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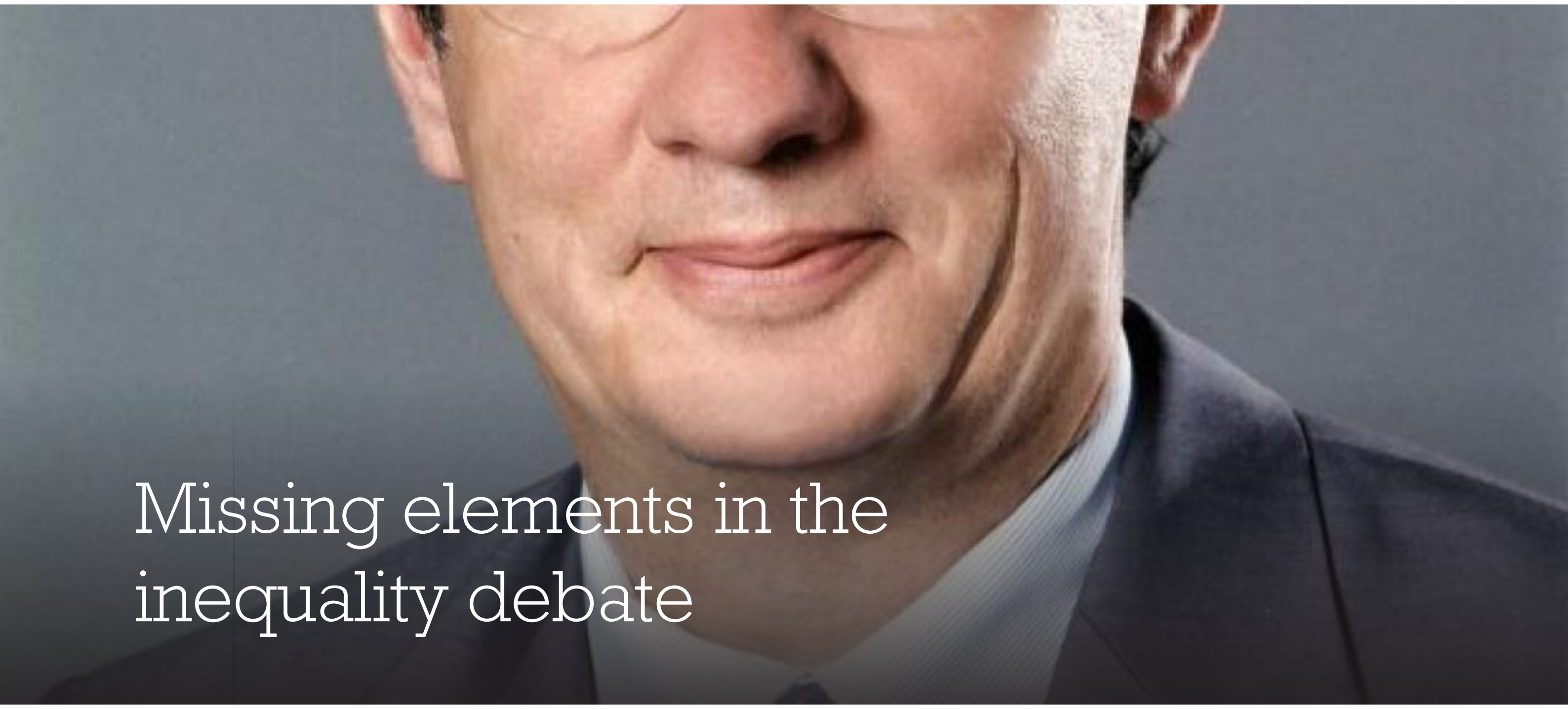


Missing elements in the inequality debate

Furor over income inequality is gaining traction on campaign trails, protest movements and economic development agendas. But are they looking at the big picture?

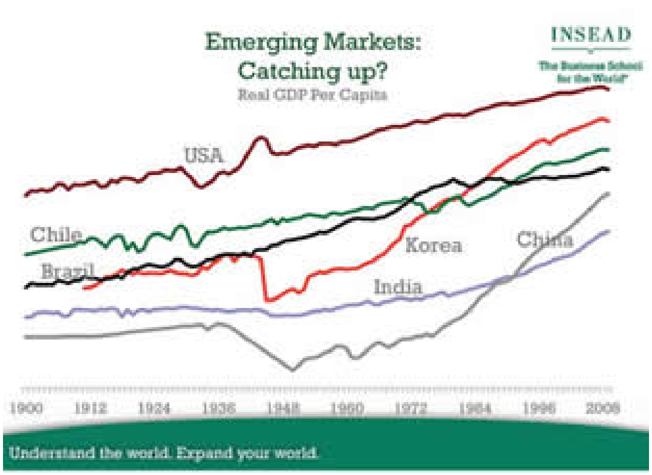
President Obama has made creating more equality of income and wealth a central piece of his re-election campaign. This is quite remarkable for a U.S. president as U.S. politicians (unlike Europeans) generally have emphasised wealth creation, not redistribution. The typical story goes that when a poor American sees a rich man's car, he is motivated to work harder so that he can also buy such a car. On the other hand, when a poor Frenchman sees a rich man's car, his response is to scratch the car and vote for a political party that wants to do away with rich people. The inequality debate has also been fueled by wealthy Democrats such as Warren Buffet who has claimed that his secretary is taxed more than him, because his tax rate is lower than his secretary's. Mr. Buffet's claim is somewhat misleading as 15 percent of US$ 1 billion is more than 30 percent of US$ 50,000. It also remains a fact that the aggregate taxes paid by the top 1 percent are, depending on the year, between 20 percent and 40 percent of aggregate taxes, so it is indeed true that the tax burden is shared very unequally, but probably not in the way intended by Mr. Buffet.

Moreover, opponents of income inequality typically ignore incentives, risk differentials and are narrowly focused on comparisons within a country, not on a global level.

Imagine Mary has more wealth than John. Wouldn't the world be a better place if a government bureaucrat took away money from Mary and gave it to John, equalising their wealth? The problem with this argument is that it ignores how Mary and John obtained this wealth. Perhaps 10 years ago, Mary and John had the same wealth, but John decided to become a teacher, take a lot of vacations and invest his wealth in low risk, low return government bonds. Mary on the other hand decided to become an entrepreneur, risk her savings and work 80 hours per week. So, if the government then had announced that 10 years from now wealth would be equalised, it is very likely that Mary would not have become an entrepreneur but would instead have followed John's example. Moreover, if John actually had been working in Mary's business, he would for sure be worse off today. Creating a society where everyone gets the same share of the pizza will produce a smaller pizza. The only way to redistribute wealth without creating negative incentive effects is to surprise people: one morning the government knocks on Mary's door and takes away half of her money and gives it to John. This will probably also end the career of the politician who dreamed up this radical idea, so it is not likely to happen in a democracy. However, it did happen in Russia in 1917 and China in 1949.

Some will argue that inequality in wealth is caused by luck, not by effort. For example, Mary inherited her wealth from her father, Peter, who was an entrepreneur 10 years ago, became very successful, and then died leaving her all his money. So one may want to argue for a strong death tax: when you die, your wealth gets confiscated by the state and redistributed to the poor. Moreover, in order to prevent people from avoiding the death tax, there should be a limit on how much wealth you can pass on to your children during your lifetime. This would essentially mean the end of the family business. Under these circumstances Peter, when he is approaching the end of his life, will probably start investing less in his company, create fewer jobs, and take more holidays. His daughter, Mary, would have to find an occupation outside the family business. Some people may argue that this is a good thing as Mary may not be such a great entrepreneur as her father. My colleagues in Family Enterprise may argue that family businesses have a long term view, lower agency costs and therefore generate more value than if the business was sold to a third party.

The "Occupy Wall Street" movement is against one particular type of inequality: bankers' bonuses, especially bankers of bailed-out banks. Blaming the recipient of this bonus is somewhat awkward as it is the government that decided to save the banks because they felt that the alternative would have been worse. Moreover, the government could have insisted on capping bankers' compensation in return for the bailout, but, in general, did not do this. For example, in return for the bailout, the U.S. government received preferred stock and warrants that have no voting rights. The reasoning seems to be that there is a market for bankers and if the bailed-out bank pays below market salaries, it won't attract high skilled bankers. This ultimately will lower the value of the bank and the value of the government-owned preferred stock and warrants. So "starving the bankers", a gesture appreciated by the public at large, may not be necessarily in the interest of the tax payers in the long run.



In order to avoid influencing incentives, some would argue that we should aim for a society that makes sure that people have equal opportunities, not results. That's probably why people are not outraged by the huge inequalities created by the lottery, where people can become millionaires overnight, without effort, just pure luck. Unfortunately, no social engineering in the world can guarantee equal opportunities. All of us are born with different talents and potential. Some of us are smarter, others have better social skills, some are healthier and others are better looking. Actually, a recent study* showed that, ceteris paribus, people with better looks become wealthier. Unless we want to arrange government sponsored plastic surgery that gives us identical noses, wealth differentials as a result of different looks will persist. We could of course guarantee that everyone has access to good "free" schooling, which makes sure that everyone can fully develop his or her intellectual potential, even if that potential is unequal. But again, it is illusionary to assume that all schools are created equal. There are good and bad schools with good and bad teachers. Searching for the best schools generally will require you to move to a different city or even country, something that will be prohibitively costly.

My final objection against the obsession with equality is that measurements of inequality (such as the Gini coefficient) are typically country-specific. This is understandable for a politician, as foreigners don't vote. Globalisation is typically blamed for growing inequality in the Western world: manufacturing jobs are getting outsourced to China and India where salaries are lower. But the fact is that, the average Chinese and Indian has seen his/her living standard increase as a result of such globalisation. In other words, while globalisation may have created more inequality between service workers (whose jobs cannot be outsourced) and manufacturing workers in, say, the U.S., it has reduced the income per capita gap between the U.S. and India/China. Figure 1 (kindly provided by my colleague Antonio Fatas) shows this more clearly. It shows the GDP per capita of the U.S., Chile, Brazil, China, South Korea and India from 1900 until 2008. The largest inequality between the U.S. and the rest of these emerging markets was observed around the middle of the century. Since then, inequality between the U.S. and the rest of the world has narrowed. In particular the gap between the U.S. and China has narrowed in a spectacular way during the last 20 years.

So, global income inequality has been reduced this century, especially at the end of the century, as a result of globalization and the fact that traditionally socialist countries and regions such as China, Eastern Europe and India have embraced capitalism. As a result, hundreds of millions of people in these countries have lifted themselves out of poverty. So in order to reduce global inequality, we need more capitalism, not less. Note that we still have a long way to go to reach that equality: today's U.S. income per capita is US $47,000 but only US $7,000 in China.

* "Beauty pays : why attractive people are more successful", by Daniel Hamermesh, Princeton University Press, 2011.

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