

General Discussion: Economic Consequences of Income Inequality

Chair: Alice Rivlin

Ms. Rivlin: Thank you, Horst, for a very provocative comment. We'll give Joe a chance to respond after we've had some discussion. Who would like to start off?

Mr. Meltzer: There are several problems that I found in your paper but I'm not going to comment on all of them. The biggest problem that I found is the mixture of positive and normative analysis. The paper was full of "cans," "coulds," and "mays." That leaves me in doubt about what basis these propositions may have. As a positive approach, the paper fails because there is no model of government and no attempt to sort out the policies that produce greater equality and their effects on growth and those policies, which produce greater equality and have negative effects on growth. The government could or might do good. But nothing in the discussions tells us anything about that or about how voters might decide what they would like. In the absence of a welfare function, which you dismiss, we go back to voters and politicians who have to make these choices. So as a positive theory, it fails because it doesn't include how the government will use the resources that are going to be given and put under its command. As a normative approach, not tied to a valid-positive theory, it can never be anything more than a wish list expressing your preferences.

Second, nothing about the benefits of inequality is mentioned in the paper. There is a long tradition in economics—Schumpeter’s name comes to mind—in which innovation occurs because people see opportunities, create monopolies, and increase their inequality of income. These inequalities, according to Schumpeter, don’t last for 30 years—they last briefly. But they are the driving force in economic development. For Schumpeter, inequality is a necessary condition for growth.

The U.S. economy in recent years, certainly to the casual observer, especially one who lived in the Silicon Valley or near it as you did, gives some evidence that, in fact, that process operates quite effectively here.

Finally, there is no discussion in the paper of the point that’s developed in Assar Lindbeck’s paper and that Horst just developed in his comment in which the result of efforts to gain greater equality produce instead, increased unemployment.

Ms. Rivlin: You set a high standard, Allan. We might have gotten a book out of Joe if he had answered all those questions, but we’ll give him a chance in a minute. Yes.

Mr. Dugger: I won’t make it any easier. I would like to link the discussion today to the discussion at Jackson Hole three years ago.

At that conference, you will recall, we dealt thoroughly with the growth structure and implications of government pension and medical care commitments. My question is, would a life-cycle income expectation that includes government pension and medical care commitments have a bearing on how we analyze income distribution-related behavior? At the conference three years ago, we were confronted with the fact that these commitments are enormously large relative to GDP and that they all have to be scaled back. Much of the politics of the last five years in all industrialized countries has been about how we can get this done, so we know these commitments are socially and economically important.

I'm, of course, no expert on income-distribution analysis. I'm more informed as a consequence of the research presented here this weekend. But what I do see is that almost all of the empirical analysis is done on the postwar period, a period when all government and medical benefits were generally rising. It seems, then, it's hard to dismiss the likelihood that these commitments have had an effect on individual, income-related, and income-distribution-related behavior.

So, linking the subject of our conference three years ago and this year, my question is, how can we analyze income-distribution-related macro behavior without explicitly reflecting somehow some form of life-cycle-income concept, which includes income support promises by the governments?

Ms. Rivlin: Joe, why don't you respond to those comments at this stage?

Mr. Stiglitz: Okay. First, let me thank Horst for his comments. I don't think I would disagree with most of the statements that have been made—that is to say, except for perhaps the tone. Clearly, there are many instruments for addressing inequality, and issues of human capital—training—and housing that Horst emphasized are among the most important. Still, one cannot be oblivious to the consequences of macroeconomic policy for inequality.

Second, I strongly agree that one should not go about redistributing income in an inefficient manner. And I also agree that many of the ways in which redistribution has been done in the past have had a lot of inefficiencies associated with them—there have been a lot of leaky buckets—and one has to be very careful about thinking about the consequences of employing such inefficient redistribution programs.

But here is where I disagree with Allan. If you look through the paper, in fact, most of the paper consists of constructing models that provide a framework for analyzing the consequences of various policies and the consequences of various changes in parameters that lead to a change in the level of inequality. Those kinds of models are the basis for an analysis of the consequences of a change in policy, and

the results of that analysis can be fed into whatever welfare function you want to use; and the analysis can also be embedded in a more general positive theory where you postulate one or another political model. Obviously, in the limited space of this paper, I couldn't do that. There was a discussion of positive models, such as the median voter models, in the paper. But, obviously, I could not have embedded *each* of the models of the macroeconomy in one or another political model. But if you look at the analysis in the paper, it is very clear there is a discussion of the consequences of certain changes in exogenous parameters and policies on the equilibrium value of inequality, on the inefficiency of the economy, on growth, on cyclical behavior; in fact, providing that analysis was the central function of the paper.

I do think that in a variety of contexts, including the conduct of macro policy, it is important to take into account the consequences of the existence of inequality and this is another one of the central points of the paper.

No one is going to be arguing—to take another point that was raised—that you want to eliminate all inequality. I don't think that's the relevant issue. The issue is, for instance, whether as you formulate policies and you ask if you should focus on variability in the rate of inflation or variability in output where different macro policies may result in different variances in those two, what implications do those kinds of policies have for inequality? And the fact that there is inequality, and that inequality gives rise to credit rationing, ought to be taken into account. How you take that into account depends on your welfare function. And that, in a sense, is the bottom line.

Ms. Rivlin: Horst, you had something you wanted to say.

Mr. Siebert: Looking at the financing cost of social security in the widest sense—unemployment, old age, health—we see that in some of the continental countries it now takes about 43 percent of gross wages to finance these social security systems. Including the problem of aging populations in some European countries, it will take about 50 percent of gross wages to finance the system if nothing changes. That is quite a tax on labor. In the European context, what

we need is a distinction between what is a large risk for an individual that he possibly cannot carry himself, and what is a small risk, that he possibly can carry out of his savings or his income. Each society, I think, has to find the distinction between the small risk that the individual can carry—the income lost in the first three days of unemployment and the large risk where society has to come in. In finding such a solution, countries can possibly reduce social security costs and solve the more moral hazard problems and the incentive and agency problems that are associated with the social security system. But, of course, this is a very difficult task: to define what is a small risk for an individual and what is a large risk.

Mr. Mussa: I am going to associate, I hope without blaming him or misrepresenting him, Karl Brunner with this question and comment. An observation of fact: there are not only wide disparities of income within societies, but there are very wide disparities of income across societies. Second observation of fact: very large amounts of money are transferred within societies to help equalize the distribution of income. Even in the United States, with a wide dispersion of income, literally hundreds of billions of dollars are transferred from the relatively well off to the relatively less well off. Very small amounts of income are transferred internationally between different societies to smooth out even larger differences of income between the members of different societies. Those are, I think, indisputable facts. And one would want to try to explain and understand those differences in a more general theory of income inequality and its effects.

One of the things that I do want to suggest, and I recall hearing this from Karl, is that there is a perception both of self-insurance and of sympathy that exists to a degree within a society that simply does not function internationally. To the extent that I feel sympathy for others in society, I suffer less of a disincentive if I believe I am contributing my taxes to something that is worthwhile. However, if I feel I am being robbed for the purpose of serving those for whom I have no sympathy, then the disincentive effects of that type of intervention are substantially larger. The self-insurance effects, I think, are smaller, much smaller across societies. I think that's an important issue that is absent from this discussion.

Now Horst talks about the situation in Germany—social insurance payments are very high in Germany and they enjoy very broad public support. However, if you talk about taxing the German taxpayer to subsidize those elsewhere in Europe, let alone around the world, you get a very different reaction.

Similarly, in the United States—and I think this is an issue that requires a little bit more thought—the United States is much larger and has a more diverse economy and society than Sweden. And that may be one of the reasons why the mechanisms for equalizing the distribution of income within the United States are much less aggressive than they are in a more homogenous, smaller, and integrated society, such as Sweden.

Mr. Heller: One word that was never mentioned today or yesterday in the discussion of income inequality is a pretty ugly word and that is bankruptcy. This year 1.3 million individuals will file for bankruptcy in the United States. Bankruptcy legislation is arguably the only major legislation affecting income distribution currently being considered by Congress. And if you ask bankers, they'd probably say that bankruptcies are the biggest single problem facing the American financial system.

So the question is, first of all, can we say anything about bankruptcy? Is it caused in the United States by the increase in income inequality? Second, can you say anything about the startlingly different rates of bankruptcy that we find throughout the world? Can we explain that in terms of income inequality, too?

Mr. Morley: Perhaps I could offer Horst one of his annoying examples, which is the German economy. When we hear the litany of all the problems and the weaknesses in the tax welfare system, we might start to overlook the fact that the German economy actually has achieved productivity per hour that's slightly higher than in the United States, and has managed to achieve this with a much more compressed wage distribution.

Now you are rightly saying there is an employment problem in

large economies in Europe like Germany. But we have other examples: Austria and Denmark, which have managed not only to achieve high productivity and compressed wage distribution, but also high levels of employment.

So one of the conclusions you might draw from that is that it seems to be easier to do this in smaller rather than larger economies. We've had a sociological explanation, but we could also have a macroeconomic explanation.

Mr. Siebert: Well, the only thing I see in the case of the major continental European countries is that unemployment has ratcheted upward in each recession. In Germany, during each of the three recessions since 1973, we added about 1 million of unemployed net, including the upswing. So there must be something wrong and malfunctioning in the incentive mechanism of that system. And if you imagine Germany in the next recession, which is sure to come, we only don't know when, we will add another 1 million to the 4 million unemployed, which we have at the moment. So there's something institutionally wrong with this system and we have to correct the incentive structure of this system. Macroeconomic policy cannot help.

Mr. Snower: I'm quite mystified by the debates that we've heard about whether there's a tradeoff between inequality and growth. Clearly, these two are endogenous variables that depend on a lot of things. If we are in a country that decides to distribute its human capital rather equally across the population through its education systems and offers people a high level of education, then it is obvious and quite conceivable that we will get a lot of equality and high growth.

On the other hand, if you want to achieve equality through redistributing money or suppressing Schumpeterian mechanisms, or if there is skill-biased technological change in an economy where there are lots of skilled and unskilled workers, then clearly you'll get tradeoffs between inequality and growth. And, consequently, I think we should be devoting our attention to the underlying determinants of inequality and growth and leave the issue of whether there's a tradeoff between these two endogenous variables to one side.

The second point I want to make is that I do find it extraordinary that Horst Siebert should say that rising inequality is simply an Anglo-Saxon phenomenon when you have emphasized that Germany and several other continental European countries have problems of rising unemployment, rising incapacity, and so on, concentrated among a very limited number of groups whose lifetime incomes are falling rapidly behind those of the rest of society.

Mr. Siebert: We have to distinguish between income inequality of the employed and income inequality in disposable income or post-government income (wages plus transfer income) of the employed and unemployed. Chart 1 of my paper only includes the employed. Data on disposable income also take into account the unemployed (including recipients of social welfare). The results of the Luxembourg Income Study do not show a significant change in disposable income inequality for (Western) Germany, that is, in the dispersion of wages plus transfer income.

Ms. Rivlin: What you are basically saying is that your solution to the problem has worked but it is worse than the disease?

Mr. Siebert: Our continental solution to the problem has brought equity, but at the same time it has changed the incentive in such a way that it has produced unemployment.

Ms. O'Neill: In addressing inequality, I think it's easier to confine the discussion to inequality of wages or earnings, because poverty and household income are affected by changes in household composition and a lot of other considerations. Now with respect to inequality in wages, an important question is whether it is a bad thing per se. To answer the question, you have to consider both the source of the inequality and whether the magnitudes being observed are worth worrying about. If the source of inequality is unrelated to the operation of the market—for example, something like the exercise of sheer political power or the plundering of the poor by the rich—obviously, that's not a good thing. But that doesn't apply to the United States or to most developed countries in modern times. In the United States, the dispersion of wages essentially reflects a dispersion of

underlying skills—education and training combined with changes in returns to occupational skills, changes in regional differentials, and things like that.

But those returns and the recent widening of the differences between them, as Kevin Murphy pointed out, are useful signals, signals that we really do need to respond to if we are to ensure economic growth. So we wouldn't want to suppress them, since doing so would only generate more serious problems.

With respect to the degree of inequality, or how much is too much, what we're talking about in the United States is an increase in inequality from a point in the century where the dispersion of wages was at its very lowest. Early in the 1900s, as best we can tell, there was much more inequality, but it is also noteworthy that at that time, there were huge waves of immigration and obviously a large dispersion of skills. I don't think we can altogether dismiss the increase in immigration that has occurred in the past 20 years as a source of the recent increase in the dispersion of skills. Right now, immigrants account for a fairly significant portion of the lowest decile in the income distribution.

But then, how much inequality is too much? One of Joe's suggested ways of answering that question is to look at the extent to which inequality generates social unrest. And by just casual observation, if you look at the polls today, people seem to be a lot more content than they were in the late 1960s, when the dispersion of wages was at a low point and there was substantial unrest. So by that standard, I don't think that the current amount of inequality of wages or earnings is generating social difficulties. But that's something that is very difficult to assess empirically.

I think it finally does come down to Alan Greenspan's point—that perhaps the more important question is, what is happening to the level of income of the poorest wage earners? If their incomes are falling to unacceptable levels, then obviously, that's a source of concern and something that we ought to deal with. It is surely more important than what is happening to the Gini coefficient, which the average

person is unlikely to worry about and really doesn't have any way of noticing—unless, of course, the degree of inequality reaches the proportions of the distant past.

Ms. Rivlin: Thank you. Joe, a brief response to this set of questions, if you will. And then we will move on to the next session.

Mr. Stiglitz: One of the functions of the first part of our paper was to dispense with the fallacy that you need inequality for growth. Looking across countries and over time, it showed very clearly that you can have high inequality and low growth or high inequality and high growth, and that there is no systematic relationship looking across countries and over time.

The second thing the paper tried to make clear is that there are a group of countries that have pursued high-growth, low-inequality policies, which suggests that there are some policies that are available that can achieve both high growth and low inequality.

These kinds of statistical results, I think, are only suggestive. I think one has to look at models where one can identify clearly the exogenous variables. What are the causes of inequality? Of growth? Both growth and inequality are really *endogenous*. We must identify the exogenous variables so that we know what the consequences of policies will be. And obviously, I do agree that we eventually have to embed these “descriptive” models into political models.

In the short paper that I presented, I couldn't do all that. I think what does emerge clearly from models presented there is that macroeconomic policies (and other policies) can affect the degree of inequality. And there is the possibility of a vicious circle where a high degree of inequality leads to more unemployment, which leads to more inequality.

It is very clear that when one accepts that message, one doesn't want to read from it that any interventions that reduce inequality are necessarily desirable; as I noted before, there are lots of inefficient interventions. In fact, in the talk I gave on Monday in Cordoba, I

actually articulated the kind of view that Horst raised in dealing with unemployment problems: You really want to think about unemployment compensation as insurance for periods of typically short duration; one should not have the kind of program we have, which has a variety of perverse incentive effects, but instead should really try to address the credit-constraint problem and, therefore, reduce the moral hazard.

I think that the issue raised by my paper and the subsequent discussion is that one has to look at macro and micro policies with an eye to the fact that one lives in a world in which there is inequality and that there are inequality consequences in virtually every policy. You simply can't use representative agent models to analyze these issues. The issues of macro policies are not just technical issues where you can ignore the consequences to the distribution of income.

Ms. Rivlin: Thank you. I think we're well positioned to move into the session on what to do about it. This session has illustrated one of the problems of talking about this quiet, emotion-laden subject: that anyone who points out that inequality can be a problem for countries is immediately told, "Well, you must want an extreme version of the welfare state." I don't think any of us want the extreme versions of the welfare state; neither do we want to do nothing about inequality. So, we now turn to the question of what we can do. We have Assar Lindbeck to start us off.