Inequality strikes back

ECONOMIC PROBLEMS CAN BE SYMPTOMS OF DEEPER SOCIAL PROBLEMS. IN THE INEQUALITY DEBATE THIS IS OFTEN IGNORED, AND THE PROBLEM IS REDUCED TO STATE REDISTRIBUTION. THIS APPROACH IS INCOMPLETE AND SURELY WON'T WORK AS A LONG-TERM PROBLEM SOLVER.

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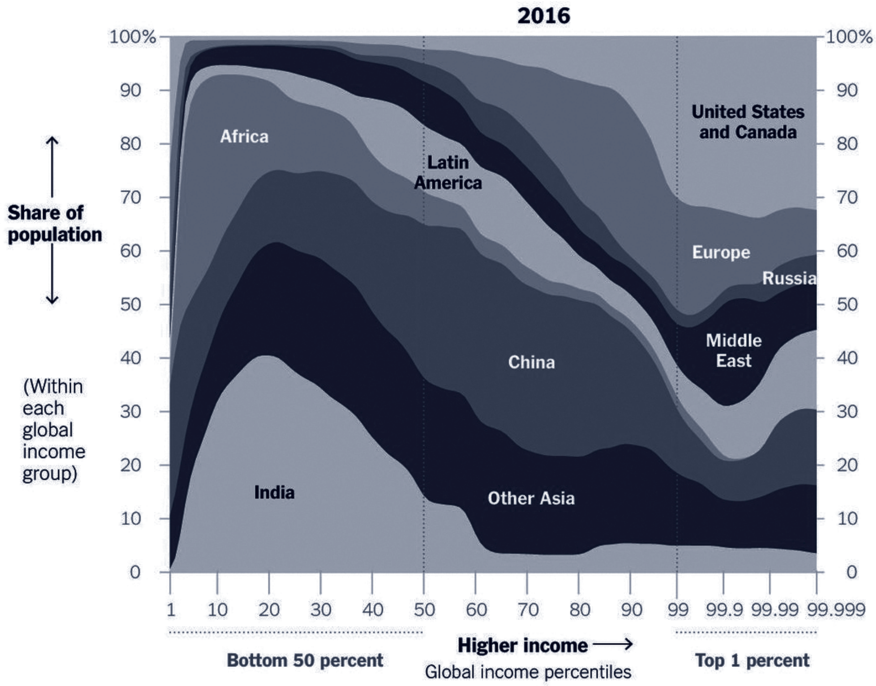
Universal literature is full of depictions and insights into the dramatic consequences of poverty and inequality during the modern and contemporary industrialization: Dickens' novels vividly portray the injustices and exploitation of teenage workers in the industrially advanced XIX century England. A highly admired novelist for his in-depth character representations, Fyodor Dostoyevsky, shows in many of his works the dire personal implications of the social inequalities in Russia's XIX century. Already in the XX century, in *The grapes of wrath*, John Steinbeck narrates the story of a family immigrating to California from Oklahoma during the Great Depression times. After a truly painful ride, with some of the family members even getting lost along the way, their over-and-over idealized dream of becoming rich turns out to be self-defeating. Also moving is the difficult adjustment of so many families to the urban life during the post-World War II times, so well described by Spanish novelist Miguel Delibes. His works depict the negative social and psychological consequences of the newly arrived citizens, who left their beloved rural landscapes in search of a better economic life. In turn, in Chinese Yu Hua's novel *To Live*, the author describes the hardships of the main character, a woman who tries to keep her family together in the difficult times of Mao's economic Great Leap Forward and Cultural Revolution. Unfortunately, her life is a ceaseless drama: she has to leave her husband due to his gambling addiction, her son passes away after a day of toil and exploitation and her daughter also dies when giving birth in a horribly-run Chinese public health care facility.

These and many other novels, born in stressed economic environments, have had great influence themselves on the society, economics and politics of the times. They certainly contributed to an increasing awareness by previous generations of these social calamities. Looking back, we can appreciate that some of these situations have been mitigated and, in many cases, completely ceased to exist. Moreover, philosophical, social, political and economic movements have been inspired or reinforced by the writings of these masters of the literature. This is still the case today, as social and economic injustices persist in various places. As a result, political, social and economic institutions have poverty and inequality very high on their agenda. The civil society is also getting their hands on the issue through all sorts of initiatives. In this context, when looking for solutions to eradicate poverty and economic inequality, the State is constantly being called to the rescue of personal dignity in the form of redistribution via tax policy. The logic being that more opportunities will be created for the poor as the money of the rich flows to the poor in the form of health, education and all kinds of subsidies. Furthermore, it is often argued that without substantial State action, social unrest will come in the form of a collapse of both economic and political systems. In short, a significant economic redistribution solution is proposed for the economic inequality problem. Against this backdrop, several questions naturally arise: Is the economy and the economic system we live in the villain of inequality? Should the State actively tackle economic inequalities? Is the State the main or the only agent responsible for making the economy fairer?

When looking for solutions to eradicate poverty and economic inequality, the State is constantly being called to the rescue of personal dignity in the form of redistribution via tax policy

THE FACTS

The dynamics of the economy are powerful and trigger deep implications in the lives of most people around the world. Over the last generations, we have witnessed a tremendous growth in wealth creation - as an illustration very close to us, total wealth in the world has more than doubled over the last 15 years-. At the same time, extreme and ordinary poverty situations remain and significant segments of population feel somewhat trapped within the current socio-economic system. Some people have immense resources while others do not have enough or barely make ends meet. From a society point of view, as long as there are people living in poverty levels, it is clear that we have a problem. In some cases government, and civil society initiatives manage to make a difference in the lives of the disadvantaged. In other cases,



however, conflicts or passivity by those who can make a difference prolong these situations. In this familiar context, one of the most commented economic phenomena over the last decades is the increase in within country income and wealth inequality in some rich countries, especially the United States. In the aftermath of the 2008 crisis, the inequality debate is starting to take a central stage in both policy and academic circles across many advanced societies.

Let's start by stating the obvious: within-country economic inequalities are natural and fair. They can be grounded on merit, work, technological factors and many other circumstances which simply should not be blamed to either rich people or the States. What we should be genuinely concerned about is the amount of people who are impoverished and have a very unlikely access to basic opportunities to improve. These situations can fall under the umbrella of excessive economic inequalities. The shared concern for excessive inequalities and the poor is quite real but we should first understand the root causes of unfair situations and the effective remedies to put feasible long-lasting solutions on the table. Yet, proposed solutions often suffer from short-termism. Today's mass media, for instance, often portray inequality under simultaneous snapshots into the earnings and wealth differences among people. The images of those poor are quite real, highlight the drama behind these situations, while proving terribly painful for any decent sensibility. Contrasting the rich and the poor, however, does not show the underlying root causes of poverty or the potential permanent solutions at hand. Moreover, they can be misleading because they contrast the rich and the poor as if one were the consequence of the other. Nothing further from the truth, for in today's more-than-ever interdependent economy, there is no necessary trade-off between rich and poor. Quite the opposite, poverty exit historically arises in scenarios with economic growth and wealth creation. Indeed, most relevant studies find that world income inequality (different from within-country inequality) has declined over the last 30 years due to the income gains in Asian countries, where multitudes have abandoned poverty, and continue doing so. At the same time, it is also encouraging to see income relatively rapid gains in Africa over the past decade.

Despite this, one perceives that the blame is often today on the "infamous" top earners. We are in fact frequently drawn into debates on the unfairness of the rich and the riches in developed countries. Unfortunately, this obscures the most revealing and operational data: the market economy keeps providing opportunities around the world to millions and millions of people, including those with very few initial resources. With the benefit of hindsight –and data–, one has to admit that the market economy historical record is really impressive in this respect, and thus should be respected and protected, if improved. Crucially, it is the main hope for millions of people who still live in poverty, since the other modern alternatives have actually proven to be a failure.

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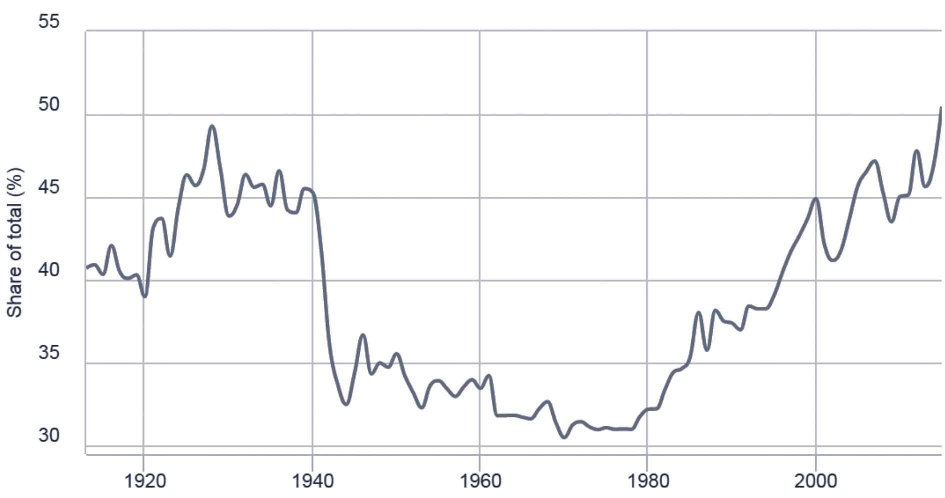
ECONOMIC OPPORTUNITIES, NOT EGALITARIANISM, IS NEEDED

The panorama of countries having accomplished economic equality is actually not very encouraging. Countries such as Cuba and North Korea seem to exhibit a lot of economic equality for the vast majority of citizens, but at very poor economic conditions.

Top 10% fiscal income share, USA, 1913-2015



Fiscal income | Top 10% | share |

Graph provided by www.wid.world

As another point of reference, we can also take stock of the past experiences in countries achieving great economic equality across most of their population: the Soviet Union, Hungary, Albania, and other countries. These examples speak for themselves of how targeting economic equality per se can turn into a nightmare. And they are especially revealing because in all these countries the State set out economic equality as the main goal in their economic policy agenda. In these instances, the economic outcomes range between very bad and extremely bad. We do have however better economic experiences with the more economically egalitarian countries in Nordic Europe, where the State has a big presence. Admittedly, these countries (small in population) are currently doing very well under some strictly economic metrics. In a somewhat daring extrapolation spirit, and despite deep crises, such as the one in little Iceland, many economists and commentators are urging policy makers to follow them in many respects.

Differences in income distribution across countries do show country socio-economic and cultural heterogeneity. This is true within Europe and around the world. This is positive in a very relevant sense, because these differences often reveal heterogeneity in social preferences and culture across countries. It is also revealing, as it shows that there is not such a thing as a necessary economic distribution process for every capitalist economy. Market economies function differently across countries and there is nothing globally mechanistic about capitalism dynamics. As recently pointed out by Jones and Kim (2014, NBER Working Paper 20637), inequality patterns greatly differ across countries. Together with wealth concentration, there is Schumpeterian creative destruction inducing turnover in wealth distribution and in the ranking of rich and poor people. And we do need this! Economies where opportunities for upward social and economic mobility arise based on merit, talents and hard work. We need stable enforced rules of law ensuring opportunities via protection of basic rights and level playing fields. As Amartya Sen points out in *Development as Freedom*, taking advantage of these opportunities will result in the necessary freedom to develop. In other words, economic opportunities are necessary both at the personal and social levels to come up with an inclusive and dynamic economy.

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Some suggest that opportunities will only increase with more governmental redistribution (Krugman, Stiglitz), especially taxing the rich. Piketty, in his book, *Capital in the 21st Century*, which is drawing a lot of attention –and criticism contradictory replications (see, for instance, Sutch, 2017 in *Social Science History*)– from many diverse quarters, proposes an 80% global tax on the very rich. This would definitely bring about a new re-equilibrium between states and markets, a new wrong rebalancing between redistribution and incentives, and thus plenty of economic distortions. For under these tax rates, one wonders where the vitality of the economy would go. In short, this suggested massive redistribution policy brushes aside the necessary supply side incentives, since the economy does have some sensible rules for its good-functioning: huge taxation prevents economic vitality and thus human flourishing, as pointed out by Nobel economist Ned Phelps in *Mass Flourishing*. Where would the vast majority of economic opportunities go as a result?

In any event -and beyond the setting of a credible rule of law-, is there a case for pro-active government intervention in times of economic distress? Clearly yes, think about the devastating consequences of the recent 2008 crisis, which still bite hard in many countries and communities. Outcomes do matter, and those governing our communities cannot simply shrug off and blame it to either spontaneous market forces or existing market failures. Quite the opposite, subsidiary counter-cyclical fiscal and monetary policies –which entail some income redistribution– should be proportionate to the recession at hand, targeting those especially impoverished by slumps and those with useful creative projects with the potential to develop our communities.

There is a relevant developmental role for the State targeting at specific depressed segments of populations or at specific strategic development plans. In this respect, much economic research and history shows that well-designed incentives can work and can alleviate the market failures -and the people who suffer from them in bad times- often present in our economies. Under dire circumstances, we simply cannot ignore evidence-based useful policy actions and have large segments of the population stagnate and wander adrift. Of course, with the excuse of enacting these policies, governments should not bypass economic sustainability constraints, such as budget balancing over the business cycle.

New crises bring up new lessons, also for crisis prevention. An important lesson from the previous crisis –which unfortunately some are starting to forget– is the need to enact macro-prudential financial policies in order to prevent the large negative externalities derived from financial crises. Indeed, while policies requiring higher levels of solvency and loss capacity from financial institutions are reducing the profitability of these institutions, they definitely go in the right direction. These policies are not perfect-foresight –this will never happen–, but they are forward looking, and thus make use of all our current info to have a more resilient financial sector in the wake of future contingencies. The potential danger in all this regulation is that it becomes excessive and asphyxiating for the economy. In this sense, the current financial complexity should be tackled with prudential, simple, strong, and forward-looking rules, as stated by Haldane (2012, Bank of International Settlements).

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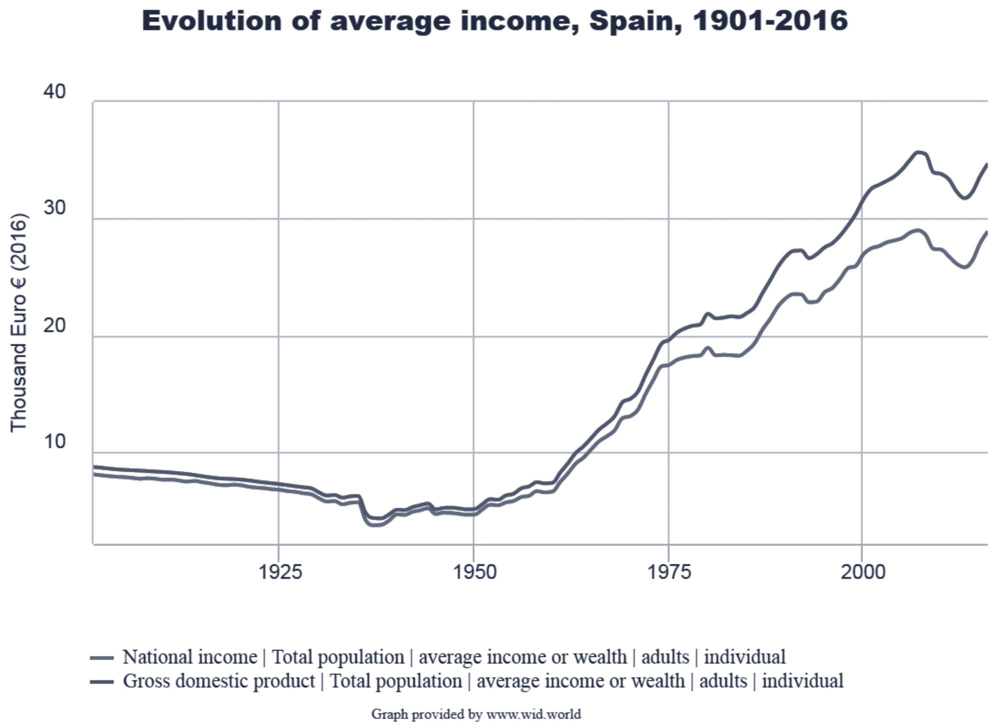
HUMAN OPPORTUNITIES: DEMOGRAPHY, THE FAMILY, EDUCATION, VALUES

There is truth in the literature emphasizing the role of credible policies, serious governments, effective regulation and well-designed institutions in driving societies out of poverty and extreme inequality (Acemoglu and Robinson, *Why Nations Fail*). In this context, economic opportunities do arise more naturally, but they are also the culmination of a long sequence of human opportunities. First, the opportunity to be born and to grow with dignity –disastrously negated in many countries around the world– is essential. Second, the opportunity to have a family where to grow, share and develop good working habits. Third, the opportunity to get a good early education, high school, and university or vocational school. By the time a person starts having the opportunity to work, one has had to lean on a lot of people, knowingly or not. To be sure, government is just one –most often secondary– player in all this process.

Economic opportunities are thus also grounded in human opportunities. In this sense, robust demography is a key driver of human opportunities from both supply and demand sides. The human factor has been historically instrumental in driving economic growth from the supply side of the economy: ideas, companies, entrepreneurship... But also from a demand side: as witnessed in Japan and Europe, bad demographics restrain demand and make these economies be trapped in stagnation. Whether one looks at the individual level –the more people the more geniuses and entrepreneurs– or the implied aggregate level –tremendous economic interdependence–, vibrant demographics is key for a dynamic economy. Let alone the bleak sustainability prospects of welfare states in countries with poor demographics.

Education is ever more important in generating human and economic opportunities. In an economy where technology is increasingly crucial, there is a clear labor market skill premium and, as a result, getting a solid education is vital. Kindergarten, grade school, high school, university... these are some of the places where we acquire knowledge, good habits and soft sills, such as social skills. These, in turn, spillover into the economy, creating virtuous networks and opportunities. But education is not just about quantity or years of enrollment. And it is not only about education in schools or universities. The education received at home is essential. Family time devoted to children is quality time. It is the place where giving to others arises more naturally. This attitude can then more easily be translated into more fluent social and economic relations, fostering a culture of trust and friendship. Education in school should complement the family cul-



ture of trust and friendship, but for this to happen more engaging time is needed to spend with children and students, both at home and at school. In this environment, opportunities more easily emerge.

Interestingly, the academic sociology literature is highlighting the key impact of contemporaneous family structure on educational achievement. In particular, the perverse effects of divorce on children in developed countries are becoming transparent. Children brought up in one-parent families suffer significantly more negative psychological and social effects, lack of motivation being just one of them. This diminishes the opportunities of these children to do well in school, as they are more likely to drop out. Subsequently, at least in the case of some minorities, they have a hard time doing well in the labor market and are much more likely to be idle or unemployed (Mclanahan and Sandefur, 1994, *Growing up with a single parent*). However, instead of strengthening the family institution –for instance fostering better reconciliation between family and work through better working schedules– many firms and institutions keep putting families and children in growingly fragile positions. This problem is especially acute in poor families and some minorities, where the interaction between economic strains and family problems results in severe disadvantages for children.

Economic problems can be symptoms of deeper social problems. In the inequality debate this is often ignored, and the problem is reduced to State redistribution. This approach is incomplete and surely won't work as a long-term problem solver. We should first reframe the problem in terms of how to alleviate situations of impoverishment and lack of opportunities for large segments of population. We should then recognize that re-distributional State policies alone are not going to be enough. In the aftermath of the last recession, in countries like Spain many people resorted to their families, which worked as a phenomenal shock absorber. For besides good policies, the appropriate social environment is needed. Social stability is necessary in order to provide more opportunities to those who need it the most. Social stability arises under a stable rule of law, education opportunities for all and solid family backgrounds with strong core values. Indeed, when objective values are lacking, chaos and mistrust surface.

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We do not know when, where and how, but economic booms and busts –with their subsequent outbursts of impoverishment– will keep happening. This is why we'll have to make full use of our knowledge about the economy and the society –including learning from both policy mistakes and market failures– to mitigate negative events. As a result, concrete, partial, technical and practical policies will be needed to dampen fluctuations and prevent calamities –this is different from a global single technical solution for the economy as a whole, which cannot exist in our contingent, ever-changing economy–. One recurrent temptation is that the State attempts to either tackle each single problem or find this single –again, non-existent – solution. In the end it cannot; moreover excessive policy activism will surely be counter-productive.

(THE AUTHOR THANKS THE COMMENTS PROVIDED BY ANTONIO ARGANDOÑA AND GREGORIO GUITIÁN TO AN EARLIER DRAFT)