Labor Force Participation:
The Key to Fight Inequality

Today's debate about income distribution must keep in mind that the key factor is employment for people with fewer resources and not exclusively social spending. The practice of observing the impact on inequality indicators of work increase for poorer deciles reveals that this is the most adequate means for this challenge.

The last OECD figures on inequality published a few days ago have once again put the subject on the public debate, generating demands for more redistribution public spending.

The truth is that in Chile the evolution of the general inequality indicators is still modest, in spite of the considerable efforts in social matters during the last decades. Nevertheless, when we study the evolution of inequality by cohort, we observe that important progresses have been made. Younger generations have increasingly lower inequality levels than the former ones (Sapelli, 2011).[i] This positive evolution is not perceived when considering the whole population, as in the usual analysis of inequality indicators.

More recent studies reveal that education has proven to be an effective mechanism for improving equality of opportunity. According to the Sapelli study, the greater coverage of the last decades explains a great deal of the inequality decline exhibited by Chile's younger generations.

The redistributive policies have also been used to improve the life conditions of the poorer, to the extent that social spending in Chile has quickly increased for several years, currently accounting for 60% of fiscal spending. This spending considerably improves the quality of life of families with fewer resources and substantially reduces the inequality level regarding "quality of life" among Chileans.

Table 1 shows how the richest inequality index 10/10 improves (which measures how much more families of the richest 10% earn in relation to those of the poorest 10%), when considering the State's action. However, redistribution has not achieved significant improvements in the distribution of the families' "earned incomes", that is, the resources that families earn on their own. Furthermore, we know that public spending increases have an important cost for the country. In the long-run, they entail a sacrifice in terms of growth, investment and employment, and it is a sort of "fine print" of public spending, that is not often mentioned in the political speech.

It would not be a good thing for the country, nor for the poorest, if redistributive spending keeps growing at the rate of recent years. Least of all if it has a double negative effect on employment. On the one hand, more taxes mean less investment and, therefore, less employment. On the other hand, subsidies produce negative incentives for employment, while introducing an implicit tax for families that generate resources on their own; as a family generates more resources it receives increasingly less subsidies. The design of the new Family Ethical Income tries to deal with this problem, at least partially.

Table 1

INDEX 10/10 FOR DIFFERENT TYPES OF INCOME

Type of income	1990	2000	2006	2009
Earned Income	46.7	54.3	41.2	52.4
Monetary Income	40.7	45.7	30.8	29.4
Mon. In. + Allocated Rent	34.4	38.0	26.5	25.4
Mon. In. + All. Rent + Education and Health Subsidies	15.0	18.3	13.9	13.5

Source: Prepared by LyD with data from the CASEN Survey.[ii]

Currently, employment is precisely the most effective mechanism for reducing both poverty and inequality in Chile. Labor force participation of the people in the lower income deciles is very low. This is evident when doing the exercise of how earnings and income distribution would change, if more low income people were incorporated into the labor market.

A Higher Labor Force Participation Exercise

Based on the CASEN Survey 2009, a study concerning the effect of greater labor force participation on income distribution, poverty and income level was carried out. In order to do this exercise, people between 20 and 60 years old that were not working, studying nor had any disability problems at the time of the survey, were defined as "eligible" for working. Additionally, people from households with less then CLP$250,000 per capita were considered. The fact of using alternative criteria or even not excluding "eligible" ones according to the household's per capita income does not qualitatively change the results.

An equation was estimated concerning the potential earnings of these people in case they started to work. The earnings equation designates the average labor earning according to the person's gender, age and schooling years. The model corresponds to a linear regression between work earnings and sets of dichotomous variables for gender, age and schooling years. This equation was estimated using only workers of the first 8 deciles, in order to avoid an upward bias in the estimation of the designated wages. Results do not qualitatively change when estimating the equation by cutting the sample to the first 4 deciles. This equation is a flexible version of the so-called Mincer equations, which are frequently used to explain wages.

Total "estimated" earnings with greater labor force participation were calculated adding to the household's original total earnings, the additional income derived from work of its inactive "eligible" members, according to the criterion described above.

Table 2 shows how the Gini inequality coefficient and the index 10/10 would change with greater labor force participation. We observe that the Gini would drop from 53 to a value of 45, while the index 10/10 would fall from 29 times to 12 times.

Table 2

EFFECT OF GREATER LABOR FORCE PARTICIPATION
ON INEQUALITY INDEXES

Index	Observed	Estimated
Gini	0.53	0.45
10/10	29	12

Source: Prepared by LyD with data from the CASEN Survey 2009.

Table 3 compares the current labor force participation levels with potential ones, in case people defined as "eligible" should work, according to the earned income decile by household defined by the Ministry of Social Development (ex Mideplan). It was considered that a person participates in the labor market when reporting work earnings. This definition is not as strict as the one for "employed" used by the same CASEN Survey.

We observe that the families of the first income decile have a much reduced participation in the labor market. Labor force participation is the most relevant phenomenon behind poverty and income distribution in Chile. If we consider the participation of "eligible" people from the first decile, the labor force participation of these families should rise to 58.6%. Although it is still far below that of the families from higher income deciles, it is significantly higher than the current one. As a reference, the OECD labor force participation average is close to 70%.

Table 3

LABOR FORCE PARTICIPATION
BY EARNED INCOME DECILE

Decile	Observed	Estimated
i	20.8%	58.6%
ii	36.1%	66.0%
iii	42.0%	67.9%
iv	47.0%	68.9%
v	51.4%	70.5%
vi	56.3%	73.5%
vii	59.7%	75.4%
viii	62.7%	69.1%
ix	65.0%	65.0%
x	70.0%	70.0%

Source: Prepared by LyD with data from the CASEN Survey 2009.

Table 4 shows how families' total monthly earnings per capita by decile of earned incomes would change if the labor force participation of these families should increase. We observe that families of the first decile would increase their current earnings by 2.4 times. Similarly, we see very relevant increases for the families from the first income deciles.

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When considering the aggregated amounts, the families' higher incomes would entail an increase of 12.5% of the total earnings, equivalent to approximately US$11,388 millions of 2009 per year. This is certainly a static exercise, which does not take into account that a change of this magnitude would have several effects which are difficult to predict.

Table 4

TOTAL IMCOME LEVEL BY EARNED INCOME DECIL IN CLP$ 2009

Decile	Observed	Estimated
i	38,003	92,200
ii	61,828	102,799
iii	81,718	120,205
iv	102,366	136,078
v	124,865	156,084
vi	154,272	183,963
vii	196,087	225,731
viii	256,869	269,540
ix	383,941	383,941
x	1,102,383	1,102,383

Source: Prepared by LyD with data from the CASEN Survey 2009.

Conclusion

If we were to reply the effect of greater labor force participation on inequality, through redistributive policies with public spending, and without considering its administration costs, the potential abuses of such a massive subsidy system, and the greater disincentives for working, these policies would cost US$11,388 millions of 2009 per year. This would amount to almost 25% of the total public spending for 2009. It is obvious that we cannot consider this public policy a reasonable one.

Although this practice has certain limitations, it emphasizes the important role of labor force participation in poverty, income level and its distribution. Likewise, it makes clear that tax reforms are not a feasible means, nor the public spending increases, to improve income distribution. It is much more effective and socially profitable to seek mechanisms to foster labor force participation which is very low in Chile, especially among the sectors with fewer earnings.

[i] Sapelli, Claudio. *Chile ¿Más Equitativo?* UC Editions, 2011.

[ii] The imputed subsidies correspond to preliminary estimates of a research still in progress from Henoch and Valdivieso.