree that more education and skills are the principal tonic for inequality. For example, when recently asked by members of the US Congress what the federal government should do about rising levels of inequality, Federal Reserve Bank Chairman Alan Greenspan counselled more skills, arguing that 'we have not been able to keep up the average skill level of our workforce to match the required increases of increasing technology.'<sup>35</sup> While there is no doubt that increased education is important, particularly in helping people who are now in the middle class move to the growing number of higher wage, higher skill jobs, more education will do little to affect the growing 'U' shaped distribution of the labour market. If the labour market keeps up its bifurcating path into more low and high wage jobs, unless we take other steps, simply providing more education and training for workers will not stop lower paying jobs from growing faster than middle paying ones. While it's true that more education can help an individual move from being a cashier to an accountant, for example, more education will not create relatively more accountant jobs and relatively fewer cashier jobs. In this case, social outcomes are quite different from individual ones.

This is not to say that efforts to boost education and training will not play a role in reducing income inequality or helping individuals move out of poverty, but by itself, it is likely to fall short. To make significant changes we need to adopt two kinds of policies. First, we need policies that work to shift the occupational structure of the economy so that there are relatively more higher skilled jobs and relatively fewer lower skilled jobs. Second, we need to put in place policies that help low wage jobs become more productive and help low wage workers earn more, including more after-tax income.

The first step means embracing what PPI has referred to as a robust growth economics agenda. Growth is important because the historical record suggests that while a rising tide is not always enough to lift all

boats, without it, it's hard to lift all boats. This means putting in place an innovation agenda that not only boosts the rate of growth, but shifts the supply of jobs more towards the higher end. Only by building on its strengths in innovation will America be able to maintain its advantage and move into higher value-added work. To do this steps should be taken such as expanding public funds for research, boosting the R&D tax credit, and developing a national IT strategy to accelerate the transformation to a digital economy.<sup>36</sup> It also means policies to ensure robust competition, including global competition, fiscal discipline to keep interest rates low, and a monetary policy that tilts towards keeping unemployment low.

Expanding the number of higher wage, knowledge based jobs and running the economy at full capacity so that labour demand is high will help, but more needs to be done. Policies need to encourage the transformation of routine, lower skilled work into higher skill, more fulfilling work. We need to take Drucker's advice when he argued that 'to make service work productive is the first social priority of the post-capitalist society, in addition to being an economic priority.'<sup>37</sup>

There are two steps governments should take. First, policies should encourage companies to automate low wage jobs. To take one example, if government transportation departments created stronger incentives to use electronic EZ pass systems, most low wage toll-taking jobs would be eliminated within a few years, allowing the workforce to be reduced through attrition or transfer to other transportation jobs. There are a host of other opportunities to automate low-end work. For example, more robust deployment of radio frequency identification devices (RFID) and e-commerce would help automate retail trade jobs. Some have argued that if technological innovation enables a larger share of lower skill jobs to be automated, this will only reduce the demand for low skill workers, reducing their wages as well.<sup>38</sup> However, it is important to note that if more low wage jobs were automated, the occupational mix of the economy would shift towards more skilled and more highly paid jobs, raising incomes for workers. If coupled with better training programmes for workers, this shift would lead to increased economic welfare for workers currently in lower skill, low wage jobs.

One problem holding back automation of low-end jobs is that, because the pay for them is so low, especially within the United States, companies have little economic incentive to substitute capital for labour. This is one reason, as discussed below, why modest increases in the minimum wage make sense. Some might argue that raising the minimum wage would boost unemployment, and they point to Europe as a case in point. However, this confuses microeconomic forces with

macro. Overall job creation in an economy is more related to macro-economic policies that affect an economy's demand for products and services. A significant reason for high levels of unemployment in Europe is the fact that unemployment insurance policies are so generous (in amount and tenure) and as such shift considerable consumer demand from the employed to the unemployed. Because workers are consuming less (because of the high unemployment insurance taxes) and because unemployed workers are consuming without producing, many European national economies remain stuck in an equilibrium of high levels of unemployment. In sum, to the extent a higher minimum wage has any labour market effect it is to shift job creation to higher wage work.

Second, workforce policies should encourage companies to remake bad, unskilled, dead-end jobs that cannot be automated into good, skilled and enriched jobs. To do this, companies need to capitalize on what are called economies of depth (such as copier technicians being able to rely on their own expert knowledge and problem solving) and economies of coordination (such as flight attendants, gate agents, baggage handlers and pilots working together to prepare an aircraft for take-off).<sup>39</sup> In other words, companies that now employ workers in low skill work environments need to find ways to enrich these jobs by methods that rely on workers' own knowledge and skills. One way to spur more kinds of high performance work organization efforts like this is to target government training funds at firms and groups of firms that are explicitly seeking to put in place high road strategies. The Blair administration in the UK has taken the lead in this area through its Sector Skills Council Initiative.<sup>40</sup> In the United States, Congress could do this by creating a quasi-public National Skills Corporation to fund industry-based skills partnerships.<sup>41</sup>

At the end of the day, even with automation and work enrichment, there will be still be low wage jobs. This means that even though people are working they may be poor. As a result, we need to take steps to ensure that the folks working in low wage jobs then have the opportunity to do reasonably well economically. Ensuring that workers have a reasonable right to engage in collective bargaining would be one step. Unions are making significant efforts to organize lower wage workers, but current laws and regulations make it more difficult. Raising the minimum wage and then indexing it to inflation would help create a floor under incomes at the lower end of the labour market. Sustaining the earned income tax credit that was expanded under the Clinton administration and is under attack by the Bush administration would ensure that people on low incomes continue to receive important support.

Finally, we need to consider policies that address the fact that even in the face of a growing and more dynamic economy, many of the gains have gone to a small share of top earners. This 'winner-take-most' phenomenon is not likely to change any time soon, as it stems from changed institutional, market and cultural factors.

The right either ignores the issue or offers broad platitudes like 'boost the skills . . . of those workers on lower rungs of the skill ladder.'<sup>42</sup> Even worse, the Bush administration tax cuts for the highest earners is blowing a typhoon at the back of growing inequality. In contrast, many on the left would want to stem growing inequality by attempting to tackle its root causes, such as globalization, immigration, heightened competition and technological innovation. But any attempts to restore the structure of the old, more equitable economy would be to throw the baby out with the bathwater, limiting the key gains that the new economy produces.

There are at least two ways to address this problem without harming economic growth. First, increased shareholder activism might help curb runaway chief executive and top executive compensation, particularly compensation that is not tied closely to corporate performance. For example, many companies are now adopting stock option plans that tie options to the financial performance of the firm. Developing corporate governance reforms that encourage shareholders, particularly large institutional ones, to better tie executive pay to performance can help.

However, even if top executive pay was more closely tied to performance there would still be significant income inequality in the corporate and professional sector. As a result, we need to consider how tax policy can be used to lean into the wind of growing income inequality. In fact, more progressive taxes may be the best and most market-friendly solution to rising inequality. More progressive taxes do not attempt to change the dynamics of the economy, but they do address the results of an economy that in its working produces increased inequality.

As a result, the Bush tax cuts on the top marginal income tax rates, on dividends, capital gains and inheritances should be repealed. In addition, social security taxation should be made more progressive by raising the top cap on wage and salary income on which social security taxes are applied. There should also be a commitment that Americans' after-tax incomes will not grow any more unequal than they were in 2000 before the Bush tax cuts were instituted. This could be done by indexing income tax rates on the top earners to growth in income inequality. To ensure that after-tax inequality gets no worse than it was in 2000, top income tax rates would be increased to 2000 levels. After

this, top tax rates would be increased if necessary, up to a fixed rate (such as 50 per cent), to keep after-tax income inequality from getting any worse, but rates on other Americans would be lowered an offsetting amount so that any changes are revenue neutral.<sup>43</sup> As long as the US economy keeps growing, high earners would continue to see their after-tax incomes grow, but at a growth rate no faster than that of all Americans.

## Conclusion

George Orwell once stated, ‘We of the sinking middle class may sink without further struggles into the working class.’ Orwell was wrong then, but for many Americans it is possible that there will be downward pressure on the wages of many workers in the middle, as well as relatively fewer middle jobs. The consequences of an increasingly polarized labour market are not insignificant. For years people have spoken about the American dream of owning a home, doing better than your parents. But this was always more than just doing better, it was a dream about all Americans moving up. Indeed, Bill Clinton captured this when he stated, ‘We need a new spirit of community, a sense that we are all in this together, or the American Dream will continue to wither.’ If we don’t address growing inequality, then indeed the American Dream will wither.