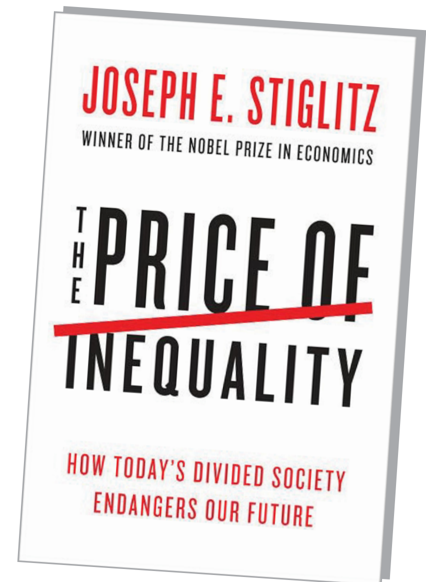
DO NUMBERS REALLY SPEAK FOR THEMSELVES?



The Price of Inequality

By Joseph E Stiglitz
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During periods of economic growth and stability, any discussion of inequality is considered almost entirely academic. While inequality is a permanent aspect of every economic system, past and present, inequality is often only brought to the forefront of political discourse during an economic collapse. This is true for the United States, which is struggling to gain economic traction in the wake of the global financial crisis. What economists had hoped would be a cyclical downturn has degenerated into a prolonged period of joblessness from which the United States has not yet recovered. In Europe, which has been gripped by crisis and is still facing a great deal of economic and political uncertainty, protestors have taken to the streets to fight against cuts to public spending. Suddenly, economists have begun pointing to the destabilising effects of inequality, and politicians have seen opportunities to engage in a kind of politics that would previously have been considered divisive.

Readers of Joseph Stiglitz's previous books will know he is no bandwagoner in sounding warnings about the problems of inequality. Since writing *Globalization and its Discontents* (2002), Nobel Prize winner Stiglitz has been arguing against the dangers of inequality in the United States and the world. Indeed, Stiglitz coined the now-ubiquitous term 'the 1%' to describe America's elite or the exorbitantly rich whose wealth has been built ostensibly at the expense of the vast American middle class, which has seen its income grow very modestly in comparison.

Stiglitz's most recent book, *The Price of Inequality*, is in part an abstraction of various studies on inequality and its causes, drawing on a range of sociological, behavioural and economic explanations. It is also a narrative, and a colourful one at that. It paints a picture of a country dominated by financial oligarchs, whose greed has resulted in rapid growth in wealth at the very top and an unstable financial system that has destroyed the wealth of millions of hardworking Americans. It describes a political system captured by powerful lobby groups and blind ideology. While it tries to retain academic rigour, it is a populist work making a political statement directed at those who sense something is wrong with their economic and political system, even if they cannot

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pinpoint exactly what is wrong. Things seem more unfair, and someone or something must be to blame but it is not clear who. While the Occupy Wall Street movement and its offshoots in the Western world may lack an intellectual impetus, Stiglitz is providing it for them.

The book focuses on three core themes: America's long-run growth in income inequality; the current recession and the need for more expansionary fiscal policy; and the decline of democracy. Stiglitz discusses a number of other topics too such as eroded corporate governance structures, discrimination, predatory lending, declining union power, ineffective competition and consumer laws, the political influence of Wall Street, education and the lack of social mobility, tax cuts that favour the rich, a central bank focused on saving banks rather than mortgagees, and hard-hearted Republicans who do not understand fiscal policy.

While much of Stiglitz's book focuses on the 'fact' of inequality, little attention is given to the methodology of measuring it.

Many will see *The Price of Inequality* as an exercise in pointing out the glaringly obvious—that American society is becoming less equal and government should be doing more to fix it. Others will find it somewhat more controversial. As Stiglitz himself points out, measuring inequality is not straightforward. Moreover, the long-term causes of inequality are not obvious, and if the causes are not obvious, solutions will inevitably be risky. However, the issue of inequality is not one that can be dismissed, and is something that must be dealt with on an intellectual and policy basis by people of all political persuasions. Most agree that income and wealth are good proxies—and probably the only practical proxies for measuring people's economic well-being—despite people's happiness depending on a range of non-financial things.

Although Stiglitz approaches inequality as an affirmed social democrat, he raises some points that conservatives agree with—a growing sense of disenfranchisement and deeper dissatisfaction with government—even if they disagree with his solutions. Both conservatives and social democrats acknowledge that some degree of inequality is inevitable, and perhaps, even necessary to experience the benefits of the free market. The larger disagreement is over how much inequality should be tolerated in an advanced economy. Unfortunately, this debate is often conducted on ideological lines and unlikely to reach a satisfactory conclusion. This is hardly surprising given that inequality is an inherently complex issue influenced by a range of factors, some beyond the scope of government control. It is easy to point to a study that shows growing inequality—it is just as easy to point out what the study overlooks. For a country like the United States, with such a large and diverse population, and with a complex tax and welfare system, this makes the problem of determining the extent of inequality and its drivers all the more difficult.

While much of Stiglitz's book focuses on the 'fact' of inequality, little attention is given to the methodology of measuring it. Do you focus on income, wealth or consumption? How do you measure the benefits of welfare, such as social security, unemployment insurance, health insurance, pensions, child support, and other public services? How do you measure real wealth, as opposed to inflated assets? It is not surprising that studies related to household income and wealth such the European Central Bank's (ECB) *The Eurosystem Household Finance and Consumption Survey* are generally controversial. Germany, one of the wealthiest Eurozone economies, has an average household wealth of €195,000—significantly below Spain (€291,000) and Italy (€275,000), whose public debts Germany is helping guarantee.[1] Is Germany the real poor country of Europe, despite having lower unemployment and being in a far better fiscal shape?

The ECB's report itself noted the pitfalls of relying on raw numbers, emphasising that the survey focused on household wealth in isolation, which is an important but by no means comprehensive indicator of a country's overall wealth. House prices and income do play an

important role in explaining the distribution of net wealth. However, as the report states, 'the role of other factors—such as the provision of public housing and the extent of public pensions, transfers and inheritances—should not be discounted.' The survey excluded all these factors to simplify the data gathering process, but not *everyone* agreed that ignoring Germany's high pension entitlement, and the quality of its welfare and public services, produced a bizarre result.

A similar problem occurs in income studies in the United States, particularly in calculating the poverty rate, which is based on methodology developed in the 1960s. Before 2011, standard measures of poverty, including the census figure of 15.1% that Stiglitz cites, were based on income before the effect of government programs. In the United States, the relative share of services is considerably higher than cash transfers. The OECD estimates that after considering the impact of services, poverty in the United States is reduced to around 8%, which, although high by OECD standards, is still a significant reduction and one of the highest reductions in the OECD.[2]

Stiglitz's main thesis is that the long-term trend in inequality, measured as the distribution of household income, is worsening significantly as a result of market excess and government policies. According to a number of studies, including a major study by the Congressional Budget Office (CBO), a major factor accounting for increasing income disparity is related to disparity in wages (as opposed to business income or capital gains). Numerous theories have tried to explain why a higher proportion of wage income has shifted to those at the top. These include the 'economic superstar' theory, which proposes that technological developments have made it easier for actors, athletes and musicians to profit from their talents. Another theory proposes that weak corporate governance structures have allowed company executives to boost their income at the expense of shareholders. Neither explanation has gained much traction in explaining wage inequality. One popular explanation, and backed by good evidence, is that this disparity is the result of structural changes in the demand and supply for skilled labour.

> Numerous researchers have concluded that, on balance, the technological changes of the past several decades—and perhaps the entire past century—increased employers' demand for workers with higher skills and more education. That increase, along with a smaller increase in the supply of workers with higher skills and more education, generated substantial gains in the relative wages of more-educated workers.[3]

If the reason for inequality is indeed structural, solutions aimed at reducing inequality such as levying punitive taxes on financial institutions will not work.

Most studies on income inequality focus on the top percentile, as this is where the most significant growth has taken place. One such study identified taxpayers in the top 0.5% of income earners in the United States between 1994 and 2004.[4] Of these, only a small proportion comprised CEOs or celebrities. Perhaps unsurprisingly, financial and legal professionals made up a significant share, but so too did doctors and other skilled professionals. The study concluded that skill-biased change was the most apt explanation to growing inequality, confirming the view that structural changes have increased the value of skilled labour.

This picture is very different to the one Stiglitz paints of CEOs using weak corporate governance structures to boost their remuneration tenfold, bankers selling complex derivative instruments to unwitting retail investors, or billionaires 'clipping coupons' and receiving safe returns on their vast capital. These descriptions, while useful in harnessing popular outrage, are not the likely cause of the underlying trend in inequality. One important cause, to which Stiglitz gives little attention, is the structural shift in the demand and supply of skilled labour.

If the reason for inequality is indeed structural, solutions aimed at reducing inequality such as levying punitive taxes on financial institutions will not work. Education is a major issue, with the United States lagging behind many parts of the

world, but Stiglitz does not adequately address it beyond the issue of teacher pay. There is a sense of incompleteness to the analyses—by the end of the book, and despite the sheer breadth of topics raised, one cannot help but feel there are deeper debates Stiglitz is only touching on for fear of devolving into an obtuse academic debate.

Although some, such as Robert Lucas, have argued that the pain of economic cycles is ameliorated by fiscal stabilisers, the slow pace of recovery in the United States has renewed the focus on the need for a strong safety net and the role of macroeconomic policy in promoting jobs and growth. Similarly in Europe, where youth unemployment in Greece and Spain is at deplorably high levels, the debate over spending versus austerity has reached fever pitch. This adds an extra degree of controversy to the already highly contentious debate on inequality. Stiglitz, a long-time opponent of the International Monetary Fund's focus on deregulation and austerity, launches his trademark attack on removing capital controls in Asia and insists on fiscal consolidation in Europe. However, a lot has changed since the book's publication last year. The IMF, led by Managing Director Christine Lagarde and Chief Economist Oliver Blanchard, has dramatically reconsidered its stance on austerity, calling for a more balanced approach.

Despite its clear leftist predisposition, *The Price of Inequality* is interesting and even compelling.

The United States has a greater capacity to take on debt than other countries because it issues the currency in which its debt is denominated and USD is in high demand throughout the world. But debt limits play a more fundamental role in Europe, where the currency is controlled by a supranational central bank. While academics may debate the theoretical maximum debt-to-GDP ratio, in reality, financial markets impose their own 'debt ceiling,' and countries such as Greece and Spain are very close to it. Even in the United States, monetising debt is not a free lunch. The relatively low inflation expectations will not necessarily hold as economic growth picks up. There is also a lot of uncertainty surrounding the Federal Reserve's exit strategy and the need to unwind its balance sheet without generating inflation. These risks are ignored in favour of a macroeconomic policy proposing more fiscal stimulus at the expense of real structural reform.

Despite its clear leftist predisposition, *The Price of Inequality* is interesting and even compelling. Stiglitz even raises some points that conservatives may agree with. His opposition to subsidies, especially to the manufacturing and agricultural sectors (including the infamous ethanol subsidy) is unlikely to provoke outrage. His view on the government's response to the financial crisis, particularly the moral hazard of bank bailouts and the political ramifications of programs such as the Troubled Asset Relief Program (TARP), will likely be shared across the political divide. Chapter 9, 'A Macroeconomic Policy and a Central Bank by and for the 1 Percent,' reads in parts like a Tea Party manifesto. The propensity for regulators to be captured by the industries they are supposed to oversee; for politicians to be bought by interest groups; and for people to act in their own self-interest are agreeable to most people. Perhaps many on the conservative side of politics in the United States feel a similar degree of apathy towards their democratic system.

Endnotes

1 European Central Bank, Household Finance and Consumption Network, *The European Household Finance and Consumption Survey: Results from the First Wave* (April 2013).

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3 CBO (Congressional Budget Office), *Trends in the Distribution of Household Income Between 1979 and 2007* (October 2011), 13.

4 Steven N. Kaplan and Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* (University of Chicago and NBER, 2007).