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# An economic analysis of social exclusion and inequality

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ABSTRACT

This article proposes a theoretical framework for understanding the nature of institutions, contributing to the emergence of the divergence in earnings. In the article, social exclusion is considered as a direct consequence of unequalized opportunities. The population consists of both qualified and unqualified workers. The article shows that there is a threshold level of average performance by unqualified workers below which only qualified workers can earn the higher wage rate. Social exclusion shapes the structure of incentives, and thereby can in itself be the cause of differences in economic performance.



## 1. Introduction

The idea that institutions matter has gained wide currency in recent years. Institutions are profoundly social, and are constituted by collectivities of people who associate with each other.[1] Institutions are the laws, informal rules, and conventions that give a durable structure to social interactions among the members of a population (Bowles, 2004). Institutional structure shapes beliefs about how people behave. Institutions constrain group members by forbidding some alternatives and choices of actions, and empower them by making some alternatives and choices of action possible. But is the concept of institutions useful in studying inequality?

This article presents a theory of institutional inequality to understand the structure of labor market inequality. The theory shows how differences in institutions lead to differences in economic outcomes. Institutions may result in low levels of economic performance. Institutional aspects of poverty encompass the wide range of hierarchical systems and relationships in society based on factors as varied as social class, gender, race, ethnicity, age, language, and region. A discriminatory regime affects the structure of opportunities open to different social groups.[2] Ethnic minorities and women are denied access to the lucrative occupations and, thus, are represented in low-paying jobs. The key idea is to relate wage payment differentials to unequalized opportunities on entry into occupations.

A large number of economic literature has studied the effect of technological innovation on the distribution of income. On the contrary, this article proposes an analytical framework for understanding the nature of institutions, contributing to the emergence of the divergence in earnings. It aims to understand how economic inequality is structured by demonstrating the effects of the institutional environment on economic performance. Labor earnings are the most important component of income for workers. The level of wage inequality plays an important role for understanding poverty and social stratification.

The concept of social exclusion has encouraged scholars to consider simultaneously the economic, social, and political dimensions of deprivation.[3] Originating in France in the 1970s and diffusing rapidly in Europe, the framework is concerned with full participation in all aspects of social life as an end in itself. Social exclusion is

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[1] Following North (1990), institutions are the rules of the game of a society, and consist of formal and informal constraints constructed to shape human interaction. In consequence, they structure incentives in human exchange, whether political, social, or economic.

[2] Becker (1957) is the seminal work on labor market discrimination. He analyzes the relationship between racial prejudice among whites and discrimination against blacks in a perfectly competitive environment. His model represents prejudice as a distance for cross-racial contact. Prejudice causes an employer to behave as if black workers' monetary wages are higher than they actually are.

[3] The concepts of poverty and social exclusion are related and, to some extent, complementary, even though they are not the same (Atkinson, 1998).

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the opposite of social inclusion which reflects the perceived importance of being part of society. A decline of inclusion generally falls most heavily on the economically disadvantaged. The disadvantaged have a right to inclusion in society. Discussions of exclusion tend to focus on the phenomena of poverty, unemployment, low educational attainment, and barriers to social and political systems. Social exclusion is a repute of social bonds. The least skilled have huge difficulties in finding a decent job, which gives them the feeling that they are not useful members of society. They choose from an impoverished opportunity set. Work fulfills the desire to have a place in society. An individual's non-participation in society is due to circumstances outside his or her control.

Social exclusion is, however, a contested term, lacking real agreement over either its definition or its causes. Socially excluded individuals suffer generalized disadvantage in terms of education, training, employment, housing, financial resources, etc. Their chances of gaining access to the major social systems are substantially less than those of the rest of the population. The 1990s marked the era when social exclusion discourse really proliferated in many European countries. A core element of New Labor's approach in Britain, articulated by Blair on his election in 1997, is "education, education, education", which aims to create citizens fit for the jobs that exist. People with low-wage prospects would improve their qualifications through additional education to gain a higher wage. Social exclusion is therefore seen as a product of under-achievement, which assumes that poverty is self-induced or the result of personal failure.

In this article, we see social exclusion as a direct consequence of unequalized opportunities. The impoverishment of opportunity sets itself is not seen as the individual's own free choice. There is a substantial minority in the workforce whose expected earnings do not constitute an income sufficient to enable them take part in the mainstream of their societies. Non-participation in society means non-participation in the market economy. On the one hand, technological or organizational change strengthens the tendency toward worker participation; on the other hand, there remains a problem of social exclusion for those who are outside. Unequalized opportunities intrude on the internal structures of organizations.

All people should get the opportunity to realize their full human potential, or to realize their own goals and aspirations. This relates to human dignity. Social exclusion can be related to Sen's concept of capability. Individuals purchase commodities with given characteristics and capabilities (Sen, 1985). In Sen's view, individuals are composed of 'functionings'. Achieved functionings make up a person's well-being, and an individual's capability to achieve functionings, therefore, represents the individual's true freedom. Thus, social exclusion can be defined as a process leading to a state of functioning deprivations.

Economists usually think of discrimination as a set of restrictions on the actions of an oppressed group that prevents members from earning a competitive market return on their abilities. If these artificial barriers are lowered, they expect the standard of living of the discriminated group to converge rapidly with that of the general population. However, some societal discriminatory affects endure once legal barriers are removed. Why have income differentials not been eliminated? The source of persistence in wage differentials lies in the influence of social categories on the individual. At a very basic level, most people are aware of how they are differentiated from their surroundings. People often receive themselves as members of social groups. Institutions are not only external to individuals. Institutions are internalized by group members as identities and selves, and they are displayed as personalities.[4] In the identity model of social exclusion (Akerlof and Kranton, 2000), legal quality may not be enough to eliminate racial disparities, and there can be a permanent equilibrium of racial inequality.

Stereotype-based expectations affect individual performance in the domain of the stereotype. Loury (2002) argues that the ideological legacy of slavery in the U.S. stigmatizes blacks and that stigma is a major factor in the persistence of social inequality. The legacy of discrimination is 'spoiled' collective identities. According to Hoff and Pandey (2006), social identity creates a pronounced economic disadvantage for a group through its effect on individuals' expectations. In their investigation, the public revelation of social identity (caste) affects cognitive task performance. Indian society is divided into groups called castes.[5] The caste system is a form of social stratification that satisfies a given number of features. There is a broad ranking of castes based on the occupations. Occupation choices are restricted, and members of a caste usually follow occupations that the caste has a monopoly over. In Hoff and Pandey (2006), publicly revealing individuals' membership in a group that has been or is being discriminated against impedes the group's ability to respond to economic opportunities. Social identity affects behavior largely because it affects expectations. Belief systems that are the legacy of historical conditions of inequality may give rise to behaviors that reproduce the inequality. The aggregate effect on the society of expectations associated with caste can be viewed as negative.

This article is organized as follows. Section 2 offers some theoretical background on economic inequality. Section 3 introduces the formal model. Multiple equilibrium outcomes are characterized in Section 4. Section 5 discusses why economic performance differs among individuals. Section 6 concludes the article.

## 2. Background

The phenomenon of increasing non-participation in the workforce by the less-skilled is worthy of serious consideration. For example, in the U.S., despite the huge increase in the number of jobs created since 1980, the proportion of less-skilled men who are holding jobs has declined in the 1980s–1990s (Freeman, 1995).

The economic approach to the problem of explaining wage inequality focuses on relative demand for and supply of different types of labor. Looking at the demand side, the growth of wage inequality in the U.S. reflects technological change, which has rendered more-educated workers more valuable to employers than less-educated workers. With regard to the supply side, the compression of wage differentials prior to the 1970s coincided with an increase in the relative supply of more-educated labor. The supply of more-educated labor subsequently failed to keep up with demand, giving rise to sharply increasing returns to education.

The increase in skill differentials in U.S. manufacturing over the 1980s has been well documented (Murphy and Welch, 1992; Katz and Murphy, 1992). The rise in the wage premium for skilled labor is typically understood with a conventional supply and demand model as the result in a large rightward shift in the demand function (Johnson, 1997). The literature shows that the rise in earnings inequality in American manufacturing during the 1980s is attributable to skill-biased technological change. Skill-biased technological change means technological progress that shifts demand toward more highly skilled workers relative to the less skilled.

According to studies on skill-biased technological change, the decline in the wage and employment prospects of less-educated workers is due to recent advances in technologies. These studies suggest that new technologies are complementary to skills by

[4] See, for example, Teraji (2009) for an economic analysis of selves.

[5] The caste system is formally modeled in Akerlof (1976). People may have beliefs such that breakers of the caste code will be out-casters. Within this structure, there exists a caste equilibrium where jobs are allocated according to castes.