"Summary of article by James K. Galbraith: Inequality, Unemployment, Inflation, and Growth"

High inequality is a well-known fact of life in America today. Much less well-known are the sources of change: what causes inequality to increase or decrease? This chapter seeks to answer that question. It presents a measure of inequality in the manufacturing wage structure, and analyzes changes in that measure. The causes of rising inequality turn out to be mainly macroeconomic: unemployment, inflation, rapid economic growth, the exchange rate of the dollar, and the minimum wage all contribute to an explanation of the pattern of inequality over time. Such factors are reversible; that is, this analysis leads to a prescription for reducing inequality in the future.

Measuring Jobs, Not People

Many studies of inequality rely on the Census Bureau's Current Population Survey, in which a representative cross-section of the population is asked to report on their personal incomes (and other information). For many purposes, such as analysis of family incomes, or racial or gender income differentials, population surveys are essential. But for analysis of the underlying wage structure, there are better alternatives. (As argued in an earlier chapter, the effects of the wage structure and of discrimination are complementary: imagining the income distribution as a multi-story building, discrimination may limit who gets into the upper floors, while the wage structure sets the shape of the building, determining how narrow the upper floors are relative to the ground floor.)

There is a high error rate in workers' responses to survey questions about their wages, and even to questions about the industry in which they work. For information about jobs, as opposed to workers, surveys of employers are much more accurate, and can provide consistent data for many years. In particular, the Annual Survey of Manufactures provides data on manufacturing back to 1958. In an earlier chapter, the author examines detailed data on manufacturing industries (at the 3-digit level) and classifies them into 23 groups on the basis of trends in productivity; in most cases, industries within the same group have similar production technologies as well as productivity trends. Here the focus is on a measure of inequality in the average hourly wages paid to workers in each of the 23 manufacturing groups, weighted by the groups' employment, calculated annually from 1958 through 1992.

Inequality in Manufacturing Wages

The dispersion of average hourly wages across the 23 industrial groups captures only a portion of inequality, even within the manufacturing sector. There is, of course, substantial wage inequality within the individual groups. And much of income inequality originates outside of manufacturing. Yet the factors that affect interindustry wage differentials are likely to have parallel effects on other aspects of the income distribution. The author's measure of interindustry wage inequality in manufacturing has a correlation of .77 with the Census Bureau's Gini ratio for family incomes, confirming the importance of this measure of wage structure.

One significant difference between the two measures appears in the late 1980s. Both the manufacturing wage inequality measure and the family income Gini ratio reach a trough in 1968 and then begin a fairly steady rise. However, the inequality of wages stabilizes (at a high level) after the mid-1980s, while the inequality of family incomes continues to rise. This pattern, which has been confirmed in other studies of wages, poses a problem for the argument that computer use is a major source of income inequality. Certainly computer use should affect the wage structure, rather than other aspects of the income distribution; however, computers became most important after the mid-1980s, when wage inequality had stopped growing.

Macroeconomics and Market Power

> My lead hypothesis is that macroeconomic events will largely determine the movement of a wage inequality measure through time. In a world of organizations – firms, industries, and unions – with greater and lesser degrees of market power, we should expect that events will differentiate the strong from the weak. [138-139]

Under the conventional model of supply and demand in competitive markets, wages should depend on the value of each worker's marginal product, not on macroeconomic variables. Aggregate unemployment or inflation should not have a systematic effect on the (real, inflation-adjusted) value of a product, and hence should not affect the pay scale.

Very different predictions emerge from a model that highlights the importance of market power. Firms and unions with monopolistic power are better able to protect themselves in bad times, cushioning workers with stable, long-term employment and pay. In good times, however, the same long-term stability inhibits the strongest sectors from taking immediate advantage of favorable economic circumstances. Weaker, more competitive parts of the economy will react more quickly to upturns as well as downturns.

Statistical tests strongly favor the market power model, finding that several macroeconomic variables have the expected relationship to inequality. As shown in an appendix, similar conclusions are reached if inequality is measured by the Gini ratio for family incomes, or by another published index of wage inequality, rather than the author's preferred wage inequality measure.

Unemployment is the most important single influence on manufacturing wage inequality. Low-wage, weakly organized, competitive industries are more likely to lower wages when unemployment is high, and raise wages as full employment approaches. High-wage, unionized, monopolistic or oligopolistic industries are more insulated from business cycle pressures.

Unemployment also affects family incomes because low-wage workers are more at risk of being laid off; while the causes are similar, this effect is distinct from the effect on the wage structure for those who remain employed.

Inflation boosts wage inequality, since unionized, high-wage workers are more likely to have cost-of-living adjustments that protect their pay against price increases. "Thus, like a rise in unemployment, a rise in inflation drives a wedge between the strong and the weak, and so raises inequality in the system as a whole." [140] In the period being analyzed, inflation was most important in the 1970s, a time when union contracts that provided cost-of-living adjustments were more common than they are today.

Rapid economic growth, perhaps surprisingly, increases inequality. The sectors that expand most at times of rapid growth are those producing investment goods, such as construction, machinery, and transport equipment; these tend to be high-wage industries. Rapid growth is good for almost everyone's income, but it is differentially better for some of those who were already doing well.

A rise in the real exchange rate of the dollar relative to other currencies also boosts inequality, by making imports cheaper and weakening the position of industries that compete with imports. A stronger dollar also makes American exports more expensive abroad, but exporting industries, such as aircraft, computers, pharmaceuticals, and machinery, tend to have a degree of worldwide monopoly power that partially protects them from exchange rate problems. The industries that compete with imports include many competitive, low-wage sectors. The exchange rate had a statistically significant effect on manufacturing wage inequality only after 1981, when trade pressures intensified.

The minimum wage has the expected effect on inequality: higher minimum wages cause a reduction in inequality. Since many minimum-wage workers are in services rather than manufacturing, this effect is stronger when all workers are included; yet it is statistically significant even when the analysis is restricted to manufacturing wages.

Technology and Unemployment

Almost all of the year-to-year changes in manufacturing wage inequality from 1958 to 1992 can be accounted for by the factors listed here (r^2 = .87). There is little left over for other forces, such as changes in education or the supply of skills, to explain. This does not mean that technology is unimportant; it does, however, suggest a switch away from the benign view of technology as "skill enhancing," and back to the old-fashioned idea that technological change is mainly aimed at saving labor. To the extent that technology leads to unemployment, its effects have already been included here.

Taking a longer historical view, the measure of inequality in the wage structure can be extended back to 1920 (with a bit of creative extrapolation, explained in the appendix). This measure of inequality abruptly shot up in the depression of the 1930s, then plummeted downward during World War II. Movements of the unemployment rate alone explain almost all of the variation in wage inequality (r^2 = .79) over the entire period of more than 70 years.

Since high unemployment increases inequality, and low unemployment decreases it, where is the break-even point? A final computation using the long historical series shows that inequality tends to increase whenever unemployment is above 5.5 percent, and to decrease when unemployment is below that level. In the autumn of 1996, as unemployment fell below 5.5 percent for the first time in many years, inequality also began to fall.

Ironically, 5.5 percent is close to many economists' current estimates of the lowest unemployment rate that is compatible with price stability – the so-called natural rate of unemployment, or nonaccelerating inflation rate of unemployment (NAIRU) . "Yet if we care about inequality in America, a 5.5 percent rate of unemployment should assuredly be a ceiling, not a floor." [149]