The Unsustainability of Inequality

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Rising inequality is symptomatic of a wide range of economic and political problems that are standing in the way of achieving a just and sustainable society. But for all the concern about the income and wealth gap within countries in recent years, there has been surprisingly little acknowledgement of the forces actually driving the trend.

AUSTIN – "Sustainability" is a relatively new organizing principle in global policy. It is new partly because economists have long been largely hostile to the very idea. Postwar neoclassical growth theories deliberately ignored resource and environmental limits, disparaged and disdained ecologists, and promised what was effectively impossible: perpetual growth fueled by unlimited resources, the free disposal of wastes, and never-ending technological progress. Early warnings – notably the Club of Rome's pathbreaking 1972 report, *The Limits to Growth* – were ridiculed. More recently, the science of limits has gained acceptance, but most economists remain preoccupied with growth.

But there is at least one dimension of unsustainability that not even economists can overlook: inequality. Income and wealth disparities, along with other forms of inequality, are relevant to sustainability for at least three reasons.

First, rising inequality reflects the economic rents captured in resource extraction and production, whether by the owners of those resources or by financiers acting as parasitic middlemen. Second, inequality fosters the extravagant excesses that some now call *plutonomy* – an economic system in which a small group, the ultra-wealthy, accounts for a large share of total consumption. Under such conditions, a rising tide lifts only yachts, and competitive consumption creates an escalating pattern of what Thorstein Veblen, perhaps the greatest American economist, called conspicuous waste. Lastly, rising inequality is a good indicator of financial instability, which increases the probability of an impending crash.

For all these reasons, understanding and controlling the rise of inequality is an ecological, socioeconomic, and political imperative. It is, in other words, a sustainability issue.

MEASURE FOR MEASURE

To get a grip on economic inequality, we must overcome two major sources of confusion. On the theoretical side, mainstream economics treats inequality largely as a byproduct of supply and demand in "labor markets." It is thus regarded as a "microeconomic" phenomenon, driven on the demand side by technological change, and on the supply side by a barely observable quantum that goes by the name of human skill.

When economists write about policies that affect inequality, they tend to work within this market framework. The labor market may be local, regional, or – at the very most – national. Proposed policies focus mainly on the characteristics and capabilities of individuals and how they can improve their positions in the market. These matters are undoubtedly important, particularly when it comes to education and health, but they ignore the broader "macroeconomic" forces – booms and busts, interest rates and debt, exchange rates and commodity prices – that affect individuals, firms, economic sectors, and entire countries.

On the empirical side, there is a question of information: What can we know from the available data? Most of the data we have come from surveys, and most surveys focus on households. These data are relevant for judging economic welfare – and also for thinking about how people with different characteristics (age, gender, race, education, and so on) interact with markets. Yet householders are not employees, and their income is not the same as the wages paid for particular kinds of work. So, data collected on households are several steps away from production, pay, and the forces of structural change.

When it comes to international and comparative analysis, there is yet another problem: surveys are expensive. More surveys are conducted in stable rich countries than in unstable poor ones. And they can be conceptually inconsistent, because the questions differ according to the choices made by those managing the surveys. Are we measuring income? Expenditure? Before or after tax? As with all surveys, the only answers one gets are to the questions asked.

An alternative approach that has become popular in recent years is to consult income-tax records. But these data are even more sparse and inconsistent than surveys, and such records are not available for all countries (indeed, not all countries have an income tax). So, in the effort to measure inequality within countries and around the world, there has long been less signal than noise.

INEQUALITY BY THE NUMBERS

For the past two decades, my students and I have been working on ways to address these measurement shortcomings. We have sought out payroll records that cover a diverse range of countries over many years, and in broadly consistent terms. With these data, we can measure economic inequalities in the structure of pay, which then allows us to estimate the associated inequalities of household income, both across countries and through time.

To explain the philosophy behind this approach, I often refer to a line from the American philosopher Charles Sanders Peirce's essay "The Fixation of Belief":

Kepler undertook to draw a curve through the places of Mars […] and his greatest service to science was in impressing on men's minds that this was the thing to be done if they wished to improve astronomy; that they were not to content themselves with inquiring whether one system of epicycles was better than another, but that they were to sit down to the figures, and find out what the curve, in truth, was.

We have attempted to follow this advice, and we have had a fair amount of success. Our measures have proven to be largely reliable and consistent with the existing survey record, while also sensitive to known historical events: wars, revolutions, and the like. Moreover, we have been able to look for patterns at the regional and even global level.

What would consistent patterns beyond the national level imply? I believe they are *prima facie* evidence that the main source of change in various forms of inequality lies in transnational developments, not in local conditions. To understand the problem of inequality, then, we need to study common developments across a continental or even global economic space.

As it happens, we have identified patterns showing a consistent gradient in levels of income inequality across both space and time. If one looks across space, there are not too many surprises. Income inequality within countries and regions rises as one moves from north to south, reflecting the concentration of advanced industry and middle-class welfare states in countries that were once the seats of empire. In Europe, inequality also rises as one moves from "East" to "West," reflecting the legacy of state socialism.

Moreover, countries in close proximity, and with similar income levels and neighborly diplomatic and trade relations, have relatively similar levels of inequality – as one can see very clearly in maps. Common sense tells us that if they did not have similar levels of inequality, regional migration patterns would sooner or later even things out.

Likewise, patterns of inequality change over time. In particular, there is a general movement toward higher inequality from the 1980s until 2000, after which inequality begins to stabilize. So far, all of this is what one would expect, which attests to the quality of the data. Our attempt to capture a much broader picture of inequality across the world has not been misguided.

WAVES OF INEQUALITY

These movements show, quite plainly, that levels of inequality once widely associated with the Third World are now quite generalized globally. The First World has not become poorer, but it has grown much less equal. There are a few exceptions, of course, and they should not come as a surprise. Measures of inequality in Denmark or Finland, for example, are not far from where they were a generation back. And some countries in Central and Eastern Europe – the Czech Republic stands out – have low levels of inequality (though higher than under their severe post-war communist regimes).

Now, consider another interesting pattern: the temporal movement of inequality *within* countries is very similar to that *between*countries. If one takes a standard measure of inequality between countries (not weighted for population, lest China and India dominate the data), one finds that it has risen both between and within countries at the same time. Again, this no surprise: rich countries comprise relatively wealthy people, whereas the people of poor countries are poorer. In a global economy, when inequality *between people* changes, it is natural that the inequalities between their respective countries change in a similar way.

But here it is important to remember that we are picking out the movement of inequality within countries, measured separately using national statistics, and standardized by an international statistical bureau. There are about 155 countries in our most recent data set, and the predominant patterns across all of them tell the essential story. From 1963 to 1971, no particular trend stands out. There is a bump in inequality within countries in 1973, followed by a modest decline. For much of the world – for poorer countries and poorer peoples alike, though not for the troubled rich – the 1970s were a time of growth and progress.

Then comes a key turning point. Beginning in 1981, inequality starts rising in waves around the world, increasing relentlessly until 2000, at which point the waves subside. In this era, the first major wave is dominated by Latin America and Africa, and subsequent waves are driven by the collapse of the Soviet Union and the associated regime changes in Eastern Europe. Finally, economic liberalization in Asia fuels another wave that culminates in the 1997 Asian financial crisis. From 2000, the rise in inequality slows, and inequalities even decline in parts of the world, including Latin America, China, and the Russian Federation.

A TALE OF FINANCIAL HISTORY

The message contained in these numbers is neither subtle nor obscure. This is a story about the relationship between debtors and creditors in the world economy. Under the post-World War II Bretton Woods framework, stability prevailed – until the system collapsed in 1971, when the United States ended the dollar's convertibility into gold. In 1973, the oil shock and a commodity boom led to a surge in credit in Latin America and elsewhere as countries took on commercial-bank debt to sustain growth in the face of higher fuel prices. As developing countries grew, their middle classes expanded and inequalities declined.

All of that ended in 1981 with the start of a worldwide debt crisis that emanated from monetary-policy changes in the US, where interest rates shot up to 22%. No longer able to pay their debts, developing countries were forced to pursue austerity measures and to abandon their independent industrial development strategies. Commodity prices collapsed, as did the Soviet bloc – much of it heavily indebted – a decade later. The Asian crisis of 1997 rounded out this period.

Inequality at the global level peaked in 2000. In the wake of the dot-com bust and the attacks of September 11, 2001, the US Federal Reserve cut interest rates, and China, growing strongly and now a member of the World Trade Organization, increased its commodity purchases worldwide. Prices and credit conditions improved, and for a while global inequality stopped rising.

The trends in inequality over this period are in keeping with the commonsense insights of Simon Kuznets back in 1955. Kuznets surmised that inequality would rise sharply during the initial stages of economic development, and then decline at later stages. China and India reflect this pattern, but for other developing countries in Asia and Latin America, industrialization and urbanization have been far enough advanced for decades that rapid growth reduces inequality and depression increases it. In a very few rich countries – notably the US and the United Kingdom – rapid growth increases inequalities, because it concentrates income in globally dominant sectors, especially finance and high technology.

So, in the rough history presented above, there are two key elements to consider: the structure of the underlying economies and the effects of booms and busts on that structure. Global forces for boom and bust have tended to affect individual countries and their people in proportion to their ability to resist them. Countries with strong institutions that were able to maintain independence and manage their own affairs fared the best. Those that could not defend themselves against global forces were periodically ravaged by them. In our time, this is the difference between, say, China and Mexico.

These global forces can be identified by the big turning points. The first was the breakdown of Bretton Woods and the rush to private debt in the 1970s. The second was the debt crisis of the 1980s, which was followed by the collapse of oil and commodity prices, and then of Soviet-style socialist governments, and then by liberalization in Asia, culminating in the 1997 crisis – but not in China, which was poised for another decade of double-digit growth. The third big turning point occurred in 2000, when lower interest rates, higher commodity prices, and modest advances in social-welfare policies and national economic development strategies helped to reduce inequality and poverty in Latin America and Russia, while in China, too, inequalities peaked and started to decline.

In Europe, events played out somewhat differently. European countries did not reject neoliberal ideology and re-embrace social-welfare policies after 2000. The introduction of the euro was followed by nearly a decade of easy credit terms, which fueled a boom in housing and commercial construction in Spain, Ireland, Portugal, and Greece (where the boom included the 2004 Olympics, among other projects). This period was not unlike the 1970s in Latin America. But as Herbert Stein, a chairman of the White House Council of Economic Advisers under Richard Nixon and Gerald Ford, famously observed, "If something cannot go on forever, it will stop." In 2009, the global financial crisis brought the happy early days of the euro to an abrupt end.

REIN IT IN

What the available evidence demonstrates is that economic inequality has been regulated over time by the behavior of global finance. The data even show that changes in levels of inequality within the smaller, open economies are closely related to exchange-rate movements. When currencies become overvalued, their countries are vulnerable to Dutch disease – eroding the competitiveness of industry – and to financial crisis. Financial crises and devaluations quickly reestablish the high level of inequality that human-development programs were meant to overcome.

Inequality is thus irreducibly a global and, contrary to what many economists like to think, macroeconomic issue. Labor-market considerations are secondary, crowded out by the dominant macro movements described above. As such, the only way to address inequality effectively is to bring the forces of financial instability, debt peonage, and predatory austerity under control. These forces can be tempered by financial regulation, a function of rich-country governments and central banks. But regulators are of course subject to capture by big finance, and central-bank mandates – whether to target full employment or only price stability – were drafted in an age of national economic policymaking. National central banks – as also the European Central Bank – are not set up to consider their policies' effects on peoples beyond their jurisdictional boundaries.

To be sure, there is still much that nation-states around the world can do to fight inequality when conditions permit. Useful measures include raising the minimum wage, strengthening trade unions, establishing social-insurance schemes, and building infrastructure and providing public goods. The problem is that these forms of progress can be – and regularly are – erased by financial crises and the subsequent imposition of severe austerity. This means that the capacity to reduce inequalities *sustainably* depends on the capacity for insulation from external financial pressures. However difficult it may be, the rest of the world needs to protect itself from the destabilizing forces of global finance.

In short, economic inequality is tied to the most unstable and unsustainable element of the world system, which is global finance. Achieving anything sustainably – especially, but not only, the reduction of extreme inequalities – requires a financial order that is broadly reformed and that can once again serve as a tool for other institutions and purposes, and not as their self-serving master. This is particularly important as humanity turns toward that other, more critical goal: the sustainability of human life on this planet. Global financial stability is a necessary step on the way to a clean-energy economy – as envisioned in the Green New Deal and similar proposals. At the end of the day, if we want to have a sustainable and civilized future, we need to get a grip on global finance.