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The rise of “good” inequalities

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A commonly held view asserts that it is impossible for free markets to foster a greater amount of equality amongst men. To the general public, it seems hard to fathom that profiteering bred by free markets might lead to anything less than a growing gap between the rich and poor. The empirical evidence seems to support the view that the gap between rich and poor has grown in the past decades. For example, the share of total income that comes from the richest 0.1% of the Canadian population rose from below 2% in 1980 to above 5% in 2000 (Saez and Veall, 2005). A similar but more pronounced trend has been observed in the United States where that share rose from slightly above 2% to over 7% in 2000 (Saez and Veall, 2005). The gap between rich and poor has indeed widened and the blame is laid on the supposed selfishness unleashed by free markets.

However, we should not assume that a growing gap is a problem in itself. The real questions that we should ask ourselves are whether or not workers stay in the same income group and how choices made by individuals affect their incomes.

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Poor from cradle to grave?

If we wish to know if an economic status (income and/or consumption relative to others) is permanent, the best tool economists can use is longitudinal data—tracking the same individuals over time. Using such data, it is estimated that somewhere between 42.3% and 57.6% of Americans in the poorest quintile (i.e., the bottom 20%) of the population in 1996 rose to a higher quintile by 2005 (Auten and Gee, 2009). A similar upward mobility was observed over the period from 1987 to 1996 (Auten and Gee, 2009). Over the 16 year period lasting from 1975 to 1991, over 80% of those who were in the poorest quintile in 1975 rose by more than one quintile in 1991 (Cox and Alm, 1999). In Canada, it is estimated that 43% of those in the poorest quintile in 2005 had moved up to a higher quintile by 2010 (Labrie, 2012). Overall, this indicates a high level of upward mobility and this is confirmed over a broad set of measures of standards of living (Bartlett, 2005).

What about absolute living standards?

Measuring income adjusted for living costs is a nuanced and complex exercise. However, many economists have observed that when they compute prices for goods and services bought at discount outlets where poorer individuals tend to shop, real incomes (adjusted for the cost of living)

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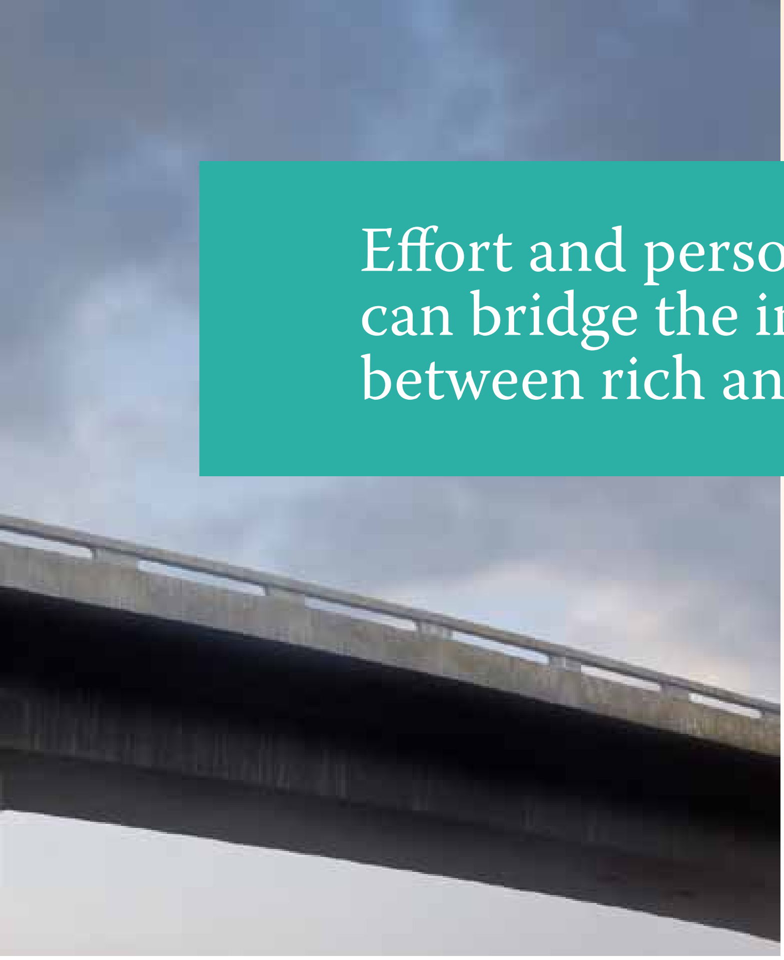
of the poor are more accurately measured and a large part of the real income gap between rich and poor disappears (Gordon, 2009). The use of such data has also allowed economists to realize that the poverty figure for the US is half that of the official figures (Broda et al., 2009). Moreover, the average real wages of the poorest continue to rise and poorer households now possess amenities like dishwashers, televisions, and the internet in similar proportions to richer households—all of which improves their standard of living (Labrie, 2012).

The observation made by economists that the share of the earnings gap in the US is explained by factors beyond one's control—being born in a particular family or area—stood at only 18% in 2001, a figure that has declined since 1968 (Pistolesi, 2009). The remaining share is explained by factors that each individual can control, namely schooling and labour supply decisions. In other words, effort and personal choices are the dominant factors in determining income and wages.

Choices matter

How can we reconcile these observations with the growing gap in static measures of income? Economist Finis Welch proposed that, as long as it is not the result of government policy, income inequality could be welcomed (Welch, 1999). The disparities between wages and earnings of different individuals lead to "increased opportunities for specialization and increased opportunities to mesh skills and activities" (Welch, 1999). Wages convey information about which skills, goods, and services are needed by consumers and businesses. In other words, they inform individuals about the possibilities for self-accomplishment.



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Effort and personal choices can bridge the income gap between rich and poor.

It is with such a viewpoint in mind that we should look at the rise of the demand for knowledge and skills that occurred in the 1980s. This rise in demand led to higher returns from schooling which benefitted those who had *already* acquired their education and widened the gap between those who acquired more schooling and those who acquired less (Becker and Murphy, 2007).

However, the prospect of greater earnings from schooling pushed young individuals to opt in greater numbers to pursue a college degree or technical degree (Becker and Murphy, 2007). Since wages and earnings respond to investments made to enhance future prospects, the longer time spent in school could provide observers with the illusion that the earnings gap is growing. In fact, it is estimated that once we account for changes in returns to schooling and in university participation, an important part

Many workers believe their free time is worth more than extra income.

of the earnings gap disappears (Lemieux, 2006). Were it not for the gap that emerged in the 1980s because of higher returns from education, fewer individuals would now be interested in pursuing higher education.

The earnings gap is also the reflection of labour supply decisions. All workers face a trade-off between leisure and work. Many workers will establish an income target for themselves to sustain their living standards and they will not work after they have reached that target. Once they have reached that target, they believe that the value of their free time is worth more than the extra income they would gain. In other words, most individuals work in order to live, not the other way around.

On the other hand, some individuals prefer to work longer hours. Many of them can be found in the richest amongst us: business executives, attorneys, and bankers—to name just a few. These individuals understand that long hours are a condition for the higher incomes they covet. Hence, they will put in longer hours at the office and accept more responsibilities in their quests for personal achievement. Considering the accelerating trend towards performance

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pay that has been observed in recent decades, financially ambitious workers would have tended to head towards jobs that were more likely to allow them to reach their goals (Lemieux, 2009). The gap in earnings reflects how workers chose to use the opportunities presented to them given each worker's individual preferences.

Conclusion

The existence of a growing gap between rich and poor does not mean that workers are left worse off. In fact, it is the reflection of different choices in schooling and labour supply according to individual preferences. We should be rejoicing at the fact that many workers feel that they do not need to work too long before fully enjoying the fruits of their labour. We should also encourage those who wish to labour longer and harder. Rather than bemoaning the rise in earnings gap, we should remove all barriers to the acquisition of skills and education for workers who see openings in the market. As long as workers are left free and are not hindered in their abilities to make decisions regarding which paths best advance their desire for individual self-accomplishment, there is no need to worry about a growing earnings gap. All that matters is that those who born amongst the poorest have the chance to reach the standard of living they desire.

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