(Source: Todaro and Smith, "Economic Development".)

What's So Bad about Extreme Inequality?

We assume that social welfare depends positively on the level of income per capita but negatively on poverty and negatively on the level of inequality.

We will talk more about poverty later, but why should *relative inequality* be a concern?

First, extreme income inequality leads to economic inefficiency.

- At any given average income, the higher the inequality, the smaller the fraction of the population that qualifies for a loan or other credit (due to lack of collateral). When low-income individuals (whether they are absolutely poor or not) cannot borrow money, they generally cannot adequately educate their children or start and expand a business.

- With high inequality, the overall rate of saving in the economy tends to be lower, because the highest rate of marginal savings is usually found among the middle classes. Although the rich may save a larger dollar amount, they typically save a smaller fraction of their incomes, and they almost always save a smaller fraction of their marginal incomes. Landlords, business leaders, politicians, and other rich elites are known to spend much of their incomes on imported luxury goods, gold, jewelry, expensive houses, and foreign travel or to seek safe havens abroad for their savings in what is known as *capital flight.* Such savings and investments do not add to the nation's productive resources; in fact, they represent substantial drains on these resources. In short, the rich do not generally save and invest significantly larger proportions of their incomes (in the real economic sense of productive domestic saving and investment) than the middle class or even the poor.

- Inequality may lead to an inefficient allocation of assets. High inequality leads to an overemphasis on higher education at the expense of quality universal primary education, and this in turn begets still more inequality in incomes. Moreover, high inequality of land ownership —characterized by the presence of huge plantations alongside tiny farms that are incapable of supporting even a single family—also leads to inefficiency because the most efficient scales for farming are family and medium-size farms. The result of these factors can be a lower average income and a lower rate of economic growth when inequality is high.

The second reason to be concerned with inequality above the poverty line is that extreme income disparities undermine social stability and solidarity.

- High inequality strengthens the political power of the rich and hence their economic bargaining power. Usually this power will be used to encourage outcomes favorable to themselves. High inequality facilitates *rent seeking,* including actions such as excessive lobbying, large political donations, bribery, and cronyism. When resources are allocated to such rent-seeking behaviors, they are diverted from productive purposes that could lead to faster growth.

- High inequality makes poor institutions very difficult to improve, because the few with money and power are likely to view themselves as worse off from socially efficient reform, and so they have the motive and the means to resist it.

- High inequality may also lead the poor to support populist policies that can be self-defeating. Countries with extreme inequality, such as El Salvador and Iran, have undergone upheavals or extended civil strife that have cost countless lives and set back development progress by decades.

In sum, with high inequality, the focus of politics often tends to be on supporting or resisting the redistribution of the existing economic pie rather than on policies to increase its size.

Third, extreme inequality is generally viewed as unfair. The philosopher John Rawls proposed a thought experiment to help clarify why this is so. Suppose that before you were born into this world, you had a chance to select the overall level of inequality among the earth's people but not your own identity. That is, you might be born as Bill Gates, but you might be born as the most wretchedly poor person in rural Ethiopia with equal probability. Rawls calls this uncertainty the "veil of ignorance." The question is, facing this kind of risk, would you vote for an income distribution that was more equal or less equal than the one you see around you? If the degree of equality had no effect on the level of income or rate of growth, most people would vote for nearly perfect equality. Of course, if everyone had the same income no matter what, there would be little incentive to work hard, gain skills, or innovate. As a result, most people vote for *some* inequality of income outcomes, to the extent that these correspond to incentives for hard work or innovation. But even so, most vote for *less* inequality than is seen in the world (or in virtually any country) today. This is because much of the inequality we observe in the world is based on luck or extraneous factors, such as the inborn ability to kick a football or the identity of one's great-grandparents.

Policy Options on Income Inequality and Poverty

1. *Altering the functional distribution*—the returns to labor, land, and capital as determined by factor prices, utilization levels, and the consequent shares of national income that accrue to the owners of each factor.

The basic idea here is to clear any distortions in the factor markets so as to prevent labor from being artifically expensive (due to unions and minimum wage laws) and capital from being artificially cheap (due to investment incentives, tax allowances etc.). To allow factor prices to act as signals and incentives in the economy. Correcting these prices (i.e., lowering the relative price of labor and raising the relative price of capital) would not in general only increase productivity and efficiency but also reduce inequality by providing more wage-paying jobs for currently unemployed or underemployed unskilled and semiskilled workers. It would also lower the artificially high incomes of owners of capital.

However, beware that there are substantial poverty reducing effects of setting a minimum wage. Therefore, there may be other important considerations besides achieving efficiency.

2. *Mitigating the size distribution*—the functional income distribution of an economy translated into a size distribution by knowledge of how ownership and control over productive assets and labor skills are concentrated and distributed throughout the population. The distribution of these asset holdings and skill endowments ultimately determines the distribution of personal income.

The ultimate cause of the unequal distribution of personal incomes in most developing countries is the unequal and highly concentrated patterns of **asset ownership** (wealth) in these countries. The principal reasons why 20% of their population often receives over 50% of the national income is that this 20% probably owns and controls well over 90% of the productive and financial resources, especially physical capital and land but also financial capital (stocks and bonds) and human capital in the form of better education and health. Correcting factor prices is certainly not sufficient to reduce income inequalities substantially or to eliminate widespread poverty where physical and financial asset ownership—and education—is highly concentrated.

It follows that the second and perhaps more important line of policy to reduce poverty and inequality is to focus directly on reducing the concentrated control of assets, the unequal distribution of power, and the unequal access to educational and income-earning opportunities that characterize many developing countries. A classic case of such **redistribution policies** as they relate to the rural poor, who comprise 70% to 80% of the target poverty group, is **land reform**.

Similar reforms in urban areas could include the provision of commercial credit at affordable rates (rather than through traditional, high-interest moneylenders) to small entrepreneurs so that they can expand their business and provide more jobs to local workers.

Human capital in the form of education and skills is another example of the unequal distribution of productive asset ownership. Public policy should therefore promote wider access to educational opportunities (for girls as well as boys) as a means of increasing income-earning potential for more people. But as in the case of land reform, the mere provision of greater access to additional education is no guarantee that the poor will be better off unless complementary policies—for example, the provision of more productive employment opportunities for the educated—are adopted to capitalize on this increased human capital.

3. *Moderating (reducing) the size distribution at the upper levels* through progressive taxation of personal income and wealth. Such taxation increases government revenues that decrease the share of disposable income of the very rich—revenues that can, with good policies, be invested in human capital and rural and other lagging infrastructure needs, thereby promoting inclusive growth. (An individual or family's **disposable income** is the actual amount available for expenditure on goods and services and for saving.)

Direct **progressive income taxes** focus on personal and corporate incomes, with the rich required to pay a progressively larger percentage of their total income in taxes than the poor. Taxation on wealth (the stock of accumulated assets and income) typically involves personal and corporate property taxes but may also include progressive inheritance taxes. In either case, the burden of the tax is designed to fall most heavily on the upper-income groups.

4. *Moderating (increasing) the size distribution at the lower levels* through public expenditures of tax revenues to raise the incomes of the poor either directly (e.g., by conditional or unconditional cash transfers) or indirectly (e.g., through public employment creation such as local infrastructure projects or the provision of primary education and health care). Such public policies raise the real income levels of the poor above what their personal income levels would otherwise be, and can do so sustainably when they build the capabilities and assets of people living in poverty.