

Bad and Good Inequality

Gary Becker (Jan 2011)

The Economist in its January 20th issue has an excellent discussion of many issues related to inequality within and between countries. I believe the main issues related to judging inequality and its changes over time come down to deciding whether the inequality is of the good or bad kind.

Many people, especially academics and other intellectuals, find the phrase “good inequality” jarring because they can hardly think of any aspect of inequality as being “good”. Yet a little thought makes clear that some types of economic inequality have great social value. For example, it would be hard to motivate the vast majority of individuals to exert much effort, including creative effort, if everyone had the same earnings, status, prestige, and other types of rewards. For example, many fewer individuals would engage in the hard work involved in finishing high school and going on to college if they did not expect their additional education to bring higher incomes, better health, more prestige, and better opportunities to marry.

On my first trip to China in 1981 I visited several factories in the Beijing area. All the employees in each factory received more or less the same pay, and they could hardly ever be fired for bad work or absenteeism. This was an extreme equalitarian approach to compensation, and the result was that no one worked hard, even though Chinese workers have traditionally been known for their diligence and energy. The picture was more or less the same in all of the factories I visited, and there was also little difference in pay between factories. Urban China was then highly equalitarian, but it was also extremely poor because of very low productivity. China’s economic miracle has been in good measure based on allowing much greater inequality in pay and incomes to motivate greater productivity in both urban and rural areas.

Bad inequality is the other side of good inequality, for it is inequality that reduces efficiency, productivity, and utility. About 80% of China’s vast population in 1981 lived in rural areas, yet it was then virtually impossible for anyone born in rural China to gain legal residence in a city, even though farm incomes averaged less than half of urban incomes. The result was a large inequality between urban and rural areas that lowered overall efficiency and productivity. Urban-rural inequality has if anything grown over time as China boomed during the past 30 years because of the rapid growth in urban incomes, and a slower growth in farm incomes. People born on farms are still at an artificial disadvantage since rural schools tend to be of low quality, and it is still not easy, although much easier than in the past, to gain legal residency in cities.

Earnings inequality in the United States and many other countries has increased greatly since the late 1970s, due in large measure to globalization and technological progress that raised the productivity of more educated and more skilled individuals. While the average American college graduate earned about a 40% premium over the average high school graduate in 1980, this premium increased to over 70% in 2000. The good side of this higher education-based earnings inequality is that it induced more young men, and especially more young women, to go to and finish college. The bad side is that many sufficiently able children could not take advantage of the greater returns from a college education because their parents did not prepare them to perform well in school, or they

went to bad schools, or they lacked the financing to attend college. As a result, the incomes of high school dropouts and of many high school graduates stagnated while incomes boomed for many persons who graduated college, and even more so for those with post graduate education.

Although inequality in many developing and developed countries grew a lot during the past 30 years, world income inequality actually greatly declined. This is because the per capita incomes of developing countries with big populations, including Brazil, China, India, and Indonesia, grew much more rapidly than did the per capita incomes of the rich Western countries and Japan. World poverty declined enormously, and so did the income gap between poorer and richer countries. This meant a large decline in the bad kind of world inequality.

A sizable fraction of the increased income and wealth inequality since the mid 1990s in the United States and some other rich countries was due to the explosion of incomes in the financial sector prior to the financial crisis. Most people are willing to accept huge incomes and vast amounts of wealth when they feel these are earned, such as with Steve Jobs, Bill Gates, and Warren Buffet. However, they are justifiably unhappy about large pay to CEOs who badly manage their companies, huge bonuses and stock options to executives who took unreasonable risks and then were bailed out by the Fed and the Treasury, and other big paydays for work that (perhaps unjustly) does not appear to be particularly socially valuable.

Controversy over inequality arises mainly because some types of inequality are not easily classified as good or bad. For example, would an increase in the marginal income tax rate from 35% to 45% on individuals earning over \$500,000 have much of an effect on how hard and how long they work, and their efforts to legally (and illegally) reduce the income they report to tax authorities? Those who support this kind of tax increase deny that it would have a big effect; while opponents are just as certain that it would significantly discourage effort. The evidence is far from conclusive, but studies by Edward Prescott, Richard Rogerson (see his "The Impact of Labor Taxes on Labor Supply": an International Perspective"), and others of the relation among different countries between the amount of work and average tax rates on earnings is convincing that tax rates in general have strong negative effects on effort. However, this evidence is silent on how much higher tax rates on individuals with very high incomes affect their effort and other behavior.

Some authors have claimed a sizable negative relation between social and economic inequality and the healthiness of a population (for an early influential work see MG Marmot's, "Understanding Social Inequalities in Health", 2003). I have no doubt that individuals who try but fail to climb the income and prestige ladder may suffer stress and other causes of poor health. On the other side, the stress and health of those who succeed tends to be improved by their success. The data on happiness and on health show conclusively that higher income persons are both happier and in much better health than others. Less clear is whether narrowing the degree of inequality in health and status, while maintaining the incomes and social ranking of the poor, would significantly improve overall health. I am doubtful, but the evidence is not yet conclusive.

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