Development Policy

Lecture Note 12

Does Inequality Matter?

Economists have generally taken the view that income inequality does not matter very much. So, for example, the prominent Harvard economist Martin Feldstein, President of the National Bureau of Economic Research, says that "there is nothing wrong with an increase in well-being of the wealthy or with an increase in inequality that results [solely] from a rise in high incomes." This is a widely held position. If no one is made worse off, then one person becoming better off is always a good thing. That is the definition of Pareto Optimality, the most important benchmark of well-being in welfare economics.

Yet this theoretical position is challenged by historical evidence and psychological experiments, both of which indicate that people do not think in terms of Pareto Optimality, but instead in terms of fairness and reciprocity (give and take). Ideas of justice vary from culture to culture and over time, but as human beings we do seem to share a common belief in mutual obligation. We do not live as isolated individuals, but we live in communities that have common objectives and require some element of sharing. Sharing takes place for the most part within the family, but we also share material goods and resources in our schools, neighbourhoods, organizations and even as citizens.

An experiment that demonstrates the power of these beliefs is the "ultimatum game." In this game, a "proposer" is given an award (say VND 100,000) that he or she must divide with another person, or the "responder." The proposer offers a proportion of the award to the responder. If the responder accepts, the responder receives the amount agreed, and the proposer keeps the rest of the award. If the responder rejects the offer, both get nothing. Tests of this game around the world have shown that proposers offer between 40 and 50 percent, and that offers less than 30 percent are routinely rejected by responders. [1]

The proposer has an incentive to make any offer that is not rejected by the responder. If his or her decision was based on Pareto optimality, the responder would accept any positive offer from the proposer, since rejecting the offer means that he or she is left

[1] Ernst Fehr and Klaus M. Schmidt (1999) "A Theory of Fairness, Competition and Cooperation, *The Quarterly Journal of Economics*, 114:3, 817-868.

with nothing. But responders feel that offers that are too far from 50-50 are not fair, and they would rather punish the proposer than accept an unfair offer.

Do our ideas about fairness and reciprocity extend to the kind of society we live in? A recent book by Wilkinson and Pickett compiles a wide range of new evidence to suggest that it does.[2] They find that many social problems that we commonly associate with the poor are more prevalent in unequal than in equal societies. Well off people are also affected by these problems in unequal societies. Moreover, among rich countries, these problems are not linked to per capita income.

Thus, among rich countries, child well-being is much higher in equal societies than in unequal societies. Finland, Sweden and Norway perform much better in areas such as infant mortality, education, child protection and child poverty than the United States. Among the same countries, child well-being is not correlated with income per capita. More equal societies perform better regardless of their income levels.

More equal societies also perform better in terms of mental illness and life expectancy. These differences are not linked to culture or nationality. If we take just American states, we find that more children drop out of school in unequal states than in more equal states. Homicide rates are also higher in more unequal states. The authors survey a large number of studies of income inequality and health and conclude that more egalitarian societies tend to be healthier. Inequality is associated with lower life expectancy, higher rates of infant mortality, shorter height, poor self-reported health, low birth weight, AIDS and depression.

We also saw in macroeconomics class that inequality may have a negative impact on macroeconomic stability, and in fact contributed to the recent US economic crisis. Real wages stagnated for most wage and salary earners, while the incomes of the rich grew rapidly. The income share of the bottom 80% of the population fell. These households responded to stagnant income levels by borrowing to sustain consumption levels. Banks accommodated this growing demand for debt by lowering credit standards. Over a trillion dollars was recycled from savers in Asia into the American subprime mortgage market, which served the poorer segments of society with bad credit ratings and limited capacity to repay. When house prices started to fall back, many of these households went into default, which was the trigger for the sub-prime meltdown.

The rich also contribute to macroeconomic instability. Rich households need outlets for their savings (largely earned as profits in the financial markets—the share of finance in corporate US profits rose from 16 percent in the 1970s to 40 percent in the 2000s). This wealth needs to find investments, and financial institutions compete with each other to

[2] Richard Wilkinson and Kate Pickett (2009) *The Spirit Level: Why Equality is Better for Everyone*, London: Penguin Books.

generate higher yields for these wealthy savers. The banks have used their tremendous assets and wealth to lobby government for financial deregulation to enable them to make even more profits. Deregulation allowed the banks to gamble with shareholders' money in risky derivative markets.

Inequality may also be holding back the recovery. Joseph Stiglitz argues that the middle classes in the United States are still too weak to sustain domestic demand. The rich have captured most of the additional income from economic growth, but they are more likely to save their money than spend it. Middle class households are also finding it difficult to invest in the education of their children. College tuition costs have risen much faster than incomes, which means that the only way that middle class kids can go to university is to borrow more money. Slow growth of middle class incomes means slow growth of government revenues, mostly because the rich are much better at evading taxes than the middle classes.

So perhaps we should be concerned about inequality after all. If that is the case, then trends in developing countries are worrying. If we look at the ten largest developing and transition countries, which together account for about 60 percent of the world's population, we find that most of them have gini coefficients above 0.40, and in many of them the gini is above 0.50, which is a very high level of inequality. Inequality is also getting worse in the large countries, most notably in China, Nigeria and Russia. Indeed, the countries of the former Soviet Union have seen some of the sharpest increase in inequality of the past two decades.

The rise in within-country inequality in export oriented countries like China is not what is predicted by the Stolper-Samuelson theorem. This theory predicts that an increase in trade should increase economic returns to the factor that is most intensely used in production. So trade should increase returns to labor in a labor-abundant country like China. However, increased participation in international trade has not increased labor's share of income in China. Quite to the contrary, economic inequality has risen sharply since the 1980s.

Gabriel Palma makes an important point about the rise in inequality the developing world during the period of globalization.[3] He examines inequality data for a range of countries, and finds that most of the economic inequality that we encounter in the world reflects the income share of the richest households, and that when societies become more equal it is mostly because the rich are able to increase their share. He concludes, "the key element that needs to be deciphered in order to understand within-country distributional diversity—and especially the huge degree of inequality in some middle-income countries—is the determinants of the share of the tenth [richest] decile."

[3] J. Gabriel Palma (2011) "Homogeneous Middles Versus Heterogeneous Tails and the End of the Inverted-U: Its All About the Share of the Rich," *Development and Change*, 42:1, 87-153.

Palma ranks the countries of the world by inequality (as measured by gini coefficients) and then plots the share of the ninth and tenth income deciles. There is very little difference between the income of share of the ninth decile between equal and unequal countries. The real difference turns up in the tenth decile: this is what drives inequality around the world.

If we take the ratio of the income share of the top and bottom deciles, we also find that the difference between very unequal and less unequal countries is the disparity between the richest and poorest segments of the population. In the two most unequal regions—Latin America and Southern Africa—the ratio is 35 to one. At the other extreme, the ratio is only five to one in the Nordic countries.

Palma's second conclusion is also interesting. He finds that there is very little difference between equal and unequal countries in the income share of the middle deciles of the population. If we compare deciles 5-9 or 7-9, we do not find much difference among countries, regions and even between rich and poor countries. Apparently the middle groups of society are very good at defending their income share, even against the rich. The problem is that the poor are not able to defend their share, and the rise of the rich is often at the expense of the bottom 40 percent of income groups. In most country we are not witnessing the disappearance of the middle classes: they, in fact, seem to be able to defend their position.

Why are the middle groups so successful at defending their income share, while the bottom forty percent are less able to do so? One hypothesis, that Palma puts forward, is that economic liberalization has created tremendous profit making opportunities for the rich, often in liberalized financial systems or through the privatization of state assets. Meanwhile, it has exposed the poor to the full force of market competition in labor markets, essential services and social protection. Despite the huge increase in manufactured exports from Mexico, wages and salaries have fallen sharply as a share of GDP since the 1970s. The wage share in GDP has fallen despite increasing labor productivity, especially since the 1990s. It is perhaps not surprising that the richest man in the world is a Mexican (he made his fortune after buying the state telephone company, which was sold off in 1990).

The causes of inequality differ from place to place. But the message of Palma's analysis is clear: if you want to understand the causes of inequality, look at the top and bottom of the distribution, not in the middle. We cannot count on globalization to *automatically* reduce inequality, and there is some evidence that globalization may actually increase it.