Example 5.2
Equality in Europe vs. the United States

In an article written for the *Brookings Papers on Economic Activity* in 2001, Alberto Alesina, Edward Glaeser, and Bruce Sacerdote (AGS) considered why public policy in the OECD European countries is so much more equalizing than public policy in the United States. Using data mostly from the 1990s, they find that the European countries are more equalizing along every dimension – social spending, taxation, and labor market protections.[1]

AGS compare a variety of income support policies and safety nets in Germany, Sweden, and the U.S., including family benefits, health care, sickness and accidental injury benefits, disability benefits, and poverty relief. In each instance the Germans and Swedes have more generous programs, with only one possible exception: payments to families with zero income. Overall, transfers to households and subsides are about twice as large in the European countries as in the U.S. The European tax systems are also more progressive, with higher marginal tax rates on higher incomes and lower marginal tax rates on lower incomes. Finally, the Europeans offer their workers far more protection through government regulations, including higher minimum wages, more stringent termination policies, and more generous leave time, and they also have higher replacement ratios under unemployment insurance. The result of all these differences is that the U.S. has much higher after-tax income inequality, in large part because the poorest members of U.S. society are much poorer, relatively speaking, than their European counterparts. Those in the lowest income decile in the U.S. have about 1/3 of the median income, on average, compared with 55% of the median income in most European countries (data for the 1980s, p. 201).

AGS consider three categories of factors that could explain these differences in equalizing policies: economic, political, and behavioral. One of their strongest

[1] Alesina, A., Glaeser, E., and Sacerdote, B. Why Doesn't the United States Have a European-Style Welfare State?, *Brookings Papers on Economic Activity*, **2**: 2001. The page numbers for specific data or quotations are given in parentheses. This example highlights the main points of the AGS article. Refer to the article and its sources for a more complete analysis.

conclusions is particularly surprising, that the standard economic arguments relating to society's preferences for equality do not seem to apply at all. They believe that the equalizing differences between the U.S. and Europe lie in a combination of political and behavioral factors.

The Economic Factors

Mainstream economic theory suggests that four factors should be important determinants of a society's preference for equality: the distribution of pre-tax/transfer income, the variability of income, social mobility, and the inefficiencies of taxing and transferring.

The distribution of income – If societies value equality as mainstream theory assumes, then the more unequal the pre-tax/transfer distribution of income the more governments should redistribute. The reason is that higher income individuals have lower social marginal utilities of income than do lower income individuals. As discussed in Chapter 5 of the textbook, the farther apart those with higher and lower incomes are in the distribution, the greater the difference between their social marginal utilities of income, and therefore the greater the increase in social welfare in transferring income from the rich to the poor. This cannot possibly explain the more equalizing European government policies, however, since the U.S. has the more unequal pre-tax/transfer distribution of income, and by a wide margin. In data compiled by Deininger and Suite, the Gini coefficient for the pre tax/transfer income distribution in the U.S. was .385 vs. an average of .291 in Europe (p. 209).

The variability of income – People prefer that their own incomes be relatively stable rather than highly variable over time, for a given total amount of income. That is, they appear to have diminishing marginal utility of income: The increase in utility from a given increase in income is less than the decrease in utility from the same decrease in income. This is the basis of private insurance, as explained in Chapter 12 of the textbook. People are willing to sacrifice some income in the form of an insurance premium in good times in return for an insurance payment when an income-reducing event occurs, such as ill health. Insurance allows them to smooth their incomes over time. Given this preference, nations with more variable incomes should be willing to redistribute more through taxes and transfers than countries with more stable incomes. In this case, the taxes and transfers are acting as income smoothing insurance policies: People pay more taxes when incomes are high and receive more transfers when incomes are low. But this desire for insurance cannot explain the greater redistribution in Europe since U.S. income is the more variable.

Social mobility – Some economists have argued that social mobility can affect a society's willingness to redistribute in democratic societies if the median voter is decisive in the political arena and the median voter has median income.[2] The idea is that the median voter might vote against redistributive policies if she believes there is a good

[2] Pages 446–7 in Chapter 22 of the textbook explain why the median voter, the voter with median preferences, is decisive in a one-person, one-vote democracy.

chance that she will be better off in the near future. In that case, voting for redistribution is essentially voting against one's long-run economic self-interest. The degree of social mobility would have to be quite different in the U.S. and Europe to explain their widely varying efforts to redistribute, however, and this does not appear to be the case. To give one example, a recent study of earnings by Gottschalk and Spolaore comparing social mobility in the U.S. and Germany found little difference in the ability of the middle class to move up through the income distribution over time (pp. 212–3).

Tax/transfer inefficiencies – Finally, redistribution should be less the more deadweight loss there is from taxation (and transfers) because then redistribution is more costly (that is, Okun's Leaky Bucket). Again, there is no evidence to suggest that U.S. taxes (and transfers) are more inefficient than European taxes (and transfers). Indeed, compliance in paying taxes is lower in Europe than in the U.S., suggesting that European taxes are the more burdensome.

In conclusion, the standard economic arguments favoring more equalizing public policies appear to have little or no ability to explain the greater redistributive efforts made by the European countries.

The Political Factors

AGS are convinced that the differences in U.S. and European redistributive policies result instead from a combination of political and behavioral factors. Regarding the political factors, they note that the U.S. has had a much more stable political history than the European countries over the past 200 years. The U.S. Constitution has remained the central political document in the U.S. and it tends to favor the protection of private property over redistribution, a tendency that was upheld by the judicial system until the mid-20th century. The U.S. Supreme Court, in particular, long favored property rights and was hostile to redistribution. As one example, it prohibited the taxation of income, a prohibition that had to be overturned by an amendment to the Constitution in 1913. In contrast, many of the European nations evolved later in time and as a result of popular uprisings against ruling aristocracies and monarchies. One consequence of the uprisings was that the judicial system in Europe was never biased in favor of private property as in the U.S. In addition, the democracies of Europe generally have proportional voting systems that gave rise to multi-party political systems. The U.S. does not have proportional representation in voting, which favors a two-party system. The two-party system in turn prevented the formation of influential and highly egalitarian socialist and communist parties, in contrast with Europe. Still another political factor providing a bias against redistribution was the adoption of a federalist form of government in the U.S., whereas most of the European nations have a unitary government. When the U.S. national government became heavily engaged in income support for the first time during the Great Depression of the 1930s, it left to the states the administration of the newly established public assistance programs. The national government provided considerable financial support for the state programs, but the states determined how generous their public assistance programs would be, a feature that still remains in setting the benefits under Medicaid and TANF. Many states are not willing to support generous public assistance programs, with the result that public assistance is highly variable across the 50 states.[3]

Behavioral Factors

AGS believe that two behavioral factors are especially important in explaining the differences in redistribution between Europe and the U.S. The first is that, in their words, "racial prejudice is a real and enduring feature of the American landscape" (p. 228). This matters for two reasons. One is that people are known to be much more altruistic towards people that they perceive to be similar to them. The other is that blacks and Hispanics have two to three times the poverty rates of whites, which means that redistribution towards the poor goes disproportionately to blacks and Hispanics.

The second factor is one uncovered by the behavioral economists in their laboratory experiments, that people tend to exhibit reciprocal altruism: They are altruistic towards people whom they believe behave appropriately but at the same time are willing to punish people whom they view as uncooperative or otherwise behaving badly.[4] Combine reciprocal altruism with the history of the U.S. in which the open frontier was a dominant factor until the early 1900s, and one that was almost entirely missing in the more densely populated and smaller European nations. The frontier promoted an egalitarianism that favored equal opportunity over equal outcomes, along with such character traits as self-reliance, less risk aversion, and a general anti-statist attitude. One lasting consequence of the frontier mentality in the U.S. is a very different view of the poor from that of the Europeans, a difference found in almost all attitudinal surveys. For example, a survey comparing West German and U.S. attitudes towards the poor found that 70% of West Germans believed that people are poor because of imperfections in society, whereas 70% of Americans believe that people are poor because they are lazy. Correspondingly, another survey found that only 40% of the West Germans believe that the poor can work their way out of poverty, whereas 71% of the Americans believe that they can (p. 237, both survey results). The combination of Americans' attitudes towards race and their view that the poor are lazy naturally leads to hostility towards redistribution.

In summary, AGS believe there are three main reasons why public policies in the U.S. are much less equalizing than public policies in Europe:

1. The belief in the U.S. that redistribution would disproportionately favor racial minorities.
2. The belief in the U.S. that the U.S. economy is fair in the sense of promoting equality of opportunity, and therefore being poor is largely one's own fault.
3. The evolution of the U.S. political system, which occurred in a way that is biased against redistribution (p. 247).

[3] See Chapter 10 of the textbook, pp. 178–83, for a description of the U.S. public assistance programs.
[4] Further discussion of reciprocal altruism appears in the Epilogue to the textbook.