

Remarks on the Political Economy of Inequality

Bank of England

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LSE

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- Research in political economy by economists has become a huge mainstream topic in the past 20 years
- Nobody would any longer seriously debate policy reform without studying the institutional framework that is needed to support that reform
 - "Well-executed policies that are 30 degrees off are much more effective than poorly-executed policies that are spot on." (Larry Summers (2004))
- We need to study "closed behavioural systems"
 - political and economic incentives studied side-by-side

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- ① There is no serious political economy in *Capital in the 21st Century*
- ② *Capital in the 21st Century* is essentially a work of political economy.
- My remarks today will try to unpack this and to use the insights in the book to reflect on how the political economy literature has engaged with the study of inequality.

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- ⑦ The art of political economy

- Is effective governance undermined by inequality?
- Basic compact of liberal democracies?
 - rich accept redistribution in exchange for security of property rights
- But depends on where inequality comes from and how economic and political power are used by those who have it.
- To understand this will require us to travel well beyond some of the concerns in the standard political economy approach.
- The UK has become increasingly dependent on income taxes levied on the rich:
 - top 1%: 1980: 11%, 1990: 15%, 2000: 20%, 2010: 25%
 - top 10%: 1980: 35%, 1990: 42%, 2000: 50%, 2010: 54%
 - this is largely a reflection of rising inequality rather than increasing progressivity.
- What is the prognosis for taxing the rich?

- Heavy focus on understanding the consequences of political institutions for policy
 - Inequality affects policy within an institutional setting
 - e.g. redistribution by a median voter
 - Inequality also shapes the set of institutions which emerge and what can be sustained
 - e.g. institutional structures in high inequality polities such as the Gulf States
 - Forces such as revolutions and coups shape the dynamics of institutional change.
- This has led to huge progress in our understanding.

- Redistribution through an income tax with heterogeneous earning ability w_1, \dots, w_N
- Variable labor supply: l_i with quasi-linear preferences: $z_i - \psi(l_i)$.
- Government budget constraint:

$$tY = T$$

where T is demogrant and $Y = \frac{1}{N} \sum w_i l_i$ is mean aggregate labor earnings.

- Suppose that the median vote with wages w_m is decisive, then the politically optimal income tax solves

$$t^* = \frac{Y - y_m}{-\partial Y / \partial t} = \frac{\text{mean} - \text{median income}}{\text{extent to which taxes discourage income generation}}$$

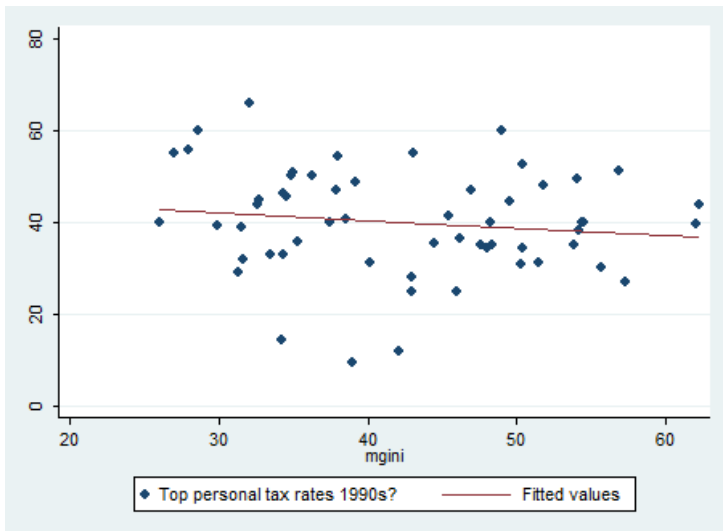
- So skewness in the earnings distribution and incentives need to be balanced.

The US over time

(from Angus Deaton)



Is there a positive correlation between taxation and inequality?



Model Predicts that Incentives Matter

- Standard labor supply incentives
 - small effects for prime earners
 - but participation for some groups important
 - BUT labor supply angle would tend to suggest that there is a lot more scope for raising revenue from the rich.
- Factors which affect avoidance and evasion
 - total income elasticities bigger than justified by labor supply responses
 - converting income across tax bases
- Greater international mobility
 - within and between countries

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- I will discuss the following issues:
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 - ④ Preferences/values/norms are given

Beyond the Median Voter

- Median voter predictions are not taken particularly seriously for a variety of reasons.
 - traditionally thought of as an issue in non-democratic society
- How does economic power translate into political power in liberal democracies?
- Classic Marxist critique of democracy, cf Lenin in *The State and Revolution*:

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- "The most important political fact about advanced capitalist societies...is the continued existence in them of private and ever more concentrated economic power. As a result of that power, the men – owners and controllers – in whose hands it lies enjoy a massive preponderance in society, in the political system, and in the determination of the state's policy and actions." Milliband

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- Ralph Milliband in *The State in Capitalist Society* (1973, page 237)

- How do de jure and de facto power structures interact?
 - example of post-bellum south in the U.S.
- State capture can be modeled as a lobbying game
 - policies are determined by those with deep pockets
 - emasculates the electoral process
 - control of the media and electoral campaigning
- Trivial summary:

$$t^* = \frac{Y - y_d}{-\partial Y / \partial t}$$

where $y_d > y_m$.

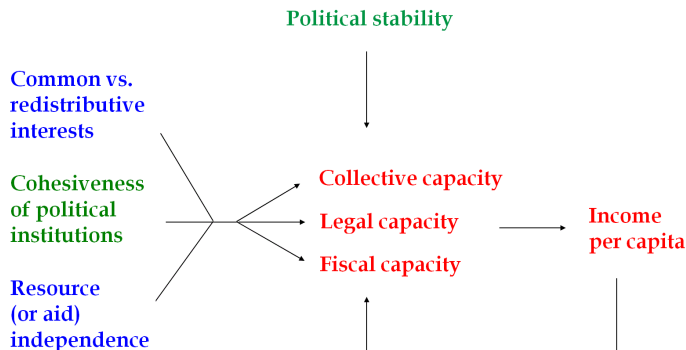
Endogenous State Capacity

- How does inequality affect operation of and development of institutions?
 - Engerman and Sokoloff
- History of the state can be viewed through the growth of state capacities.
- Such capacities are a fundamental constraint on state action
- Built by conscious decisions
 - monitoring and tax compliance
 - redistributive programs (the social state)
- Incentives to create capacities depend on interests, power structures and institutions:
 - Institutions for acquiring and exercising power
 - Importance of cohesive institutions

Three dimensions of State Capacity

- Legal capacity
 - contract enforcement (from Doing Business)
- Fiscal capacity
 - income tax share in total taxes
- Collective capacity
 - life expectancy and human capital

Complementaries and common determinants



- Cohesive states
 - defy the Marxist critique?
 - Western European welfare capitalism
- Special interest states
 - come in many flavors (Anna Karenina)
 - China
 - Russia
 - Gulf states
- Weak states
 - The norm in history
 - But mainly in Africa today
 - But also characterizes supra-national institutions

Exhibit I: State Capacity in LAC

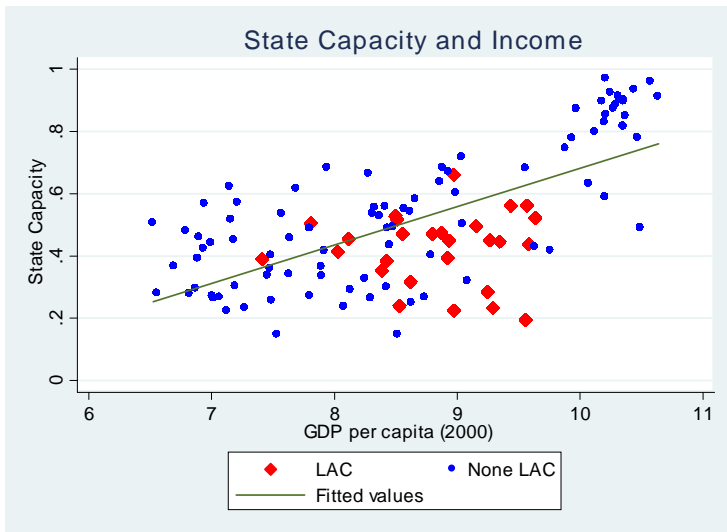


Exhibit IIa: State Capacity and the Gini Coefficient

Unconditional

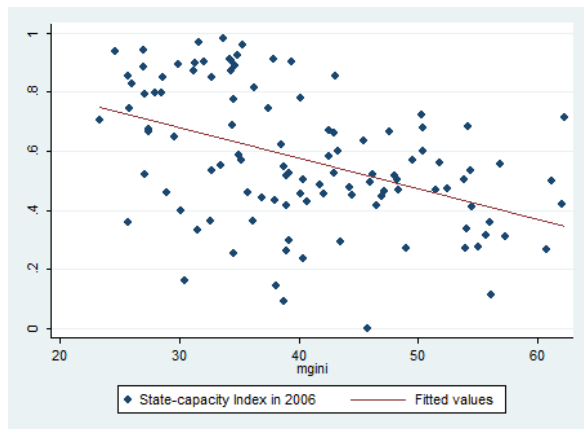
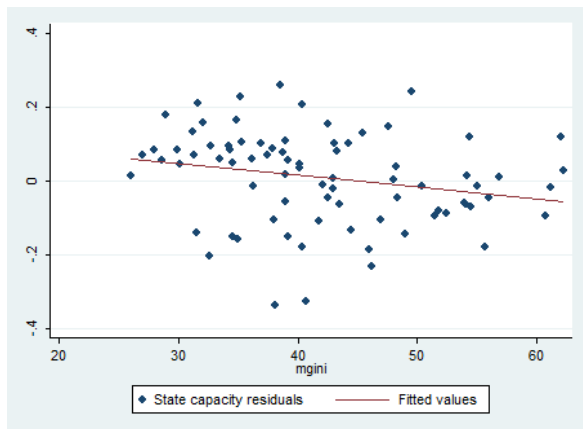


Exhibit IIb: State Capacity and the Gini Coefficient

Conditional on income and executive constraints



Why Does Inequality Matter?

- Affects the extent of common interests, making it harder to achieve common interests.
 - interacts with institutions
- This can skew the priorities of the state:
 - Rich want strong legal capacity (in some dimensions?)
 - Weaker fiscal capacity
 - Less obvious what elites want with regard to collective capacity
 - do universalistic norms emerge?

- Can one-off interventions have long-lived effects?
 - land redistribution in Taiwan and South Korea
 - Thatcher/Reagan deregulations
- "General equilibrium" political economy effects are poorly understood.
 - "Trojan horse" policies
- Knowledge of how to study the dynamics of institutions is also imperfect.

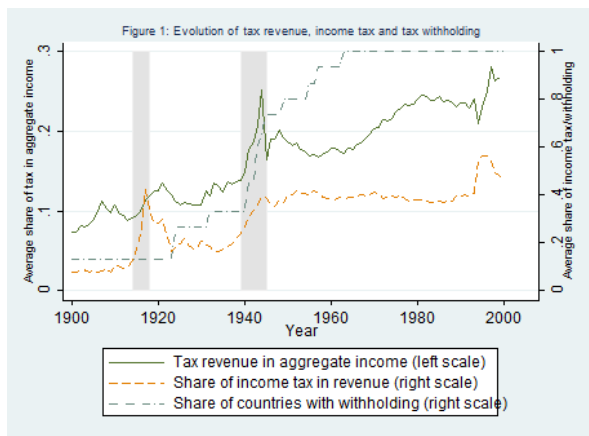
- Core framework is based on earnings inequality
 - depends on distribution of
 - human capital
 - access to physical assets (land, structures and financial capital)
 - competitiveness/flexibility of labour and product markets
 - discrimination
 - public sector employment policies
- What about policies which act directly on these?
 - in standard framework, it is conceptually no different to tax-based redistribution

Political Economy of Wealth Taxation

- Even the Swedes abolished their wealth tax
 - it was never more than 0.4% of GDP and 0.16% by the end (2006 was last year)
 - a problem in fiscal capacity
 - issues of monitoring and compliance
- Indirect forms of wealth taxation
 - housing as in UK
 - soft target with government-induced scarcity of housing
 - inheritance
 - riddled with exemptions
- Is limited wealth taxation a puzzle given skewness of the distribution of wealth?

Shifting values

- Not always part of what economists study
- But collective obligation and entitlement is central to endogenous common interests
 - Historically war played a defining role



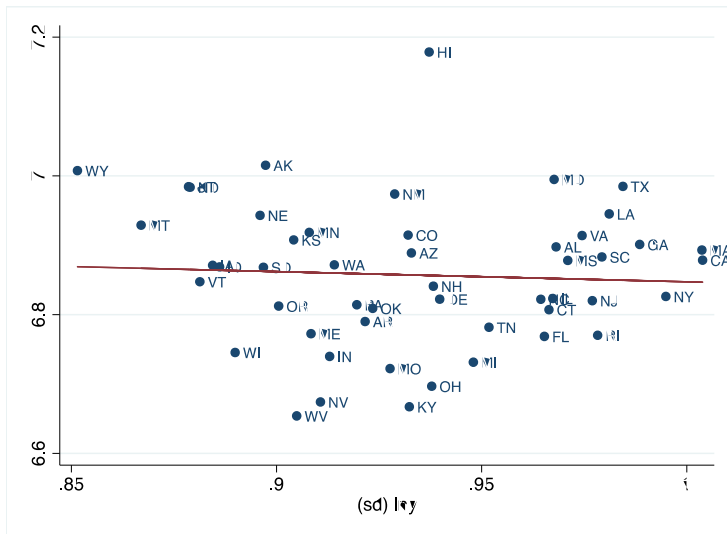
Shifting values and recognizing shared obligations

- Creating universalistic norms of citizenship
- How do the rich in society perceive their obligations to others?
- Participatory transfer programs with reciprocal obligations
 - beyond "them and us"
- Key debate about funding social insurance
 - also focus on lifetime consequences of redistribution
- Catalyst to cohesive institutions?

Does Well-Being Respond to Inequality?

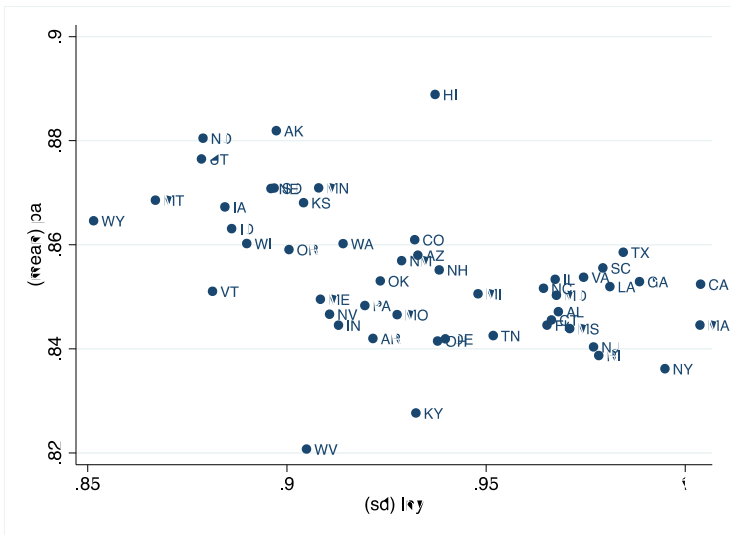
- Key dimension in debates about how inequality drives public action.
- More generally, reactions to inequality are interesting to study
- How much do people actually care about inequality and what determines this?
 - There is very little evidence
 - And also debates about how to look at well-being
 - ladder of life
 - positive and negative affect (Kahneman)
- The following three Figures come from recent preliminary work by Angus Deaton
 - they use cross state variation from the US

Ladder of Life and Inequality (U.S. States)



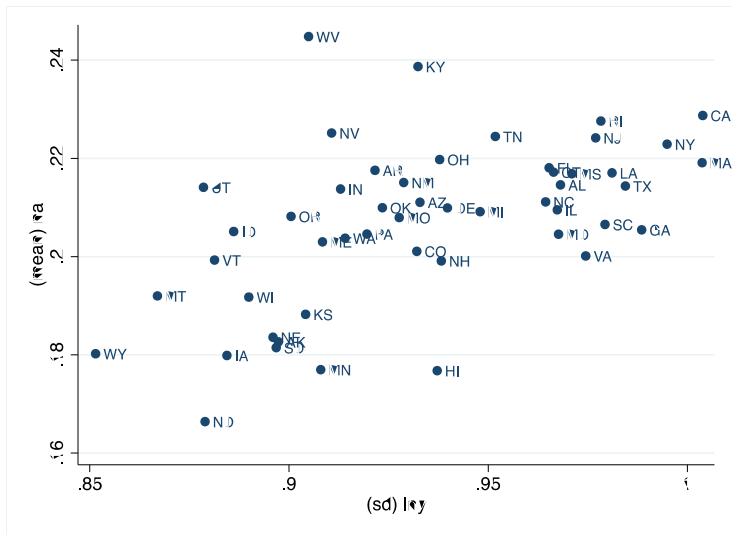
Positive Affect and Inequality (U.S. States)

(average of smiling, enjoyment, and happiness each day)



Negative Affect and Inequality (U.S. States)

(sadness and worry each day)

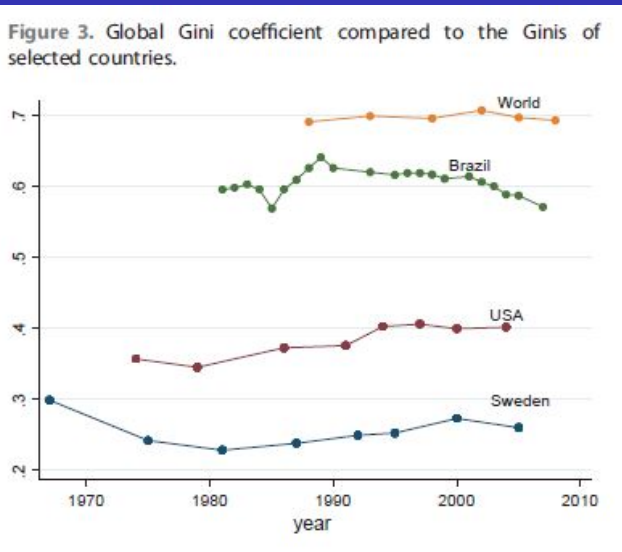


The Well-being and Inequality Agenda

- There is much to be done in understanding how inequality affects people's lives
- There is then a question of how this links to public action and changing values
- Economists tend to focus on the impact on material well-being
- But the political economy consequences depends on how it shifts attitudes and policy preferences

Global Issues

Figure from Branko Milanovic (2012)



- Taxation above the nation state looks like a remote possibility
 - EU has not even managed to enforce a common tax base let alone common tax policies
 - But the EU lacks legitimate democratic institutions which would support common policies in many areas
 - Questions around the sequencing of reforms to create supra-national fiscal capacity are interesting
 - first step is to shift norms?
- Action beyond the EU seems even more remote
 - Lacks both values
 - the cosmopolitan citizenship agenda (Pogge)
 - And lacks legitimacy for action without cooperation from nation states

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 - I think that this is what Thomas is referring to when he mentions "a multi-polar political economy" in the preface of his book.

The Art of Political Economy

- Action to address growing inequality is more likely than not to come from the actions of nation states
 - currently global structures are like a "weak state"
- Political economy needs to study
 - Political incentives within an institutional setting
 - How institutions change and evolve
 - The interplay between norms/values/preferences and economics/politics
- Will require mixing insights from theory, data and history.
- Part IV of capital is the least developed and most speculative part of the book so plenty to be done to follow up on the issues discussed there.