The Economist

Inequality

Unbottled Gini

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

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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."

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