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0521816955 - Designing Inclusion: Tools to Raise Low-end Pay and Employment in Private Enterprise

Edited by Edmund S. Phelps

Excerpt

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## Introduction

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*Edmund S. Phelps*

Access to a career and to a livelihood in society's mainstream economy is again a topic of discussion among economists and sociologists. Great value is placed on working-age people having the opportunity to obtain rewarding work in the formal economy and to earn enough in such jobs to be self-sufficient. These are the twin conditions for what is sometimes termed *social inclusion*, or, more aptly, *economic inclusion*.

The central importance of jobs and self-support derives from several human needs. People need to engage their minds and, for most people, jobs are the main means by which they encounter new problems to solve, discover their talents and expand their capabilities. People gain satisfaction from achieving something and experience personal growth from working with others. A great many people also want involvement in their society and, for them, to work in a job in the economy's mainstream is to be a part of society's grand project. Last but not least, the pecuniary reward from working is of both material and symbolic value. People want the dignity brought by self-support and the autonomy brought by having a substantial income of their own to meet their special needs. Earning one's own way – making enough to support one's self at a decent level by society's standards and to be a part of community life – is hugely important for people's self-respect. For these reasons, the *availability* and the *quality* of a country's jobs as well as the wages employers can afford to pay, hence the *productivity* of work, are among life's "primary goods" in John Rawls's terminology. It is no wonder, then, that people want to be included. The recognition of inclusion, by the way, is not new to economics, which has long prized low unemployment, high job satisfaction and high productivity.

Until recent decades, the goal of inclusion was a rallying cry to break down the discriminatory barriers that were depriving women and many minorities from the ample access to the economy and the community that white males had long enjoyed. Commentators did not need to canvass moral philosophy to condemn these barriers. It was (and is) axiomatic that all persons having the same qualification – the same talent and

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preparation – ought to have the same career chances, regardless of race, religion or gender. And it was understood that the courts could pave the way, without benefit of economic theory and fiscal expertise. Those were simpler times.

### **Inclusion of the less advantaged**

The deficiency of inclusion, remedies for which are the subject of this volume, is the tendency of a great number of the less advantaged, or less qualified, to be marginalized from society and possibly even from the labor force. Not all those whose labor in the market economy would be productive to some positive degree, however small, are found to be employed in the market, even those who would like to work and contribute if offered terms that society could afford.<sup>1</sup> Like the inclusion failure deriving from racial or ethnic or gender bias, this classic inclusion failure is quite old. It must have emerged (or intensified if it was already a problem) when impersonal private ownership of businesses began to pervade the market economy, so that a marginal worker in the family or in that of a neighbor would no longer be employed out of obligation or reciprocity.

The problem involves unequal treatment of persons of unequal marketability, which is philosophically different from unequal treatment of persons of equal ability and preparation. It is a great deal more difficult, since it is impossible to equalize rewards, such as wage rates, without deadening some of the incentives to prepare and to make an effort; more generally, it is impossible to pull up rewards to those on the bottom rung of the ladder without also pulling up rewards on the next rung and the rung after that, and so forth. So the problem cannot be usefully addressed by pretending that it is one of two homogeneous classes, proletarians and the rest; or even three such classes or several.

The marginalization of the less advantaged operates both through a paucity of jobs for them and through pay offers so remote from the earnings of those in the mainstream of the labor force that their morale is impaired or broken. Clearly the system called the market economy does not promptly deliver a viable job for everyone upon request – no matter

<sup>1</sup> Understandably, many would at once object to the idea that even people with just an epsilon of productivity should be brought into the market economy or else be deemed an inclusion failure. Thus, many will advocate a positive threshold level that people's productivity must exceed for us to count their non-employment as an inclusion failure. But moral philosophers have not suggested a solution to the problem of what an appropriate threshold level might be if not zero. As a practical matter, however, minimum wage laws remove the problem. One would not want to design and evaluate machinery to pull up wages from so low a level that they would remain below the statutory minimum wage.

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how low a wage one is prepared to accept; there is involuntary unemployment. And, although some number of unemployed persons may be justifiable to concentrate the minds of employees on their jobs, the invisible hand is not thought to have restricted unemployment to the optimum level from this point of view. Even if that efficiency maximum prevailed, some workers might be so unlucky from entry to retirement that they never get a career going and earn their own support, which would be inequitable. That is a failure of inclusion. It is not enough to say that all workers had acceptable chances for a career and a decent living. And people cannot buy insurance against missing out on self-support and personal development – on having a life.

The way a market economy determines wage rates also affects inclusion. People are far from identical in their capabilities, and their productivity in terms of market value ranges over a vast spectrum from barely positive productivity at all to dazzling ability. There were times when a deficiency in capabilities did not translate into a deficiency of inclusion. A family farm might involve all the family members, even those only marginally productive. In the modern corporation, managers do not have much left after the demands of shareowners with which to subsidize some workers' employment – especially with the increased competition brought by globalization. As a result, the average pay check even a tenth of the way up the wage distribution is a small fraction of the average pay in the middle – about one-half in the United States and the so-called Anglo-Saxon countries generally. So workers in that region of the distribution, even when they are steadily employed, can hardly achieve the self-support and self-worth once thought to be attainable by all in the working class and have to live in poverty by the standards of the middle class. In turn, the meager pay available to these low-wage workers weakens their job attachment and their productivity, thus forcing up employers' costs. The effect is to reduce low-wage workers' wage rates further and also to reduce their employability, thus driving up their unemployment rate. So, to the deprivations of a low pay rate are added the economic and emotional burdens of joblessness.

A serious decline in the inclusion of less qualified workers swept over the advanced Western economies in the late 1970s and 1980s. None entirely escaped it and, in general, it was not fully offset by the higher employment and elevation of wages brought by the investment booms in several Western economies from 1996 to 2000; in any case, those booms have now largely subsided.<sup>2</sup> Compared with the 1960s, the pay

<sup>2</sup> The United States is not an exception to the decline of inclusion in either of its two dimensions. In the last years of the boom, 1998–2000, both relative wages and relative

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gap between the low end of the labor market and the middle remains far wider, and, among less educated men, participation in the labor force is still lower and the unemployment rate still higher. (In Europe over the past two decades, France and Germany actually compressed the pay gap and Italy resisted a widening, but they appear to have paid the price with a far greater rise of unemployment and fall of participation among less educated men than elsewhere in Europe.)

One can summarize these observations by saying that the advanced economies have generally suffered an adverse shift of what may be called their *inclusion frontier*. That frontier relates the relative wage in the *lowest-paid* ranks to substantially these workers' absolute unemployment rate – or, more conveniently, their *employment* as a ratio of their number in the labor force. The unemployment rate is a measure of the frequency with which workers join or are discharged into the unemployment pool multiplied by the waiting time that entrants into the low-wage job pool must expect before being called to a job. These two data, the relative wage of the low paid and the proportion of the time they are employed, express their degree of inclusion.

### Causes of the lost ground

Today, after considerable investigation, there is some degree of consensus that the deterioration of inclusion is, approximately at any rate, the result of structural forces operating through essentially non-monetary channels – both macro-structural forces and micro-structural ones. From this perspective it appears that most of the decline of inclusion in the Western economies can be explained by the evolution of three macro-structural forces: the economy's productivity growth, personal wealth and the world real rate of interest. The extraordinarily low jobless rates in the so-called "glorious years" from the mid-1950s to the early 1970s are now seen as the product of exceptional circumstances in all three respects. For one thing, the austere level of private wealth in relation to productivity that was a legacy of the war kept wage pressure low enough to permit very high employment; and the sprint of productivity, especially on the Continent where businesses moved to catch up with best technical practice in the

unemployment rates were much improved over their levels a decade earlier. But it is doubtful one could show that the bottom decile of wage earners could afford good housing, clothing and community participation to the same extent the corresponding group in, say, the 1960s could, since the relative wage as measured by the 10/50 ratio – the ratio between the 10th and 50th percentile wage rates in full-time jobs – declined so much over the preceding two and a half decades. Further, both high-school dropouts and (by a smaller margin) those workers with only a high-school diploma had higher reported unemployment in 1998 than in 1970 or 1965, notwithstanding the strong boom.

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United States, caused wealth to lag further behind productivity, which lowered wage pressure more. Second, real interest rates throughout the world were low, thanks to the desire to reaccumulate wealth; this and the prospect of continued productivity growth at a fast rate served to lower the expected net cost of capital (net of expected productivity growth), which boosted the wage that businesses could afford to pay and thus the hiring they were willing to do. The United States and the United Kingdom were similarly blessed in some or all respects, though not to the same degree, and so their unemployment rates never reached the record lows recorded on the Continent. Yet the postwar structural boom could not last. Legislatures expanded welfare entitlements in the 1960s, and this rise in *social* wealth appears to have played a role over ensuing years as wages showed upward pressure and unemployment rates moved generally higher and profit shares generally lower. As the technical catch-up neared completion in one country after another in the 1970s, expected future productivity growth slowed from its breakneck speed to a normal pace; the resulting rise in the cost of capital (net of expected productivity growth) dampened hiring, and the resulting slowdown of paychecks relative to wealth generated upward wage pressure. Finally, a further rise of the cost of capital and still more wage pressure resulted from the sharp elevation of the world real rate of interest early in the 1980s. In the United States, of course, such a catch-up did not apply, but there was a substantial though lesser productivity slowdown from 1974 until 1994 and overseas interest rates became a regular object of American worry.<sup>3</sup>

This slump is distinctive not only in being largely structural in nature, but also in the severity of its relative impact on the less advantaged – say, for statistical purposes, those in the least educated group, the high-school dropouts. With few exceptions in the countries of the Organisation for Economic Co-operation and Development (OECD) over the 1980s and neighboring years, the *proportionate* increase in unemployment rate, not just the absolute increase, and the proportionate decrease in wage rates were both greatest in the lowest education category – and generally by a wide margin. Two of the macro-structural forces may have struck the earning power of the less educated with disproportionate force. The rise in the net cost of capital may have penalized the less educated if hiring them posed a greater investment cost relative to their wage than hiring more qualified workers did. And social wealth (social insurance and social assistance) rose steeply from the 1960s into the 1990s in most countries

<sup>3</sup> These views are developed and many of them tested in Phelps (1994), Hoon and Phelps (1997) and Phelps and Zoega (1997, 1998). Some of the same views (and others) are also found in Pissarides (1990), Layard, Nickell and Jackman (1991) and Blanchard (1997, 1999). A new perspective is offered in Greenwood (1997).

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and the less advantaged got the lion's share of it. At the same time, poor families shared fully in the slowdown of productivity. As a result, particularly in low-productivity areas, work ceased to "pay" for as many as it did decades earlier. It is also plausible that the less advantaged suffered further reversals at the hands of some micro-structural forces: Globalization increased the reach of outsourcing by employers and information technology put an added premium on educated labor.<sup>4</sup>

To address the deficiency of inclusion through governmental action on a large scale – large enough to make a large difference – requires a paradigm shift in political economy that some policy makers are not yet ready to accept. So we are obliged to take up the philosophy of such a step and only then proceed to the business of this volume, which is the engineering of concrete fiscal programs to boost inclusion.

### Political economy

A basic question here is whether the deficiency of inclusion among the less advantaged is, to any degree, a problem for society to address through the state. In the view of some observers, low inclusion, however regrettable, is *not* a phenomenon appropriate for *social intervention* – not something to be corrected through collective action by the state.

The reply to that position, a reply dating back to the eighteenth-century Enlightenment, is that a democratic country's formal economy is a project for citizens' mutual gain, so the accessibility of this project and the satisfactoriness of the terms it offers participants are a legitimate object of social policy. Some of the classical economists, with their notion of consumer surplus, suggested that in fact a mutual gain does result, an idea brought up in the Progressive era. A formulation is sometimes found in textbooks today: Just as the gains from foreign trade, which originate in the diversity of national resources, benefit everyone – or *could* be made to do so, if necessary with the help of redistributive taxes and subsidies – so likewise all workers interlinked in a large society's market economy enjoy wages rates superior to those they would earn if they worked alone or in homogeneous teams (at any rate, superior wage rates *could* be arranged through fiscal tools). So there is a "social surplus" that society can distribute in any one of a great many different ways to the diverse kinds of workers without leaving any group with no gain over what it could have if it broke away.<sup>5</sup>

<sup>4</sup> A less cursory discussion is in Phelps (1997a). See also Greenwood (1997).

<sup>5</sup> In Phelps (1997b) the economic doctrine of the Scottish Enlightenment is seen as a liberation movement prizing people's release from domestic work within the family or hamlet into the relative freedom, diversity and stimulus of the market economy. On the

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The Progressive era first raised the question of the size of the surplus and – a matter of basic principle in any case – the appropriate uses of it. Most took the surplus to be nearly all of what is produced, suggesting, as did Hobhouse (1922), that one who does not collaborate or barter with others would not have any productivity to speak of.<sup>6</sup> Whatever its size, the surplus could be used to add to the rewards of participants who would otherwise earn a very low wage, taking away from others some or all of what the surplus had been adding to their relatively high rewards. Or it could be used to boost the educational preparation of persons who would otherwise be unable to earn more than a very low wage. With the surplus evidently in mind, Theodore Roosevelt sounded the theme of “distributive justice” in his 1912 re-election campaign.<sup>7</sup> Much later, in John Rawls’s 1971 book, the surplus is viewed from its first pages as the rock on which any theory of economic justice must build. To his credit, the analysis takes fully into account that steadily boosting marginal tax rates to fund higher wages or education for the disadvantaged, in reducing the incentives of the others to work and save, would actually be lowering the surplus; and that, at some point, the marginal rates would be so high that no further boost in rates would succeed in moving more surplus to workers with the lowest wage. So it is not as if the surplus were some honey pot against which to measure the adequacy of public expenditures and subsidies aimed at a more equitable distribution of pay.

In present times, attention is more apt to be given to the *negative* interactions among people that may arise if an underclass is allowed to develop: *All* suffer a loss of amenities – unsafe streets, drug use among youth, public health hazards, high tax rates for social assistance, and so forth – if large numbers of working-age people are marginalized from work and self-support.<sup>8</sup> A central part of my book *Rewarding Work* (Phelps, 1997a)

social surplus, Paul Samuelson’s textbook (1948, 4th edition, 1958: 445) cites Adam Smith’s water–diamonds paradox and quotes Progressive era social theorist L.T. Hobhouse (1922: 162–163).

<sup>6</sup> Possibly the surplus is a smallish proportion of what is produced, since there is more behind labor productivity in a country than workers’ diversity and specialization. Theoretical calculations by Gilles Saint-Paul and myself put the surplus at roughly 1 percent of the gross domestic product (GDP). (Phelps, 1997a: 141, also cites this result.) In judging the significance of that result, three points must be borne in mind. First, the neoclassical model used is just one model of the many that could be built for studying the question. The specialization of a heterogeneous labor force may produce Smithian learning and externalities. Second, it may produce a diversity of new ideas for new goods and methods. In any case, 1 percent of the GDP in the United States is close to US\$100 billion, which far exceeds the net budgetary cost of the modest plan proposed in Phelps (1997a).

<sup>7</sup> Roosevelt’s views on the economy are presented in a recent biography (Dalton, 2002).

<sup>8</sup> Although the occasional investigation fails to find an effect of unemployment rates on one or more social indicators, there are many successes. For example, Ernesto Felli and Giovanni Trià (1999) find that regional unemployment rates in Italy correlate pretty well with regional murder rates.

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argues that the benefits from reducing these negative externalities through low-wage employment subsidies that draw the marginalized into regular work and self-support would come close to covering the cost of the subsidies.<sup>9</sup>

To commentators unmindful of the classic lines of thought reviewed above, however, deficient inclusion is nothing more than an instance of income inequality and, for some, not the most serious inequality either (if bad at all). On the seriousness issue, it is true that in several countries, upon controlling for a range of factors such as education, pay rates are estimated to discriminate against both women and blacks. Of course it rankles that there should be a systematic pay difference between two apparently equally prepared subgroups, and we must all be sensitive to the historical background of extreme racism and sexism. Yet the extant pay differentials of this kind are no longer garish and they appear to be still trending downwards.<sup>10</sup> By contrast, the inequality between the tenth percentile wage and the median wage is huge in the United States and quite wide in a great many other Western economies.<sup>11</sup>

On the basic issue, the reductionism that takes inclusion failure to be essentially an income inequality, the point is that a deficiency of inclusion – too few employed in society's central economic institution, the market economy, or too few of the employed able to support themselves by working, even full time – has social effects beyond income inequality, wage inequality and inequality in general.<sup>12</sup> Because having a job and earning enough in that job to be independent are crucial in their own

<sup>9</sup> See chapters 4 and 9 in Phelps (1997a).

<sup>10</sup> A paper by Sandra Black and Elizabeth Brainerd (1999) finds that the competition resulting from globalization has induced US companies to reduce costly discrimination against women.

<sup>11</sup> Finis Welch, in his Ely Lecture at the American Economic Association meetings in 1999, held that most Americans would prefer today's vast inequality to the more homogeneous income distribution of the late 1940s when racism and sexism blocked occupational choice and pay. Perhaps so. But the question, if there is one, is whether marginalization of the disadvantaged now is less serious than racism and sexism *now*, not *then*. Take the United States. The wage difference now between childless men and childless women ages 27 to 33 is put at less than 2 percent by the Independent Women's Forum of Washington, DC (*Wall Street Journal*, April 13, 1999, p. 1). In contrast, the wage ratio between the 10th and 50th percentiles of full-time jobs is put at 44 percent in 1986 by Gottschalk and Joyce (1992). In December 2001 the gap between the male unemployment rate and the female rate was equal to zero, whereas the gaps between the average unemployment rate in the bottom education group and the rate in each of the other education groups were very large.

<sup>12</sup> Empirically, inclusion difficulties add to income inequality. Theoretically, though, they might not do so. In a "lifecycle" model of the economy in which successive cohorts of homogeneous workers are born in the unemployment pool and emerge with lifetime jobs, there may be *lifetime equality* because *all* the young suffer *equally* from the inclusion difficulty (for such a model, see Phelps, 1998).

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right – no matter how much non-wage income, including the benefits offered by entitlements, may be available – failure to achieve these objectives is apt to deprive a person of gains in knowledge, information, achievements, personal growth and self-esteem that would otherwise have been acquired.<sup>13</sup> The consequences in turn are that the unemployed and the dependent make poor parents and neighbors, and when a community is dominated by these problems the effects extend to drug trade and the loss of public safety. One might think that all this is commonplace wisdom. “Yet,” as Derek Bok said, “we continue to talk . . . as if income statistics captured the phenomenon in some meaningful way” (Domestic Strategy Group, 1998: 18).

By its nature, then, the inclusion problem cannot be solved by “throwing money” in the form of *transfer payments* to those not included. Receiving income support from the state does not make one a contributor to society’s economy and a member of society who works for what he has. When the OECD governments expanded the system of entitlements offering transfer payments under various contingencies (illness, reaching a certain age, etc.), they were meeting a desire of the electorate for greater security – not for greater inclusion, which had been rising in the postwar decades and which was already pretty broad in several of these countries. Unfortunately, these programs have lessened inclusion. That must be so if recent studies are right in confirming that what lies behind the inclusion difficulty faced by many working-age people – their low pay rates in relation to their other resources, their low participation rates and their high unemployment rates as a result of their poor morale – is their low marginal productivity after taxes and any subsidies *relative* to the benefits from their private assets and their entitlements. To legislate still more government transfer payments would worsen the inclusion problem by making jobholding less competitive as a means of supporting one’s self and thus lowering participation and increasing

<sup>13</sup> Another unfortunate effect of viewing deficient inclusion as an instance of income inequality is that it burdens the discussion of inclusion with the baggage of controversy and confusion about inequality. First of all, an increase in income inequality cannot be judged out of context to be either good or bad. Yes, it may be that some non-inclusion is theoretically needed (in the form of positive unemployment) to avoid serious inefficiency in employee conduct, so there is a theoretical ambiguity there too; but there is a strong presumption that inclusion at present is far from reaching a level at which it threatens productivity. Second, many economists appear to think that existing taxation of high incomes is about right, believing that continuing moderation in marginal tax rates at the top is serving to pull up after-tax wage rates across the board – hence those of the least advantaged – by energizing effort and innovation. (Some other economists muster no interest in income equality whatsoever.) It is possible to stand in that camp, however, and still believe that a great deal more inclusion, suitably achieved, would yield a pretty general gain.

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unemployment, especially among working-age people with relatively low earning power.

By the same logic, the spread of the underground economy does not solve the problem either. The underground economy, like the welfare state, shrinks and damages the formal economy by weakening performance incentives in formal jobs and weakening the incentive to participate in the formal economy. Working underground may be socially preferable to *welfare*, since at least something is produced, but it is a poor substitute for a job in the legitimate economy. Like the domestic economy of paid housework, the underground economy functions as an escape valve that drives unemployment in the legitimate economy above the level it would be if there were no such escape from unemployment.<sup>14</sup> If that is right, the underground, far from offering a welcome *cushion* of alternative work for people viewed as having irrevocably lost the possibility of employment in the formal sector, ultimately substitutes its inferior jobs – dead-end jobs, jobs with poor conditions that would once have been passed up, jobs that are viable only because of tax evasion and other criminal acts, all work activities that were once rejected – for the good jobs that would otherwise have been created in the formal economy. The personal and social effects of this development may be nearly as stultifying and pernicious as the effects of the entitlements of the welfare state. However, the toleration of both the explosion in welfare entitlements and the expansion of the underground economy is part of the *problem*, not a solution.

I would add that the value of careers in the formal economy depends on the stimuli provided by its organization along capitalist lines. Any country can achieve full employment and high relative wage rates at the low end by sacrificing private enterprise and forgoing decentralized wage-setting. The Soviets did it through central wage-setting and toleration by state enterprises of employee shirking, absenteeism and alcoholism. Yet that system could not offer the job satisfaction and personal growth obtainable

<sup>14</sup> When payroll tax rates and income tax rates were increased in the 1970s and 1980s, the *initial* response was a fall of employment in the form of both higher unemployment and lower labor-force participation. In the theoretical perspective of incentive-wage theory, wages were cut insufficiently to accommodate the cost shock because employers knew that further wage cuts, which would be needed to restore employment, would reduce pay *relative to wealth* to such low levels as to have disincentive effects that would actually leave production costs increased on balance. (The collective bargaining perspective tells a parallel story.) Yet, if there existed no underground economy, the *long-term* response would have been a fully accommodating decline of wealth and pay in equal proportion, triggered by the reduction of saving in response to the decrease of employment and earnings; this would have proceeded to the point where employers could afford to offer the same number of jobs as before. In offering escape into subterranean jobs the underground blocks the completion of that adjustment of wealth and wages, thus blocking full recovery of employment in the *formal* economy.