

Global Perspectives on the Causes and Consequences of Growing **Inequality**

Joseph E. Stiglitz

World Bank

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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

Recession made matters worse

- In US, 121% of increase in wealth 2009-2011 went to upper 1%
- Median wealth fell by 40%, back to level of early 90's
- Poverty is up
- Median income at level of 1996
- 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**
- **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
- Atkinson measure probably better measure than Gini coefficient

Inequality of opportunity

- For most people, even more important than equality of outcomes
- Large differences among countries
- 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

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
 - **Disparity in “endowments”**
 - **Changes in market prices of endowments**

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

- Large numbers of those at the top whose fortunes 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 that promotes rent seeking, would not expect to see much effect on growth—confirmed by data

- Lowering tax rates at the top may lead to more inequality
 - If non-pecuniary rewards to wealth creation represent a larger fraction of benefits, then lowering tax rates at top will encourage rent-seeking behavior
 - Consistent with empirical evidence
- Political economy suggests possibility of reverse direction
 - If higher economic inequality gets reflected in political system, tendency of such economies to vote for less progressive tax systems

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

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 on inequality**
- **Vicious circle**

Inequality and instability

- Empirical finding in IMF studies
- Consistent with recent downturn
- Not inevitable
- Not every dimension of inequality

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 framework has effects on inequality
 - Bankruptcy law, competition law, corporate governance, financial sector regulation
- One has to be mindful of indirect effects of inequality on instability and growth (political economy)
- And indirect effects of instability on inequality
 - Downturns typically hurt workers at the bottom
 - Both directly (unemployment), indirectly (cut in wages, public programs)

Promoting Opportunity

- **Education**
- **Financial inclusion**
- **Inheritance taxes**

The importance of inclusive growth

- Growth doesn't necessarily benefit all
- 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
 - Reflected in inequality-corrected HDI
 - Implies that all cross country regressions need to be redone, focusing on better measures of performance

Policies have to focus on inequality, instability, and inclusive growth

- Policies which expose countries to more instability (CML, FML, some aspects of trade liberalization) may have adverse distributional consequences
- FML may disadvantage SME's, work contrary to financial inclusion
- Adverse distributional consequences may have adverse effects on long run economic performance

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

Inequality Trap

- Economies/societies can get trapped in a high inequality equilibrium
 - High inequality, low investment in public goods (education)
- But some economies/societies are seeming to escape this trap
- Major role for the World Bank in helping countries to understand the risks of the inequality trap and the policies through which it can be avoided