

# What's wrong with predistribution

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**Lane Kenworthy** questions whether predistribution is up to the task of ensuring a fair distribution of incomes and says that the best way to tackle the squeeze in wages is through good old-fashioned public insurance.

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Is 'predistribution' the way forward for the centre-left? Perhaps – but it may prove to be an inadequate remedy for one of the core problems facing the US, the UK and quite possibly a number of other rich nations in coming decades. I recommend we consider an additional approach.

The problem is the lack of wage growth for lower-half households. In the United States, inflation-adjusted wages at the median and below have been stagnant since the late 1970s.<sup>1</sup> That's three-plus decades. It isn't just a function of the great recession: real wages barely budged from the business-cycle peak in 1979 to the peak in 2007. Nor is it due to a shortage of economic growth: US per-capita GDP rose at a pretty healthy clip during those years.

The result has been slow growth of household incomes. In fact, the only reason incomes have increased at all is that more and more American households have added a second earner.<sup>2</sup> This isn't how it should be. In a good society, those in the middle and at the bottom ought to benefit significantly from economic growth. When the country prospers, everyone should prosper.

## STAGNANT WAGES IN THE LOWER HALF

Over the past two centuries, wages have tended to rise with productivity, so is the current state of affairs just a temporary aberration? Unfortunately, it's more likely that this is the new normal. As the economy grows, firms have more revenue to share with their employees. But that doesn't mean firms *will* share it. In the US, three shifts have made them less likely to do so.

First, even if productivity has been rising in the economy as a whole, more people now work in industries and jobs in which raising productivity is difficult. Fewer employees in the bottom half work in manufacturing; more are providing in-person services.

1 Mishel L et al (2012) *The State of Working America*, Economic Policy Institute.

2 Kenworthy L (2014 forthcoming) *Social Democratic America*, Oxford University Press, ch 2.

Second, firms face stronger pressure to resist raising wages. Most face much more competition, both global and domestic, than their counterparts of half a century ago. And many have shareholders that now demand constant cost-cutting and buoyant quarterly earnings rather than steady long-term growth.

Third, firms face less pressure to boost wages. American unions have steadily weakened to the point where they are now irrelevant for nearly all of the private sector workforce.

In this context, the absence of wage growth for those in the lower half isn't surprising. And, sadly, there is little reason to expect this context to change: the most likely scenario for wages in coming decades is 'more of the same'.

Is this a particularly American story? Possibly – but there are worrisome signs in the UK too. Real wages in the lower half did rise in the 1980s and '90s. But then, from 2003 to 2007, when the economy was humming along quite nicely prior to the crash, that wage growth stopped.<sup>3</sup> Maybe this was simply a blip? Given the similarity of the UK's economic context to the US's, that may be wishful thinking.

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## THE PREDISTRIBUTION APPROACH

The predistribution approach would aim to address the problem of stagnant lower-half incomes without increasing government transfers.<sup>4</sup> As such, it could embrace a range of strategies.

**More education:** The better we do at developing cognitive skills and productive noncognitive traits among children who grow up in less-advantaged circumstances, the greater their likelihood of finding employment in the analytical fields that pay relatively well. In this scenario, wages rise via a compositional shift: over time, more and more of the workforce is employed in high-end, well-paying positions and fewer in low-end services. If it works, this strategy is a double winner, as education has other benefits that make its improvement a worthwhile pursuit for policymakers.<sup>5</sup>

The worry here is about scope. Even if it goes swimmingly, there will remain a non-trivial number of people in low-end jobs. Imagine a high-education, high-employment future for the UK and the US. Suppose 80 per cent of the working-age population is employed. And suppose 60 per cent complete university and end up in analytical jobs.<sup>6</sup> That optimistic scenario still leaves 20 per cent working in lower-paying positions.

**More manufacturing jobs:** For individuals with limited education, a job in manufacturing is one of the few paths to decent and rising pay. It's for this reason that protecting existing manufacturing jobs, bringing back lost ones, and creating new ones is a perennial aim of the left.

3 Commission on Living Standards (2012) *Gaining from Growth*, London: Resolution Foundation.

4 For more on predistribution, see Miliband E (2012) 'Labour's New Agenda', speech to Policy Network; Plunkett J (2012) 'Fleshing Out a Predistribution Agenda', Policy Network, 28 November 2012; Hacker J (2013) 'How to Reinvent the Centre-Left? Predistribution', *Guardian*, 12 June 2013.

5 Kenworthy L (2012) 'Two and a Half Cheers for Education', in Cramme O and Diamond P (eds) *After the Third Way: The Future of Social Democracy in Europe*, London: IB Tauris.

6 The share finishing university currently is around 50 per cent in the UK and 40 per cent in the US, according to OECD data.

But possibilities here are limited. Manufacturing's share of employment has been shrinking for decades in all rich nations. There are no exceptions: not Germany, not Japan – not even South Korea, which didn't industrialise until the 1970s and '80s. As in agriculture, this employment decline is due partly to automation. It owes also to opportunities for low-cost production in poorer nations. Neither is likely to abate. In the not-too-distant future, manufacturing will account for less than 10 per cent of employment in most affluent countries, perhaps even less than 5 per cent.

**Stronger labour unions:** Unions are the principal institutional force available to counteract downward pressure on wages. Their strength during the 'golden age' following the second world war was integral to the sustained growth of wages that occurred during those three decades.

But here too the future does not look bright. Unionisation rates have been falling in almost all affluent nations. Only five now have a rate above 40 per cent, and four of those (Belgium, Denmark, Finland and Sweden) are helped by the fact that access to unemployment insurance hinges on union membership. It's well and good to argue for stronger unions, but no one has yet figured out a successful strategy for accomplishing that.

**Minimum wage hikes:** Unlike most rich nations, the UK and US have statutory wage floors. One way to ensure that wages go up at the low end is to steadily raise this floor over time.

Once again, though, there are worries. For one thing, policymakers may not comply: in the UK, the minimum wage has increased since its introduction in 1999, but in the US it has been flat for more than 40 years. Also, while increasing the wage floor could have positive effects further 'up' in the lower half, closer to the median wage, in practice this effect has tended to be quite limited.<sup>7</sup>

**A tighter labour market:** If employers face strong pressure to keep wages in check and union capability to counteract that pressure is limited, then the chief mechanism for generating wage increases throughout the lower half is 'full employment'. We can see this very clearly in the US experience. In the late 1990s, the unemployment rate dropped to 4 per cent, its lowest level since the 1960s. Not coincidentally, the late 1990s were the only period of non-trivial wage growth for the lower half in recent decades.<sup>8</sup> In the UK, the pattern is less clear. The years of wage stagnation despite economic growth, from 2003 to 2007, were ones in which the unemployment rate was low relative to its level during much of the 1980s and '90s.

Can we achieve full employment? That's dicey. It hinges largely on the approach of the central bank when the economy is growing briskly and the unemployment rate dips low. I'm pessimistic about prospects in the US – the next time our unemployment rate gets near 4 per cent, the federal

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7 Plunkett J and Hurrell A (2013) 'Fifteen Years Later: A Discussion Paper on the Future of the UK National Minimum Wage and Low Pay Commission', London: Resolution Foundation, figure 12. Some advocate sector-specific and area-specific minimum wages. This makes some sense, but it also has the potential to become rather complex and politically contentious, with firms, industry associations and local policymakers arguing for special consideration and opponents complaining that we're on the verge of full-scale regulation of wages.

8 Bernstein J and Baker D (2003) *The Benefits of Full Employment*, Washington DC: Economic Policy Institute; Bernstein J and Baker D (forthcoming) *Getting Back to Full Employment: A Better Bargain for Working People*.

reserve is likely to step on the brakes by raising interest rates. In the late 1990s, chair Alan Greenspan held interest rates low despite opposition from other board members who worried about potential inflationary consequences of rapid growth, rising wages and the dot.com bubble. Greenspan's belief in the self-correcting nature of markets led him to worry less than others. Given the painful consequences of the 2000s housing bubble, the federal reserve is unlikely to repeat that approach.

**Codetermination:** Shareholder insistence on healthy short-run profits is one of the key obstacles to wage growth. One way to alleviate this is to give employees more voice in firms' decision-making. A number of European countries have mandatory codetermination for large firms, whereby employees elect up to half of the board of directors. This makes long periods of wage stagnation less likely. And it appears to have no adverse impact on firm performance.<sup>9</sup>

Codetermination could help in the UK and US. But hardly any firms will opt for it unless required to do so by law, and the required legislation isn't likely to be forthcoming anytime soon. Moreover, if it is restricted to large firms, it will help only part of the workforce.

**Profit-sharing:** In profit-sharing plans, employees receive part of their compensation in the form of a portion of the firm's profit rather than as a guaranteed wage or salary. This has an upside for both owners and workers. For owners, the advantage is that when the firm is struggling, for example during a recession, its labour costs will fall, because workers will absorb part of the reduction in profits in the form of lower take-home pay. For workers, the advantage is that if profits rise, their pay will automatically rise. Over time, their pay will be higher than it would have been without profit-sharing.<sup>10</sup>

Despite its attractiveness, however, profit-sharing is likely to be only a partial solution. The idea has been around for quite some time, and yet it has made limited headway in rich nations. That could change, but the historical record provides little reason for optimism.

**Rising employment:** Increases in employment offer a way to achieve rising household incomes even if wages are stagnant.<sup>11</sup> Indeed, in the US that is exactly what happened in the 1980s and much of the 1990s. While wages in the lower half were stuck, the share of households with second earners rose steadily, which led to increasing household incomes. We may see no further increase in employment among prime-working-age men (aged 25 to 54), around 85 per cent of whom are already employed in both the US and the UK. But among women and the older working group (aged 55 to 64) there remains substantial room for growth.

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9 Vitols S (2010) 'Board Level Employee Representation, Executive Remuneration, and Firm Performance in Large European Companies', Hans Böckler Foundation.

10 Blasi JR, Freeman RB and Kruse DL (2013) *The Citizen's Share*, New Haven: Yale University Press; Lawton K and Lanning T (2013) *Sharing profits and power: Harnessing employee engagement to raise company performance*, London: IPPR. <http://www.ippr.org/publication/55/11028/sharing-profits-and-power-harnessing-employee-engagement-to-raise-company-performance>

11 Kenworthy L (2013) 'Rising Incomes and Modest Inequality: The High-Employment Route', in Parker S (ed) *The Squeezed Middle: The Pressure on Ordinary Workers in America and Britain*, Bristol: The Policy Press.

A good bit of this new employment may be in low-end services – and I recommend we embrace this. As we get richer, most of us are willing to outsource more tasks that we don't have time or expertise or desire to do ourselves – changing the oil in the car, mowing the lawn, cleaning, cooking, caring for children and other family members, advising, educating, organising, managing, transporting. This can be a win-win proposition if we approach it properly. We need more people teaching preschool children, helping others find their way in the labour market or through a midlife career transition, caring for the elderly, and so on. Improved productivity and lower wage costs abroad will reduce the price we pay for manufactured goods and some services. This will enable more of us to purchase helping/caring services and more of us to work in helping/caring service jobs.<sup>12</sup> This added employment will boost household incomes.

Yet rising employment can't, by itself, solve the problem of income growth for lower-half households. First, there is a ceiling. Once we reach maximum employment – perhaps 85 per cent of working-age men and 80 per cent of working-age women – there will be no more possibility of relying on rising employment to secure rising incomes.<sup>13</sup>

Second, some households may not benefit from a rising employment rate. We can see this in the US experience in the 1980s and '90s. Despite a steady rise in employment for Americans on the whole, average work hours for those in the bottom quarter did not increase at all. This is partly because of big swings in demand: hours dropped severely during recessions, offsetting gains during economic upswings.<sup>14</sup> It's also because some people at the low end struggle to maintain regular employment even when the labour market is healthy.<sup>15</sup>

Third, it's by no means a given that we can continue to generate employment growth. The US record in the 2000s is worrying. The early years of recovery after the 2001 recession were marked by feeble job growth, and things didn't improve much after that. By 2007, the peak year of the 2000s business cycle, the employment rate had not yet recovered to the previous peak in 2000 – and then the ensuing crash erased nearly all of the progress of the 1980s and '90s.

**More public goods and services:** Public goods, services, spaces and mandated free time – early education, roads and bridges, healthcare, housing subsidies, holidays and vacations, paid parental leave, and much more – increase the sphere of consumption for which the cost to households is minimal or zero. Their addition to living standards doesn't show up in income statistics, but it's real nonetheless. This is a viable route to improving material wellbeing even if wages and employment are stagnant. And some public services, such as early education, not only directly enhance living standards but also contribute to higher employment and/or wages.

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12 Baumol WJ (2012) *The Cost Disease*, New Haven: Yale University Press; Carlin W (2012) 'A Progressive Economic Strategy: Innovation, Redistribution, and Labour-Absorbing Services', working paper, London: Policy Network.

13 According to the OECD, as of 2012, the UK employment rate (25–64) was 82 per cent for men and 69 per cent for women; in the US it was 79 per cent for men and 66 per cent for women.

14 Kenworthy L (2011) *Progress for the Poor*, Oxford: Oxford University Press, ch 3.

15 Herr T and Wagner SL (2011) 'Persistent Nonworkers among the Long-Term Unemployed', Project Match.

## THE PUBLIC INSURANCE APPROACH

There is much to like in the predistribution approach as I've sketched it here, and a full-scale pursuit of its more promising elements would undoubtedly do some good. In the near term, this might be the wise course of action. That's particularly true in the UK, where it's unclear whether the wage stagnation of 2003–07 was a harbinger of future trends or merely an aberration.

In the long run, however, I'm sceptical that predistribution will be up to the task. The pressures militating against wage growth in lower-half jobs are strong, and in all likelihood they will grow even stronger. We may need to do more. Fortunately, we have another option.

Public insurance is a widely used tool for mitigating economic and social risks. Schools, government-financed health insurance, public pensions, unemployment compensation and most government transfers are versions of public insurance. We contribute collectively via taxes, and those who experience the risk event or condition receive transfers or services.

Through this lens, wage stagnation is a new social risk. There is a simple insurance mechanism for alleviating it: an employment-conditional earnings subsidy, along the lines of the UK's working tax credit (gradually being replaced by universal credit) and the US earned income tax credit. These programmes provide a subsidy, in the form of a refundable tax credit, to households with low earnings. The amount of the subsidy increases with earnings up to a point, then flattens out, and then decreases as earnings reach into the middle class.

The subsidy both boosts household incomes and increases employment. It's a very good policy. Not surprisingly, it has been spreading to other affluent nations.<sup>16</sup>

These employment-conditional earnings subsidies help to compensate for low wage levels, but in their current form they don't address the problem of wage *stagnation*. To do the latter, the amount of the subsidy needs to rise over time in sync with economic growth. One way to achieve this would be to index it to GDP per capita.<sup>17</sup> Or decisions about yearly changes could be entrusted to an independent commission, such as the existing Low Pay Commission.

The scope also needs to be expanded. Currently, about 20 per cent of households in the UK and the US receive it. In order to help more than just low earners, it should be extended well into the middle class.<sup>18</sup>

This won't compensate fully for wage stagnation. If the subsidy amounts to a quarter or even half of a household's earnings and the subsidy rises

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16 Immervoll H and Pearson M (2009) 'A Good Time for Making Work Pay? Taking Stock of In-Work Benefits and Related Measures Across the OECD', OECD Social, Employment and Migration working paper no 81.

17 Or perhaps to average compensation, which tends to rise in sync with GDP per capita. See Pessoa JP and Van Reenen J (2012) *Decoupling of Wage Growth and Productivity Growth: Myth and Reality*, London: Resolution Foundation.

18 To reduce employment disincentives, I recommend giving it to individuals rather than households, as in Sweden; see Edmark K et al (2012) *Evaluation of the Swedish Earned Income Tax Credit*, IFN working paper 901.

in line with the economy but earnings don't, then the household's income (earnings plus subsidy) growth will lag behind growth in the economy. It's a partial remedy, not a full solution – but it will help.

There are objections, of course. Some will ask why taxpayers rather than employers should bear the cost of ensuring that household incomes rise. This is an understandable sentiment. But consider how we think about health insurance, pensions, unemployment insurance and sickness/disability insurance. Like income, these contribute to material wellbeing, and in all affluent nations they are financed at least partly by taxes or social contributions. Few object to the fact that firms aren't the sole funders.

Others will worry that a subsidy along the lines I suggest will encourage employers to keep wages low. It will, to an extent. But the same hazard exists with all insurance. Public pension programmes encourage people to save less during their working years than they otherwise would. Unemployment insurance encourages people to remain out of work longer than they otherwise might. Affordable healthcare encourages people to use more health services than they truly need. In each case, we judge the likely cost to be smaller than the gain in economic security, psychological wellbeing and social justice. Arguably, the same is true here.

Finally, what about affordability? This has a near-term component and a long-term one. The near-term problem is the still-influential notion that government spending should not increase while the economy is struggling. This probably has it exactly backwards.<sup>19</sup> But for the UK's Labour party, the problem is compounded by the public perception that expenditures rose too greatly in the years up to 2010. In view of this constraint, smart politics at the moment might consist of defending the size and scope of existing tax credits and waiting for more favourable conditions to push for an expansion.

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The long-term problem is that population aging will cause government expenditures unavoidably to rise in coming decades, potentially leaving less room for a more generous employment-conditional earnings subsidy. An increase in employment would help by producing more tax revenue, and we should continue to strive for greater efficiency in the public sector. But there are no easy answers here. Expanding the earnings subsidy may well require cuts to some other programmes. Note, however, that the predistribution approach isn't necessarily exempt from this tradeoff, as it too has elements that involve an increase in government spending.

What, then, should we do – predistribution or public insurance? If forced to choose between the two, I would opt for defending and expanding employment-conditional earnings subsidies. But over the long run, we ought not think in terms of one or the other: we'll very likely need both.

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<sup>19</sup> Krugman P (2012) *End This Depression Now!*, New York: WW Norton.