The Increase of Inequality Since the Mid-1970's

Inequality has risen in Canada and in other Western countries since the mid-1970s. In particular, there has been a widening income gap between unskilled and skilled labour and between those with and without post-secondary education. At the same time, the rate of growth of labour productivity has fallen below its long-run trend. The rise of inequality has three basic causes—globalization, rent seeking or the use of resources to redistribute wealth toward particular individuals or groups, and the technological revolution based on the micro-processor and related information-based technologies.

First: **Rent Seeking.** After the collapse of Soviet-style socialism or state capitalism, deregulation became more popular in western countries in order to realize the "magic of the market." Far from being magic, however, unregulated markets allowed financial institutions and other large enterprises to extract large amounts of wealth from the rest of the economy, while amassing political power that enabled them to maintain this wealth by gaining control over government policy. Such rent seeking has been less of a problem in Canada than in the U.S., Europe, and China. In the U.S., rent seeking has played a major role, not only in creating inequality, but also in sustaining it. To varying degrees, governments have come under the control of rent-seeking special interests, with the result that government policies have often promoted inequality instead of combating it. The recent tax reform in the United States is a case in point.

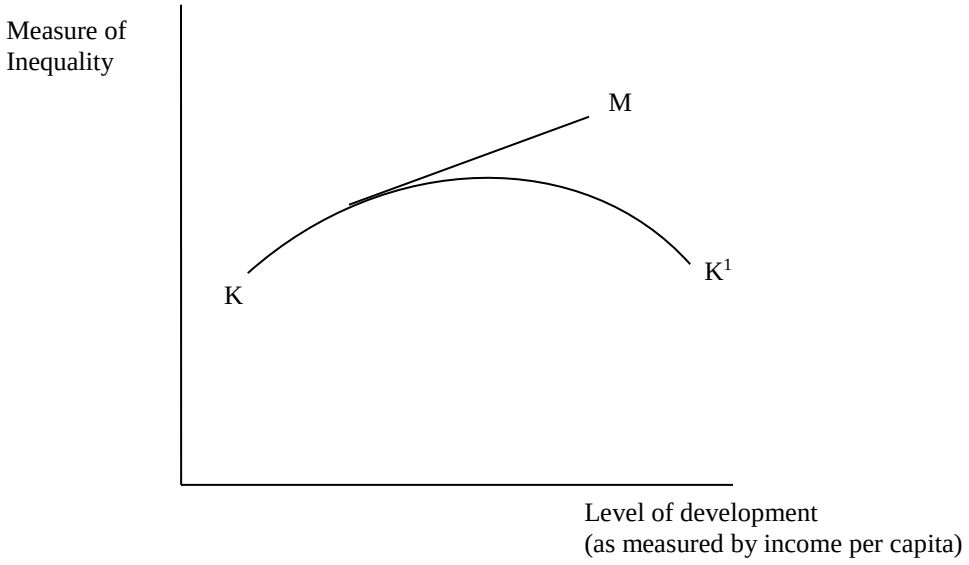
Second: **Growing economic integration (globalization)** has featured falling barriers to international trade, investment, and technology transfer plus the emergence or expansion of regional trading blocs, such as NAFTA and the European Union. Workers in high-wage countries now face stiffer competition from lower-wage areas, with the resulting disappearance of good-paying jobs.

Third: **The invention of the microprocessor** has given rise to an explosive growth of information-based technologies, which has promoted automation and the elimination of many less-skilled jobs. In the process, it has raised inequality by raising the skill premium in earnings and by generating opportunities for abnormally high profits in the "new" economy, while

threatening the profits and even the survival of firms that did not adapt quickly enough. Skills that were once valuable became less so or even obsolete. Those who were first to acquire the new skills received a large premium in their earnings.

In addition, new ways of transmitting information have increased the size of the market for highly-skilled suppliers of services at the expense of less skilled local suppliers by enabling the former to reach larger numbers of potential customers--part of the "winner take all" economy. An example would be doctors examining and prescribing for patients that are far away.

An explanation of the recent rise in inequality based on the Kuznets curve would stress the third or technological explanation. The Kuznets curve is shown below as curve KK^1. It contrasts with the curve labelled M, which shows how Marx expected inequality to change under capitalism. (He thought that it would grow until a revolution replaced capitalism with socialism.) The Kuznets curve deals with modern economic growth, based on expansion of industrial output or output of services. It describes the evolution of inequality following a major technological revolution. This evolution has been observed in many countries.



According to the Kuznets curve, economic development first causes inequality to rise in the early stages of industrial growth. Nevertheless, even

the poorest groups in society often receive some benefit.

Subsequently, inequality falls. In the U.K., inequality began rising around 1760 and continued to increase for about 100 years. It was this widening that Marx and Engels observed. They explained the initial rise of inequality (which they expected to continue under capitalism) as a result of labour-saving technological change. They failed to observe the subsequent fall of inequality, beginning around 1870 in the U.K. and in the late 1920s in North America. In addition, it now seems unlikely that technological change was labour saving.

The theory behind the Kuznets Curve suggests that widespread adoption of any basic new technology is a skill-intensive process. It requires skills that are new and therefore not widely held. It devalues some previously existing skills, and some jobs disappear. Finally, it generates abnormal profits for firms who are able to supply products demanded by the new economy and losses for those who are left behind. This is Schumpeterian "creative destruction." Once the new technology is in widespread use, most of the abnormal profits are competed away, however, and the skill premium in earnings tends to fall for two reasons—one related to supply and the other to demand:

I. DEMAND SIDE: Over time, cost conscious firms learn how to substitute away from more skilled toward less skilled labour, which is also less expensive. This shifts the demand for more skilled labour down and is part of learning how to make better use of the new technology. Standardization and routinization of products and production processes are part of this substitution.

II. SUPPLY SIDE: Less-skilled workers seeking better earnings will, in time, acquire the new-economy skills demanded by the information age, both by retraining and by accumulating the right kind of job experience. This shifts the supply curve of workers with the requisite skills to the right and enables them to raise their productivity.

Thus the widening of inequality goes hand-in-hand with a slowing of labour productivity growth—since workers are learning and honing the new-economy skills—and the subsequent fall in inequality coincides with rising growth of labour productivity, as workers put these skills to use.

In addition, opportunities for further creative destruction gradually dwindle,

as the new technology is more widely absorbed and understood. As a result, abnormal profits and losses resulting from the new technology decline. Eventually, therefore, inequality is forecast to peak and then to begin falling. This is in contrast to Marx's forecast of ever-widening inequality—in the form of rising *S/V*—under capitalism.

In short, each phase begins with one or more major technological breakthroughs, followed by growing inequality plus a slowing of productivity growth. Then these tendencies are reversed.

Greenwood's explanation attaches a Kuznets curve to each major phase of the industrial revolution. We are in the third phase, which is based on the revolution in information technologies, after phases based on steam power and then on a combination of electricity, internal combustion, and the assembly line. Marx and Engels observed only the first, or steam phase. It plausibly accounts for the Kuznets curve observed in the U.K. and some other European nations, while the electricity/internal combustion/assembly line phase plausibly accounts for the Kuznets curve observed in North America.

The information revolution would be the major cause of the widening of inequality since the mid-1970s, according to this view. However, other factors may also be involved in the Kuznets curve. For example, the extension of voting rights in Western Europe in the 19th and early 20th centuries probably helped to reverse the previous rise of inequality there.

Moreover, the technological explanation ignores the role of rent seeking in inequality. The latter may now be the main cause—and Marx would probably feel vindicated—although it is impossible to be sure since reversal of the initial rise in inequality can take a long time. The success of rent seeking, as well as the rising inequality to which it contributes, signals a change in the way Western governments derive the political support that enables them to hold power. This change has been especially pronounced in the U.S., less so in Canada, which may even be going against the trend south of the border.

Specifically, Western political systems have become less inclusive. They rely more on narrow special interests for political support and less on the broad public. These interests trade political support to the government and receive political favours in return from which others are excluded. In

particular, the special interests in question are protected from competition, leading to excess profit for them and a falling share of labour in national income.

This is political support generated largely by redistribution of wealth rather than by creating wealth. Gaining support from wealth creation often reduces distributional rent by increasing competition and is likely to produce benefits that are more widely shared.

Finally, we should note that growing inequality within nations has coincided with falling inequality between nations, in the sense that average incomes in poorer nations are now larger percentages of average incomes in wealthier nations. The percentage of the world's population in direst poverty has been cut in half.

See Jeremy Greenwood, "The Third Industrial Revolution," Univ. of Rochester, Center for Economic Research, Working Paper #435, Oct. 25, 1996.