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> What is the connection between income inequality and the macro-economic variables that are center stage in most economic debate? What is the inter-relationship between economic performance and income distribution? How can we use economic theory to explain what is happening to the incomes of individuals, families, and households? [299]

This article examines and interprets recent evidence on income distribution, focusing on the British experience. It identifies the related roles of earnings inequality, the workings of capital markets, and the impact of government transfers, suggesting the ways in which economic theory contributes to an understanding of each of these areas – and the ways in which economics needs to be enriched by new approaches.

The Unparalleled Rise in Income Inequality

The celebrated Kuznets curve, proposed in the 1950s, seemed to imply that inequality would continue to fall, steadily if not rapidly, in developed countries. It was still possible to hold this belief as recently as the 1970s; since then, the evidence has contradicted the earlier optimism. Inequality in the distribution of household income has increased since the 1970s in many developed countries. The increase was most spectacular in the United Kingdom, where the Gini coefficient for household income rose by 10 percentage points between 1977 and 1991.

Not only has the Kuznets curve been confounded by recent events; it has become clear that there is no lasting trend in the distribution of income. In both the United States and the United Kingdom, changes in inequality are easily matched with changes in government policy. It may be better to speak of well-defined episodes in which inequality falls or increases. Most of the increase in inequality in the United Kingdom happened between 1984 and 1991; the latter year is, so far, the highwater mark of British inequality.

The Sources of Inequality

Earnings from work (employment and self-employment) are the most important source of British household income, although they declined from 83% of the total in 1973 to 73% in 1993. There is plain evidence of widening dispersion of earnings: from 1979 to 1995 the real earnings of the bottom decile of full-time workers grew by 11%, compared with 50% for the top decile. There is a close relationship between trends in earnings inequality and in overall household income

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inequality during the 1970s and early 1980s. However, in the late 1980s the trends diverged, with household income inequality rising much faster. Part of the explanation is the divergence in employment experience, with rising numbers of both workless and two-income families.

Capital income, another source of inequality, also increased. Real rates of interest rose in the early 1980s and remained high a decade later; real dividends and share prices also climbed. The rise in expected real interest rates may have affected household decisions about savings, investment in human capital, and other financial matters.

The main source of non-work income is social security. In the past, the system of taxes and transfers has sharply reduced inequality; this effect was weakened by numerous changes in the late 1980s. Application of the 1978-79 tax and benefit system, indexed for the growth in per capita GNP, to the 1994-95 distribution of household incomes would have reduced the tax burden for all groups below the top decile; the Gini coefficient would have been about five percentage points lower.

Explanations of Earnings Dispersion

A lively literature on earnings dispersion, in both the U.S. and the U.K., begins from a point of apparently widespread agreement: there has been a shift in demand away from unskilled labor in favor of skilled workers, leading to a growing skill differential in earnings. Since the premium for skilled workers increased at a time when their relative numbers also rose, there must have been an increase in the relative demand for skilled labor.

Why should the demand curve for skills have shifted? One popular explanation attributes the shift to international trade with countries where unskilled labor is abundant. Another theory is that technological change has been biased toward skilled labor with the introduction of automation and information technology. However, the skill-based explanation is often extended to include not only observable job characteristics, but also unobserved skill components. This is necessary to explain the increasing inequality of earnings even within narrowly defined, seemingly homogeneous categories: the dispersion of British male earnings grew significantly during the 1980s in 34 out of 38 detailed occupational groups. Faced with such evidence, one must conclude either that there is a growing demand for unobserved skills – or that other explanations are needed.

Earlier writing on wage differentials included a creative tension between market forces and alternative explanatory factors, which are missing in more recent accounts. For example, sociological or labor relations approaches emphasize interactions through institutions such as collective bargaining and government intervention. Some analysts have estimated that the decline in unionization might account for 15-20% of the increased earnings dispersion in the 1980s. The direct impact of the British government in the 1980s included the removal of wage standards for government contractors, and the abolition of wage protection for lower-paid workers. These and other government policies had an important effect, although there is debate on the effectiveness of the redistributive government incomes policies of the 1970s.

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A useful earlier approach, too hastily discarded by recent theorists, emphasized the role of social customs and norms in wage determination. In a monopolistic or oligopolistic setting, supply and demand may only place broad limits on the range of possible wage differentials, with other factors such as social norms determining wages within those limits. This institutional approach allowed analysis of notions of fairness or equity, a line of investigation that has been reopened by a handful of recent writers. Work by George Akerlof and by Robert Solow has shown how observance of social norms can be consistent with individual rationality, in cases where long-term reputation is important to economic success. In these terms, it is possible that the 1980s witnessed a weakening of conventional norms, and a shift from one equilibrium with low wage differentials to another with higher differentials.

Other Parts of the Puzzle

If there is a persistent, widened skill differential, what effect will this ultimately have on the supply of workers with different skills? Although there is little empirical evidence bearing on this question, its importance can be seen from theoretical models. Assuming that education is the only requirement for skill, and that everyone can borrow at the same interest rate to finance education, then the equilibrium wage differential for skill will be just enough to compensate for the costs of education, leaving workers indifferent between skilled and unskilled jobs. If the same conditions persist over multiple generations, the income distribution converges toward equality.

This result, however, depends on the details, and can be reversed by minor modifications in the assumptions. Unequal inheritance in the form of primogeniture can lead to sustained inequality. So, too, can non-convexity, or increasing returns, in the accumulation of wealth. An interesting recent theory applies this idea to the economics of education and income distribution. Suppose that people make bequests to the next generation that are proportional to their lifetime wealth, and that only those who receive more than a critical level of bequest can afford the education required to become skilled, high-paid workers. If the critical level (i.e. the cost of education) is high enough, then only the descendants of skilled workers can themselves afford to acquire skills, and inequality will persist across generations. In contrast, if the critical level is low enough so that unskilled workers can often leave bequests sufficient to educate their descendants, then there will be long-term convergence toward equality.

This model highlights the significance of the cost of education, indirectly raising the issue of the importance of state transfers for the distribution of income. There has been a recent resurgence of interest among economists in the politics of income redistribution. Unfortunately, much of the discussion has adopted models of political equilibrium based on simplistic theories of the expected behavior of the median voter. "In my view, this understates what economists can usefully learn from political scientists... The median voter theory is far from being 'standard.'" [316] Modeling the preferences of voters is a matter of some subtlety, even on simple economic choices. When unemployment increases, so that the total cost of unemployment benefits rises, do employed voters prefer to spend less on benefits, since unemployment insurance is now more expensive – or more, since the perceived risk of their own unemployment is now greater? "[T]he explanation of trends in the income distribution cannot be complete without an analysis of public choice, and this cannot be treated simply as a routine application of a well-tried theory." [317]

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In conclusion, current economic theory offers insights into parts of the story of inequality, but still needs a framework within which to fit the different mechanisms. The skill shift explanation for wage differentials, for example, is a valuable but incomplete insight. The good news is that income distribution is beginning to receive again the attention that it deserves, and that economics is beginning to learn from other social sciences in this crucial area.

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