BRIEFING PAPER

Does inequality matter?

Dalibor Roháč

Executive Summary

This study argues that, for those of us who care about the welfare of the poorest and the most vulnerable, income inequality is not a useful measure. Measures of income inequality tell us nothing about the living conditions of the poor, their health and their access to economic opportunity. Income inequality can easily increase in societies in which everyone, including the very poorest individuals, is becoming better off. Conversely, a reduction in inequality can be associated with deterioration in the living conditions of the less well-off members of the society.

While country-based measures of income inequality rose in the developed world in the 1980s, it is not clear that inequality in the developed world since then has constantly been on the rise. UK's Gini coefficient has been declining since 1998. Furthermore, it is not clear that consumption inequality and inequality in life satisfaction has increased since the 1970s. Hence, much more caution is needed when interpreting the recent data on inequality, and certainly some of the more radical claims about the widening gap between the rich and poor appear unwarranted in light of more nuanced evidence.

The received wisdom about the effects of inequality on social outcomes appears to be largely flawed. Arguments proposed by publications such as *The Spirit Level* on the negative impact of inequality on health outcomes, homicides, drug use or teenage pregnancies are unconvincing and based on very problematic evidence. Furthermore, as we explain, there is no convincing link that would enable us to associate high levels of income inequality with the financial crisis of 2008. By those standards, that crisis should have occurred at a different time and also in different countries.

Sometimes, rising income inequality can be symptomatic of underlying institutional problems. The growth of executive remuneration in the financial industry, for instance, cannot be dissociated from a cosy relationship which has long existed between policymakers and bankers. The implicit guarantees to the banking sector have led to excessive risk-taking and leverage, translating into high bonuses in good economic times and bailouts in bad economic times.

Focusing on income inequality rather than drivers of poverty, obstacles to economic opportunity and systematic injustice obfuscates what works and what doesn't in the realm of economic policy, and ultimately harms the poor and the vulnerable.

1. Introduction

Many authors and commentators argue that income inequality is among the most pressing current problems of our era. The received wisdom is that inequality has significantly increased on both sides of the Atlantic in recent decades. Some go so far as to blame income inequality for a whole range of social ills. Richard Wilkinson and Kate Pickett, respectively of the University of Nottingham and the University of York, claim that if the UK halved inequality, "murder rates would halve, mental illness would reduce by two thirds, obesity would halve, imprisonment would reduce by 80 percent, teen births would reduce by 80 percent, and levels of trust would increase by 85 percent."[1]

Is inequality the most pressing problem of our era?

1 http://www.equalitytrust.org.uk/why.

Adam Smith Institute - The free-market thinktank
23 Great Smith Street, London, SW1P 3BL
+44 (0)20 7222 4995
www.adamsmith.org

In America, commentators like Paul Krugman of the New York Times like to talk about the "new Gilded Age,"[2] in which unprecedented levels of income inequality risk polarising the society and putting our democratic institutions into jeopardy. Raghuram Rajan, a University of Chicago economist, argues that the growing income inequality was a key factor leading to the financial crisis and to the current economic downturn.[3]

Those are very serious claims, because they directly concern the poorest and most vulnerable people in our societies. If taken at their face value, they would suggest that combating income inequality should indeed be priority for policymakers in the West. Unless their distribution of income becomes much narrower, the argument goes, the unequal industrialised societies – including the US and UK – risk becoming plutocracies. Worse yet, inequalities might destroy the social fabrics keeping those societies together, resulting in low levels of social capital and trust, and high rates of various social pathologies, including drug abuse, teenage pregnancies and the like.

This report will look critically at those alarmist claims.

First, it is not clear whether an unambiguous increasing trend in material inequality exists, either in the United States or in the United Kingdom. Whether we see an increasing tendency that goes beyond a mere trend in nominal income inequality – something different from material inequality – is extremely sensitive to the specific measures of inequality we use.

Second, and more importantly, we find that the problem of income inequality, although fuelling heated political and ideological debates, has relatively little substance. At most, material inequality can be a symptom of underlying social and institutional ills, and is not the cause of them. Focusing on inequality, rather than on those deeper problems, does very little to make our societies more prosperous and more just. To be sure, the welfare of the least well-off members of society should be of concern to policymakers, as should be their ability to access economic opportunities and lead fulfilling lives. However, attempts at tweaking the distribution of income in a society, and at reducing its variance, do little to address those substantive concerns. The poor are not being helped by schemes that reduce income disparities; they are helped by institutions and economic policies that work and that enable them to lead happy, fulfilling lives.

Our argument goes against the conventional wisdom, which is reflected in the widespread use of measures of inequality, and of relative poverty, to evaluate social outcomes. Those measures have been endorsed by the UK government and by political groups across the spectrum, and also by the European Commission, UNICEF and other international organisations.[4] If such measures are wrong-headed, however, then governments are potentially making the plight of the poor and vulnerable much worse than if they focused on the right issues.

We begin the report by reviewing some of the evidence concerning material inequality in the United Kingdom and in the United States. We then discuss some of the arguments raised by those who are alarmed by the allegedly high levels of inequality and argue that the public debate would be helped by a more nuanced view. Finally, in the last section, we enquire about the potential policy implications of our analysis.

2. The rise of inequality?

There appears to be an almost unanimous agreement that inequality in the Western world has been on the rise in the past 30 years. Paul Krugman, for instance, says that "in 1970 the top 0.01 percent of taxpayers had 0.7 percent of total income - that is, they earned 'only' 70 times as much as the average, not enough to buy or maintain a mega-residence. But in 1998, the top 0.01 percent received more than 3 percent of all income. That meant that the 13,000 richest families in America had almost as much income as the 20 million poorest households; those 13,000 families had incomes 300 times that of average families. As a result, income inequality in America has now returned to the levels of the 1920s. Inherited wealth doesn't yet play a big part in our society, but given time – and the repeal of the estate tax – we will grow ourselves a hereditary elite just as set apart from the concerns of ordinary Americans as old

2 Paul Krugman (2002). "For Richer." *The New York Times Magazine*, 20 October 2002. Available at: http://www.nytimes.com/2002/10/20/magazine/20INEQUALITY.html.
3 Raghuram Rajan (2010). *Fault Lines:How Hidden Fractures Still Threaten the World Economy*. Princeton: Princeton University Press.
4 Kristian Niemietz (2011). *A New Understanding of Poverty. Poverty Measurement and Policy Implications*. London: Institute of Economic Affairs, p. 67. Niemietz provides a very compelling overview of the pitfalls of social policies based on measures of relative poverty.

Horace Havemeyer."[5] Echoing that concern on the other side of the Atlantic, former Labour MP George Galloway, claims: "This week the official figures confirm what those of us in east London can see with our own eyes: that class inequality has increased to Victorian levels even as tens of billions of pounds of public money has gone into banks which remain in private hands."[6]

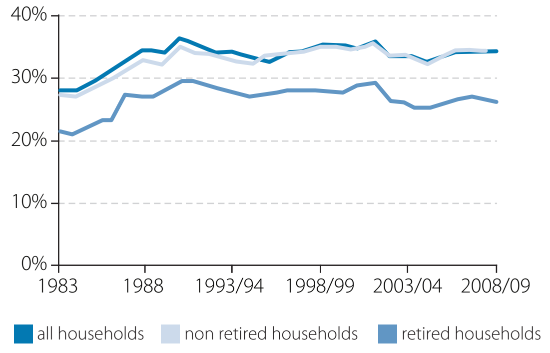
George Galloway was referring to the report by the National Equality Panel, *An Anatomy of Economic Inequality in the UK*,[7] which argued that Britain was "an unequal country, and more so than a generation ago." The report examines inequality in various measures of income and wealth and in educational outcomes. It concludes that, although on some measures inequality in the UK has stabilised over the past decade or so, the rise in inequality, which had occurred in the 1980s, has not been reversed.

Most of the studies looking at inequality look at measures of nominal income and at its dispersion, captured for instance by the Gini coefficient.[8] That is not, however, entirely uncontroversial. Assuming we are more interested in tangible material well-being than in nominal income, what should be relevant are the differences in the array of goods and services that different social groups are enjoying, rather than the differences in monetary income.

Nominal income is a very imperfect measure of consumption or material well-being. Consumption of individuals deviates from their income, either through savings or borrowing. Through scholarships, borrowing, or parents' help, a graduate student typically consumes more than his current income from productive activities. Individuals at the height of their career will probably be putting aside parts of their income to save for retirement. Hence, although the income gap between a graduate student and someone who has already advanced in their professional life might be sizeable, the actual gap in consumption might be much smaller.

There is little doubt that income inequality has risen over the past three decades. Thomas Piketty and Emmanuel Saez[9] provide evidence for the United States, while the National Equality Panel provides an exhaustive account of that development in the UK.

Figure 1. Gini coefficient in the UK



Source: Office for National Statistics

While Figure 1 shows an increase in the Gini coefficient throughout the 1980s, it also demonstrates that the levels of nominal income inequality have remained remarkably stable throughout past 20 years. If anything, the Gini coefficient has declined throughout the 2000s. A recent report by the Institute for Fiscal Studies,[10] moreover, argues that the growth of incomes has been steady since 1996 throughout the income distribution and that the Gini coefficient has fallen slightly in the current recession.

In any case, it is safe to say that *nominal income* inequality has risen since the late 1970s, but that its rise was only episodic. However, that would only be informative about the levels of genuine material inequality in cases where all income groups faced the same prices. That is not the case. Past decades have been marked by the rise of cheap exports from the developing world, particularly from China, and also by new forms of retailing, epitomised by Wal-Mart, Tesco, and the like. As a result, a much greater array of goods and services – including cheap substitutes for previously expensive products – are available to the

Income inequality has increased since the 1970s but has genuine material inequality?

5 Ibid.

6 George Galloway (2010). "People deserve a left alternative to Labour." *The Guardian*, 29 January 2010. Available at: http://www.guardian.co.uk/commentisfree/2010/jan/29/progressive-politics-labour-conservatives.

7 National Equality Panel (2010). *An Anatomy of Economic Inequality in the UK*. Available at: http://sticerd.lse.ac.uk/case/_new/publications/NEP.asp.

8 Gini coefficient is probably the most widely used measure of income inequality. It ranges from 0 (complete equality) to 1 (complete inequality – one person earning all of the country's income, the rest not earning anything).

9 Thomas Piketty and Emmanuel Saez (2003). "Income Inequality in The United States, 1913–1998." *Quarterly Journal of Economics*, Vol. 118, No. 1, Pages 1-39.

10 Robert Joyce, Alastair Muriel, David Phillips and Luke Sibieta (2010). *Poverty and Inequality in the UK: 2010*. London: Institute for Fiscal Studies. Available at: http://www.ifs.org.uk/publications/4877.11

poor, at substantively lower inflation-adjusted prices than ever before. Using a single price index for the rich and for the poor will thus downplay the real gains in the standards of living of the poor.

Looking at UK data, UCL economists Richard Blundell and Ben Etheridge (2009) find that consumption inequality rose at a much slower pace than income inequality. The paper also finds an interesting pattern between different percentile groups: While the ratio of median income to the 10th percentile (the 50:10 ratio) has increased – suggesting an increase in the median consumption relative to the consumption of the least well-off, it turns out that the ratio of earnings of the 90th percentile to the median (the 90:50 ratio) has remained practically unchanged since the late 1980s. This suggests that it is rather unclear whether a new class of the super-rich has emerged, or whether, relative to the median, the consumption of the wealthiest has remained fairly constant since the late 1980s.

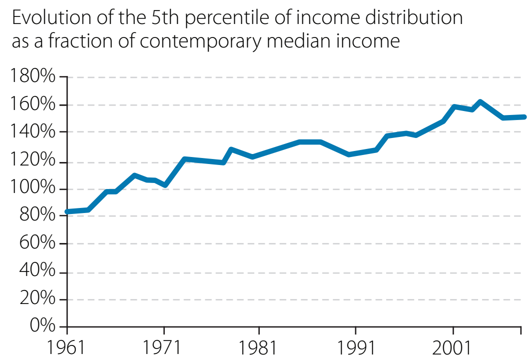
Living conditions of the poor in the West are better than at any point in history

Similarly, Daniel T. Slesnick from the University of Texas claims that, in the United States, consumption inequality has either decreased or remained constant throughout the 1990s.[11] This view seems to be supported also by the fact that inequality in subjective wellbeing has fallen substantially since the 1970s.[12] In a very like-minded report on inequality, published in 2009 by the Cato Institute in Washington, Will Wilkinson says:

> *"You can see leveling in quality across the price scale in almost every kind of consumer good. At the turn of the 20th century, only the mega-rich had refrigerators or cars. But refrigerators are now all but universal in the United States, even while refrigerator inequality continues to grow. The Sub-Zero PRO 48, which the manufacturer calls "a monument to food preservation," costs about $11,000, compared with a paltry $350 for the IKEA Energisk B18 W. The lived difference, however, is rather smaller than that between having fresh meat and milk and having none. The IKEA model will keep your beer just as cold as the Sub-Zero model."* [13]

It is undeniable that the material conditions of the poor have improved tremendously over the past century. Figure 2 shows the evolution of real income of the bottom 5 percentile of the income distribution in the United Kingdom, illustrating that, in absolute terms, poor are better off today than they have been ever before. Note that the bottom 5 attained 1961 median income levels within less than a decade, and have since far surpassed them.

Figure 2. Income of the 5th percentile of income distribution



Source: Joyce et al. (2010).

Inequality, especially in the bottom half of the income distribution is closely linked to relative poverty. Some claim that relative position of individuals matters because it reflects the costs of participating in the society. Sure, poor in the West are not undernourished, and have access to drinking water, warm shelter, and enjoy a variety of goods that would have been considered as luxuries some 40 years ago. However, in a more affluent society, it costs more to access certain social amenities – entertainment, schooling or culture – which are considered to be important by the members of that given society.

However, that does not provide justification for using relative measures of poverty, such as the 50:10 ratio, without a regard for the absolute levels of income and consumption of the least well-off. The evidence suggests that although costs of participating in the society and of enjoying certain socially contingent amenities do increase with median income, they increase less than proportionally, and

11 Daniel Slesnick (2001). *Consumption and Social Welfare: Living Standards in the United States and Their Distribution*. New York: Cambridge University Press. This conclusion is echoed by the influential paper by Dirk Krueger and Fabrizio Perri (2006). "Does Income Inequality Lead to Consumption Inequality? Evidence and Theory." *Review of Economic Studies*, Vol. 73, No. 1, pp. 163–193.

12 Betsey Stevenson and Justin Wolfers (2008). "Happiness Inequality in the United States." NBER Working Paper no. 14220. Available at http://www.nber.org/papers/w14220.pdf.

13 Will Wilkinson (2009). "Thinking Clearly about Economic Inequality." Cato Institute Policy Analysis. Available at http://www.cato.org/pub_display.php?pub_id=10351

therefore absolute improvements do matter. It is instructive to note the anti-growth ideology that permeates Wilkinson's and Pickett's book, *The Spirit Level*, which starts from the assumption that at current levels of income in the Western world, further growth would bring no improvements in well-being. That attitude is not only unjustified,[14] but is also arrogant and inconsiderate towards the very poorest members of Western societies, who would certainly benefit from absolute increases in their real incomes – as opposed to mere reduction of variance in incomes - and therefore from absolute improvements in their living conditions.[15]

Certainly, there is more to happy life than just material goods and consumption. As Arthur Brooks argues,[16] for most people an active, fulfilling life is a prerequisite for happiness. Hence individuals' happiness is critically dependent on their ability to earn their success. That is done more easily in a free society, in which there are many economic opportunities, rather than in a society that strives for the maximal degree of income equality. If we care about genuine equality, i.e. equality in happiness or utility terms, we should realise that such equality might best be achieved in environments where people are left free to pursue their different callings and ambitions.

Similarly to Arthur Brooks, David Schmidtz, a philosopher at the University of Arizona, explains that what people really need is neither material equality nor equality of opportunity but simply good access to economic opportunity.[17] Life in society is not a race, in which we would be ranked by our performance – if it were, then of course equal opportunity would be essential. Rather, we have the opportunity to explore and pursue a variety of aspirations, goals and ambitions, with the purpose of leading happy and fulfilling lives. It is a process in which no one needs to "win." Material inequality, therefore, tells us very little about the actual ability of individuals to lead happy, fulfilling lives. And it is the latter, not the former, that should be of concern to policymakers.

Inequality alarmists conflate the society with the nation-state

The final reason why we should be sceptical about much of the current inequality literature is the fact that the nation state constitutes its basic unit of analysis. If we care about inequality and relative measures of poverty because they might reflect how easy or difficult it is for the poorest to access certain societal amenities, then it is rather unclear why the nation state should be considered as the proxy for society. Furthermore, it can lead to conclusions that run contrary to our moral intuitions.

On the one hand, it is plausible to think that the relevant unit of analysis should be much smaller. In big cities, such as London or New York, accessing schooling, entertainment and culture is much more costly than in sleepy backwaters. Of course, big cities usually offer much more interesting bundles of these goods and services than small towns, but at the same time these are vastly more expensive. Relative measures of inequality will thus understate the degree of deprivation suffered by poor people in affluent cities and overstate the degree of deprivation of poor people in poor regions.

Upon closer inspection, Europe appears more unequal than the United States

On the other hand, there is a case to be made that the relevant unit of analysis should transcend national boundaries. We are living in a globalised world and when it comes to the consumption of goods and services, young urban professionals living in big cities of the world – London, New York, Paris or Dubai for instance – might have more in common than they do with people of different age living in less developed regions of their respective countries.

The World Bank economist Branko Milanovic[18] points out the fact that, relative to within-country inequality, the role of inter-country inequality has risen in recent decades. Accident of birth into some geographical area has a much greater predictive power about one's wealth than the accident of being born into any given "class" on a predefined territory. By that token, looking at inequality within the European Union gives us a completely different picture from the one suggested by the popular knowledge. While income inequality within the individual member states is lower than, say, in individual states of the US, income inequality within the EU as a whole is much higher than the one within the US. This is explained by the inter-

14 B. Stevenson and J. Wolfers (2008). Economic Growth and Subjective Well-Being: Reassessing the Easterlin Paradox. IZA Working Paper no. 3654. Forschunginstitut zur Zukunft der Arbeit.

15 See also Niemietz (2011), supra, pp. 112-113.

16 Arthur C. Brooks (2008). *Gross National Happiness. Why Happiness Matters for America – and How We Can get More of It.* New York: Basic Books.

17 Wilkinson (2009), op.cit., p. 23

18 Branko Milanovic (2008). Where in the world are you? Assessing the importance of circumstance and effort in a world of different mean country incomes and (almost) no migration. WB Working Paper 4493. Available at: http://go.worldbank.org/XEN8YSJFN0

country variation existing between the rich and poor member states. Should Turkey join the European Union, the overall EU level of inequality would reach the level of certain Latin American countries.

Using nation-state as the basic unit of observation can lead to a number of rather problematic implications. For example, let us assume that a Guatemalan worker decides to emigrate into the United States. Let us also assume, for the sake of the argument, that he was earning a slightly above-average wage in Guatemala. Upon his arrival in the United States, he will start earning a much higher wage, but nonetheless very much below the US average. Leaving other considerations aside, it is safe to conclude that his move is a win-win situation for everyone involved: the Guatemalan is better-off as a result of his move, his family in Guatemala can expect remittances and will presumably be better-off as well, and consumers in the US can enjoy cheaper goods and services as a result of an increased supply of inexpensive labour. Furthermore, if we are concerned about inequality, then we should note that through this move global income disparities have been decreased.

However, the picture radically changes once we adopt a nationalistic perspective, in which we take into consideration countries instead of individuals. First, the move from Guatemala into the United States decreases average income in both countries, although the individual concerned is now better-off – potentially radically so. Second, in the setting above, the move increases income inequality in both countries, as Guatemala has just lost a member of its middle class and the US have added another individual into its low-income "underclass." That example, in our view, illustrates the pitfalls of an approach which does not take individuals as the basic units of analysis and which implicitly makes a distinction between persons based on what passports they have.

Indeed, looking at material inequality globally provides us with a much different picture than the alarmist stories that suggest that our societies are getting progressively more unequal. It is true that the Great Divergence[19] of 18th and 19th centuries must have led to a global increase in inequality as more and more people in the West lifted themselves from subsistence. Yet, it would be only reasonable to expect that global income inequalities would decline in the later decades of the 20th century, as economic growth slowed down in the West and economic development in many regions of the developing world accelerated. The economist Xavier Sala-i-Martin indeed argues that this view is correct.[20] He estimates a global distribution of income and finds that while every measure of inequality was higher in 1980 than it was in 1970, all the indices point towards a lower level of inequality in 2000 than in 1980. The comparison between 2000 and 1970 is ambiguous, with some measures suggesting an increase in global inequality and others suggesting a decrease.

To sum up, it is certainly not clear that the developed world – or the world as a whole for that matter – is becoming a more unequal place. Measures of global income inequality point to a convergence occurring in past decades. It is true that nominal income inequality has increased *within* the countries such as the United States or the United Kingdom. It is much less clear whether this should be of any concern at all, as this process was accompanied by a massive reduction in costs of living of the poor, and therefore it was not translated into an equivalent increase in consumption inequality – or inequality in happiness.

3. Is inequality a problem?

It might be useful to enquire why material inequality is a source of worry at all, and why it has become such a salient issue in the public and political discourse. It seems self-evident that we should care about the welfare of the least well-off individuals, try to improve their living conditions, and make available a wide range of economic opportunities for them. However, it is much less clear that the income of the poor relative to the income of other social groups should influence our judgment of what constitutes a good, fair and prosperous society.

3.1 The Myth of the Spirit Level

Different arguments – both empirical and theoretical – have been proposed to demonstrate that material inequality is a problem that can have adverse effects on societal outcomes. Richard Wilkinson and Kate Pickett, epidemiologists at Universities of Nottingham and York, respectively, have been trying to show, in a book that has

> ***The Spirit Level*** **is simply not a piece of serious scholarship**

19 This term, coined by Samuel Huntington, denotes the economic rise of Europe and North America in the 18th and 19th centuries.
20 Xavier Sala-i-Martin (2006). "The World Distribution of Income: Falling Poverty and... Convergence, Period." *Quarterly Journal of Economics*, Vol. 121, No. 2, pp. 351-97.

been hugely influential in the UK,[21] that income inequality is associated with a variety of social ills, such as homicides, teenage pregnancies, physical and mental health problems. Many, including like-minded reviewers on the political Left,[22] have pointed out the serious deficiencies of the book, including dubious citation practices,[23] and a lack of sound reasoning.[24]

In a nutshell, the book attempts to identify the link between income inequality and various social problems by looking at simple correlations, on a sample of 23 industrialised countries. Most of the correlations are not robust to outliers[25] – so for instance the link between homicides and inequality is driven solely by the case of the United States, where arguably different factors, such as culture, or gun ownership, can be at play. The country selection is also troublesome, as the authors have arbitrarily excluded the Czech Republic, Slovenia and Hong Kong from the sample, while keeping in highly unequal Portugal. With the inclusion of the former, many of the extravagant claims made by the book would be untenable.

A fundamental deficiency of the argument of the book is its consistent reliance on simple correlations – or univariate regressions – to prove a causal link between inequality and all sorts of social problems. Such practice is seen as unacceptable even in introductory statistics courses – and rightly so. Correlation does not imply causation. Without controlling for other potentially important explanatory variables, we can make no inference about the true direction of causal mechanisms.

Throughout *The Spirit Level* one finds claims that all of these difficult statistical questions have already been solved – either in other publications by the authors themselves or by other researchers. Wilkinson and Pickett thus create the illusion of a consensus where none really exists. To illustrate, they claim that there is an established causal link between inequality and bad health outcomes, supported almost unequivocally by the literature. Nothing could be further from the truth. Angus Deaton, a leading micro-economist at the University of Princeton, concludes that "there is no direct link from income inequality to ill-health; individuals are no more likely to die if they live in more unequal places."[26]

Empirical problems aside, is there any theoretical basis for the claims made by Wilkinson and Pickett? Their theoretical framework relies mostly on the insight that low status individuals experience persistent stress which has negative effects on health outcomes. They cite the research that shows that monkeys who were moved into new environments, while their diet and characteristics were kept constant, experienced high levels of chronic stress that translated into immune and cardiovascular problems.[27]

Most of us know from introspection that we certainly do not enjoy being put into socially inferior and possibly undignified positions. But is this enough to establish a causal link between income inequality and bad health – or bad social outcomes in general? The first problem with doing so is related to the methodological nationalism implicit in our measures of inequality. While it might be the case that being at the bottom of any social ladder is potentially stressful, it is not clear why the distribution of income on a given territory should be the correct way of defining that social ladder. After all, most envy is local. People are not bothered by the astronomic remunerations of the super-rich, but they are disturbed by their neighbours who bought a new Mercedes, or by their high-school classmate who has been appointed CEO.

The second problem is that this analysis assumes that income is a variable that is critical in defining relevant social hierarchies. While this might be true for some people, it is difficult to imagine that it would hold as a general rule. People compete for status in different ways, and distinguishing oneself through high income and conspicuous forms of consumption is only one of them. Without any doubt, there are rewards that people balance against pecuniary earnings and high levels of consumption. Academics compete for status by publishing in reputable

21 Richard G. Wilkinson and Kate Pickett (2009). *The Spirit Level: Why More Equal Societies Almost Always Do Better.* London: Allen Lane.
22 John Kay (2009). "The Spirit Level." *Financial Times*, 23 March 2009. Available at: http://www.ft.com/cms/s/2/77b1bd26-14db-11de-8cd1-0000779fd2ac.html#axzz1CC5jHIEk Christian Bjornskov (2009). "The Spirit Level: Why Greater Equality Makes Societies Stronger" *Population and Development Review.* Available at: http://nonicoclolasos.files.wordpress.com/2010/08/pdr-bjornskov-review-file.pdf
23 Wilkinson and Pickett misrepresent the views of Nobel Prize Winner James Heckman, for instance. http://spiritleveldelusion.blogspot.com/2011/01/misrepresenting-evidence.html
24 Christopher Snowdon (2010). *The Spirit Level Delusion. The Spirit Level Delusion: Fact-checking the Left's New Theory of Everything*. Democracy Institute/Little Dice. Snowdon also provides up-to-date supply of further evidence and reviews of the Spirit Level on his blog, http://spiritleveldelusion.blogspot.com.
25 Outliers are extreme, or unusual observations – very often due to the presence of particular features, unique to this observation – which can then drive certain results that are mistakenly considered as valid for the whole sample.
26 Angus Deaton (2003). "Health, Inequality, and Economic Development." *Journal of Economic Literature*, Vol. 41, No. 1, pp. 113-158.
27 Robert M. Sapolsky (2005). "The Influence of Social Hierarchy on Primate Health." *Science*, Vol. 308 no. 5722 pp. 648-652.

journals and by earning the respect of their peers. As Paul Samuelson, one of the most influential academic economists of the 20th century, said:

> *"Scientists are as avaricious and competitive as Smithian businessmen. The coin they seek is not apples, nuts, and yachts; nor is it coin itself, or power as that term is ordinarily used. Scholars seek fame. The fame they seek…is fame with their peers - the other scientists whom they respect and whose respect they strive for."*[28]

And it is not just academics. Environmentalists compete for status by engaging in recycling, buying organic, or other environmentally-friendly products. Infovores, or "geeks," compete for status by accumulating very detailed information about one specific subject (say Star Trek or DC Comics) or, respectively, by acquiring a very broad view of general trends in current affairs, arts and literature.

Relative status is not determined by money alone

More than any other period in human history, the present era enables individuals to compete for status in different ways. While someone can consider competing for status through income as wasteful and socially damaging, alternative forms of status competitions – between writers, artists, scholars or scientists – are making the world a better place.

Human beings have diverse callings – some of which may involve competing for status – but to argue that income is the only variable that distinguishes them is both inaccurate and self-defeating, particularly when it comes from people who manifestly care about things other than income and material consumption.

3.2 Did income inequality cause the financial crisis?

Perhaps material inequality produces bad social outcomes in indirect ways. Is it not plausible, for instance, that excessive economic inequality can lead to social instability, and maybe even to economic crises? Is it a coincidence that the rise in income inequality in the United States occurred during the years preceding the crash of 2008? In one view, advocated by the Nobel Prize-winning economist Joseph Stiglitz,[29] inequality was associated with a flood of money to those who couldn't possibly have spent it all. The inflow of liquidity then triggered excessive leverage and risk-taking, as the available funds were used for consumer borrowing by low-income groups. Alternatively, the University of Chicago economist Raghuram Rajan[30] argues in his book, *The Fault Lines*, that it was economic inequality that triggered a policy response which ultimately resulted in the present economic downturn. In his view, inequality rose in the late decades of the 20th century because of skill-biased technology change, which rewarded disproportionately highly skilled and highly educated workers, while the incomes of low-skilled workers stagnated or declined. Because the United States did not have in place a fully-fledged system of welfare support and redistribution, and because there was an in-built cultural bias against creating one, policymakers had to have recourse to other methods to appease the low-income groups. One way of doing that was through promoting home ownership among low-income groups, which has ultimately led to a cluster of unsound decisions taken by the financial industry, resulting in the financial meltdown that occurred in 2008.

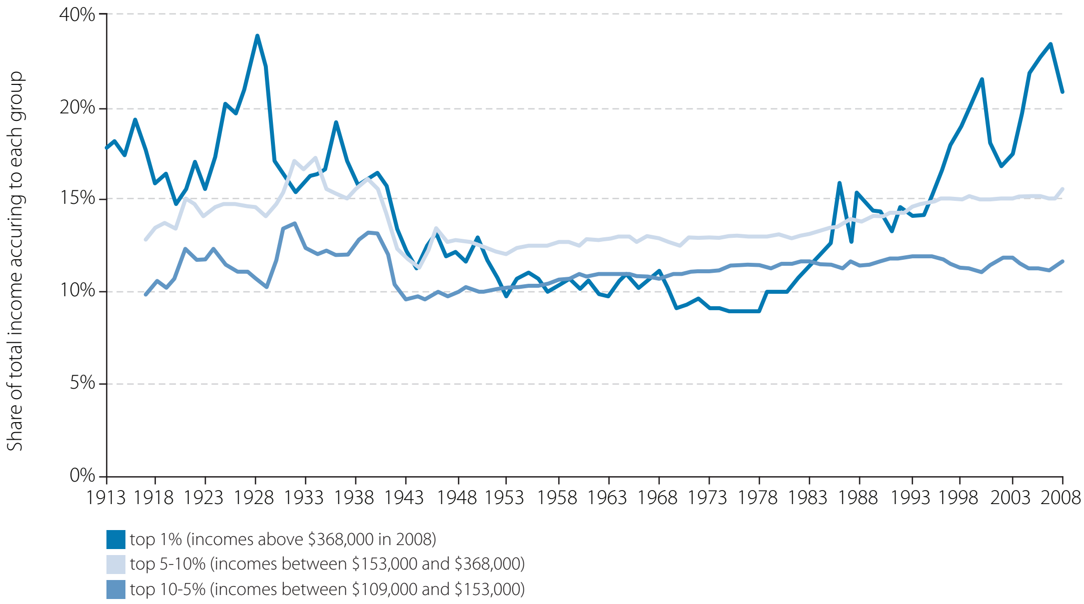
Inequality did not cause the financial crisis. Rather, too-big-fail policies drove both the irresponsible behaviour of the banking industry and excessive executive pay, contributing to the growth in income inequality

However, there are reasons to believe that this story is too simplistic to capture the real dynamics that led to the crisis. Sir Tony Atkinson and Salvatore Morelli, both at Oxford University, have raised the following points,[31] suggesting that a more nuanced view is needed.

Not only has income inequality risen just marginally in the 10 years preceding the crisis – while no unambiguous trend can be identified in the case of consumption inequality – it is also true that an investigation of other countries that have undergone a financial crisis reveals that there is no link between inequality levels and susceptibility to financial crises.

28 Paul Samuelson 1986. "On the Prowl in an Enchanted Forest." *The New York Times*, 12 October 1986
29 Joseph Stiglitz (2009). "Drunk-Driving on the US's Road to Recovery." RealClearPolitics. Available at: http://www.realclearpolitics.com/articles/2009/01/drunkdriving_on_the_uss_road_t.html.
30 Raghuram Rajan (2010), op. cit. A similar argument has been made by Michael Kumhof and Romain Rancière (2010). *Inequality, Leverage and Crises*. IMF Working Paper 10/268. Available at: http://www.imf.org/external/pubs/ft/wp/2010/wp10268.pdf.
31 Anthony B. Atkinson and Salvatore Morelli (2010) *Inequality and Banking Crises: A First Look*. Available at: http://isites.harvard.edu/fs/docs/icb.topic457678.files/ATKINSON%20paper.pdf

Figure 3. Inequality of various income brackets



Source: Daron Acemoglu (2011) Thoughts on Inequality and Financial Crisis. *AEA Meeting, Denver.*

If inequality and the relative impoverishment of the working classes were the culprits, then it is puzzling why the crisis occurred after a decade of stagnating incomes of low-income groups, and not after a period of when incomes of low-income groups were actually *falling*, as in the 1980s. Arguably, the need for appeasing the poor must have been more urgent back then, and yet it did not result in a financial meltdown – just as extreme income differences did not result in financial and economic crises in other parts of the world, as they should have under the Stiglitz-Rajan hypothesis.

That does not mean that finance and inequality are completely unrelated. After all, it would be difficult to imagine the evolution of income inequality in the United States in the past 10 years without taking into account the massive growth of remuneration in the financial industry. Data suggest that skill-biased technological growth can explain much of the evolution in income inequality in recent decades – perhaps even everything that happened below the 99th percentile of the income distribution.[32] As Figure 3 shows, the growth of the top 1 percentile, however, appears to be disconnected from this story. Daron Acemoglu, a political economist at MIT, thus says that inequality, finance, and our current economic problems are indeed interconnected, but in a way which puts politics in the centre of the picture.[33]

Large parts of the financial industry in the West have long operated with implicit government guarantees. Acemoglu also posits that the banks have successfully lobbied for a deregulation of the financial industry. While we believe that a story built around “deregulation” in some absolute sense is factually incorrect, as finance has indeed been one the most heavily microregulated industries, it is true that inept regulations, and regulations that suited some influential actors in the financial industry, did play a complicit role in creating the crisis.[34] Likewise, the implicit guarantees did encourage excessive risk-taking and “shorting volatility” as an assured way of making money both in good and bad economic times.[35] In that regard, politics and government-accorded privileges acted as factors driving both the series of unsound and ultimately destructive decisions that led to the meltdown of 2008 and also the rise of income of the super-rich in the 2000s.

What ought to emerge from the present discussion is that income inequality is little more than a statistical artefact. It

32 A similar development can be observed in the UK. See Brian Bell and John Van Reenen. (2010) *Bankers’ Pay and Extreme Wage Inequality in the UK*. LSE Centre for Economic Performance. Available at: http://cep.lse.ac.uk/_new/publications/abstract.asp?index=3570.

33 Daron Acemoglu (2011) *Thoughts on Inequality and Financial Crisis*. AEA Meeting, Denver.

34 Matthew Sinclair and Dalibor Roháč (2010). *Financial Regulation Goes Global: The Risks for the World Economy*. A report by the TaxPayers’ Alliance and the Legatum Institute. Available at: http://www.li.com/attachments/20101228_LegatumInstitute_FinancialRegulationGoesGlobal.pdf

35 Tyler Cowen (2011). “The Inequality That Matters.” *The American Interest*, January-February 2011. Available at: http://www.the-american-interest.com/article-bd.cfm?piece=907

tells us very little about the underlying social and institutional forces, and it also is a very bad proxy for genuine inequality in living standards. Talking about material inequality more broadly, we should recognise that this too, is essentially a value-neutral pattern of economic data. Under normal circumstances, when individuals earn their money through creative and entrepreneurial efforts, it is difficult to imagine a convincing argument for why the resulting distribution of income should be seen as undesirable. In contrast, most people are concerned – and rightly so – about income inequality that results out of privilege, access to political power, and other forms of injustice. Nonetheless, we should realise that what is troubling is not inequality per se, but rather the underlying social and institutional flaws, which are the source of injustice. Focusing on inequality per se, rather than the mechanisms which have brought it into existence, obfuscates rather than illuminates the real problems and can lead to the right policy prescriptions only by accident.

4. Inequality and policy

The purpose of this report is not to deny that we live in an imperfect world, where injustice, unfairness and unequal access to economic opportunity can be found. However, we believe that organising the debate about these important themes around the concept of income inequality is not only unhelpful, it is also deeply misleading and can motivate policy measures that hurt the poorest and most vulnerable members of society.

To be sure, there exist quite a number of policies that are regressive and directly exacerbate material disparities. Those who are worried about living conditions of the poor – either in absolute or relative terms – should therefore call for an elimination of regressive forms of taxation. They should also call for changes to public education systems that disproportionately reward the middle classes and do not deliver the same services to students coming from less affluent backgrounds. Finally, they should be arguing against government spending that is directed at the affluent and which brings very little enjoyment to the genuinely poor.

Minimum wage legislation is another illustration of policies that disproportionately hurt the poor. It is a measure that should, in principle, achieve a greater degree of wage equality. However, its most likely effect is increased unemployment among low-productivity workers who would otherwise be able to earn a wage below the minimum stipulated by the regulation. An undue emphasis on income redistribution is another example, especially in situations when steeply progressive tax rates lead highly-skilled workers to work less, or to leave for more tax-friendly jurisdictions. A standard result coming from the optimal tax literature is that the marginal tax rate facing those who earn the highest income in the economy should be zero – encouraging them to work more and help to rise the tide that would eventually lift all boats.[36]

This report has argued that, in order to arrive at sound policies, we need to abandon the nationalistic obsession that leads one to focus on individual nation states as the best proxy for what a society is. If people are concerned about the welfare of the poor, they need to be concerned at least as much about the poor in Kenya or Ethiopia as they are about the relatively much more affluent poor in East London or Detroit.

A corollary is that if people are worried about income inequality, then they should be worried primarily about inequality between countries, and much less so by inequality within countries. Indeed, there is a very simple way of helping the poor in developing countries: letting them trade freely with the more affluent countries in the West and also letting their citizens immigrate freely into wealthier countries.

Of course, one may object that uncontrolled immigration represents a burden for the host country, both in terms of the impact on the system of government-run redistribution, but also in terms of its social fabrics. Whatever those costs, they do not appear to outweigh the sum of direct, personal, benefits to the migrants themselves and to the consumers who will be able to enjoy lower labour costs in some areas of the economy. Indeed, there are external costs associated with many human activities, and yet the usual policy response is not to ban them, or to restrict them in a draconian way. If immigration is costly, then it could be subject to taxation, or the right to immigrate could be auctioned in a way that it is allocated to those for whom immigration would provide the highest net benefit. Gary Becker, Nobel Prize-winning economist from the University of Chicago thus advocates a system of auctions – and loans to help liquidity-constrained immigrants – as the best way of dealing with the issue of immigration.[37] Whatever we

36 James A. Mirrlees (1971). "An Exploration in the Theory of Optimum Income Taxation." Review of Economic Studies, Vol. 38, No. 2, pp. 175-208

37 See, e.g., the 19th Annual Hayek Lecture hosted by the IEA. Video available: http://www.iea.org.uk/multimedia/video/annual-hayek-memorial-lecture-2010-prof-gary-becker.

might think of his proposal – and it certainly is one that has various alternatives – it should be obvious that it is vastly superior to a system in which billions of people in developing countries are deprived from having access to economic opportunity in the West.

However that may be, the poor all over the world need policies that will enable them to live a life of economic opportunity and will allow them to improve their standards of living through their own efforts. In that sense, the low-hanging policy fruit – measures that would lead to massive improvements in standards of living of the poor – would consist of removing the barriers that currently prevent people in the developing world from accessing global markets in goods, labour, and capital.

There are different ways to help the poor, but measures of income inequality will not provide one with any guidance

As an illustration, the system of tariffs and agricultural subsidies existing in the West does great harm to the most vulnerable agricultural communities in the developing world, to the benefit of a rather narrow agribusiness elite in Europe and in the United States. Eliminating these policies would do a much better job in helping the poor and underprivileged than any imaginable redistribution scheme in any developed country.

Likewise, there exist substantial barriers to trade and free movement of capital, goods, and labour within the developing world. Encouraging African nations to remove those barriers is likely to bring about massive benefits for people who are currently locked in poverty.

Nevertheless, we do not wish to suggest that no changes are necessary in the West itself. While income inequality in itself can't be seen as a social problem, systematic, government-orchestrated injustice can. Remember that the massive remunerations of certain financial executives, causing an outrage on the political Left, are partly a result of implicit government guarantees that encouraged the relevant actors to take excessive leverage and risk while eliminating the downside risk in the case when things go wrong. Removing government guarantees and cutting the connection between finance and politics would address an important case of systematic injustice – which also happens to be a driver of material inequality.

Hence, even if one believes that reducing income inequality was a worthy goal in itself, there simply is not a space for redistribution schemes that would have an important effect on inequality. Furthermore, this report adopts the position that income inequality is simply not a good measure of welfare of the poor, nor of justice in any given society.

Nonetheless we should avoid the pitfalls of naive supply side economics that posits that tax cuts can have huge effects on economic growth. In our present era, it is unlikely that tax cuts for the top income brackets would spur economic growth a great deal. As Tyler Cowen argues,[38] the era of low-hanging fruit for the American economy is likely gone, and a similar case can be made for the economies of the EU. Since the late 1970s, the growth of industrialised economies has been much slower than in the previous 30 years, and it is not clear whether, how, and when we will be able to return to the much more impressive pre-1970s growth rates. In a sense, we are awaiting a significant technological breakthrough that would put the developed world again on a more dynamic growth trajectory that was actually profitable in economic terms. This word of caution about the effects of tax cuts on economic growth is, at the same time, a strong argument against redistribution. Because we are likely to live in an economy that is growing relatively slowly – and might continue to do so for a number of years to come – there is simply no space for expanding social programs in a significant way – and certainly not without massive economic costs.

Furthermore, it is unclear how effective redistribution is at reducing income inequalities, especially in the context of the real-world political process which is necessarily imperfect. It is true that the Nordic countries are often cited as examples of countries with high rates of income redistribution and low levels of inequality, but it is problematic to generalise their experience into broader policy recommendations for other countries in the world. After all, the Mediterranean countries also have high rates of income redistribution but are among the most unequal in Europe. The difference between the two probably has to do with the fact that the Nordic states are very homogenous, have high levels of social capital, incentives supporting entrepreneurship and are extremely well-governed. Simply transplanting Nordic redistributionist policies into environments that do not have these characteristics cannot be expected to deliver the same results.

38 Tyler Cowen (2011). *The Great Stagnation: How America Ate All The Low-Hanging Fruit of Modern History, Got Sick, and Will (Eventually) Feel Better.* Dutton/Penguin (e-book).

However that may be, we should realise that the public debt problems, which are endemic to the affluent industrialised economies of the world, have been driven by the implicit assumption that our economies were growing more rapidly than they actually were – and hence that we were richer than we really were. If anything, dealing effectively with the accumulated debt problem will require us to scale back both our plans of private consumption spending and public spending.

With current debt levels and sluggish growth rates, there is not anything left to redistribute

If understood correctly, equality is a noble and worthy ideal. Individuals have immeasurable intrinsic worth and should be treated with the same respect, regardless of their race, religion, gender or socioeconomic condition. However, that does not imply that we should be striving towards eliminating *differences* between individuals. People differ vastly in their tastes, abilities, and interests. No wonder that these lead to different economic outcomes. A genuine concern for equality would imply a sustained support to a world in which no one has access to particular privileges at the expense of others. Much can be done to bring our world closer to this ideal, but it requires sound thinking and intellectual rigour, which are not easy to find in the tracts of those who yearn for greater material equality.

Acknowledgements

Brad Barlow, Marian L. Tupy, Hemal Shah, Ryan O'Sullivan and Katharine Mineyko provided valuable comments and suggestions on earlier versions of this report.