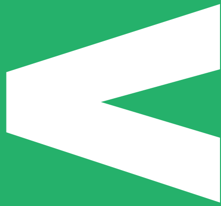

Inequality

The IFS Deaton Review

How inequality undermines institutions

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How inequality undermines institutions

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Economic inequality has spiked in many countries in the last several decades, raising questions about whether policy should do more to combat it. Until scholars such as Thomas Piketty put economic inequality on the public agenda, a common view among policy analysts and government officials was that economic inequality was not a matter of moral concern, as long as the least well-off received adequate resources to satisfy their basic needs (which Debra Satz and Stuart White call the 'sufficiency' view) (Frankfurt, 1987). This view has come under pressure in recent years. But the questions of what is wrong with inequality, and what is the best way to address it, remain highly contested.

One view, reflected in Benthamite utilitarianism, as well as the more sophisticated social welfare functions used in the public finance literature, is that income inequality reduces aggregate welfare because of the diminishing marginal utility of money. A millionaire values a dollar less than a homeless person does, so moving dollars from the millionaire to the poor enhances aggregate utility. Another view is that economic equality is a distinctive value on its own (Nagel, 1995). A third is that it generates pathologies by dividing society into mutually suspicious castes or creating relationships of dependence.

But these claims have been met with scepticism in some quarters. As Satz and White discuss, the commitment to economic equality implies that policy should seek to 'level down' the best-off even when such policies are wasteful and do not help the poor. A dollar transferred from a billionaire to a millionaire is a victory from the standpoint of equality; so is burning that dollar rather than transferring it to anyone. Moreover, commitment to economic equality may conflict with other values, such as liberty and equality of opportunity. Though neglected by philosophers, many people seem to value hierarchy for its own sake, as shown by their support for authoritarian rulers or their voluntary association with hierarchical religious, military and social organisations. And equality-promoting policies may distort incentives to work or require substantial administrative costs, leaving fewer resources available for public projects and private consumption. Finally, it is worth observing that the two most powerful engines toward economic equality in the last several decades – the expansion of international trade and of worker migration – have also been the most reviled because of their distributive impacts within nations and their harms to other moral values.[2] People who hold the sufficiency view are unbothered by inequality as long as basic needs – which can be defined narrowly to mean nutrition, literacy and shelter, or broadly to encompass a range of capacities necessary for the good life – are satisfied (Nussbaum, 2013).

Satz and White offer a pluralistic account of the wrongs of economic inequality (by which they mean inequality of wealth and income).[3] They argue that policy should aim to reduce income inequality for three reasons. First, inequality is harmful to human well-being – because it hampers economic growth, undermines social stability, and reflects a misallocation of resources so that some people have too much and others have too little. Second, economic inequality often reflects unfairness, as it can be the result of historical injustices or imperfections in the institutional structure of the market economy. Third, inequality can generate further unfairness and harms to

[1] Thanks to Brian Leiter, Martha Nussbaum and Erik Zimmerman for helpful comments.

[2] As is well known, the expansion of trade enhanced global economic equality mainly by redistributing manufacturing jobs to China. Less well known, the Gulf States' frequently criticised guest worker programmes have made an extraordinary contribution to global equality on a per-capita basis (Weyl, 2018).

[3] Their view and discussion echo Scanlon (2018).

well-being by giving the wealthy excessive political influence, damaging social relationships, and creating caste-like divisions among races and other groups.

Pluralism is all very well, but pluralistic justifications for a policy approach – here, broad-based reduction of economic inequality – are vulnerable to the objection that different justifications imply different remedies. It is possible that the harms identified by Satz and White can be more effectively addressed by policy instruments tailored to those harms than a general policy of reducing economic inequality through taxes and transfers, as they appear to advocate. For example, a more direct way for remedying a historical injustice is to make awards to victims or their descendants, who normally seek public recognition of the harm imposed on them and not just money or restitution of property. A higher income or wealth tax will not accomplish that aim – especially when the victims or their descendants are wealthier than average, as is sometimes the case (e.g. some of the victims of communist-era expropriations). If imperfections in the market economy cause harms, then the natural remedy is correction of those imperfections through market regulation rather than redistribution of wealth. Antitrust law or price regulation, for example, is the normal response to market concentration – and these policy tools both increase efficiency and mitigate economic inequality. Redistribution of wealth is not a good remedy for market concentration because the concentration remains in place, causing a waste of resources. Social instability, segregation and related ills have traditionally been addressed with reforms in education, zoning, political structure and much else.

On this view, the appropriate policy approach is to improve institutions – economic, political, educational, etc. – and to do so by using *tailored or piecemeal policy reforms* that correct whatever imperfections are identified, rather than *large-scale redistribution*, which is typically conducted through taxes and transfers. Policies that advance economic equality are then justified only by reference to fundamental norms. This view is the traditional view among policy analysts in western countries, and we see it in the division of policy labour in many countries. Some policy analysts specialise in markets and advocate market reforms; others specialise in politics and advocate political reforms; and so on. Meanwhile, other policy analysts recommend tax and welfare reforms that advance distributive justice.

However, this work has assumed that if the basic institutions of society improve, economic inequality will decline as a result – either automatically or as a result of progressive taxes-and-transfers. Rising economic inequality over the last several decades suggests that this assumption is unwarranted. In some countries, rising economic inequality has been accompanied by a degradation of many institutions (the United States is the most prominent example). This raises the possibility that the causation is backwards, or at least partly so: perhaps some degree of economic equality is a necessary premise for effective social, economic and political institutions, rather than a consequence of them. Satz and White suggest as much, but their discussion is vague, leaving it unclear how one would determine empirically whether economic equality is a necessary premise for the effective operation of the institutions, or not. Below, I fill in some of the detail with the hope of stimulating research in this area.

The market economy

The standard economic justification of the market economy is that it generates wealth ('efficiency'). If competition is perfect, the distribution of resources will be Pareto-optimal. Most economists recognise that a Pareto-optimal economy does not exhaust the responsibility of society. The view is rather that policy should attempt to improve market institutions where they are appropriate, and that *other institutions* – mainly the tax-and-transfer system – should be used to achieve distributive fairness. That is why questions of economic equality and distributive justice

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are mostly absent from economic analysis of market institutions, and the focus is instead Pareto-optimality or another measure of efficiency.

In a standard model of a competitive market, the initial distribution of wealth (or 'endowments') makes no difference to efficiency. To see why, imagine two initial scenarios. In the first, the distribution of wealth is equal. In the second, it is highly unequal. Let a perfect market operate on both scenarios. People in both scenarios will trade until no more mutually beneficial trades can occur; the outcomes are in both cases by definition Pareto-optimal. The degree of inequality at the start might influence the distribution at the end but it does not interfere with market exchange or degrade efficiency. Sellers earn a competitive rate of return regardless of whether they are wealthy or poor. Entrepreneurs with good ideas can self-finance if rich and borrow if poor, so they will produce the same output regardless of their initial wealth. Only consumption will vary with wealth.

However, in the real world of imperfect markets, there are reasons to think that economic inequality can interfere with efficiency. Consider two talented entrepreneurs who are identical in all respects except that one is rich and the other is poor. As before, the rich entrepreneur can self-finance any entrepreneurial activities. The poor entrepreneur is likely to have trouble persuading an investor to contribute capital. In real-world conditions, the poor entrepreneur faces obstacles: she may have talent and a good idea but investors will be sceptical. She cannot credibly disclose her private information about her ability. This means that the poor entrepreneur will have to take costly actions to prove herself. For example, she may go to work for a firm in the relevant industry where she can demonstrate her talents and work her way up the corporate hierarchy. But this will take time from her entrepreneurial activity (by hypothesis, her highest-value use), and she may end up being further bound by covenants not to compete and related restrictions imposed by employers who seek to profit from her talents. Or she may simply forgo the entrepreneurial route for an economically inferior job. The imperfection of capital markets offers an advantage to wealthy entrepreneurs, and thus results in misallocation of human capital.

It is easy to think of other ways in which economic disparities combine with market imperfections to generate inefficiencies. Consumers face significant search costs for complicated goods and services, such as housing, insurance and credit. In theory, consumers could borrow to finance their search costs; in practice, borrowing is itself costly. It seems likely that sellers realise that wealthy and sophisticated buyers can compare prices more efficiently than poor buyers can, and will offer them better terms than those they offer to the poor. This will result in effective higher prices for the poor, and less output and consumption. Moreover, sellers will engage in a form of rent-seeking by trying to segregate customers into rich and poor, so that they can offer different terms to the two groups – while the less well-off will try to conceal their economic position so that they avoid these extra costs. Even a more innocent form of price discrimination to take advantage of wealthy people who are less price-sensitive generates inefficiencies. Sellers will try to reconfigure essentially identical goods or services so that they appeal differently to the wealthy and to the poor, as the familiar example of business and economy class for air travel illustrates.

Further, as economic inequality increases, market efficiency will increasingly deviate from public welfare. While in an egalitarian society, talented people will do work that benefits everyone, in an unequal society, talented people will be led by market incentives to become tax lawyers, financial whizzes, yacht-builders and other servants of the wealthy. That means that even a perfectly competitive market that generates a Pareto-optimal outcome will tend to reinforce inequalities. And while those inequalities can in principle be reversed with taxes and transfers, the political and economic costs of taxes and transfers will increase as inequality increases.

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A standard rebuttal is that economic inequality is essential to a well-functioning market economy because people will engage in risky investment only if they are compensated with outsized returns. As long as multiple people engage in such risks, there will unavoidably be winners and losers, resulting in large disparities of wealth even if everyone started from an equal position. But while it may be correct that a well-functioning market economy will inevitably generate some inequality, it does not follow that policy should not mitigate it. There are two reasons for this. First, real-world markets almost certainly generate returns in excess of what is necessary to motivate people to take risks, at least in some corners of the economy. Second, inequalities that are the legitimate outgrowth of risk-taking must be balanced against the harms that those inequalities generate for the next round of market activity, as described above. It is not clear how these concerns should be balanced out, but it is clear that reduction of inequality on the margin should generate more good than harm.

Regulation

Government agencies regulate the market economy to correct externalities and resolve other market failures. Familiar examples include environmental, financial and workplace-safety regulation. Regulators must choose when to regulate and how strictly to regulate, and these choices require regulators to balance the costs to industry (typically passed on as higher prices to consumers) and the benefits. Regulators commonly use cost–benefit analysis, in which the trade-off is made after the costs and benefits are converted into monetary values based on the willingness of consumers to pay for the benefits and the costs of industry compliance.

To perform cost–benefit analysis, regulators usually rely on market prices or willingness-to-pay figures elicited with surveys. In ideal conditions, cost–benefit analysis should advance social welfare. Imagine a population in which people have equal wealth. The government must decide whether to build a bridge. The cost is $1 million. The bridge satisfies a cost–benefit analysis if the people who use it would be willing to pay in aggregate more than $1 million. They might do so because they save time or gasoline costs; these benefits can be easily converted into monetary values.

But if economic inequality prevails, both market prices and willingness-to-pay figures become less accurate approximations of well-being. Because of the diminishing marginal utility of the dollar, wealthy people will pay more for a public good than poor people will, even if the public good benefits the two groups the same. A bridge that benefits a small number of rich people and harms a large number of poor people may pass a cost–benefit analysis. If rich and poor are equally affected by the project, the excessive influence of one group of rich people will be cancelled by the excessive influence of the other group. But this need not be the case. And, while willingness-to-pay can be adjusted on the basis of wealth, so that it better approximates the welfare effects of projects or regulations, there is no consensus as to how to do this. Thus, as inequality increases, cost–benefit analysis becomes a noisier signal of the normative value of public projects. Welfare-maximising regulation becomes more costly as inequality increases, and so will be less common.

Economic inequality can cause other problems for regulation. As inequality increases, regulators may increasingly prefer the interests of the rich, and so issue inefficient regulations that further advance inequality. Part of the reason for this preference is the greater political influence of the rich, a topic I will address below. But another reason is specific to the way regulation works. Regulators are rarely paid as well as the people they regulate. That means regulators may be tempted to quit the government and go to work in the regulated industry where they can share their expertise about the government's investigative methods and priorities. Industries in which

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people are highly paid – e.g. finance – will attract more talented regulators than industries in which people are less well paid (e.g. agriculture). Thus, inequalities can reverberate through the system, distorting the talent pool available to government agencies and the quality and strictness of regulation in different sectors of the economy.

The rule of law

The market and the regulatory system are underpinned by the legal system, which is administered by courts. In most countries, citizens enjoy equality under the law, which means that the courts will resolve disputes impartially and not recognise advantages based on status or wealth. But legal systems are also vulnerable to economic inequality, which through various paths may convert legal equality into an empty form.

In the United States, for example, an elaborate hierarchy of legal talent prevails. The wealthiest people and institutions hire the best legal talent, and often teams of lawyers who can overwhelm the resources of their opponents with a blizzard of subpoenas, depositions, paperwork and the other weapons of legal attrition. This leads to a host of pathologies. Wealthy people can hire legal talent to advise them on tax-minimisation strategies, to identify regulatory loopholes, and to defend them if they violate the law. Poor people cannot, and have access to lawyers only when they are accused of crimes. Wealthy people can make credible threats to sue in order to elicit settlements from opponents; other people cannot. And judges themselves are usually drawn from the pool of wealthy and talented lawyers, and so may not feel much sympathy for the less well-off.

Inequality in the legal system can undermine market efficiency. A well-functioning market assumes the government impartially enforces property rights and contract rights. If the legal system actually is biased in favour of the wealthy, then the non-wealthy will be less willing to use it. If people cannot depend on their property rights, they will not invest in improving their property. If people cannot depend on contract rights, they will not enter deals. Ironically, even wealthy persons and corporations are harmed by a legal system that favours them because they cannot make contractual commitments that counterparties can depend on. Historically, when legal systems were inadequate, people relied on family and ethnic ties, private institutions and organised crime. Today, the legal system is too expensive for most people, who may as a result be reluctant to enter mutually beneficial transactions.

The political system

The dangers posed by economic inequality to the political system are well understood, as Satz and White observe. Democracy guarantees formal political equality in the form of the right to vote and to run for office. Other political rights – including the right to free speech and assembly – are also distributed equally. But in conditions of economic inequality, these political rights are hollow. While outright bribery is rare in advanced countries, the wealthy can exert greater influence on political outcomes than poorer people by donating money to preferred candidates and causes. And extremely wealthy people can self-finance their own political campaigns, obtain offices in return for their financial support for parties and officials, and even use their funds to influence academic writing and political commentary.

Many countries have limited the role of money in politics by regulating donations and spending. But in countries where economic inequality is high, the wealthy can use their political influence to resist efforts to implement such regulations in the first place. In the United States, efforts to

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restrict campaign financing began in the early 20th century, and accelerated in the 1970s in the wake of the Watergate scandal. But the Supreme Court has overturned many such restrictions, and has taken an increasingly hard line, culminating in the Citizens United case of 2010, which struck down a law that prohibited political expenditures by corporations and other organisations under the First Amendment. Increasing economic inequality in the United States accompanied by looser restrictions on political expenditures has led to widespread unhappiness with the political system.

In the last several decades, governments have found it increasingly difficult to regulate large multinational corporations, whose political power derives from their ability to easily move assets across borders as well as from their teams of lobbyists. This in turn has led to a new style of shareholder activism. Shareholders organise and pressure managers to reduce greenhouse gas emissions, diversify boards and avoid business with dictators. In this way, shareholders can force corporations to 'self-regulate' for the sake of policy goals that government regulations can no longer attain. Many commentators welcome a growing movement that pressures corporations to act in a socially responsible way. But 'shareholder democracy' is not the same as democracy. The vast majority of shares are owned by relatively wealthy people. Shareholder democracy is actually a form of oligarchy, and so the policy agenda of shareholders will tend to favour wealthier interests.

Educational attainment and meritocracy

In recent years, people have expressed worries about the impact of economic inequality on education and, more broadly, meritocracy. These worries are related to the idea that economic inequality may undermine the modern market economy, which depends on large investments in human capital. But the worries about education and meritocracy reflect a separate cultural and political dimension and involve additional complexities. One such worry is that inequality advances educational disparities. In the United States, wealthy people self-segregate in expensive suburbs where the tax base can finance high-quality public schools or send their children to expensive private schools. Poorer children end up in worse schools. As a result, many Americans are poorly educated, and, as a result of technological advances, the US economy can no longer supply jobs to unskilled or poorly educated labour. While in the past, the uneducated could obtain reasonably well-paying jobs, support a family and obtain status in their communities, today those jobs are disappearing. A large unemployed and unemployable population is a waste of human resources, a source of political instability and a failure of public policy.

Meanwhile, at the upper end of the wealth distribution, growing economic inequality feeds anxiety among parents that their children will be left behind. As the income distribution flattens, fewer but more-high-paying jobs become available for the most talented and best educated, which means that parents pressure their children, pay for tutors, and foot expensive tuition bills or move to expensive suburbs. The increasing competition for a decreasing number of ever more lucrative jobs – mainly in finance, law and business – has, in the popular imagination and possibly in reality, put unrelenting psychological pressure on children and parents alike.

As wealthy parents put more resources into their children, the idea of meritocracy has come under pressure. The theory of meritocracy is that the most talented people are assigned the most important jobs, and are commensurately rewarded for their contributions to the public good. But both prongs of this theory are questionable. Unavoidably, educational institutions rely on tests and other screening mechanisms to identify the most talented children. These mechanisms can be gamed. Wealthy parents can afford tutors, enrichment activities and consultants, and this can help less-talented children obtain slots in schools and universities that should be reserved for

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more-talented children of poor families. As a recent admissions scandal in the United States has shown, wealthy parents can also bribe universities to accept their children, though this activity has traditionally been accomplished lawfully through donations and other subterfuges. But if wealthy parents can game the system by making donations and financing activities for their children that satisfy admissions requirements without actually improving their children, then meritocracy has been replaced with a wasteful and unfair system that allocates rewards to elites.

Even more troubling, evidence suggests that educational attainment – and, more broadly, the capability to compete with others in the market – heavily depends on early childhood development, and even development in the womb. Large-scale redistribution that put money in the pockets of the poor could equalise economic outcomes, and yet if that redistribution were not supplemented by aggressive and early educational (and possibly nutritional) intervention, economic equality at the population level will mask serious inequality in terms of human capacity and a waste of human resources. A policy of advancing economic equality by distributing resources might detract attention and urgency from tailored reforms that more directly advance human well-being.

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Let us take stock. Economic equality is not a fundamental moral value that commands widespread consent. There are too many competing values and goals, many of which seem more urgent, such as the goal of eliminating poverty and improving people's capacities to advance through life. If economic equality is a policy goal, then the argument must rest on a more complex set of considerations, as Satz and White argue. A better argument is that economic equality to some degree is a necessary premise of prized institutions that form the bedrock of our way of life. This argument is that the institutions advance economic prosperity, political stability and other values only when the economic inequality is limited.

This argument depends on a key premise – which is that these institutions cannot be reformed so that the influence of wealth on their operation can be minimised to an adequate degree. I will call such reforms *institution-specific*, to distinguish them from the systemic policy of using taxes and transfers to reduce economic inequality. Consider the political system again. The traditional strategy for preserving political equality has taken the form of campaign finance laws and other restrictions on the unfair use of money to influence political outcomes. If wealthy people can donate no more than poor (or, more realistically, middle-class) people to candidates (which is currently the law in the United States), and can spend no more than others on political advertising and other indirect methods for supporting preferred candidates (which is not currently the law), and in other ways cannot use their wealth and influence to pressure elected officials and bureaucrats, then we might believe that formal political equality will produce real political equality. Campaign finance regulations are institution-specific because they protect the political system – and no other institution – from economic inequality. They are more tailored to the problem of the excessive influence of wealth on politics than the policy of reducing economic inequality through taxes and transfers.

As we have seen, an institution-specific response to political inequality may be impossible in the United States because the Supreme Court has blocked the most effective means of campaign reform. As a result, the case for untailored taxes-and-transfers is strengthened. If the government cannot regulate campaign finance to reduce the influence of wealth on politics, then the only way to do this is to redistribute wealth so that fewer wealthy people will have excessive political power. In other countries, however, the untailored response may be unnecessary.

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A similar point can be made about the other institutions. In theory, market reform could reduce the distortions caused by economic inequality. A push to improve the competitiveness of markets, for example, would reduce the economic advantages of wealthy investors, sellers and consumers. This would require a greatly strengthened antitrust law as well as regulations that preserve market competition. And where markets are naturally monopolistic, rate regulation could keep prices in line. But many economists and lawyers are sceptical that antitrust law and regulation can improve markets. And even if legal reform would work, it is steadily resisted by the wealthy who benefit from the status quo. Again, if markets work best when economic equality prevails, and regulation to limit the influence of inequality on markets is costly and ineffective, then a commitment to markets may also commit one to untailored reforms that reduce inequality.

Efforts have also been made to reduce the influence of economic inequality on regulation and law. For example, regulators use an identical value of a statistical life (VSL) for rich and poor even though wealthy people are willing to pay more to avoid mortality risks than poor people are. But, as many commentators have pointed out, the use of an identical VSL across income classes may result in products and services that are not affordable for low-income people. As for the legal system, governments supply free legal assistance to criminal defendants, and lawyers in private practice donate some of their time pro bono. But these bandages are plainly inadequate. Here again a strategy of reducing economic inequality – so everyone can afford legal talent – may be more effective than the modest regulation of the legal system that seems to be politically and practically realistic.

Similar points can be made about the education system. Public schooling promised to provide an equal education for all, but wealthy people self-segregated in suburbs or sent their children to private schools. Universities offer scholarships, and the government offers grants and guarantees loans, but these resources do not offset the advantages offered by wealth. Early interventions to improve prenatal health and offer educational opportunities to young children may conflict with parents' autonomy and their legitimate interest in having control over their children.

The root problem is that rules that are meant to restrict the influence of money on attainment in the market, the political system, the legal and regulatory system, and education can all be gamed by the wealthy. Wealth enables one to buy lawyers, experts, consultants and other resources that allow one to outmanoeuvre less wealthy competitors in all of these institutions. A related problem is that restrictions on the influence of wealth may undermine institutions by overloading them with complex and unworkable rules that undermine their effectiveness. And then, of course, wealthy people have strong incentives to resist reform, or to ensure that reforms include loopholes through which the rich can crawl. All of this makes a case for a general, rather than institution-specific, reform – in the form of taxes and transfers that redistribute.

Importantly, this argument explains why levelling down (at least within limits) may be justified. Burning a billionaire's dollar incrementally improves the function of markets, the political system, education and so on. The reason is that relative wealth distorts the operations of the institutions that modern society relies on. If everyone is rich or everyone is poor, market prices will reflect people's valuations and (if they are reasonably well-informed) well-being, and so the market and institutions that incorporate market prices should advance well-being. If some people are rich and others are poor, market prices become noisy indicators of well-being.

Several counterarguments should be addressed. First, if the wealthy use their political power to resist institutional reform that limits the impact of income inequality, why would they consent to

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large-scale redistribution? The answer is that the wealthy as well as the poor benefit when social institutions operate effectively. Moreover, it seems politically more feasible to organise a coalition that will support large-scale redistribution since it benefits the majority and its effects should be clear. Reform of antitrust laws, regulatory methods, campaign finance and education is less politically visible, harder to understand, and more vulnerable to back-room deals and legal challenge.

Second, one might believe that untailored redistribution through the tax-and-transfer system is just as costly, complex and vulnerable to gaming as the institutional reforms I have discussed. That may well be true, but it is hardly clear. Taxes and transfers involve administrative costs but these costs are relatively low. They reduce incentives to work and invest, but there is a great deal of uncertainty about how great this distortion is, and some economists believe that it is small even for high marginal income tax rates. The biggest problem is probably (legal) avoidance or (illegal) evasion, including the risk that capital will move overseas. But the extent of this problem too remains empirically uncertain.

Third, one might believe that tailored approaches to institutional reforms allow for a calibrated response that is attentive to competing values, while wholesale redistribution through tax and transfers has a blunderbuss feel. However, on reflection, the truth may be the opposite. Institutional reform that limits the impact of politics will unavoidably tell wealthier people that they cannot spend money to advance their political preferences and values, which will be seen as, and may well count as, an unacceptable constraint on liberty. Reform that improves the fairness of education may require restrictions on how parents spend money on their children, and that too may be an unacceptable constraint on the liberty of parents and the autonomy of the family. By contrast, taxes work on only one margin – wealth or income – and, while they may influence broad choices as to how much to work, redistributive taxes-and-transfers do reflect intrusive and possibly wrong-headed judgements about how much people should contribute to politics, educate their children and so on.

As should be clear, there are a large number of unresolved empirical issues about the relationship between economic inequality, the effectiveness of institutions, and outcomes for the public. Rigorous empirical work by social scientists is desperately needed.

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