

Causes and Consequences of Growing Inequality *and what can be done about it*

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Inequality has been growing within most countries around the world

- But the level of inequality differs markedly
- And there are some countries in which inequality is decreasing
- Economic forces are global, affecting similarly situated countries similarly
- **Differences in outcomes suggests that the level of inequality is greatly affected by policy—and politics**



Recession made things worse

Those at the bottom hurt thrice over

- Directly by unemployment
- Shifting distribution of income
- Cutbacks in public services

Again, it's politics and policies: how we responded to the crisis made matters worse



Recession made matters worse

- In US, 95% of increase in income went to upper 1% between 2009-2012
- Median wealth fell by 40%, back to level of early 90' s
- Poverty is up
- Median income at level of 1989
- Median income of a full time male worker at level of 40 years ago



Many dimensions to inequality

- Income
- Wealth
- Health
- Exposure to environmental hazards
- Access to justice
 - In US, treatment of homeowners, bankers in mortgage crisis (where homeowners who owed no money were thrown out of their homes, but bankers who lied to court were not prosecuted) raises questions about what the US can be said to have a “rule of law”
- Inequalities in many of these are greater than in income



Many Aspects of inequality

- More of income, wealth going to the top
- Hollowing out of the middle class in many advanced countries
- Increases in poverty in some advanced countries
- Can't summarize income distribution in a single number
- But whatever way one looks at it, things are getting worse in *most* countries



This is even true of the so-called “successful” countries

- In Germany, from mid 1990s to 2008 the bottom three deciles showed *negative* growth in real disposable income


Inequality of opportunity

- For most people, even more important than equality of outcomes
- Large differences among countries: Many advanced countries do much more poorly than is widely recognized; some (Scandinavian) do much better than others. **Again, its not just economics, its policies and politics that seem to matter most**
- Surprising comparison: US among least mobile
- No single number that can summarize mobility matrix
 - Conventional measure: Correlation between income/ education of child and that of parent
- **Inequality of outcomes and inequality of opportunity are closely linked**

Causes of Inequality

- Each aspect of inequality has its cause
- Causes are interrelated—hard to parse
 - Weak unions
 - Social conventions and customs
 - Marriage
 - Discrimination
 - Legal frameworks
 - Globalization
 - Corporate governance laws—allowing CEO's to take a larger share of corporate pie
 - Competition laws
 - Financial sector regulations
 - Affect the extent to which there can be predatory lending, market manipulation, abusive credit card practices, insider trading, etc.
 - Bankruptcy Laws
 - US gave first priority to derivatives! Student loans can't be discharged even in bankruptcy
 - **All the laws and regulations help shape the degree of inequality**
 - **Markets don't exist in a vacuum**

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- Macroeconomic policy
 - Focusing on inflation rather than employment

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- Disparity in “endowments”
 - Changes in market prices of endowments
 - “Skilled biased technical change”
 - Globalization
 - But even these are affected by policy
 - Incentives for different kinds of innovation
 - Rules of the game
 - New proposed trade agreements may make things worse




Rent Seeking vs. Marginal Productivity Theory

- Latter suggests that those at the top contribute more—have made the size of the economic pie bigger
- Former says that those at the top have excelled in their ability to get a larger share of the pie
- Markedly different implications for acceptability of inequalities
- Markedly different views of consequences of tax policy



Rent seeking more plausible explanation

- Obvious importance in many developing countries that are characterized by rent seeking
- But also true in advanced industrial countries
- Example: large bonuses, incomes of corporate executives
 - Bearing little relationship to private contributions, even less to social contribution
 - Evidenced in Great Recession
 - Exploiting deficiencies in corporate governance

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- Large numbers of those at the top have fortunes that are associated with rent seeking
 - If those at the top made the economic pie bigger, would expect that as their incomes increased, others would also—there would be trickle-down economics; evidence to the contrary
 - Experiment: Increase tax rates at the top
 - If inequality is largely associated with rent seeking, would not expect to see much effect on growth—confirmed by data



Adverse consequences of inequality

- Undermines our democracy
- Divides our society
- Weakens our economy

The effects are intertwined: societies in which many individuals believe that there are fundamental inequities—that the system is not fair—don't function well. Individuals and the economies suffer.



Adverse consequences of inequality

- One of reasons that health outcomes in the US may be so poor, even for those who can afford access to health care, has to do with inequality
- Inequality in health undermines economic performance



Adverse economic consequences of inequality

- We pay a high price for this inequality
- Could have more growth, more stability, and more equality
- **This is fundamental change in perspective: *There need not be a trade-off***
- *This is in addition to the moral case for a more equal and fairer society*



Adverse economic consequences of inequality

- Lack of opportunity means that we are not using fully human resources—children of poor are not living up to their potential
- Rent seeking means that resources are diverted from wealth creation to rent seeking
- Political economy: more divided society has difficulty getting political consensus behind important public investments
 - And top may use political influence to achieve legal frameworks which increase inequality and instability



Vicious circle

- More economic inequality leads to more political inequality
- More political inequality leads to *rules of the game* which amplify economic inequality and political inequality



Inequality and instability

- Inequality is associated with instability
- Instability has a direct cost, if individuals are risk averse
- Instability also adversely affects growth
- Instability also contributes to inequality
- Vicious circle



Inequality and instability

- Empirical finding in IMF studies
- Consistent with recent downturn, Great Depression
 - Not inevitable
 - May be consequence of some forms of inequality more than others

Simple model

- Increased inequality lowers aggregate demand, in absence of countervailing government action
 - Differences in MPC between the top and bottom
- If government responds by using monetary policy to stimulate the economy, in the presence of inadequate regulation, risks creating bubble
- The breaking of bubble leads to marked downturn
- Unlike standard DSGE models, bubble is *endogenous*
- There are alternative ways by which government could have responded (increased public investment), but in presence of high levels of political inequality, these are unlikely to be chosen




Policy Implications

- Every aspect of policy/legal/institutional framework has effects on inequality
 - Bankruptcy law, competition law, corporate governance, financial sector regulation
- One can design policy/legal/institutional frameworks in ways which promote growth and equality (both of outcomes and of opportunities)
- One must remember: **Growth doesn't necessarily benefit all.** Trickle down economics doesn't work.
- Taking account of inequality, broader measures of well-being gives very different views of performance
 - Main message of International Commission on the Measurement of Economic Performance and Social Progress



Multiple Roles for government

- In changing distribution of income before taxes/transfers
 - Innovations and investment that save the environment, rather than save labor
 - Education
 - Bankruptcy laws
 - Laws affecting the scope for rent seeking
- In changing distribution of income after taxes/transfer
 - Earlier discussion emphasized the interaction between the two
 - Current tax system—favorable treatment of capital gains (speculation)-- both distorts economy and increases inequality



There needs to be a Comprehensive Progressive Agenda

- No magic bullets: problems have been long festering; won't be dealt with quickly
- Enhancing equality of opportunity
 - Education
 - Financial inclusion
 - Inheritance taxes
- Promoting Full Employment
 - End to austerity
 - End to inflation targeting
- Discouraging rent seeking
 - Making markets work like markets are *supposed* to work
- Industrial policies, including redirecting innovation



The problem is in the politics

- We know reforms that would promote growth and equality
- The question is how can we change the politics?
 - The design of the euro-system makes redistribution more difficult —race to the bottom
 - More of the responsibility for creating a more equal society must lie at the European level
- That's why the *democratic* agenda of social democrats is so important
 - Transparency
 - Empowerment to individuals and civil society
 - Fighting against the disenfranchisement efforts going on, e.g. in US
 - Changing the rules of the game so that we restore “one person one vote,” rather than “one dollar one vote”