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Income inequality and social preferences for redistribution and compensation differentials

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ABSTRACT

Countries with greater inequality typically exhibit less support for redistribution and greater acceptance of inequality (e.g., U.S. versus Western Europe). If individual nations evolve along this pattern, a vicious cycle could form with reduced social concern amplifying primal increases in inequality. Exploring movements around these long-term levels, however, this study finds mixed evidence regarding the vicious cycle hypothesis. Larger compensation differentials are accepted as inequality grows. Weighing against this, growth in inequality is met with greater support for government-led redistribution. Inequality shocks can be reinforced in the labor market but do not result in weaker political preferences for redistribution.

1. Introduction

The substantial increase in wage and income inequality over the last three decades is a central focus of recent economic research and policy discussion. Much of the earlier literature focuses on accounting for why inequality is increasing. One line of work considers changes in the relative supply and demand for skilled workers due to shifts in educational attainment, the introduction of labor-saving production and computing technologies, and capital deepening. Other researchers consider structural changes of the labor market itself, like the decline of institutions and policies that have historically compressed the wage structure (e.g., unions and minimum wages) and the proliferation of "superstar" labor markets where top performers earn disproportionate sums to those just behind them. The potential erosion of social preferences regarding compensation inequality and redistribution is also widely discussed. For the United States, particular emphasis is placed on the explosion in executive pay and deepening within-establishment inequality.[1]

The empirical literature mostly considers these potential determinants in isolation. Yet, an important theme of recent macroeconomic models is that the interactions among the factors bear significant responsibility. Moreover, a greater potential for the entrenchment or amplification of inequality exists in this general-equilibrium setting.[2] Taking skill-biased

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[1] Gordon and Dew-Becker (2008) and Heathcote et al. (2010) provide recent surveys of various inequality determinants. The appendix provides extended references on these different channels.

[2] Examples include Acemoglu et al. (2001), Alesina and Angeletos (2005a, 2005b), Benabou (2003), Guvenen et al. (2011), and Hassler et al. (2003).

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technical change as an example, its individual effect on inequality to raise the skilled–unskilled wage differential will be checked in the long-run as firms substitute towards cheaper factors of production or as labor supplies and education investments endogenously adjust. If the bias is sufficient, however, the technical change and its concomitant increase in inequality may also prompt lasting changes in the structure of the labor market (e.g., deunionization, increased segregation of skilled workers) that entrench or magnify its solitary effect. Of course, interactions can alternatively dampen inequality shocks. Understanding these dynamics is important for identifying how economies respond to primal inequality shocks.

This potential for amplification is particularly strong for social preferences regarding income equalization and social support. First, if changes in inequality directly influence ideology, then social preferences are a propagation channel for any shock to the income distribution, regardless of the source. Second, of all the factors discussed, social attitudes are the least governed (if at all) by market-like mechanisms that can retard excessive changes. Third, social preferences can affect many forms of institutions and policies—from firm employment structures to redistribution policies—resulting in higher amplification.

Given these conditions, the formation of a "vicious cycle" is possible—where an increase in disparity weakens concern for wage equality or redistribution and thus propagates and amplifies the original shock. Under this scenario, growth in inequality creates larger differences across groups in society. These greater gaps then directly reduce support among the wealthy for redistribution, as the wealthy feel less likely to become themselves poor or feel that the poor are less like them. Increased social stratification in society may also amplify the shock if preferences for redistribution decline as groups spend less time in direct contact with each other. Indirect channels may further exist, as the rich increasingly segment themselves into workplaces and schools that entrench these differences across groups. Thus, under a vicious cycle, the initial weakened concern produces even greater future compensation differentials, a further shrinking of the welfare state, and so on, which kicks the process off again.

Support for the vicious-cycle hypothesis can be taken from the cross-sectional distributions of countries (particularly long-term OECD members) and regions of the United States. Nations with greater income inequality typically demonstrate less support for redistribution and greater acceptance of wage inequality than their more-equal counterparts. While the evolution of countries or regions along this pattern would be consistent with hypotheses of reduced social concern, this response is not guaranteed as many primal factors determining these long-term ideology positions (e.g., beliefs regarding social mobility) may be stable.[3] In contrast to the vicious-cycle hypothesis, changes in social preferences may counteract inequality increases. In the face of higher inequality, individuals may believe that greater redistribution and sharing of resources are warranted for the current generation and to ensure equal opportunities for future generations.[4]

Ultimately, this question is an empirical matter as powerful factors are operating in potentially conflicting directions and have unknown relative strength. The empirical response of social preferences to changes in inequality has not been quantified. This empirical analysis is of critical importance for immediate policy discussions. It would also provide a better foundation for developing macroeconomic models of inequality in society, the discernment of optimal policies that balance trade-offs between insurance and agent incentives, and the appropriate depiction of fixed versus state-dependent preferences.

This paper investigates this question by focusing on short-term movements in inequality and social attitudes around the long-term level of each country or U.S. region. A fixed-effect estimation strategy removes permanent differences in inequality and redistribution philosophies, as well as common time trends. The contribution of this study is to characterize how the resulting longitudinal responses resemble and differ from the cross-sectional pattern. How responses differ by income class and neighborhood racial heterogeneity is also considered. A first set of international results are drawn from a panel of countries repeatedly surveyed by the International Social Survey Programme (ISSP) and the World Value Survey (WVS). Complementary results and extensions are developed through regional variation in the United States captured by the General Social Survey (GSS). To establish causality, an instrument-variable specification that exploits exogenous changes in the real federal minimum-wage rate interacted with predetermined regional characteristics is also employed. This step is a very important contribution of the study given the substantial degree to which inequality, policies, and preferences jointly influence each other. The U.S. regional analysis also allows us to consider the implementation of policy outcomes connected to social preferences (e.g., state tax code progressivity and welfare expenditures), contrast multiple forms of inequality (e.g., wage and consumption), and consider how gaps can emerge between preferences and policies through features like voter participation.

The results of this study show that the potential mechanisms of the vicious-cycle hypothesis conflict with each other, thereby weakening its overall strength. On one hand, larger compensation differentials are accepted as inequality grows. This growth in wage differentials is of a smaller magnitude than the actual increase in inequality, but it is nonetheless positive and substantial in size. On the other hand, growth in inequality is met with greater concern over inequality, greater

[3] The determinants of this cross-sectional pattern have been a frequent and lively political-economy topic since at least de Tocqueville. Alesina et al. (2001) and Hornstein et al. (2005) offer broad studies of why the United States has both higher inequality and a smaller welfare state than Western Europe, including appropriate references.

[4] Political-economy models differ in their predictions of how responses to inequality changes vary by income class. Piketty (1995) constructs a Rawlsian model where increases in the inequality of opportunity, holding fixed beliefs regarding the incentive costs of effort, promote greater support for redistribution independent of current income. On the other hand, redistribution preferences diverge with rising inequality in the median-voter model (e.g., Meltzer and Richards, 1981) as gaps to the median income widen.