



# The workshop on Inequality and Welfare

September 3<sup>rd</sup> 2015

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## 2 INTRODUCTION

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The COEURE Coordination Action (which stands for COoperation for EUropean Research in Economics) brings together the key stakeholders in the European economic research space – funders, policy-makers and researchers – in a process of stocktaking, consultation and stakeholder collaboration. The aim of this process is to identify the knowledge gaps on key EU economic policy issues and assess the current challenges and opportunities facing European-based researchers, with the ultimate goal to inform the European agenda for research funding. It is funded by the European Commission and carried out under the initiative of the European Economic Association. More info at [www.coeure.eu](http://www.coeure.eu)

This report summarizes the workshop, devoted to “Inequality and Welfare”, which has been one of twelve thematic workshops organized by COEURE as part of its stockholding exercise. It brought on September 3<sup>rd</sup>, 2015 together a small group of high level scholars as well as high level policy-makers and other stakeholders who discussed the research frontier in these areas. The workshop focused on policy experience and policy challenges when it comes to the question of inequality and welfare. It had as an objectives to form a grounded view on the role of scientific advice in EU policy decision-making and identify knowledge gaps, and document and discuss the state of European research on these themes and the challenges and opportunities facing European-based researchers.

The scientific committee consisted of Frode Steen (Norwegian School of Economics), Alain Trannoy (EHESS, GREQAM-IDEF, Marseille), and Bertil Tungodden (Norwegian School of Economics).

Ingar Haaland from Norwegian School of Economics had the major responsibility for the minutes.

The workshop took place at Université libre de Bruxelles who cordially hosted the workshop.

### 3 THE WORKSHOP PROGRAM

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**09H30 – 09H45: INTRODUCTION**

**Frode Steen** (Professor, Norwegian School of Economics)

**Marianne Paasi** (Research program and policy officer, European Commission)

**09H45 – 10H45: INEQUALITY AND WELFARE: THE SCIENTIFIC STATE OF THE ART**

**CHAIR: Bertil Tungodden**, (Professor, Norwegian School of Economics)

**Alain Trannoy** (Professor and Research Director at EHESS, GREQAM-IDEP, Marseille)

**10H45 – 11H15 COMMENTS FROM RESEARCH**

**Alexander W. Cappelen** (Professor, Norwegian School of Economics)

**11H15 – 11H30:** *Coffee break*

**11H30 – 12H00: COMMENTS FROM POLICY/ACADEMICS**

**Franck Vandebrouck** (Former Minister in the Belgian Federal Government and the Flemish Regional Government, professor at the K.U. Leuven)

**12H00 – 12H30: Q&A FROM AUDIENCE**

**12H30 – 13H30:** *Lunch break*

**13H30 – 14H30: ATTITUDES TO INEQUALITY: EVIDENCE FROM SURVEYS AND EXPERIMENTS**

**CHAIR: Hannah Gitmark**, (the think tank *Agenda*, Oslo)

**Ingvild Almås** (Researcher IIES, University of Stockholm)

**Erik Shokkaert** (Professor, University of K.U. Leuven)

**14H30 – 15H00: INEQUALITY AND WELFARE: POLICY PERSPECTIVES**

**CHAIR: Barbara Chizzolini**, (Professor, University of Bocconi)

**Marc Fleurbaey** (Professor, Princeton University)

**15H00 – 15H30:** *Coffee break*

**15H30 – 17H00: INEQUALITY AND WELFARE: POLICY PERSPECTIVES (CONT.)**

**Marte Gerhardsen** (Director of the think tank *Agenda*, Oslo)

**J. Peter Neary** (Professor, University of Oxford)

**Karl Ove Moene** (Professor, University of Oslo)

**17H00 – 18H00:** Cocktail

**20H00:** Dinner (by invitation)

## 4 THE WORKSHOP PARTICIPANTS

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Almås	Ingvild	Stockholm University, NHH
Cappelen	Alexander W.	Norwegian School of Economics
Chizzolini	Barbara	Università Bocconi
Contigiani	Alessandra	Toulouse School of Economics
Falch	Ranveig	Norwegian School of Economics
Fleurbaey	Marc	Princeton University
Gerhardsen	Marte	Agenda
Gitmark	Hannah	Agenda
Haaland	Ingar	Norwegian School of Economics
Ivaldi	Marc	Toulouse School of Economics
Mayor	Eunate	Toulouse School of Economics
Moene	Karl Ove	University of Oslo
Moriconi	Simone	Università Cattolica di Milano
Neary	J. Peter	University of Oxford
Paasi	Marianne	European Commission
Sanchez-Robles	Blanca	Spanish Embassy, University of Cantabria
Schmidt	Ulrich	University of Kiel
Schokkaert	Erik	K.U. Leuven
Steen	Frode	Norwegian School of Economics
Trannoy	Alain	EHESS, GREQAM-IDEP
Tungodden	Bertil	Norwegian School of Economics
Vandenbroucke	Frank	K.U. Leuven
Wyndham	Timothy G.A.	Norwegian School of Economics

## 5 INEQUALITY AND WELFARE: THE SCIENTIFIC STATE OF THE ART

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The workshop started with a welcome speech by Frode Steen from the NHH Norwegian School of Economics. The main event of the workshop was a report on inequality and welfare prepared by Alain Trannoy from EHHS and AMSE, followed by comments and discussion from both research and policy.

Marianne Paasi from the European Commission continued the introduction and talked about why collaboration across member states is necessary to improve economic research within the union. Research is typically performed across member states, who fund research from the perspective of their national concern. This can lead to *fragmentation* with an *undersupply of good ideas* as the result. The goal of the commission is to combat this tendency through a coordinated effort to identify knowledge gaps with respect to key economic policy challenges in the EU. Furthermore, Paasi said that the economic research community itself is in the best position to identify these gaps. That is why she thinks we need initiatives such as this workshop to foster idea exchanges between the key stakeholders in the European economic research space: funders, policy-makers and researchers.

This first section of consisted of Alain Trannoy presenting his report followed by comments from research by Alexander Cappelen, NHH Norwegian School of Economics, and from policy/academics by Frank Vandenbrouck, K.U. Leuven and former minister in the Belgian Federal Government and the Flemish Regional Government.

## 5.1 PRESENTATION OF THE REPORT

Alain Trannoy motivated his report by asking whether Europe is special. According to Trannoy, Europe is special: although inequality and welfare do not directly belong to the fields covered by the European treaties, the topics are on the policy agenda in many European states in a way that is unparalleled in other continents. Trannoy quotes the German chancellor Angela Merkel who frequently point out that “Europe represents seven percent of the world population, 25 percent of the GDP, and 50 percent of the total spending at the world level”. Implicit in this quote, according to Trannoy, is a fear that this level of welfare spending will not be sustainable forever: preferences may change or Europe may become too weak to support such a generous welfare system. *Trannoy’s main goal with the report is to bring together the agenda of the scientific community about the policy agenda in Europe.*

To achieve his objectives, Trannoy focused on nine specific targets:

- I. Why is the topic important, both in general and in the European economic policy context?
- II. How can economics contribute to our understanding and analysis of this political and societal topic?
- III. What are the key questions in the area?
- IV. What are the key points of agreement and disagreement in the academic literature on the subject?
- V. What are the key open questions which have not been addressed in economic research but are of vital importance of policy making?
- VI. Where does Europe stand of research and expertise in this area compared to other contributors to research, in particular the US?
- VII. What is the role of scientific advice in EU policy decision making?
- VIII. What is the research methodology used to address questions in this area?
- IX. What specific challenges do Europe-based researchers working in this are face?

This as a broad agenda and to limit own discriminatory power, Trannoy choose to address each topic successively, looking at the scientific agenda before turning to policy challenges. As in his presentation, we will go briefly through each point and summarize his main findings.

### 5.1.1 Inequality and welfare

#### 5.1.1.1 *Inequality*

As Trannoy emphasized, there has been a long standing attention to inequality in Europe. This attention has historically been directed at *ex-post* inequality (inequality of outcomes). During the last decades, however, the economics profession has also acknowledged the *ex-ante* approach (inequality of opportunities). The latter is theoretically important but difficult to measure. Although inequality of outcomes is easier to measure, there are differing opinions on how one should do it. Thomas Piketty has

received much attention for his approach of looking at top income shares – that is, how many percent of total income is going to the e.g. top 1 percent income earners – but in Trannoy’s view, this approach may be too simplistic, and we need to include other measures as well to get a satisfying picture.

#### 5.1.1.2 *Welfare*

Welfare is a normative concept and researchers have different opinions on how it should be measured. There are two main views in the profession. While the most common view among economists is that we should organize the debate using a social welfare function, prominent economists have recently suggested that we should bypass the construction of social welfare question by asking individuals simple survey questions and plug this information into the optimal taxation function. Although Trannoy recognizes that this is an open question, his view is firmly that we should follow the social welfare function approach.

An important challenge is how to aggregate social welfare across individuals. Many different dimensions are important to social welfare, and one needs a framework to aggregate these dimensions into one overall measure. There are two main routes to accomplish this: The first route constructs social welfare from an aggregator of each dimension. This route bypasses the construction of individual well-being and hence ignores possible correlation between the dimensions. The second route, which is more common, is to construct a measure of social welfare directly from individual well-being. This approach allows for correlation between dimensions and is thus preferable on theoretical grounds; however, it can be harder to construct in practice.

#### 5.1.1.3 *The link between inequality and welfare*

Although inequality and welfare are two distinct concepts, they are closely connected under assumptions of decreasing and identical marginal utility. Even a person only concerned about maximizing a sum of individual utilities should favor an equal income distribution in this case: social welfare would increase in transfers from those with high income (low marginal utility) to those with low income (high marginal utility) until the point where everyone had equal incomes.

These assumptions do not necessarily hold in all settings. For instance, marginal utility for a given income may depend on age, gender and whether you have children. Trannoy emphasizes that it is important to discuss these assumptions, and he holds the view that departures from these assumptions should only be based on objective characteristics.

#### 5.1.2 Normative and positive issues involving other sciences

Trannoy here addressed how other sciences have contributed to our understanding of inequality and welfare:

- philosophy, by refining which objectives we should address, for instance the distinction between ex-ante and ex-post inequality
- history, by giving us ways to compare inequality today with that of the past
- sociology, by focusing on the relative importance of social structure vs. autonomy in determining individual behavior, in contrast to economics, which through its assumption of stable preferences is traditionally only concerned about the latter
- political science, by helping us understand why political gridlock can make it difficult for governments to prevent increasing inequalities

- psychology, by its expertise in designing questionnaires about happiness and how to interpret answers
- neuroscience, by giving objective measures of pain and pleasures

As an example on the influence of history, Trannoy showed historical data that compared extraction rates across time and countries. The data show that many countries, especially those colonized by European powers, have been subject to almost total extraction over long time periods. For the UK and the US, the extraction ratio declined steadily from the 1700 until the mid-1970s. From then until now, however, the pattern is actually reversed.

### 5.1.3 Inequality in Europe and the US

Trannoy here compared Europe and US and presented some key facts on different issues relating to inequality.

#### 5.1.3.1 *Key facts: income inequality*

First, European countries in general have low income inequality. Second, while the within-state inequality in general is low, between-state inequality is high. Because of this, inequality among European citizens is as high as in the US. Third, while inequality has remained largely unchanged in most European countries during the last decades, inequality has increased rapidly in the US since the 1980s. Fourth, there have been a convergence between many European countries during the last decades in terms of redistributive power of the states, which Trannoy thinks is good news for the construction of common social policies.

#### 5.1.3.2 *Key facts: intergenerational mobility in Europe*

First, there is great heterogeneity in Europe. Second, although the correlation is not perfect, in general countries with low income inequality tend to have high intergenerational mobility. The Nordic countries is a case in point, characterized by both low income inequality and high intergenerational mobility compared to other European countries. The US, on the other hand, performs badly on both income inequality and intergenerational mobility.

As an example, Trannoy compared intergenerational mobility in Denmark and Hungary. While the correlation between male earnings and parental education was practically nonexistent in Denmark, parental education was a strong predictor of male earnings in Hungary.

#### 5.1.3.3 *The link between income inequality and equality of opportunity*

Trannoy discussed how equality of opportunity tomorrow depends on income inequality today. Offspring income inequality is determined by income inequality between parents *and* the strength of the transmission channel from parental income to offspring income. Curiously, Trannoy notes how France has experienced two pulls *in opposite directions* on offspring income inequality: parental income inequality has decreased, but the strength of the intergenerational transmission channel has increased.

#### 5.1.3.4 *Inequality and European integration*

Trannoy concludes that while Europe has low inequality, there is lots of heterogeneity in terms of mobility. There is also much heterogeneity in terms of other factors, for instance in beliefs about why people are in need and in terms of self-reported happiness. As a telling illustration, Trannoy points out how even otherwise similar countries in terms of economic performance such as Finland and Sweden have very different beliefs on, say, how important laziness and lack of willpower are in explaining why people are in need.

To conclude, Trannoy thinks deeper European integration will be a failure if we do not cope with all this heterogeneity. To combat inequality in Europe, Trannoy thinks it is necessary that societies with high inequality manage to transform themselves into becoming less unequal; in Trannoy's opinion, understanding the social processes that leads to more equality is much more important than, for instance, transfers of resources from North to South, which is not a viable option to solve the challenges.

#### 5.1.4 European research is at the forefront on many topics

Comparing European research on inequality and welfare with the US frontier, Trannoy finds that European research is at the forefront on many topics, especially on empirical and conceptual issues. For instance, European researchers have made path-breaking contributions on how to measure inequality and, more recently, on the issues of fairness and distributive justice. In contrast, the US has taken the lead on identifying causal mechanism behind income inequality. As an example, Trannoy highlights the Center for Economic of Human Development in Chicago, which is at the forefront on research on identifying causal channels to increase equality of opportunity. *To increase our understanding of these issues in Europe, Trannoy proposes to build a European research network on equality of opportunity to bring together specialists in different fields.*

#### 5.1.5 Data are improving but remain incomplete

Europe has taken the lead on creating many important data sets to study inequality and welfare. Some remarkable examples include the Luxembourg Income Study and the World Top Income Database. What Trannoy thinks is missing, however, is good data for those at the *bottom* at the income distribution, arguably the group we care most about from a policy perspective. As Trannoy notes, in survey data, where poor income groups are featured, many poor declare a consumption greater than their income. *To fill this gap at the bottom, Trannoy's second proposal is to construct a European panel to study the bottom part of the income distribution.* The panel will in addition to consumption data also feature information on health, family, social relations and other important issues. The goal will be to identify how the worst off can get out of poverty.

#### 5.1.6 Inequality and Welfare as transversal issues

Trannoy mentioned some important transversal issues where inequality plays an important role, for instance with regards to global warming, migration, ageing, growth, technical progress, borrowing and globalization. In his opinion, we have both data and models to study these issues, which are very much on the research agenda, but we still lack good calibrated models.

#### 5.1.7 Cutting edge research issues

Trannoy has identified three cutting edge research topics. First, understanding the causes of increasing wealth inequalities. Thomas Piketty has challenged the conventional view that increasing inequalities are caused by increasing returns from college education, but broad agreement is not reached on this topic yet. Second, and related to the first, is the increasing disparity between CEO earnings and ordinary employee earnings. Whether this is due changing size of companies or changing norms is also very much on the research agenda. Third, and less on the research agenda today compared to the two previous topics, is the link between mental health and poverty. People may be temporary bad equipped to tackle all of society's challenges, with long-term dire consequences for themselves and their offspring. *Trannoy's third proposal is therefore to build a research program on standing up.* This point with this program should not be how to increase benefits, but rather to identify tools to help with the difficulties of life. This program should define which goals and means such a standing-up policy should include.

### 5.1.8 Issues more specific to Europe

With Europe emerging as a fiscal federation, a *conflict* exists between national sovereignty and mobility of capital and labor. This mobility leads to tax competition between EU states, which reduces the scope for raising taxes – the very symbol of national sovereignty. Since capital is more mobile than labor, this makes it especially hard to raise sufficient revenue through capital taxation in the EU.

Furthermore, Trannoy fears for the sustainability of the welfare states in the Eurozone in particular. The Eurozone allows for more migration of labor, which was supposed to mitigate the effect of asymmetric shocks. However, more migration could also undermine the support for the funding of social security systems, especially in pay-as-you-go systems. *Trannoy's fourth proposal is therefore to look at the sustainability of welfare states with mobility of factors with and without a monetary union.*

### 5.1.9 Concluding remarks

Trannoy concluded by summarizing his proposals to where further research would help European policy makers:

- A network of researchers in economics and social sciences to understand the fabric of equality of opportunity
- The building up of panel data specific to study the dynamics of poverty, how people are getting in, how people are getting out
- To prepare the ground for a standing-up policy to fight poverty and promote equal opportunities
- To look at the sustainability of nation welfare states in an environment where capital and labor are mobile
- The issue of the convergence of Southern societies to the social model of Northern societies

*Trannoy concluded his talk by saying that without the impulse of the European commission, the research effort and output will be lower than needed.*

## 5.2 COMMENTS FROM RESEARCH

Alexander Cappelen started the discussion by praising the report for providing an impressive overview of the research frontier on inequality and welfare. In particular, Cappelen thought the report did a great job on giving a conceptual analysis of inequality and welfare and the complex relationship between the two. He also praised the report for including insight from other sciences. Furthermore, Cappelen highlighted the discussion about the link between normative theories of distributive justice and the work done by economists in the field. Lastly, Cappelen agreed that we lack data to address many important issues as discussed in the report.

### 5.2.1 Additional topics

Although Cappelen stressed that it is impossible to cover everything in a 40-page report, he went on to discuss some topics that he would have liked to see even more of in the report as well.

#### 5.2.1.1 *Inequality among whom?*

The focus in the report is on inequality between citizens of a country. Cappelen pointed out that inequalities between groups in the same country are less discussed. Even in the Nordic countries, large inequalities exist between different groups. Gender inequality is one example: hardly any of the top

income earners in Norway are women. There are also large differences in inequalities *between* countries, although Cappelen once again acknowledged that not everything could be covered in the report.

#### *5.2.1.2 Do people view equality as fair?*

Cappelen praised the report for discussing differences between ex ante and ex post inequalities, but he thought the report also could have discussed why we focus on inequality rather than unfairness. As Cappelen mentioned, attitudes towards inequality depends on the source of inequality. In fact, most individuals *like* inequalities when they are based on merit, but not when they are based on luck. It is therefore important to recognize that the development of inequality is not necessarily the same as the development of unfairness.

#### *5.2.1.3 Instrumental role of equality*

While the report focuses on diminishing marginal utility of money as an argument for reducing inequalities, Cappelen mentions some other factors that could be important as well. For instance, inequality is correlated with health and social problems, which could reflect some underlying mechanism involving relative income comparisons. Although more speculative, Cappelen pointed out that we also see a clear correlation between trust and economic growth. One possible mechanism could be that equality increases trust which again increases growth, creating a possible *causal* link between inequality and growth.

#### *5.2.1.4 Risk preferences and social preferences*

Although the report is explicit that it does not consider the social insurance motive of redistribution, Cappelen points out that, from a policy perspective, it is often hard to distinguish the social insurance motive from the redistributive motive. Cappelen therefore thinks that studying the role of risk preferences in explaining welfare policies and the relationship between risk preferences and social preferences could be part of a fruitful research agenda as well.

### **5.2.2 Cutting-edge topics**

After presenting his questions, Cappelen went on discussing what he considers to be some additional cutting-edge research topics with regards to inequality and welfare, and the sustainability of the welfare state in particular.

#### *5.2.2.1 Sustainability of the welfare system: false positives and false negatives*

A challenge with all welfare systems is that they are vulnerable to mistakes. Two common mistakes are related to *false positives* and *false negatives*: respectively, giving support to those who do not deserve it and not giving support to those who do. A fundamental question in the design of welfare policies, then, is to determine how one should make the trade-off between false positives and false negatives. This is challenging as even individuals who may agree about what is fair may disagree about this tradeoff.

#### *5.2.2.2 Sustainability of the welfare systems: tax compliance*

The economic approach to tax compliance has traditionally focused on the expected punishment. What economist have neglected, however, is the role of fairness in tax compliance. A key driver in individual behavior is perceptions about what others do, and many economic experiments have documented that individuals act as conditional cooperators: if they believe that others behave nicely, they will do so as well. Countries could therefore be in different social equilibria: one in which tax compliance is high because this is common information and one where tax compliance is low because this is common information as well. Cappelen tested this in a field experiment in Norway where he and coauthors sent out letters with

randomized information. They found that adding a sentence that most Norwegians paid their taxes had a large effect on tax compliance.

### 5.2.2.3 *Personal responsibility and merit*

Although most *normative* theory suggests that people should only be held morally responsible for factors within individual control, economic experiments have shown that most people also view inequalities due to talent as fair despite the fact that talent to a large degree is the result of a genetic lottery. Understanding this discrepancy between normative theory and what people actually think could be important for understanding what drives support for different welfare policies.

### 5.2.3 Institutions and social preferences

Cappelen ended his comments by discussing institutions and social preferences. As he noted, traditional economic policy design has been concerned with uncovering people's preferences and then create policies that reflect those preferences. What has been neglected, however, is that institutions also shape preferences. An important question, then, is how institutions shape preferences. For instance, Norway has put a lot of resources into expanding kindergarten coverage. This could have an important causal effect on social preferences later in life.

## 5.3 COMMENTS FROM POLICY/ACADEMICS

Frank Vandenbrouck titled his presentation "Inequality in Europe. A tragic dilemma?" and organized it around the five areas Trannoy had suggested for further research. Vandenbrouck wanted to make some shorts comments about the first three areas and then discuss the last two areas in more depth; according to Vandenbrouck, we should be more ambitious about the frontier we wish to move on the last two areas.

### 5.3.1 Understanding the fabric of equality of opportunity

Vandenbrouck agreed with the proposal that we need a network of researcher to understand equality of opportunity in more depth. Vandenbrouck said, praising a previous study by Trannoy and coauthors, that focusing on equality of opportunity presented a normative dilemma. Since inequality of income opportunity is determined both by income inequality between parents and the intergenerational transmission channel from parent to offspring income, we may want to focus on outcome equality in the parent generation. However, from the point of the view on the parent generation, this may conflict with equality of opportunity. Vandenbrouck thinks this is a dilemma that should be further investigated.

### 5.3.2 Panel data to study the dynamics of poverty

Vandenbrouck also fully agreed that we need a panel data to study the dynamics of poverty. He also added that the commission had already done some good work on this, for instance in the *Economic and Social Development in Europe* reports. Vandenbrouck thinks these reports are undervalued by the economic community: although they are at a lower technical level than economists usually expect, they are still worth reading.

Vandenbrouck also noted that there is serious underinvestment by national statistical offices and that we need bigger samples to trace people when they move.

### 5.3.3 A standing-up policy to fight poverty and promote equal opportunities

Vandenbrouck said he was absolutely convinced by Trannoy's third proposal. He also thinks that it is not necessary to justify this with happiness data because mental health is so important in itself. Vandenbrouck

noted that there is much evidence on the correlation between different dimensions of *deprivation* during younger age and outcomes later in life, and that social deprivation correlates with both personality features and with mental health later in life.

#### 5.3.4 The sustainability of national welfare in a context of mobility/Convergence of Southern societies to the Northern social model

Vandenbrouck wanted to frame his main discussion around the last two proposal by Trannoy. Vandenbrouck asks a simple question: Do we compare Bulgarians with Bulgarians and Belgians with Belgians, or do we also want to compare Bulgarians with Belgians? Although we have traditionally discussed poverty within countries, Vandenbrouck argues that we should care about poverty on the pan-European level. Vandenbrouck acknowledges two arguments against this position: first, if poverty is about the risk of exclusion from the mainstream of your society, it makes sense to measure it at the national level; second, no governmental organization is responsible for pan-European relative income poverty. However, with a single market of labor, Vandenbrouck thinks these arguments breaks down, noting that nearly two-thirds of the increase in inequality in Europe is due to children of migrants. Building a European social model, however, is difficult, as there have been growing tensions between the European social space and the domestic social spaces. To solve these tensions, Vandenbrouck thinks we need a basic consensus on the European social model and the meaning of European solidarity.

## 5.4 DISCUSSION

Trannoy got the opportunity to respond to the comments from Cappelen and Vandenbrouck before accepting questions and comments from the audience.

### 5.4.1 Trannoy's response

Trannoy mainly picked up on three topics from the comments:

#### 5.4.1.1 *Two threats to the welfare state*

Trannoy thinks there are two threats to the welfare state: internal and external threats. While acknowledging the importance of Cappelen's perspective that false negatives and false positives are important threats to the welfare state, he thinks these are mainly internal threats. What he focused on in the report, however, are external threats, such as migration, austerity and globalization, because he thinks that these are the issues where the research frontier needs to place more attention.

#### 5.4.1.2 *Tax compliance*

Trannoy agrees that there are two kind of equilibriums in tax compliance. Sweden, where tax compliance is high, is obviously in a different equilibrium than Greece, where tax compliance is low. The interesting question to Trannoy is how we can switch from one equilibrium to the other.

#### 5.4.1.3 *Pan-European perspective*

Trannoy thinks Vandenbrouck made some very important points on how migration make a pan-European perspective on social justice more important: the more migration, the more we need to think about inequality on a pan-European level. But Trannoy thinks that successfully communicating the need for this and the reason for this change will require time. During this transition, there where will be some instability and adjustments costs, and this needs to be incorporated into the thinking about the design of the welfare state.

#### 5.4.2 Comments from the audience

First, Mark Fleurbaey, Princeton University, noted that in order not to miss important correlation, we should not have separate surveys on different domains. One difficulty in terms of research on inequality is how to define a synthetic measure of wellbeing and how to weight different measures.

Second, taking up on Cappelen's comment about differences in views about philosophers and the general public, Fleurbaey also acknowledges that people are more meritocratic than philosophers. This implies, however, that we should not give the research done too much normative meaning; instead, we should interpret the research more as casting light on what determines people's outcomes. Cappelen added to this that it is difficult to aggregate inequality of different dimensions; for instance, people are more accepting of differences in income than in health. Cappelen thinks it is important to identify how we can move from a bad equilibrium to a good equilibrium, and added that one factor that could be very important in this respect is reference dependence.

Third, Fleurbaey thinks much of the inequality debate has been dominated by the top of the income distribution; he also noted that at the conference, much attention had been given to those at the bottom. What Fleurbaey would like to see more of, however, is research on *all* parts of the distribution.

##### 5.4.2.1 *Trannoy responds*

Trannoy thinks the audience made some very important points on aggregation. He also wanted to emphasize that poverty was not his chief concern in the report: of his five proposals, only one was directly concerned with poverty. This in contrast to Vandenbrouck's presentation, which focused very much on poverty and less on inequality per se. Trannoy notes that depending on the focus and which kind of distribution one focuses on, it is possible to obtain different result. He focused on a measure of inequality which was based on the whole distribution.

Taking up on Cappelen, Trannoy added some further thoughts on moving between different equilibria. A key question is to understand whether EU integration is leading to a more rapid convergence of the social equilibrium. In particular, Trannoy is interested in whether migration leads to a more rapid convergence of the different social equilibria.

## 6 ATTITUDES TO INEQUALITY: EVIDENCE FROM SURVEYS AND EXPERIMENTS

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This part of the workshop consisted of two presentations by Ingvild Almås, University of Stockholm, and Erik Shokkaert, K.U. Leuven. The division of labor was that Almås primarily covered economic experiments, while Shokkaert primarily covered economic surveys.

### 6.1 INEQUALITY AND ECONOMIC EXPERIMENTS

Ingvild Almås started her discussion by noting that even though it took economists some time to embrace economic experiments, experiments are today extensively used in all fields of economics, from development to finance. She said that experimental methods have been important in challenging standard economic theory, which traditionally has assumed that people are fully rational and motivated by pure self-interest.

Economic experiments are powerful because they limit the number of factors that can influence choices. By making subjects do anonymous and incentivized choices without the use of deception, economists can study meaningful situations without making the environment too artificial. Furthermore, *treatment analysis* makes us able to do causal inference.

### 6.1.1 Current research and the way forward

Almås discussed methodologies at the frontier of experimental economics today and the way forward.

#### 6.1.1.1 *Combining field interventions with lab experiments*

Lab and field experiments can be combined together. As an example, Almås pointed to a study where a lab experiment was used to evaluate the effect of a field experiment. In the lab, the researchers could measure how the field experiment intervention affected competitiveness, risk taking and empowerment of women.

#### 6.1.1.2 *Match survey and register data with lab experiments*

In the Scandinavian countries in particular, we have very detailed register data. Almås mentioned one of her own studies that utilized this fact by inviting 15-year olds into the lab to measure a range of different outcomes. They could then match this with background data to see how lab outcomes correlated with, for instance, parental education and income level. As the children grow older, the register data will also allow us to see how these lab outcomes are correlated with educational choices and labor market outcomes.

#### 6.1.1.3 *Build a panel with laboratory data to look at the stability of preferences*

What laboratory experiments have not been able to tell us yet is how stable preferences are. Almås therefore thinks that we should build a panel data set to study the stability of preferences: do for instance social preferences change over time?

#### 6.1.1.4 *Utilize infrastructure from large nationwide surveys to conduct experiments on representative samples*

By utilizing a spectator design, where *spectators* in nationally representative samples make choices on behalf of *stakeholders* that have, say, done an assignment in the lab, one can in effect conduct incentivized experiments on nationally representative samples. Almås used the rest of a talk to discuss a recent study where she and coauthors used this methodology.

### 6.1.2 Are Americans more meritocratic and efficiency-seeking than Scandinavians?

Using a spectator design, Almås and coauthors wanted to compare inequality acceptance between the US and Scandinavia. Nationally representative samples of the US and Norway acted as spectators, while workers recruited from an online labor market acted as stakeholders. Almås motivated the question by noting that despite Norway having less pre-tax inequality than the US, Norwegians still prefer to redistribute more incomes than Americans do. While economists have tried to explain this by looking at the sources of inequalities and the cost of redistribution, Almås and coauthors wanted to investigate the much less studied role of social preferences.

#### 6.1.2.1 *Results*

Using *identical economic environments*, they indeed find much higher inequality acceptance in the US than in Norway. However, they do not find that Americans are more meritocratic than Norwegians or that

Americans put more weight to efficiency than Norwegians. This suggests two things. First, it suggests that less support for redistribution in the US than in Scandinavia does not reflect a greater concern for merit or efficiency, but rather greater acceptance for inequality caused by luck. Second, it suggests that the source of inequality is more important than efficiency considerations for understanding inequality acceptance.

## 6.2 INEQUALITY AND SURVEYS

Erik Shokkaert started his talk by noting that empirical investigation of the public's values is necessary if we want to understand society. He also noted that most research papers investigating the public's values are based on answers to simple questions in representative surveys. For instance, a typical question from the European Social Survey is whether "The government should take measures to reduce differences in income levels".

### 6.2.1 A large consensus, but much variation

From the nationally representative surveys, Shokkaert notes a remarkably large consensus on what are the important determinants of redistributive attitudes: own income, effect of inequality on own income, mobility, and a concern for justice with a distinction between different factors that contribute to income creation. However, Shokkaert also notes that there exist much variation between people in their redistribute preferences, both in terms of personal experiences and intercultural variations.

### 6.2.2 Attitudes and institutions

Influential economic studies have suggested that differences in redistribution across countries mainly are due to *beliefs* about the relative importance of effort and luck in determining incomes. Shokkaert is skeptical of this view: he notes that the *weight* people apply on effort differences in justifying income differences seems to be much more important to explain redistributive preferences than differences in beliefs. He also notes that the difference between pure redistribution and social insurance is to a large extent neglected in the literature.

### 6.2.3 Definition of inequality and the role of misconceptions

Shokkaert also notes that economic papers are seldom explicit about what it means to reduce inequality. Answers to broad questions are not necessarily consistent with more specific ones. For instance, even a majority in the US, where most people do not support state interventions to reduce income differences, support a cap on high incomes.

Furthermore, Shokkaert notes that people often have biased beliefs – both in terms of the actual income distribution and about their place in the income distribution – which can affect their redistributive preferences. He cites an experimental survey where a fraction of the respondents were informed about their true place in the income distribution. Subjects with a positive bias of their place in the income distribution responded to this information by requiring more redistribution.

He also talked about results from the ISSP survey which apparently shows that eastern Germans prefer more redistribution than western Germans do. However, when you control for perceptions about the income distribution, it turns out that eastern and western Germans have the same preferences for redistribution. Shokkaert therefore thinks results from such surveys can be highly misleading if you not take into account all the differences that lie behind the answers that are given.

#### 6.2.4 Methodological consequences

Shokkaert gives Trannoy much support for his view that social welfare functions are important and that one should not base optimal income taxation on answers to simplistic questions. Noting that there is a wide variation of different opinions, Shokkaert asks how we should aggregate the different views; it is not obvious that we should focus only on the average.

Shokkaert thinks that in order to make surveys more informative, we need a normative framework to structure the findings. He therefore proposes what he calls the questionnaire-experimental approach. Noting that it is difficult to test the acceptance of a general theory of justice, we can rather ask about the building blocks on different theories by focusing on the axioms such that the fairness views follows. This allows researchers to ask simple questions without becoming simplistic.

Concluding his talk, Shokkaert suggested that we should focus less on students and rather implement experiments on nationally representative samples, focusing on better structured questions to identify fairness views.

## 7 INEQUALITY AND WELFARE: POLICY PERSPECTIVES

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The last section of the workshop was devoted to policy perspectives. It consisted of talks by Mark Fleurbaey, Princeton University; Marte Gerhardsen, Agenda think tank, Oslo; J. Peter Neary, Oxford University; and Karl Ove Moene, University of Oslo.

### 7.1 INEQUALITIES: IN SEARCH OF IMAGINATION

Mark Fleurbaey started his talk by making a distinction between two types of policy tools to fight inequalities. The first is the *containment policy*, where one allows market forces to generate inequality and then use the state apparatus to redistribute income afterwards. The second is the *steering policy*, where one tries to reorient market forces in a way that is less inequality prone. Fleurbaey thinks that both approaches are important, and that the distinction is sometimes artificial.

Income inequalities trigger inequalities in many other aspects of life, both in the economic sphere and in the political sphere. Fleurbaey thinks the influence of income inequality on these other inequalities should feature more prominently in economic research, and notes that the distribution of power should be just as important as the distribution of income.

#### 7.1.1 Fight inequality-generating acts

Fleurbaey gave many perspectives on different policies to reduce inequality that he thinks have gotten too little attention in economics.

##### 7.1.1.1 Taxing wealth received

Fleurbaey thinks that we should not tax bequests. If well distributed, bequests can actually reduce inequalities, which happens when a poor person receives bequests. Fleurbaey therefore proposes that we should tax the wealth that is received by people over the lifetime instead. When bequests reach a certain threshold, taxes should start to apply.

### **7.1.1.2 Corporate pay policy**

Fleurbaey makes a similar argument for corporate pay policy, and argues that basing tax on payroll and income is unfair. A successful firm with an egalitarian pay policy may be taxed a lot, while another less successful firm with an unequal pay policy may be taxed much less. Instead of basing taxes on payroll and income, Fleurbaey argues that corporate taxes should depend on other factors such as hiring and firing policies, pay scale and governance.

### **7.1.1.3 Pooling risk in the financial sector**

Fleurbaey argues that the financial sector creates a lot of externalities in society. The role of the financial sector is to pool risk, not generate risks. Fleurbaey argues that we should tax the risk level at the institution level to correct for these externalities.

### **7.1.2 In search of the big picture**

To move the frontier forward, Fleurbaey argues that we need to search for the big picture. To do this, we should think long-term: in terms of centuries, not just years or even decades. We should also think about structural and institutional change, and not just about current policy. Lastly, Fleurbaey thinks it is important for economists to use multi-disciplinary expertise. As an example on how to do this, he points to a new initiative he himself is part of called the International Panel of Social Progress. The panel is inspired by the IPCC on climate change, but without the governmental involvement. The goal is to both give an objective presentation of the consensus and debates and recommendations on how to progress forward.

## **7.2 CHALLENGES FOR NORWAY**

Marte Gerhardsen started her talk by listing three reasons Norway is among the most equal countries in the world. First, she mentioned low wage differences due to centralized wage determination, second, a redistributive welfare state, and third, a progressive tax system. Gerhardsen says this has been called the Nordic supermodel because it has been able to combine high growth with low inequality, which according to standard economic theory should be close to impossible.

### **7.2.1 Egalitarian country, but inequalities are increasing**

Gerhardsen mentioned that Norway is one of the countries within the OECD where inequalities are increasing fastest with the Gini coefficient, a common measure of inequality, rising 30 percent since 1986. A large part of this increase has been due to rising top executive pay, which has outperformed the wage growth of ordinary workers by more than 2 to 1 since 1980. Asking a sample of 1000 Norwegians, more than 80% answered that it was important or very important to reduce the growth in inequalities.

The challenge, according to Gerhardsen, is how to translate this into politics. She mentioned a proposal to cap executive pay at 20 times the average salary, and she challenged the research community to do more research on the effects of such caps and similar policies to fight inequalities. She also wanted more evidence on the link between taxation of high income earners and job creation, which she believed was negligible. Taking up on the debate about good and bad equilibria, Gerhardsen raised the problem of tax competition. With countries such as Ireland lowering taxes to a minimum, Gerhardsen fear that tax competition will threaten the sustainability of the welfare state.

### 7.2.2 Growing black labor market

Another possible threat to the welfare state is growth in the black labor market. From a survey, Gerhardsen found that 50% of Norwegians had bought black market services in their house during the last two years. While Gerhardsen was concerned about the loss of tax revenue this amounts to, she was perhaps even more concerned about how this will effect societal norms. Norms are formed at home, and Gerhardsen wonders what will happen to society as a whole if people start to think that it is legitimate to pay for black market services in their private homes.

In addition to increasing use of black market services, Gerhardsen also raised concerns about the impact of digitalization and new sharing markets. If the welfare state is dependent on some degree of homogeneity among workers, a changing labor market, where trade unions are unable to protect all employees and jobs disappear faster than new ones are created, could pose new challenges. Gerhardsen ended her talk by asking for more research on these subjects to ensure the sustainability of the welfare state.

## 7.3 INTERNATIONAL INEQUALITY: THEORY, MEASUREMENT, DATA

Peter Neary started his talk by noting that international inequality has never been unfashionable, with the topic receiving much attention from both economists and the general public.

In the same way as economists have convinced the general public that one should correct for inflation when comparing living standards across time, there is also near-consensus that one should use Purchasing Power Parity (PPP)-corrected data rather than market exchange rates when adjusting for price differences between countries. This does make an important difference in practice: As Neary noted, world inequality shrinks when we take into account that goods generally are cheaper in poorer countries.

### 7.3.1 How to correct for deviations from PPP?

Although there is near-consensus that one should use PPP-corrected data, there is still a large debate on *how* one should do this. There are five criteria we would like PPP-corrected data to satisfy:

1. Transitivity
2. Characteristicity/“Independence of irrelevant countries”
3. Additivity: consistent disaggregation of goods and countries
4. No “substitution bias”: Fixed-weight indexes underestimate inequality
5. Allow for non-homothetic preferences

The problem, as Peter noted, is that no method satisfies all of these criteria at once. For instance, one desirable characteristic is transitivity. Transitivity means that if for instance Belgium has a higher relative income than the Netherlands, and the Netherlands has a higher relative income than France, then it should follow that Belgium have a higher relative income than France. To achieve this desirable property, however, you have to automatically violate another desirable property called characteristicity. Characteristicity means that the relative income between Belgium and France should be independent of price changes in the Netherlands. Neary showed that choosing alternative indexes to correct for PPP deviations could have a large effect on income comparisons as well.

### 7.3.2 Other issues

Neary also discussed differences between comparing living standards and GDP. When comparing living standards, rational consumers substitute away from more expensive goods; fixed-weight indexes thus underestimate international differences. When comparing GDP, however, rational firms substitute towards more expensive goods, and fixed-weight indexes thus overestimate international differences. Another issue is international taste heterogeneity. Traditional approaches assume that preferences are identical across countries, but this seems inherently implausible. Neary noted that research on both of these important issues are far less studied than research on how to correct deviations from PPP, and he would like to see more research done on these issues in the future.

## 7.4 INEQUALITY AND WELFARE SPENDING

Karl Ove Moene motivated his talk by showing correlations between welfare generosity and pre-tax inequality. Strikingly, the pattern shows that the most egalitarian countries are the one that have the most generous welfare states; similarly, the least egalitarian countries are those with the least generous welfare states. The pattern is robust between countries and over time: it suggests that equality creates more equality and that inequality creates more inequality. While Moene notes that the correlations in themselves do not imply causation, his research suggest that there indeed causal links between inequality and the generosity of the welfare state.

### 7.4.1 Social insurance vs. redistribution

According to standard political economy models, demand for redistribution should increase with inequality. The reason is that since the median of the income distribution is below the average, the median voter, which is typically assumed to be decisive, has an interest in redistribution which increases as inequality increases. However, the negative relationship between welfare spending and inequality is difficult to reconcile with these models. Instead Moene offers an alternative theory which is consistent with the observed relationship. According to his theory, the welfare state provides societies with goods that markets cannot easily supply, such as health services, schooling and social insurance. If these are normal goods, the richer you are, the more you want of them. This could explain why more egalitarian countries, where those in the bottom of the income distribution are richer, prefer higher welfare spending. Moene therefore makes an important distinction between the social insurance motive of the welfare state and the redistributive motive of the welfare states. While social insurance is a normal good, redistribution is an inferior good, at least if people are driven by narrow self-interest. Looking at surveys, Moene find support for these notions: keeping risk constant, higher income generates more support for social insurance and less support for purely redistributive policies. In driving support for the welfare state, however, Moene thinks the social insurance motive dominates the redistributive motive.

### 7.4.2 Equality and economic performance

Moene also talked about how equality could lead to greater economic performance. One reason Norway and Sweden have low wage differentials is because these countries take the wage distribution out of the market competition and place it into a centralized wage coordination. With centralized wage coordination, one cannot justify as large income differences as market forces would generate otherwise. At the same time, Norway and Sweden are small open economies that exports 50 percent of what they produce, hence they have to be competitive to stay floating. According to Moene, it seems to be the case that outside competitive pressures creates inside collaboration: Although Norway and Sweden have centralized wage

settings, they are decentralized in many other settings. This reduces monitoring costs and other inefficiencies, which can help explain why Norway and Sweden outperforms even the US in terms of economic growth.