The rich and the rest

What to do (and not do) about inequality

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APART from being famous and influential, Hu Jintao, David Cameron, Warren Buffett and Dominique Strauss-Kahn do not obviously have a lot in common. So it tells you something about the breadth of global concerns about inequality that China's president, Britain's prime minister, America's second-richest man and the head of the International Monetary Fund have all worried, loudly and publicly, about the dangers of a rising gap between the rich and the rest.

Mr Hu puts the reduction of income disparities, particularly between China's urban elites and its rural poor, at the centre of his pledge to create a "harmonious society". Mr Cameron has said that more unequal societies do worse "according to almost every quality-of-life indicator". Mr Buffett has become a crusader for a higher inheritance tax, arguing that America risks an entrenched plutocracy without it. And Mr Strauss-Kahn argues for a new global growth model, claiming that gaping income gaps threaten social and economic stability. Many others seem to share their concerns. A new survey by the World Economic Forum, whose annual gathering of bigwigs in Davos begins on January 26th, says its members see widening economic disparities as one of the two main global risks over the next decade (alongside failings in global governance).

Equally muddled

The debate about inequality is an old one. But in the wake of a financial crisis that is widely blamed on Wall Street fat cats, from which the richest have rebounded fastest, and ahead of public-spending cuts that will hit the poor hardest, its tone has changed. For much of the past two decades the prevailing view among the world's policy elite—call it the Davos consensus—was that inequality itself was less important than ensuring that those at the bottom were becoming better-off. Tony Blair, a Labour predecessor of Mr Cameron's, embodied that attitude. His New Labour party was famously said to be "intensely relaxed" about the millions earned by David Beckham (a footballer) provided that child poverty fell.

Now the focus is on inequality itself, and its supposedly pernicious consequences. One strand of argument, epitomised by "The Spirit Level", a book that caused a stir in Britain, suggests that countries with greater disparities of income fare worse on all manner of social indicators, from higher murder rates to lower life expectancy. A second thread revisits the macroeconomic consequences of income disparities. Several prominent economists now reckon that inequality was a root cause of the financial crisis: politicians tried to counter the growing gap between rich and poor by encouraging poorer folk to take on more credit. A third argument is that inequality perverts politics, with Wall Street's influence in Washington often cited as exhibit A of the unhealthy clout of a plutocratic elite.

If these arguments are right, there might be a case for some fairly radical responses, especially a greater focus on redistribution. In fact, much of the recent hand-wringing about widening inequality is based on sloppy thinking. The old Davos consensus of boosting growth and combating poverty is still a better guide to good policy. Rather than a sweeping assault on inequality itself, policymakers would do better to take on the market distortions that often lie behind the most galling income gaps, and which also impede economic growth.

Begin with the facts about inequality. Globally, the gap between the rich and the poor has actually been narrowing, as poorer countries are growing faster. Nor is there a monolithic trend within countries. In Latin America, long home to the world's most unequal societies, many countries—including the biggest, Brazil—have become a bit more equal, as governments have boosted the incomes of the poor with fast growth and an overhaul of public spending to improve the social safety-net (but not by raising tax rates for the rich).

The gap between rich and poor has risen in other emerging economies (notably China and India) as well as in many rich countries (especially America, but also in places with a reputation for being more egalitarian, such as Germany). But the reasons for this differ. In China inequality has a lot to do with the *hukou* system of residency permits, which limits internal migration to the towns; by some measures inequality has peaked as rural labour becomes more scarce. In America income inequality began to widen in the 1980s largely because the poor fell behind those in the middle. More recently, the shift has been overwhelmingly due to a rise in the share of income going to the very top—the highest 1% of earners and above—particularly those working in the financial sector. Many Americans are seeing their living standards stagnate, but the gap between most of them has not changed all that much.

The links between inequality and the ills attributed to it are often weak. For instance, some of the findings in "The Spirit Level" were distorted by outliers: strip out America's high murder rate (which many would blame on guns, not inequality) or Japan's longevity (diet, not equality), and flatter societies no longer look so much healthier. As for the mooted link to the financial crisis, the timing is dodgy: America's poor fell behind in the 1980s, the credit bubble took off two decades later.

Message to Davos

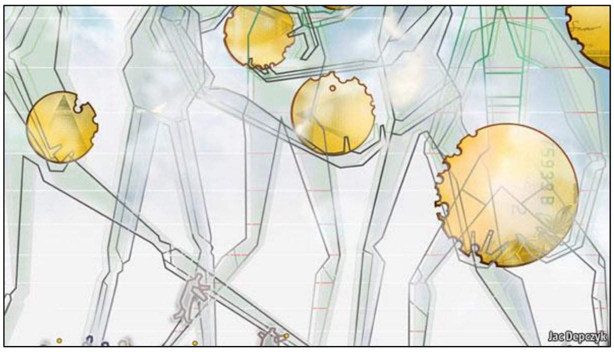
These nuances suggest that rather than fretting about inequality itself, policymakers need to differentiate between its causes and focus on ways to increase social mobility. A global market offers far bigger returns to those at the top of their game, be they authors, lawyers or fund managers. Modern technology favours the skilled. These economic changes are themselves often reinforced by social ones: educated men now tend to marry educated women. The result of all this, as our special report this week shows, is the rise of a global elite.

At heart, this is a meritocratic process; but not always. Rules and institutions are often rigged in ways that limit competition and favour insiders at the expense both of growth and equality. The rules can be blatantly unfair: witness China's limits to migration, which keep the poor in the countryside. Or they can involve more subtle distortions: look at the way that powerful teachers' unions have stopped poorer Americans getting a good education, or the implicit "too big to fail" system that encouraged bankers to be reckless and left the rest with the tab. These are very different problems, but they all lead to wider inequality, fewer rungs in the ladder and lower growth.

Viewed from this perspective, the right way to combat inequality and increase mobility is clear. First, governments need to keep their focus on pushing up the bottom and middle rather than dragging down the top: investing in (and removing barriers to) education, abolishing rules that prevent the able from getting ahead and refocusing government spending on those that need it most. Oddly, the urgency of these kinds of reform is greatest in rich countries, where prospects for the less-skilled are stagnant or falling. Second, governments should get rid of rigged rules and subsidies that favour specific industries or insiders. Forcing banks to hold more capital and pay for their implicit government safety-net is the best way to slim Wall Street's chubbier felines. In the emerging world there should be a far more vigorous assault on monopolies and a renewed commitment to reducing global trade barriers—for nothing boosts competition and loosens social barriers better than freer commerce.

Such reforms would not narrow all income disparities: in a freer world skill and intellect would still be rewarded, in some cases magnificently well. But the reforms would strike at the most pernicious, unfair sorts of income disparity and allow more people to move upwards. They would also boost growth and leave the world economy more stable. If the Davos elites are worried about the gap between the rich and the rest, this is the route they should follow.

The links between rising inequality, the Wall Street boom and the subprime fiasco



THERE was not a single year between 1952 and 1986 in which the richest 1% of American households earned more than a tenth of national income. Yet after rising steadily since the mid-1980s, reckon Thomas Piketty and Emmanuel Saez, two economists, in 2007 the income share of the richest percentile reached a staggering 18.3%. The last time America was such an unequal place was in 1929, when the equivalent figure was 18.4%. The similarities in the evolution of income inequality in the years leading up to the Depression and the global economic crisis make for one of the most striking parallels between the two episodes. Some talk of a repeat of the Roaring Twenties, when Jay Gatsby threw lavish parties at his Long Island mansion—although this time round, the dubious profits have been made from real-life finance, not fictitious bootlegging.

Economists have been thinking hard about the causes, extent and consequences of the recent rise in inequality. At the annual meeting of the American Economic Association (AEA) in Denver this month, there was a spirited debate about one of the most controversial hypotheses so far. That has been advanced by Raghuram Rajan, of the University of Chicago Booth School of Business, in a recent book, “Fault Lines”. He argues that increased inequality—more precisely, the political response to it—helped to cause the financial crisis.

Mr Rajan reckons that technological progress increased the relative demand for skilled workers. This led to a widening gap in wages between them and the rest of the workforce, because the supply of the skilled did not keep pace with demand. This reasoning is widely accepted. But Mr Rajan goes further than most when he argues that this growing gap lay behind the credit boom whose souring precipitated the financial crisis.

Governments, he argues, could not simply stand by as the poor and unskilled fell farther behind. Ideally, more should have been spent on education and training. But in the short run, credit was an easy way to prop up the living standards of those at the bottom of the economic pile. This was especially true in America, with its relatively puny welfare state.

Mr Rajan thinks, therefore, that it is no coincidence that America in the early 2000s saw a boom in lending to the poor, including those folks that banks used to sniff at. He points to the pressure the government put on the two state-backed housing giants, Fannie Mae and Freddie Mac, to lend more to poorer people. Affordable-housing targets, slacker underwriting guidelines and the creation of new “low down-payment” mortgages were all used as instruments of public policy.

The push for affordable credit worked. Subprime mortgages, whose share of all mortgages serviced rose from less than 4% at the turn of the century to a peak of around 15% before the crisis, were the most visible examples of this. They helped push American home-ownership rates to record highs. But the credit boom also inflated an enormous housing bubble, whose collapse precipitated a financial crisis brought on by defaults on those very subprime mortgages. According to Mr Rajan, therefore, well-intentioned political responses to the rise in inequality that many found disturbing ended up having devastating side effects.

This is a provocative idea. But do the facts support it? Two prominent economists—Daron Acemoglu of the Massachusetts Institute of Technology and Edward Glaeser of Harvard University—argued at the AEA meetings that Mr Rajan's hypothesis, for all its plausibility, is flawed. Neither critic doubts that inequality rose and that poorer people gained access to more credit. But they disagree with Mr Rajan on the link between the two.

Mr Acemoglu argues that the expansion in credit came far too late for Mr Rajan's hypothesis. The subprime boom began around 2000. Yet those at the bottom of the income distribution were getting hammered by technological change in the 1980s. Since then, the least-skilled workers in America have not become still worse-off, largely because they work in service industries which are hard to automate. Inequality has continued to rise because the rich have done even better; it is those in the middle who have fared relatively poorly. Why would the state try to help the poorest at a time when they were doing better than before?

Mr Glaeser has a different criticism. He thinks that the role of easy credit in the housing bubble was not as large as Mr Rajan believes. He refers to research by Atif Mian, of the University at California, Berkeley, and Amir Sufi, of the Booth School, which shows that increased mortgage availability pushed up American home prices by only around 4.3%. This was a small fraction of the rise in prices during the boom. Irrational exuberance and a willingness to bet on prices rising for ever were probably much bigger contributors to the bubble than credit expansion.

Let's all agree to blame the speculators and lobbyists

Mr Acemoglu does believe that there is a link—albeit not a causal one—between increased inequality and the crisis. He thinks both were the consequence of politicians' willingness to deregulate the financial sector, which partly reflected the industry's lobbying prowess. A consequence, documented by two more economists, Ariell Reshef and Thomas Philippon, was that salaries in finance soared, causing a substantial part of the explosion in top incomes noted by Messrs Piketty and Saez. Runaway lending and lax standards, which fuelled the boom and contributed to the crisis, were others. So he thinks Mr Rajan is right to focus on politics but that they did not play out in quite the way he believes.

Ultimately it may be hard to prove a causal connection between inequality, subprime lending and the Wall Street boom. Even so, most economists at the AEA gathering agreed that the three forces combined in the American economy in an unsustainable and unhealthy way. To misquote "The Great Gatsby", the rock of the world was founded securely on a fairy's wing.

Inequality is rising. Does it matter—and if so why?

FOR the head of the IMF to quote Adam Smith may seem unremarkable. But here is Dominique Strauss-Kahn citing the great man in November 2010: "The disposition to admire, and almost to worship, the rich and the powerful and…neglect persons of poor and mean condition…is the great and most universal cause of the corruption of our moral sentiments."

Mr Strauss-Kahn then bemoaned "a large and growing chasm between rich and poor—especially within countries". He argued that inequitable distribution of wealth could "wear down the social fabric". He added: "More unequal countries have worse social indicators, a poorer human-development record, and higher degrees of economic insecurity and anxiety."

That marks a huge shift. Just before the financial crisis America's Congress was gaily cutting taxes for the highest earners, and Tony Blair, Britain's prime minister, said he did not care how much soccer players earned so long as he could reduce child poverty. So why has fear of inequality stormed back into fashion? Does it matter in some new way? Does it have previously unknown effects? The most obvious reason for the renewed attention is inequality's apparent increase. A common yardstick is the Gini coefficient, which runs from 0 (everyone has the same income) to 1 (one person has all the income). Most countries range between 0.25 and 0.6.

The Gini coefficient has gone up a lot in some rich countries since the 1980s. For American households it climbed from 0.34 in the mid-1980s to 0.38 in the 2000s. In China it went up even more, from under 0.3 to over 0.4. But this was not universal. For decades, Latin America had the world's worst income inequality. But Brazil's Gini coefficient has fallen more than five points since 2000, to 0.55. And as poor countries are on average growing faster than rich ones, inequality in the world as a whole is falling.

Getting richer quicker

Greater inequality can happen either because the wealthier are getting wealthier, or the poor are falling behind, or both. In America it has had more to do with the rich. The income of the wealthiest 20% of Americans rose 14% during the 1970s, when the income of the poorest fifth rose 9%. In the 1990s the income of the richest fifth rose 27% while that of the poorest fifth went up only 10%. That is a widening income spread, but not a drastic one. Robert Gordon, an economist at Northwestern University in Illinois, reckons that for the bottom 99% of the population, inequality has not risen since 1993.

The problems at the bottom are reasonably well understood: technology enables the automation of blue-collar trades; globalisation lets unskilled jobs move to poorer, cheaper countries; shrinking trade-union membership erodes workers' bargaining power. But inequality is rising more sharply at the top, among what George Bush junior called the "haves and have-mores". Here the causes are more mysterious.

The economists Emmanuel Saez and Thomas Piketty studied the incomes of the top 0.1% of earners in America, Britain and France in 1913-2008. America's super-rich, they found, were earning about 8% of the country's total income at the end of the period—the same share as during the Gilded Era of the 1920s and up from around 2% in the 1960s. A study by the Economic Policy Institute, a think-tank in Washington, DC, looked at the ratio of the average incomes of the rich and the "bottom" 90% of the population between 1980 and 2006. It found that the top 1% earned ten times more than the rest at the start of the period and 20 times as much at the end—ie, its "premium" doubled. But for the top 0.1% the gain rose from 20 times the earnings of the lower 90% to almost 80-fold.

You can understand why people might regard this as unfair: the top 0.1% do not seem to be working 80 times as hard as everyone else, nor are they contributing 80 times more to welfare. But that is a matter of public opinion, and mostly of politics. The question of the economic impact of extreme inequality is separate. Recent evidence suggests it may not be as damaging as many imagine. Our special report casts doubt on the widespread view that inequality causes (or is associated with) a host of social problems. Economics focus finds little evidence that it stoked the financial crisis.

But recent research does suggest two other reasons why the rise in inequality is a problem. One is that rich economies seem to provide disproportionate and growing returns to the already wealthy. The other is that inequality may literally be making people miserable by increasing stress and the hormones it releases.

In a recent series of lectures at the London School of Economics, Adair Turner, the chairman of Britain's Financial Services Authority, cited several factors that appear to be pushing up the incomes of the rich. First, financial, legal and health services have increased their shares of GDP in most rich economies—especially Anglo-Saxon ones—and these professions contain some of the richest people in the country. Financial services' share of GDP in America doubled to 8% between 1980 and 2000; over the same period their profits rose from about 10% to 35% of total corporate profits, before collapsing in 2007-09. Bankers are being paid more, too. In America the compensation of workers in financial services was similar to average compensation until 1980. Now it is twice that average. Rich bankers really are all around you.

Turner turns the screw

Next, argues Lord Turner, as people get wealthier they tend to devote more discretionary income to what are called "positional goods"—items such as limited-edition, celebrity-endorsed sneakers whose main value lies in their desirability in the eyes of others. The willingness of people to buy such stuff, combined with the vast new markets of millions of emerging middle-class consumers in China, India and elsewhere, has boosted the stars' brands beyond anything that was possible in the past. Bobby Jones, the best golfer of the 1920s, was an amateur. Tiger Woods earned $90m in 2009, before sex scandals wrecked his image. Writing children's novels used to keep authors in chintz and twinsets. J.K. Rowling, author of the Harry Potter books, is a billionaire.

Admittedly, truly global celebrities are few in number. But they have a penumbra of agents, lawyers and image-makers. As Lionel Robbins, a British economist, once said, "a substantial proportion of the high incomes of the rich are due to the existence of other rich people."

The growth of celebrity rents explains more than just why there may be more rich people around. The point about positional goods—and of fashion and brands in general—is their relative attractiveness. Owning the latest gadget or garment is particularly attractive when others don't have it, rather as buildings are valuable because of their location: ie, how desirable they seem to others. With such goods, a rising tide does not lift all boats. You yearn to be not merely richer, but richer than your neighbours. So the more brands, fashion and houses become important, the more relative income and inequality matter.

This would seem to qualify one of the commonest justifications for being relaxed about inequality: that it is not a big concern if the rich are getting richer so long as the poor are doing well too. That view was shared by Margaret Thatcher and Ronald Reagan and more recently by Mr Blair and Ben Bernanke, the Fed chairman. But if positional goods are taking a larger share of people's salaries, then relative income does matter and so do income disparities between rich and poor. Positional goods do not affect material welfare, as do poor schools or substandard housing. But they do affect people's quality of life and well-being. That leads to a second reason for worrying about inequality: its physiological and physical consequences.

In “The Spirit Level”, a bestselling book of 2009, Richard Wilkinson and Kate Pickett argue that inequality “gets under the skin” and makes everyone worse off, not just the poor. They mean “gets under the skin” literally. The argument is that inequality causes chronic stress, and makes people secrete too much of a hormone called cortisol. This normally has benign metabolic and other functions. Produced in large quantities it can harm among other things the brain and the immune system. So cortisol may be a direct link between inequality and bad health.

Another is that inequality impairs the production of a second hormone, oxytocin. Sometimes referred to as the “cuddle hormone”, this is secreted in childbirth and during breastfeeding, and seems to encourage pair-bonding and trust in others. The claim is that people living in unequal societies secrete less oxytocin, hence they have lower levels of trust. These accounts might be dubbed the medical, as opposed to material, explanations for inequality’s bad effects.

The hypothesis is plausible. Humans are social animals and have been refined by evolution to be extremely sensitive to social interactions. Though intuitively attractive, the link is not yet well established. Most studies of hormonal stress markers have focused on particular groups subject to huge, chronic woes, such as carers of patients with Alzheimer’s disease. Little research so far has dealt with the general population. A recent review of the scientific literature found little consistent evidence of a link between bio-markers of stress and social or economic status.

Nor is it certain that income inequality is the right problem to focus on. What seems to affect levels of stress hormones is not income, but competition for status, a broader, fuzzier notion. Evolution has primed humans to seek high status. Losers in competitions for esteem may well suffer. Societies with fierce status competition may well be unhealthier and more violent. But it is the disparities of status, not of income, that matter.

Often the two go together: Nordic countries have low income inequality and not too much status competition. But one can also imagine societies with narrow income disparities that are riddled with status conflict. The old Soviet Union is a vivid example. The inverse is conceivable too: countries with large income disparities but less status conflict, perhaps because competition is smoothed by social mobility. Arguably America fitted that description until recently. Overall though, it is true that in most places growing income disparities are a reasonable proxy for growing status competition.

Economists have long argued that inequality is a much less important problem than poverty. The recent research linking inequality to widespread social ills has not decisively overturned that view: the evidence is still mixed, at best.

The claim that inequality now matters more because of brands and status competition may turn out to be more robust. Such concerns could seem peripheral compared with global woes such as poverty. But inequality is local. As Adam Smith also once wrote, “if he was to lose his little finger tomorrow, he would not sleep tonight; but provided he never saw them, he would snore with the most profound security over the ruin of a hundred million of his brethren.”