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## Inequality: Trends, Harms and New Agendas

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September 2015

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# 1 Introduction

The notion that inequality matters has spread and gained currency over the last years. After decades of neglect, inequality is finally ‘in from the cold’ (Atkinson 1997), and firmly at the centre of research and policy agendas. This renewed interest in inequality is a response to increases in income and wealth inequality observed in a significant number of industrialised and developing countries (Atkinson and Piketty 2007, 2010; Milanovic 2002, 2011; OECD 2008, 2011a, 2011b; Oxfam 2014; Piketty 2013; UNDP 2013). That trend is not universal. The most significant exceptions seem to be in Latin America. This has traditionally been a region of high inequality. Yet in recent years, income inequality has diminished in several countries in the region, including Brazil (Cornia 2014; Lopez-Calva and Lustig 2010; Lustig, Lopez-Calva and Ortiz-Juarez 2012). Elsewhere, the evidence – which is often patchy and of limited reliability – points to an overall growth in income and wealth inequalities within nations since the late 1970s, with no sign of curtailment. The statistics are now well-known among academics, policy actors and the general public alike. In the US, the top 1 per cent owns around 20 per cent of total national income (15 per cent in the UK) and over 30 per cent of the country’s wealth (just under 30 per cent in the UK) (Piketty 2013). About 9 per cent of the world population receives one-half of global income, while the bottom half of the world population receives 7 per cent of global income (Milanovic 2005, 2011).

Why should we care about this rise in income and wealth inequality? Building on recent research on inequality across the social sciences, we argue in this paper that income and wealth inequality matters because it causes inefficiency and harmful effects, hindering the collective and political capacity of societies, markets and states to deal with a myriad of issues around the provision of public goods and justice. The paper focuses on within-country inequalities.<sup>1</sup> We discuss in particular how the consequences of inequality are shaped by specific mechanisms that operate at the national, community and individual levels. These mechanisms intersect in complex ways and tend to be persistent and difficult to shift. Altering them requires moving the focus of research to better understanding the consequences of inequality. It also requires rethinking how political institutions, markets and civil society can operate together – in developed and low-income countries alike – to curb the devastating effects of rising inequality. Before dealing with this argument in detail, we discuss first recent trends in inequality in industrialised and developing countries.

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<sup>1</sup> The mechanisms that shape global inequalities are discussed in Milanovic (2005).

## 2 The ‘new’ rise in inequality

The statistical evidence on inequality is more comprehensive and reliable for the category of countries that until recently were confidently labelled ‘developed’ or ‘industrialised’ – which we will term the ‘old industrial countries’. For those countries, we also have a broad political economy explanation of the reasons for the rise in inequality since the 1970s or 1980s. That explanation is based in large part on an appreciation of why income and wealth inequality had previously declined substantially. In other words, the ‘new inequality’ in today’s industrialised countries is in large degree a reversion to the ‘old inequality’ of the early years of the twentieth century. The story for developing countries is more patchy and complex. We discuss in Section 2.1 some of the reasons underlying the reduction of inequalities in the period post-First World War in the old industrial countries and recent rises in inequality since the 1970s. We turn our attention to developing countries in Section 2.2.

### 2.1 Recent trends in inequality in old industrial countries

Inequality in the old industrial countries of Europe and the US was historically quite high until the First World War, when it started to reduce drastically. Why did it decline so much, broadly over the period 1918 to 1980? Three sets of factors were particularly important: relatively low levels of unemployment, the enhanced political power of organised labour, and ‘solidarity-promoting’ wars:<sup>2</sup>

#### 2.1.1 Low levels of unemployment

A combination of factors resulted in a relative scarcity of labour, low unemployment, upward pressures on real wage rates, and thus income redistribution towards the populations dependent principally on earnings from wage employment:

- Rates of population growth declined after the ‘demographic transitions’ of the late nineteenth and early twentieth century.
- Manufacturing expanded absolutely and, relative to other sectors of the economy, absorbed a great deal of (male) labour.
- Migration to areas of overseas European settlement where labour was scarce – especially to North America and Australasia, also Argentina – restricted the growth of the labour force in Europe.

#### 2.1.2 The political power of organised labour

Organised labour acquired considerable political power, through the following broad sequence:

- Industrial workers concentrated in large manufacturing plants (and in railways, ports and mines) provided the basis for strong trade unions and for a strong sense of class or occupational interest defined principally in material terms.
- This working-class organisation and consciousness was translated into political power, eventually through two distinct channels. On the one hand, social democratic parties entered legislatures and governments, stimulating initiatives to increase the bargaining power of trade unions, improve working conditions, and increase government tax revenues and spend them on a range of social programmes,

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<sup>2</sup> In addition, and mainly in the second half of the twentieth century, the emergence of the (large) publicly quoted limited liability company as the standard form of business enterprise, and the consequent expansion of share market capitalisations (relative to gross domestic product) provided opportunities for substantial numbers of relatively low-income earners to share in the profits of capitalist enterprise, notably through pension funds and unit trusts.

including pensions, unemployment protection and public health and education provision. On the other hand, communist rule in the Soviet Union and China provided direct and indirect competition for the political allegiance of the working class in the rest of the world, and motivated ruling elites to embrace social democratic policies.

- Large-scale public spending on social programmes created groups with a vested interest in their maintenance and expansion: the (unionised) public sector employees who provided them as well as the direct beneficiaries.

### 2.1.3 Solidarity-promoting wars

The First World War (1914–18) and Second World War (1939–45) involved virtually all the old industrial nations. They were extended conflicts between alliances of nation states that had deep and pervasive impacts on daily lives, economic organisation and socio-political relationships through three main mechanisms:

- Advances in transport and logistics made it possible to mobilise large proportions of the male population in direct combat and combat-support operations.
- Significant proportions of the non-combatant populations, including many women, were mobilised into the employed labour force to maintain the high levels of manufacturing production needed to feed the war machines.
- Large-scale aerial bombing meant that non-combatants located far from ‘the front’ were potential casualties.

This kind of ‘total’ or ‘industrial’ warfare generated political pressures for more inclusive socioeconomic policies.

### 2.1.4 Inequality returns

These equality-inducing factors interacted with one another in complex ways, with varying impact over time and in different places. All began to weaken in the later twentieth century, especially from around 1970 (Atkinson 2014a; Milanovic 2005; Piketty 2013; Stiglitz 2013):

- **Deindustrialisation:** Employment shifted out of factories and manufacturing (and railways, ports and mines) into services and more differentiated jobs in smaller workplaces. This weakened trade unions and reduced the class-consciousness of employees.
- **Globalisation** exposed the labour force to wage competition from elsewhere in the world, both through the shift of industrial production to Asia and the increased scope for legal and illegal immigration into the old industrialised countries.
- **The collapse of international communism** after 1990 undermined the credibility of any threat that a politically disaffected working class would be able to find political and material support abroad from geopolitical competitors to the governments of the old industrialised countries. The more recent generations of rejectionist radical political movements communicate and mobilise more through the internet and religious and ethnic organisations than through direct workplace interactions, and construct their identities more through cultural and religious affinity than through occupational similarities. Unlike either communism or social democracy, they do not consistently or coherently articulate or promote the interests of labour in relation to capital.
- **Warfare** is no longer total and ‘mobilising’ as it was in the early and mid-twentieth century. Leaving aside nuclear war, which would render all other concerns redundant, the contemporary war for which the governments of the old industrialised countries prepare, in varying combinations: (i) is conducted by small numbers of highly trained military specialists using high technology, (ii) involves long distance, selective ‘strikes’ delivered aerially and informed by remote surveillance

technologies, and (iii) through the use of cyber warfare, terrorism, insurgency and counter-insurgency techniques, pervades 'civilian' populations and institutions and erodes the distinction between war and 'politics pursued by other means'. Distinctions between 'us' and 'them' and between 'war' and 'peace' helped to generate a commitment to fuller citizenship from the experience of the First and Second World Wars. Those distinctions are decreasingly clear.

- **Large-scale outsourcing of public service provision** in some industrialised countries has weakened public sector trade unions and undermined the political capacity of public sector employees to protect both their own employment conditions and high levels of public service provision.
- **Longevity** began to put major fiscal pressures on governments' social expenditures. It is increasingly hard to provide for the old (with their increasing needs for increasingly expensive medical and social care), for the growing numbers of the 'working poor' whose wages will not support families, and for the young, under-educated, under-employed, and often under-housed. Among the various groups that are increasingly perceived to be in competition for public social spending, the old are generally electorally more influential.
- **Financialisation:** The expansion of (often under-regulated and globalised) financial sectors in many of the old industrial countries has contributed to growing income inequality through several channels. Directly, globalised financial activities generate very high incomes for a small number of people. Indirectly, the emergence of a small class of mega-rich individuals has contributed to a recent flight from public share market listings. Existing companies have been using profits to buy back their own shares. New enterprises are increasingly financed by private equity. There are decreasing opportunities for 'average citizens' to buy into capitalist profits for pension purposes through various kinds of share market funds.
- **Changes in gender relations:** The large-scale entry of women into the formal workforce, combined with some movement towards equal pay for men and women, appears to be leading to increased inequality through 'assortative mating', i.e. women and men of similar income levels partnering with one another. Assortative mating in turn intensifies intergenerational inequality, by further concentrating the cultural/educational/human capital that enables young people to be more successful in formal education and in accessing more rewarding careers.
- **Increases in property prices:** Especially in the English-speaking old industrialised countries, political parties have increasingly sought electoral support through measures that are formally justified in terms of an inclusive and democratic narrative ('property-owning democracy'), but whose actual effect is to redistribute wealth and income to owners of property, especially housing. The instruments include mortgage subsidies, building maintenance subsidies, tight restrictions on new construction, and reductions in property taxes of various kinds, including capital gains and inheritance/transfer taxes. The effects include the inflation of real estate prices; increased rental housing costs for those unable to purchase property; and a shift of income and wealth to those who have it.

The intensity and nature of these processes has varied among the old industrialised countries, and among different locations within individual countries. Several of these processes have impacted most strongly on the UK and the US – the countries in which increases in inequality are especially marked. Further, the trend towards increasing inequality has not been linear. Over some periods of time and in some contexts, wealth and/or income inequality decreases. For example, the low returns to capital that have characterised many parts of the world economy since 2008 imply, when taken in isolation, a shift towards more income equality.

The biggest uncertainty about the future of inequality in the old industrialised countries lies in the effect of technological change on the demand for labour. Many jobs have been eliminated through recent changes in technology. They have generally been low-skilled jobs, and the effect on income distribution is probably negative. But labour-displacing technology is not in itself new. It is still unclear whether the net effect of recent technological change on employment – once we take into account the ways in which it also directly and indirectly generates employment – is positive or negative. Sceptics might claim that anxiety about the possibility of large-scale net displacement of labour by technology will again prove to be misplaced. Conversely, claims that computerisation is about to displace large amounts of labour currently viewed as skilled – or that ‘jobless growth’ is now likely – cannot be dismissed.

Partly because of this uncertainty about the effects of technology on employment, it is not yet clear whether we should characterise this recent increase in inequality in the old industrial countries as (i) a departure from the historical norm, (ii) a reversion to the norm, or (iii) something which we cannot yet evaluate. There is a significant chance that it is a reversion to the historical norm, i.e. that in the old industrial nations inequality will tend to persist or intensify for the foreseeable future (Piketty 2013). Most of the reasons listed above for the recent growth in inequality are relatively deeply rooted in changes in the structure of economies, labour markets and warfare. We explain below that a similar degree of pessimism seems appropriate in relation to ‘developing countries’, although the statistical basis for that conclusion is less strong, the mechanisms causing inequality are to some extent different, and the degree of inter-country diversity is probably larger.

## **2.2 Recent trends in inequality in developing countries**

In the section above, we explained why inequality has been increasing in the old industrial countries, and why it is likely to increase further. But what about the rest of the world – a large grouping of highly disparate nations that we label ‘developing countries’? We can begin with some broad conclusions and cautions:

- It is difficult to draw conclusions about inequality trends in developing countries because the statistical base is particularly weak.<sup>3</sup>
- Over the past century or longer, levels of inequality in wealth and income have consistently been higher in poorer countries. There are probably many reasons for this. Two of the more consistent are that (i) the contemporary political and economic institutions of many developing countries were constructed under colonial rule in a context in which relatively small elites dominated their societies and economies; and (ii) small elites often remain powerful, sometimes deriving much of their power from the ways in which they act as political and economic ‘gatekeepers’ between their own populations and global institutions and markets.
- The results of recent attempts to trace macro-level changes in inequality in developing countries are ambiguous. UNDP (2013) reports that income inequality increased by 11 per cent in developing countries between 1990 and 2010, taking into account population size. This implies that in 2010 more than 75 per cent of households in developing countries were living in societies where income was more unequally distributed than it was in the 1990s. By contrast, Ravallion (2014) reports an overall reduction in inequality across developing countries in the period between 1980 and 2010, followed by rises (with the exception of Latin America) between 2005 and 2010.

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<sup>3</sup> One exception is Atkinson (2014b). Solt (2009, 2014) has compiled the most complete dataset on income inequality covering 174 countries.

The most important conclusion is that trends in inequality in developing countries are likely to be especially disparate. This is partly because the countries are themselves so disparate: there are more socio-political and economic differences between Brazil, Dubai, South Sudan and Vietnam than between Australia, Denmark and Italy. But it is also because politics plays a larger and more direct role in the distribution of material resources in developing countries than in most of the old industrial countries. The results of directly political resource allocation mechanisms tend to be relatively unstable. Political changes might bring about substantial shifts in the distribution of income and wealth.

It is easiest to explain this through a simple schema: a continuum relating to the extent to which the socioeconomic mechanisms that distribute and redistribute material resources either directly involve or are insulated from the direct application of military force or political power:

- **A. Market distribution.** Here material resources are allocated through markets, especially markets for capital and labour. Those markets are regulated principally through the rule of law. Political power/military force is deployed principally to create or maintain the more fundamental institutions on which the market system is based. This distribution mechanism occupies centre stage in Piketty's (2013) account of the growth of inequality in three old industrial nations.
- **B. Market-mediated rent-taking.** Markets still play a major role in shaping distribution, but political power/military force is deployed to shape market outcomes in order to advantage particular interests and actors. A clear recent case concerns the regulation of the financial sector before the 2008 financial crises. Large financial institutions used their political financing and lobbying power to fend off initiatives to regulate the sector to discourage the kind of lending and borrowing behaviour that would lead to serious systemic risk. The success of this lobbying enabled them to take large risks and make large profits. That behaviour contributed substantially to the financial crisis. Because the threat was systemic, it was governments and taxpayers who incurred most of the costs of bailing out large financial institutions (Johnson and Kwak 2010).
- **C. Direct political and military appropriation.** Holders of political and military power obtain assets and incomes through use of *force majeure*: looting, conquering territories, taking over properties, obliging owners of private companies to donate equity shares, taking a proportion of official revenue collections, taking control of mines and oil wells, collecting a percentage on public sector contracts, ensuring market monopolies for companies owned by politicians or the military, allocating state land or under-priced privatisation assets to well-connected people, granting tax exemptions in return for some kind of political financing, and so forth.

The more directly political mechanisms for distributing material resources – mechanisms B and C – are relatively more common in developing countries. In some cases, they are pervasive. Because the activities are either illegal or illegitimate, information on the incomes and wealth acquired in this way is generally very difficult to obtain. Much of the wealth is transferred overseas to tax havens and to property markets in the old industrial countries. Some reappears in its country of origin as 'foreign investment'. Concern about the levels of these 'illicit financial flows' from developing countries is currently high (High Level Panel 2014).

There are insufficient reliable data of adequate historical depth for us to draw general conclusion about general trends in inequality in developing countries. We can at best draw conclusions about a limited number of cases. In the remainder of this section, we explore four issues that are likely to be especially significant in shaping future trends in material inequality:

### **2.2.1 Rents from natural resource extraction<sup>4</sup>**

The economies of many developing countries are dominated by natural resource extraction: oil, natural gas and mining products. Many of these extractive activities generate very high *rents*, i.e. receipts that are well in excess of the costs of production. World market prices for oil, gas and mining products fluctuate considerably. But even when they have stood at relatively modest levels, as in much of the 1990s, rents from extractive sectors still constitute a significant fraction of the gross domestic product (GDP) of many countries. That is especially true of the Caspian Basin and Middle East regions. From a political economy perspective, the key point about rents is that they could all be appropriated through criminal, political or military means yet the actual producer would still earn sufficient profit to make it worthwhile to continue producing. Natural resource rents are therefore the object of a great deal of political and military competition. Depending on circumstances, they tend to generate both relatively authoritarian and militaristic rule and regional separatist movements. In almost all countries with a natural resource extraction sector, governments get their hands on a significant fraction of the available rent through one mechanism or another. They are generally much more successful in doing this in the case of oil and gas than in the case of mining activities. The extent to which governments actually redistribute that surplus to their populations varies widely. Generally speaking, they do not redistribute very fairly. Large proportions of rent are spent either on military or political intelligence activities, or on increasing the comfort levels of the political elite. And significant fractions go overseas as illicit financial flows.

Natural resource extraction, especially mining, expanded considerably in many low-income developing countries over the last decade, especially in sub-Saharan Africa. This trend is likely to continue: to date there has been relatively little geological exploration in most of sub-Saharan Africa. It is likely that more intensive exploration will lead a number of other countries to join Mozambique, Tanzania and Uganda as new natural resource exporters. There are active campaigns in those countries to try to ensure that the fruits of this new natural resource extraction are widely shared. Similarly, there are growing efforts to ensure that mining companies pay a reasonable amount of taxes in the countries where they are conducting their operations. At present, they in some cases get off very lightly. Those taxing decisions, like the other decisions about the distribution of the benefits from natural resource extraction, are intensely political – with various kinds of militaries often playing a significant role. The outcome of these political competitions will make a significant difference to future levels of quality in a significant number of developing countries.

### **2.2.2 Real estate**

Real estate of all kinds – especially urban real estate but also strategic locations for commercial investment (ports, hotels, power stations, etc.) and agricultural land – is increasing in relative value particularly fast in many lower-income countries as a result of combinations of fast population growth, rapid urbanisation, relatively fast rates of economic growth and globalisation (that makes real estate in low-income locations more accessible to and useable by people and companies located in high-income regions). Land values in the centre of Addis Ababa, in one of the poorest countries in the world, are close to those of some major European cities. Governments exercise considerable influence over patterns of real estate development, either because they own a great deal of the land (especially in many low-income countries) or because their authorisation and cooperation is essential if large-scale real estate investment is to take place. People exercising political power are therefore well placed to profit from real estate transactions and development. They can capture assets, sometimes while simultaneously depriving other, poor, people through ‘land grabs’ of various kinds. Information on these processes is fragmentary. Land registries rarely contain comprehensive, transparent information on property transactions. One of the most

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<sup>4</sup> This paragraph is based on a very large research literature on the ‘resource curse’.

useful sources is investigative journalism. But the risks of enquiring into these issues are high. These land grabs therefore generate relatively little attention from scholars trying to explore or measure inequality. It seems likely that these processes of redistribution of real estate resources may be a significant cause of current and future changes in patterns of equality in low-income countries in particular.

### **2.2.3 Conflict and drugs**

A significant proportion of low-income countries are afflicted by weak formal political institutions and more or less open and endemic conflict – conflict that is sometimes largely ‘internal’ but often spills across borders and relates to competition over control of transnational activities such as smuggling and the drug trade. Such situations are characterised by rent-taking in its most basic forms: the use of violence to redistribute material resources (see North, Wallis and Weingast 2009). While such activities often consume economic resources and discourage investment, they are likely also to have significant effects on wealth and income distribution. They are very hard to measure.

### **2.2.4 Manufacturing, globalisation and labour**

The main cause of the decrease in inequality in the old industrialised countries in the earlier part of the twentieth century was the emergence of manufacturing and other associated economic sectors that absorbed a great deal of labour (in large workplaces). Directly and indirectly, this empowered the working class both in the labour market and in politics (see Section 2.1). One of the reasons for the more recent rise of inequality in the industrialised countries is that much of this manufacturing activity has moved to Asia, notably but not only to China. Should we not then expect that those equalising processes observed in the old industrialised countries in the earlier twentieth century will also take place in China and other low-income countries that are developing significant manufacturing sectors? The question is clearly very important. The answers to date are, however, ambiguous.

In the 1960s, 1970s and 1980s, the South Korean and Taiwanese economies grew very fast. They leaped the per capita income gap that seemed at that time to clearly separate the industrialised from the low-income, more agrarian economies. And the effects of this economic growth on wealth and income distribution seemed broadly to validate expectations from the economic history of the ‘old’ industrialised countries. Labour was absorbed in manufacturing. Once labour became scarce, real wages grew relatively fast. Overall, the distribution of income and wealth seems either to have improved in South Korea and Taiwan during their rapid industrialisation, or at least not to have deteriorated significantly. By contrast, the consequences of the industrialisation of China in the period since the late 1980s have been very different. Initially, in China as in South Korea and Taiwan, wealth and income were distributed relatively equally by global standards. Unlike in South Korea and Taiwan, Chinese levels of inequality then increased very rapidly. Part of the explanation seems to lie in the relatively abundant reserve of labour that existed in rural China, and the perpetuation of the *hukou* (household registration) system that deprived the urban workforce of rural origin normal citizenship rights in urban areas. Another part lies in the capacity of Communist Party elites to use their political privileges to take a major stake in new capitalist enterprise. Nevertheless, the contrast with the South Korean and Taiwanese experiences is worrying. It is only in very recent years that the manufacturing labour market in China has become noticeably ‘tight’. There has been real upward pressure on wage rates, and autonomous trade union activity has emerged at the same time.

So is China now experiencing the ‘standard’ transition to a more equal society, driven by the emergence of a working class empowered both in the labour market and politically and organisationally? Was the very rapid growth in inequality over the past three decades simply a ‘blip’ that will be eradicated over time? We cannot yet know the answer to those questions. However, leaving aside any readings of the likely future of Chinese politics, there is reason

for pessimism, i.e. to believe that there will be no great shift back towards more equality in China. The reason is that Chinese employers – and transnational companies with operations there – have already to some degree pre-empted the problem of rising labour costs by moving low-skilled jobs to other countries, especially in South East Asia, including to places where forced labour is still sometimes employed.<sup>5</sup> In essence, the kind of ‘off-shoring’ of jobs that was new and contentious in the ‘old’ industrialised countries only about two decades ago is now being practised from China. This raises the possibility that the strategy could be repeated sequentially, with low-skilled jobs going on very disadvantageous terms to the regions of the greatest labour surplus. Even if low-skill manufacturing jobs do not largely disappear, as predicted in the light of the emergence of technologies such as additive manufacturing and robotics, there are rather dim prospects that they will mop up the surplus labour that exists in India and much of sub-Saharan Africa. The process also throws doubt on the hope that the recent tightening of the labour market in China will lead to a substantial reduction of income inequalities there.

We can be almost certain of one thing: there are unlikely to be clear trends in inequality across any large grouping of countries labelled as ‘low income’, ‘developing’, and so forth. The drivers of equality and inequality in low-income countries are and will remain very diverse, as will the outcomes. And, unless there is a major reversal in economic globalisation, inequality trends in individual countries are likely to be increasingly shaped by their international economic and political relationships.

We now turn to the existing literature on inequality and ask how recent research may help us understand these recent trends in inequality across the world and point to ways of reducing it.

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<sup>5</sup> *The Economist* (2015: 15) talks of Factory Asia – a strong network of regional supply chains with China at its centre.

### 3 A brief history of inequality research

Research on income and wealth inequality goes back several centuries. The distribution of resources was at the centre of the classical economics writings of David Ricardo, Adam Smith and Karl Marx. This early literature on the causes and evolution of inequality focused on mapping and understanding shares of factors of production – capital and labour – in aggregate national incomes. As labour markets developed, the literature became more concerned with the personal distributions of incomes and their relationship with overall patterns of development and economic growth. One seminal example is the work of Kuznets (1955), which postulated the well-known inverted-U relationship between economic development and income inequality, whereby inequality tends to rise in the initial stages of development and decrease once a certain level of economic development has been achieved.

Another large body of literature has dealt with defining the concept of inequality – inequality of what? – as famously discussed in Sen (1977). While the first generation of research focused on material inequalities, studies beyond income and wealth inequality grew substantially (Sen 1973, 1983, 1985; Nussbaum and Sen 1993; Anand and Sen 1993; Narayan *et al.* 2000), encompassing work on health inequalities (e.g. Deaton 2013; Gakidou, Murray and Frenk 2000; Wagstaff 2000), education inequalities (e.g. Checchi 2000; Thomas, Wang and Fan 2000), and inequalities in political participation (Cederman, Gleditsch and Buhaug 2013). Alongside these studies, a substantial body of research developed theoretical frameworks for the measurement of multidimensional inequality (Atkinson and Bourguignon 1982, 1987; Maasoumi 1986; Tsui 1995, 1999). Discussions have also emerged around the notions of vertical versus horizontal inequality and within-group versus between-group inequality (Sen 1973; Stewart 2000; Tilly 1998), as well as the links and intersections between vertical inequality and inequalities across groups, identities, social categories and geographical locations (Kabeer 2010; Kanbur and Haddad 1990, 1994; Kanbur and Venables 2005; Narayan *et al.* 2000; Sen 1999; Stewart, Jolly and Cornia 1987). Other work at the crossroads between economics and philosophy reflected on what inequalities may matter (Sen 1985; Rawls 1971; Roemer 1996), generating an important debate around the importance of inequalities of opportunities versus inequalities of outcomes (e.g. Roemer 1996, 1998).

The literature on the measurement of inequality is vast, and has given rise to a wide range of indices (see Atkinson 1970; Atkinson and Bourguignon 2000, 2015; Sen 1973). Most measurements of global and national-level inequality (whether on income or other underlying variables) have been based on either household surveys or on administrative data (census and national accounts). Some of these data have suffered from several limitations, well documented in the literature (Atkinson and Bourguignon 2000, 2015; Atkinson and Piketty 2007, 2010; Milanovic 2005), notably in terms of historical perspective and under-representation of top incomes and wealth. Recent work by Anthony Atkinson, Thomas Piketty and Emmanuel Saez has sought to address some of these limitations (Atkinson and Piketty 2007, 2010; Atkinson, Piketty and Saez 2011; Piketty 2003; Piketty and Saez 2003, 2006; Banerjee and Piketty 2005). Piketty's 2013 seminal book *Capital in the Twenty-First Century* in particular has brought this work to the forefront of academic and policy discussions and the public arena.

This body of research has led to significant new advances in our current understanding of trends and determinants of inequality. First, it has emphasised – as in the texts of classical economics of the nineteenth century – the central role of capital/wealth inequality. Second, this new research has made use of previously unused data on tax returns. These data are

not available to researchers in all countries. Where available, they have proved to be invaluable in the analysis of the full distribution of incomes across the population (see Atkinson and Piketty 2007, 2010).<sup>6</sup> Its main advantage over household survey-based data is that it gives us more accurate – although still incomplete – information on the incomes of wealthy and very wealthy people. Third, this new research has shown how inequality can prevail over long periods of time. Piketty's (2013) economic model (his 'fundamental laws of capitalism') is formed from the interaction of three macroeconomic variables: the stock of capital (or wealth), the rate of return to capital, and the rate of national economic growth. His central argument, as expressed in the now (in)famous formula  $r > g$ ,<sup>7</sup> is that inequality will increase or decrease depending on whether the rate of return to capital is greater or smaller than the rate of economic growth.

Piketty's analysis has commanded much attention. Some of that attention has been critical. His core model of the determinants of changes in levels of capital/wealth inequality is elegantly simple, but also simplistic. It is a model of the working of capitalism, narrowly defined. It focuses on labour and capital markets, and the relationship between them. Those markets are assumed to be largely competitive. While he acknowledges the importance of power and politics in establishing and maintaining the conditions for the capitalist system to function, the distributional outcomes are driven by changes in economic variables. He takes politics into account to the extent that he recognises the potential effects of government fiscal activities (welfare state spending, taxation) on the distribution of income and wealth. However, he takes more limited account of the fact that other types of political activity – frequently labelled rent-seeking and rent-taking – may have a significant influence on the distribution of income and wealth, especially in low-income countries.

One common pattern highlighted by this brief account of the history of inequality research is its clear focus on the causes of inequality and the measurement of inequality. Much has been written about the economic, social and political factors that drive changes in inequality. Large efforts have also been made to develop methods to measure as accurately as possible such changes. But the fact that inequality is again back 'in from the cold' has as much to do with its levels, as it has to do with its vastly adverse effects. One important limitation in the literature on inequality accumulated over the last six decades is the fact that few studies have focused on understanding the *consequences of inequality*.

### 3.1 The consequences of inequality

Until the early 1990s, the discussion around the consequences of inequality focused very much on the trade-off between equity and efficiency (see Okun 1975; contrasting views are discussed in Chenery *et al.* 1974 and Bowles 2012), and dominated by the idea of 'trickle-down' economics (see discussion in Stiglitz 2013). Neoclassical economics postulated that some degree of inequality might spur innovation and investment (see discussion in Acemoglu and Robinson 2012 and Stiglitz 2013). Initial levels of poverty and inequality would then be reduced by rewards to productive effort and savings. Many have heavily contested these arguments, and a significant number of studies have emerged arguing that equality matters both as a normative good and due to its negative impact on societies,

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<sup>6</sup> The World Top Incomes Database includes information for the following countries: Argentina, Australia, Canada, Colombia, Denmark, Finland, France, Germany, India, Indonesia, Ireland, Italy, Japan, Korea, Malaysia, Mauritius, Netherlands, New Zealand, Norway, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, United Kingdom, United States and Uruguay. Further work is being completed on former British colonial territories (Bangladesh, Barbados, Belize, Botswana, Myanmar, Cyprus, Fiji, Gambia, Ghana, Guyana, Hong Kong, Jamaica, Kenya, Kiribati, Lesotho, Malawi, Malta, Mauritius, Montserrat, Nigeria, Pakistan, Papua New Guinea, Sabah, Saint Lucia, Saint Vincent, Samoa, Sarawak, Seychelles, Sierra Leone, Solomon Islands, Sri Lanka, Swaziland, Tanzania, Tonga, Trinidad and Tobago, Uganda, Zambia, Zanzibar and Zimbabwe). Additional work is being done on some of the territories of the French colonial empire (Algeria, Annam, Cambodia, Cameroon, Cochinchina, Laos, Tonkin and Tunisia), Iceland, Indian provinces before 1922, Brazil, Chile, Hungary, Belgium, Israel, Bulgaria and Greece.

<sup>7</sup>  $r$  is the rate of return to capital and  $g$  is the growth rate of national incomes.

markets and political systems (Sen 1973; Rawls 1971). Some of the most significant adverse effects include:

### **3.1.1 Social exclusion and poverty**

Several studies have shown that individuals and households remain poor and excluded from the benefits of economic development not because they live in poor countries – in fact much poverty and social exclusion persists in high-income economies – but because high levels of inequality create exclusion and pockets of persistent poverty among certain population groups (Ravallion 2005, 2013; World Bank 2003b). The ineffectiveness of economic growth in reducing poverty in high-inequality countries has been well documented, challenging many of the underlying assumptions about the trickle-down effects of economic growth (Birdsall and Londoño 1997; Ravallion 1997). Several studies have also shown that inequalities that result from discrimination or segregation of certain population groups – often women and ethnic, cultural or religious minorities – explain the persistence of levels of poverty and destitution among those groups, as well as the persistence of inequalities across and between generations (e.g. Bowles, Durlauf and Hoff 2006). Notably, social inclusion may be further reduced when inequalities result in ‘extractive’ institutional processes that promote further exclusion and dysfunctional inequalities (Acemoglu and Robinson 2006, 2012).

Inequalities affect how state and market institutions function, as well as how local self-governing institutions deliver local public goods. Notably, high levels of inequality may lead to local institutional failures when resources and power are captured by elites at the expense of poorer and more vulnerable sections of the population (Bardhan 2005; Ostrom 1990; Platteau 2004). These effects are of particular concern in developing countries where local governing institutions (formal or informal) are central to the organisation of societies and the distribution of (natural) resources when governments are unable to provide adequate public goods, and insurance, credit and other markets are absent (Fafchamps 1992; Ostrom 1990; Rosenzweig 1988; Townsend 1994).

A large body of literature has also linked inequality in incomes and wealth to poor mental and physical health and lower education outcomes (Marmot *et al.* 1991; Sen 1983, 1985, 1999; Stiglitz 2013; Wilkinson and Pickett 2010). Although it is unclear to date whether this represents a causal effect or a reflection of underlying factors that predict simultaneously material inequalities and lower levels of human and social capital outcomes (Case and Paxson 2011; Deaton 2013; Underwood 2014), it is clear that there is a strong relationship between being at the bottom of the income distribution and suffering from low levels of human capital endowments (notably, lower life expectancy and physical and mental health and lower levels of education and skills) (Sen 1985; UNDP 2013). There is also strong evidence that income and wealth inequalities are closely related to political inequalities, the distribution of political power and influences over political outcomes (Gilens 2012; Hacker and Pierson 2010; Stiglitz 2013).

### **3.1.2 Lower economic growth, market inefficiency and environmental sustainability**

The ability of some individuals to save more may spur innovation and market efficiency, as long as markets are regulated to curb excessive differences on how resources and profits are distributed. Markets may in principle lead to equalising outcomes by ensuring that skills are matched to sector needs (see discussion in Stiglitz 2013). However, persistently high levels of inequality may affect negatively market efficiency by, for instance, restraining the demand capacity of the middle-class (Murphy, Shleifer and Vishny 1989), which are the most significant consumers of manufactured goods. This is because rising inequalities are likely to induce reductions in private consumption and, consequently, shrinking internal markets and lower prospects for economic growth.

High levels of inequality may also affect market efficiency and economic growth through losses in individual productivity. In particular, high levels of income or wealth inequality may be associated with reductions in the stock of human capital available in each economy if accompanied by high levels of illiteracy and poor health among disadvantaged groups. Dilapidated stocks of human capital will, in turn, decrease the capacity of individuals to access better jobs and higher incomes, which will be reflected in the countries' inability to pursue higher rates of economic growth (Galor and Zeira 1993; Perotti 1993; Ribero and Nuñez 1999; Saint-Paul and Verdier 1992).

A significant body of work has also documented how inequalities result in market failures around environmental issues when disparities in incomes and access to social and political decision-making processes affect the capacity of societies for collective action. This relationship between inequality, collective action and environmental sustainability has received increasing attention in the development literature, particularly in research concerned with the management of common property resources (see Baland, Bardhan and Bowles 2006). For instance, Bardhan, Ghatak and Karaivanov (2006) have shown how high levels of inequality may result in lack of social cooperation and, consequently, in negative externalities in terms of environmental sustainability.

### **3.1.3 Socio-political instability and insecurity**

A substantial number of studies spanning centuries have argued that persistent inequalities among certain socioeconomic groups may increase social discontent and, consequently, the propensity of individuals and/or groups to engaging in criminal activities, violence and even wars (see discussion in Gurr 1970). A recent body of research has argued that the emergence of stable, inclusive and democratic societies is largely explained by how institutions manage social diversity and different interests at historical transition points (Acemoglu and Robinson 2006; Boix 2003; Engerman and Sokoloff 2002; North *et al.* 2009). Rising inequalities have been associated with an increased risk of crime (Becker 1967; Sala-i-Martin 1996; Fajnzylber, Lederman and Loayza 1998), and forms of socio-political conflict (Lichbach 1989; Gupta 1990). Several studies have also shown a close association between armed conflict and income and asset inequality (Muller and Seligson 1987; Schock 1996), class divides (Paige 1975; Scott 1976), horizontal inequality between ethnic, religious and other cultural groups (Langer 2004; Stewart 2000, 2002; Murshed and Gates 2005; Østby 2006), relative deprivation (Gurr 1970), levels of polarisation (Esteban and Ray 1994; Montalvo and Reynal-Querol 2008; Esteban and Schneider 2008) and ethnic fragmentation (Easterly and Levine 1997). Recent food riots in many countries in Asia, Africa and Latin America, the 'Arab Spring' events and the 'Occupy' movement are examples of forms of civil protest and unrest driven by increasing social discontent.

There is therefore strong evidence that inequalities in income and wealth may result in less than optimal – and sometimes harmful – social, economic and political outcomes in the form of increased poverty and social exclusion, lower economic growth, reduced environmental sustainability and market efficiency and socio-political instability and insecurity. What is less understood is how and when inequalities will result in the negative effects outlined above, a task which we turn to now.

## **4 Mechanisms: how do income and wealth inequalities generate harmful outcomes?**

This section attempts to bring together and systematically conceptualise a disparate body of literature on the causal effects of inequality to identify a set of key mechanisms that shape how inequalities may lead to societies operating below their potential and cause adverse effects. Our general argument is that the effects of inequality are linked to how political systems, markets and civil society operate at the national, group and individual/family levels.

### **4.1 National-level mechanisms**

Inequality may result in inefficient or harmful outcomes when global shifts lead to differences in returns to skills, talent and across sectors, or through structures that ensure that the interests of those at the top dominate the organisation of markets, how resources are distributed within society and the outcomes of national political decision-making processes. Existing literature suggests three national-level mechanisms whereby inequalities may result in inefficiencies and adverse effects: (i) through technological change and its effects on the skills premium, (ii) through effects in redistributive policies and attitudes towards redistribution, and (iii) through the control of political and market institutions.

#### **4.1.1 Technological change and the skills premium**

Technological change has been heralded as being simultaneously a key engine of economic development (Solow 1956, 1957), the equaliser of incomes and wealth distributions in the aftermath of the Industrial Revolution (Boix 2015) and one of strongest causes of recent rises in global and national-level inequality (Boix 2015; Lindert 2000). Technological change may also shape how inequalities affect social, political and economic outcomes, notably through the widening of differences between those that benefit from higher wages in more technological advanced sectors (or from higher rents and profits in these sectors), and those women and men that are not able to benefit from such dynamics and may remain unemployed and excluded (Atkinson 2014a; Boix 2015; Lindert 2000).

These processes are reinforced by how education systems shape the demand and supply for skills: in recent years, the rise in returns to higher levels of schooling (secondary schooling and university, in particular) explains most of the earnings gaps observed between educated and less educated individuals in the US (Autor 2014; Goldin and Katz 2008). This process has been reinforced by technological change that has led to unemployment and a reduction in earnings among those with less schooling and skills (Autor 2003; Autor, Katz and Krueger 1998; Goldin and Katz 2008). In principle, higher returns to higher levels of education may not result in negative effects because there are social benefits associated with these returns. However, inequalities in skills and earnings may result in adverse social, economic and political outcomes when social mobility is reduced (Autor 2014), leading to the perpetuation of inequalities and exclusion. Recently, Atkinson (2015) has argued that technological change does not have to be associated with rises in inequality and further widening of skills premium as long as government policy curtails such dynamics.

#### **4.1.2 Redistribution and taxation**

Inequality may result in adverse outcomes when accompanied by reduced levels of redistribution and non-progressive tax systems (Piketty 1995, 1998a). Standard median-voter models used in political science and economics predict that when inequality in a certain society is high the median voter is located closer to the majority of poor voters. In

those circumstances, policies targeted at the median voter ought to be pro-poor (Meltzer and Richard 1981). In reality, this result is highly dependent on the political influence of elites. In some cases, it is possible that elites may have a vested interest in the political and civic participation of the rest of the population when high levels of social exclusion may threaten their status quo (Acemoglu and Robinson 2006; Boix 2003). It is also possible that those at the bottom may exhibit lower preference for redistribution. This is particularly true of societies that have a relatively high tolerance for inequality due to high expectations that they will do better in the future (Hirschman 1981; Hirschman and Rothschild 1973). For instance, a recent survey has found that despite rising inequalities, only 30 per cent of Chinese people supported redistribution because inequality is seen as a fair price to pay for economic growth (Whyte and Im 2014). The reality observed in most high-inequality countries is that the provision of public goods tends to systematically exclude non-elites (World Bank 2003a) because they are either excluded from voting processes or are bought out by richer voters, which prevents them from voicing their demands in equal weight to elites (Lijphart 1997). High levels of inequality may also hinder the coordination of collective action for more redistribution because group cohesion is more difficult to establish, leading to the weakening of civic associations, trade unions and other collective bargaining systems (Bartels 2008; Bardhan 2005; Freeman and Medoff 1984; Miguel and Gugerty 2005).

### **4.1.3 Control of political and market institutions**

The distribution of resources and power within society are very much a political decision (Acemoglu and Robinson 2006; Atkinson 2015; Ferguson 1995; Hopkin 2014; Stiglitz 2013). Inequality can only be perpetuated or rise permanently if those that benefit from the status quo are able (and allowed) to block redistributive policies and ensure their control over resources (Acemoglu and Robinson 2006; Boix 2015). This is the case in many parts of the world ruled through patronage rather than programmatic politics, where elites control both rents and the political system that distributes them (see discussion in Acemoglu and Robinson 2012). This is true of developed and developing countries alike. Recent studies have shown how inequality has led to greater polarisation of party competition in the US (McCarthy, Poole and Rosenthal 2006) and how wealthy interests dominate policy processes and decisions in the US (Gilens 2012; Ferguson 1995; Gilens and Page 2014; Hacker and Pierson 2010). The financialisation of global economies and the consequent rise in 'supersalaries' in the financial and banking sectors has been largely responsible for recent patterns of political capture. As argued in Piketty (2013: 331–332),

The very highest levels salaries are set by the executives themselves or by corporate compensation committees whose members usually earn comparable salaries (such as senior executives of other large corporations)... It is reasonable to assume that people in a position to set their own salaries have a natural incentive to treat themselves generously, or at the very least to be rather optimistic in gauging their marginal productivity.

The main lesson from these findings is that rising inequalities that are not curtailed through policy may lead to the appropriation of the political system and economic structures by those that hold most income and wealth, resulting in social, economic and political outcomes that benefit those at the top at the expense of the poorer and more vulnerable sections of the population (Piketty 2013; Stiglitz 2013).

## **4.2 Group-level mechanisms**

At the sub-national level, high levels of income and wealth inequality may result in adverse outcomes when they intersect with forms of exclusion, segregation and discrimination across different social groups, thereby changing norms and behaviours at the group levels in ways that lead to social cleavages and reductions in social cooperation. We examine below four group-level mechanisms whereby inequality in incomes and wealth may lead to social,

economic and political inefficiencies and harms: (i) the intersection between vertical and horizontal inequalities, (ii) neighbourhood and peer-group effects that reinforce social and spatial segregation, (iii) changes in norms of reciprocity, fairness and altruism that benefit those at the top and encourage (iv) the rise of parochialism and social cleavages.

#### **4.2.1 Intersection between vertical and horizontal (or categorical) inequalities**

Tilly (1998) has argued that ‘durable’ inequalities between different social or political categories – or horizontal inequalities (Stewart 2000, 2002) – arise ‘because people who control access to value-producing resources solve pressing organizational problems by means of categorical distinctions. Inadvertently or otherwise, those people set up systems of social closure, exclusion, and control’ (Tilly 1998: 8). Inequalities along identity lines are an important mechanism whereby income and wealth inequalities may lead to adverse economic, political or societal outcomes. It is possible to envisage situations in which some income inequality may promote positive outcomes. For instance, Olson (1965) has shown that elites may provide more public goods when they are able to take on a higher share of the collective good (i.e. when inequalities are higher). This would also benefit those at the bottom of the distribution because the collective good yields positive externalities, i.e. they are better off than in a situation where the collective good is not produced. Acemoglu and Robinson (2006) and North *et al.* (2009) have argued, respectively, that ‘inclusive institutions’ and ‘open access societies’ may emerge when they are of the interest of elites. But income or wealth inequality may lead to opposite effects when wealth differentials exist alongside other dimensions of inequality such as caste, class, gender or ethnic-based discrimination, and elites are able to manipulate the structures of collective action in order to appropriate most of the gains at the cost of other members of the group (Banerjee *et al.* 2001; Gaspart and Platteau 2006). Social distances between members of collective action groups will in turn affect individual participation in the group and the structures of within-group cooperation (Cardenas 2006; Gaspart and Platteau 2006).

#### **4.2.2 Neighbourhood and peer-group effects and spatial and social segregation**

A large body of literature has shown that group membership (for instance, of race, religion and ethnic groups, local associations and so forth) shapes economic and social capital outcomes (Durlauf 1996; Fafchamps and Lund 2002). In particular, the harms of income and wealth inequalities have been traced to ‘neighbourhood’ effects (Durlauf 1996; Wilson 1995) and social segregation (Bowles, Loury and Sethi 2014). Benabou (1993), for instance, has shown that the provision of public goods and education opportunities are greater in richer neighbourhoods than in poorer neighbourhoods due to increased social segregation whereby higher wages for skilled labour and increases in land prices exclude lower-income groups from moving into better-off neighbourhoods. Cutler and Glaeser (1997) found that a one-standard deviation decrease in segregation would eliminate one-third of the black–white differential in schooling and employment outcomes in the US. Other studies have argued that neighbourhood characteristics, such as average educational level of adults, contribute to poverty-inducing factors, such as teenage pregnancy and low-level schooling achievement among the young (Durlauf 2000). Wilson (1995) showed that residential segregation may contribute towards labour market discriminations and, consequently, to differences in initial opportunities between those individuals that live in better areas and those that live in less desirable residential districts (see also Sethi and Somanathan 2004). The lack of role models and social control in disadvantaged neighbourhoods are additional mechanisms that perpetuate social segregation (Sampson 1987; Sampson and Groves 1989; Wilson 1996). Furthermore, because credit constraints tend to accentuate forms of residential segregation, credit imperfections, local segregation and discrimination can operate together and lead to a cumulative process of socially inefficient persistent inequality (Piketty 1998a).

### 4.2.3 Social cooperation and norms of reciprocity, fairness and altruism

Norms, preferences and beliefs that shape social cooperation and trust are likely to influence how inequality in incomes and wealth may affect the functioning of societies, markets and political systems (Algan and Cahuc 2010; Attanasio *et al.* 2012; Bernard, Dercon and Taffesse 2011; Easterly, Ritzen and Woolcock 2006; Knack and Keefer 1997; Ray 2006; Jappelli and Pistaferri 2000; Woolcock 1998). Inequalities are produced and sustained to a great extent by social norms. For instance, as discussed in Piketty (2013), the (currently accepted) high levels of income enjoyed by those at the top of the income and wealth distributions is very much a reflection of their 'power to set their own remuneration' sustained by social norms that make that power acceptable, rather than set by market forces related to marginal productivity. Social norms and attitudes also shape the alignment between vertical and horizontal inequalities discussed above including, for instance, how gender inequalities are generated and reproduced (Perron 2014),<sup>8</sup> and how those at the bottom of the distribution either acquiesce with or contest how earnings are distributed (Hirschman 1981, 1982; Morrison, Fast and Ybarra 2009).

While few studies to date have offered a systematic analysis of which causal mechanisms may explain why inequalities (and what inequalities) may affect group cooperation and trust, recent literature has suggested that high levels of inequality may affect social preferences, norms and attitudes around trust, altruism and reciprocity (Attanasio *et al.* 2012; Bowles and Gintis 2011; Cox 2004; Glaeser *et al.* 2000; Gambetta 1988; Karlan *et al.* 2009; Thöni, Tyran and Wengström 2012), preferences for egalitarianism (Alesina and Rodrik 1994; Alesina, Cozzi and Mantovan 2012) and individual beliefs grounded on people's expectations (about the behaviour of others and about future outcomes) (Manski 2004; Ray 2006; Schelling 1966). These behavioural channels vary across gender, age, ethnicity, religion, caste and class (Alesina and LaFerrara 2005; Banerjee, Iyer and Somanathan 2005; Besley, Coate and Loury 1993; Eckel and Grossman 2001; Habyarimana *et al.* 2009), either leading to more inclusive societies, markets and political structures, or to further entrenching existing structural inefficiencies (Bowles, Durlauf and Hoff 2010). The net effect is *a priori* ambiguous and likely to depend on the levels of inequality observed *within groups* and *between groups*, which we discuss below.

### 4.2.4 Parochialism and collective action

High levels of inequality within groups (across gender, ethnicity and wealth levels) have been shown to reduce group cooperation at the local level (Alesina and LaFerrara 2005; Baland and Platteau 2006; Bardhan 2005; Bardhan *et al.* 2006; Barrett 2005; Miguel and Gugerty 2005). For instance, Alesina and LaFerrara (2002) have shown that that interpersonal trust is lower in communities with higher income inequality in the US. Nunn and Wantchekon (2011) have traced the origins of the relationship between group inequalities and trust in Africa to the slave trade, which appears to still shape current associations between high inequality and low levels of trust at the community level. This literature suggests that more homogenous groups (i.e. with lower levels of inequality within them) are more likely to exhibit stronger levels of social cooperation and trust. However, internally homogenous groups may also be characterised by forms of 'parochialism' (Bowles and Gintis 2004, 2011) when inequalities between groups are significant, leading to suspicion and discrimination against 'other' groups and lower levels of social interaction (Putnam 1993, 2000). In these cases, it is possible that high levels of inequality across different groups or communities will enhance cooperation and other norms of pro-social behaviour within those groups that will further increase the gap between different groups in the population. Anti-migrant attitudes are examples of this phenomenon (Citrin *et al.* 1997; Mayda 2006), as is

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<sup>8</sup> A large literature has identified and discussed the extent of gender inequalities. A review of this literature is outside the scope of this paper but see, for instance, Kabber (2010).

the increasing disconnection between the top 1 per cent and the rest of the population in several developed countries (Piketty 2013).

### **4.3 Individual- and family-level mechanisms**

High levels of inequality may result in social, political and economic harms and inefficiencies because mechanisms that operate at the level of the individual and their families lead to the internalisation and acceptance of inequality, as well as to the transmission of income and wealth inequalities across generations. Key mechanisms include: (i) aspirations, self-fulfilling beliefs and identity-based preferences, and (ii) self-reinforcing influences through the intergenerational transmission of wealth, tastes and values and assortative matching.

#### **4.3.1 Aspirations, self-fulfilling beliefs and identity-based preferences**

Inequalities may lead to social, economic or political harms or inefficiencies because they affect individual aspirations, perceptions and attitudes. It is possible that some levels of inequality may result in higher aspirations, notably in societies with high tolerance for inequalities (Hirschman 1981). Recent studies have, however, shown a close link between high inequalities and low aspirations (Genicot and Ray 2014; Ray 2006). This effect may be shaped by the persistence of self-fulfilling beliefs (Bourdieu 1986; Bourdieu and Passeron 1970; Piketty 1998b) or identity-based preferences (Akerlof and Kranton 2000), which result in individuals at the bottom of the distribution internalising their inability to climb the ladder and, as a result, assuming behaviours that keep them at the bottom. Gender inequalities and low civic engagement of ethnic minorities and the very poor have been shown to be reproduced through self-fulfilling beliefs allied to group norms and attitudes discussed above (Lijphart 1997, 1999; Perron 2014). The strength of these effects depends in turn on individual perceptions of distance from their immediate reference group (Boudon 1982; Hoffman, McCabe and Smith 1996; Merton and Rossi 1950), and to the extent to which 'inequality gets under the skin' (Wilkinson and Pickett 2010). Notably, stress, anxiety and fear associated with high levels of economic and social vulnerability may lead individuals to display high levels of pessimism and hopelessness, and high levels of risk aversion leading to behaviours that may reinforce their levels of vulnerability (such as not applying for certain jobs or adopting new investments and innovations, for instance) (Banerjee and Duflo 2011; Eysenck *et al.* 2007; Karlan and Appel 2011; Lerner and Keltner 2001; Raghunathan and Pham 1999; Wilkinson and Pickett 2010).

#### **4.3.2 Self-reinforcing influences**

Aspirations, perceptions and attitudes are shaped by family and immediate social circumstances, which tend to transmit values, wealth, tastes and beliefs across generations (Bowles *et al.* 2006). One channel is wealth inheritances, which, in the presence of imperfect credit markets, result in dynasties with little initial wealth facing limited investment opportunities and remaining poor (Piketty 1998a, 2013). Other channels include the transmission of productive abilities and efficient human capital investments across generations (Boudon 1974; Piketty 1998a), the family transmission of ambition and other tastes conducive to high productive ability (Piketty 1995, 1998a), and positive assortative matching whereby individuals of a certain social status and levels of skills tend to relate to (and marry) similar individuals (Kremer 1993). These effects may lower aspirations among those at the bottom of the distribution, resulting in less engagement in society, markets and political structures, such as voting (Lijphart 1997, 1999), or other forms of collective organisation (Cardenas 2006). These effects in turn, allied to important failures in credit and insurance markets, hinder social mobility because those at the bottom will not be able to offset the initial advantages of those at the top (Stiglitz 2013).

Taken together, these individual and family mechanisms may explain the emergence of 'inequality traps' through the internalisation of unequal conditions. This internalisation –

which also depends on how inequality is experienced across different classes and identities (Perron 2014) and on the power exercised by different groups to shape such norms (Bowles and Gintis 2011) – may in turn determine levels of aversion or tolerance towards inequality. Notably, self-fulfilling beliefs and their transmission across generations may result in inequality becoming the status quo of society and therefore acceptable. The likely outcome of these processes will be to strengthen the very channels that lead to further inequality such as reduction in participation in collective action by those at the bottom of the distribution (resulting in less demand for redistribution), and the adoption of behaviours that reinforce their social and economic status.

## 5 Challenges ahead and new agendas

The sections above described a world where income and wealth inequalities are on the rise, leading to economies, societies and political systems operating below optimal welfare levels due to national, group and individual/family mechanisms that perpetuate inequality and generate adverse consequences. Is this an unavoidable representation of the world to come? What next for inequality agendas?

We would like to use this last section to make two important points about future research and policy agendas around inequality. The first is that there is still much we do not know about inequalities. In particular, it is time that debates about inequality move from sterile discussions about inequality thresholds to serious understanding of the consequences of inequality. The second point is that even though inequality is rising, the adverse consequences of inequality are not unavoidable and do not have to be the price to pay for prosperity. Reducing the adverse effects of inequality requires, however, rethinking about how political institutions, markets and civil society can act together.

### 5.1 From the rise of inequality to the consequences of inequality

Research and debates about inequality are still very much concentrated around thresholds – how much inequality is there, and how much inequality is necessary for investment incentives and innovation versus how much inequality will cause harms and inefficiencies. The new unparalleled rises in inequality that we have been experiencing in recent years require a shift in this old debate from how much inequality matters – we have now reached the point in many countries where levels of inequality are so high that it is difficult to justify them for efficiency and innovation reasons – to what adverse effects are being generated, why and for whom.

Despite enormous research advances over the last six decades on the causes, outcomes and measurement of inequality, there is still much we do not know in terms of the consequences of inequality. Some progress has been made on identifying causal mechanisms that shape the effects of inequality on social, economic and political outcomes. Much of this research is dispersed and focused on single mechanisms, but has generated impressive bodies of evidence on how the consequences of inequality are shaped by technological change, levels of and attitudes towards redistribution, the control of political and market institutions, the intersection between vertical and horizontal inequalities, neighbourhood effects and segregation, group-level norms and beliefs, individual aspirations and preferences, the intergenerational transmission of wealth, tastes and values and processes of assortative matching. This paper has attempted to provide a systematic conceptualisation of this body of knowledge by showing how the harmful consequences of inequality are linked to the type of structures and dynamics that operate at the level of political structures, markets and society at different levels of analysis: national, group and the individual/family. There are, however, important gaps in the literature.

The first gap is about *which mechanisms matter more and for what outcomes*. For instance, how do the group-level mechanisms discussed in the previous section influence national institutions, on the one hand, and shape individual preferences and outcomes, on the other hand? What are the implications of individual-level mechanisms for overall economic, social and political choices? Do individual- and group-level mechanisms matter to explaining national- and global-level questions around rising inequalities? Currently, there is limited knowledge about these key questions.

A second related gap in the literature is about the *intersection of mechanisms* and how these intersections may combine to create inefficiencies and/or harms in specific contexts and specific outcomes. Knowledge about the intersection of mechanisms is particularly scarce in low-income countries where trends and patterns may be very different from those observed in more industrialised economies. For instance, what combinations of material deprivation and spatial segregation result in racial inequalities in different contexts? Under what circumstances do combinations of established norms of behaviour and wage structures explain gender gaps in earnings and identity-based differences in access to political decision-making processes? Understanding both the trade-offs and synergies between mechanisms and associated policy prescriptions will be key to sharpening our understanding of how inequalities along different dimensions may be associated and intersect to produce different welfare outcomes. This will in turn provide a better understanding of the intersections at which political institutions, markets structures and civil society organisations can intervene to curtail inequality across its various dimensions and in different parts of the world.

## **5.2 It is possible to avoid the harms of inequality**

Understanding how the consequences of inequality are shaped by the intersection of mechanisms that operate at different levels is particularly important because it may allow us to identify important entry points for political, market and social institutions to tackle the harmful effects of inequality in different societies. Many of these interventions are known. At the national level, state-led fiscal policy and social expenditure have had important roles to play through, for instance, progressive income taxation systems, education policies that improve the distribution of human capital and the equality of opportunities, the implementation of safety nets and minimum income/wage policies, and the regulation of property rights in ways that address the unequal distribution of wealth (e.g. through inheritance taxes, regulation of real estate capital gains, building regulations, and interest rate and credit regulations) (Atkinson 2014a; Piketty 2013; Stiglitz 2013). Many of these policies have been progressively dismantled in the last decades in many industrialised countries through drastic reductions in top income taxes, the decline in welfare transfers financed by progressive taxation and the reduction in equalising labour market policies such as minimum wages legislation, incomes policy and equal pay legislation (Piketty 2013; Atkinson 2014a).

Policies that operate at the group and individual levels have received stronger attention in recent years as they are seen to be less distortive of market forces. Policies that address group-level mechanisms have included known interventions such as the improvement of opportunities through anti-discriminatory policies related to gender, race, religion, ethnicity, disability and sexual orientation; and the improvement of social mobility through more equalising education policies and anti-segregation policies (see discussion in Bowles *et al.* 2006 and Stiglitz 2013). New work on the mechanisms that shape the consequences and perpetuation of inequalities at the level of individuals and families has also generated interesting policies around changes in norms, beliefs and attitudes that counteract the mechanisms that lead to the internalisation of inequality by those at the bottom of the distribution. Examples include policies that strengthen the capabilities and aspirations of the poor (see Banerjee and Duflo 2011), the provision of ‘nudges’ that relax restrictions to certain behaviours (Karlan and Appel 2011; Thaler and Sunstein 2008) and interventions that counteract the psychological consequences of being vulnerable and at the bottom of the distribution (Bolton *et al.* 2003; Haushofer and Fehr 2014).

Each of the policies outlined above has generated large debates. Some of the most prominent debates include discussions about government taxes and redistributive transfers versus market efficiency, the role of trade unions versus labour market flexibility and the

importance of 'nudges' to correct for irrational forms of behaviour and market failures.<sup>9</sup> Doubts have also been expressed as to the extent to which policies implemented at the group and individual level are able to tackle global and national shifts in income and wealth inequalities. While useful, these debates have generated the perception that reducing inequalities is dependent on solving tensions and trade-offs between state-, market- and society-led interventions. Moving the debate from thresholds of inequality to the mitigation of the adverse consequences of inequality – as we argued in this paper – shows in contrast that the consequences of inequality are very much shaped by structures and dynamics that operate *at the intersection* of political structures, markets and society in different countries.

In this, it is important to acknowledge that state, market and society mechanisms not only interact with each other (at different national and sub-national levels), but are also heavily influenced by global shifts in economic and political power. And, in today's globalised world, global solutions are needed to reduce inequality in incomes and wealth. As a result, Piketty (2013) has proposed a new global tax on wealth, while Atkinson (2014a, 2015) adds to that the need to provide social security for all through a participation income, whereby payments are made on the basis of participation in society rather than citizenship in order to account for global trends in population movements. Many oppose these and similar proposals citing the impossibility of achieving effective global coordination. However, there may not be a choice. As with other global trends such as climate change, international terrorism and the management of global corporations, the challenge to those concerned with rising inequalities is then to be able to devise global political economy solutions that will enable greater equality and better standards of living among all.

But while we wait for new global governance solutions – which will indeed be central to curtailing global inequalities but require large levels of coordination across countries and regions – there is a real danger that income and wealth inequalities will keep rising in most countries. It is possible that global inequalities will not be reduced until these global solutions are found. But there is certainly a role for national and sub-national interventions to mitigate the adverse consequences of rising inequalities for so many – and, in the process of doing so, also restraining the very mechanisms that perpetuate inequalities.

This will require strong coordination between governments, markets and societies to act together in order to mitigate the devastating effects of rising inequality, rather than maintaining false dichotomies between state versus market versus civil society solutions. Examples of such joint solutions include, among others: issues around social responsibility of corporations; the regulation of lobbying activities; the regulation of top incomes and bonuses; the provision of guaranteed minimum incomes and safety nets in conjunction with interest rate policies that support small savings; policies that rebalance factor shares towards labour such as government policy that encourages innovation but supports the employability of workers and emphasises the human dimension of service provision; the enforcement of ethical pay policies; and the strengthening of the bargaining power of workers over employers through, for instance, an increased role for labour unions and the inclusion of workers in company management (Atkinson 2014a; Mazzucato 2011; Piketty 2013; Stiglitz 2013).

These solutions may not be sufficient to reduce current income and wealth inequalities to pre-1980 levels. Similar reductions were only achieved in the post-war period by radical changes in social, economic and political structures through wars, revolutions, massive welfare transfers and substantial increases in taxation. Reducing current levels of income and wealth inequalities may also require similarly radical changes at the level of global governance systems. In the meantime, it is important to identify entry points whereby

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<sup>9</sup> These debates are extensively reviewed in Acemoglu and Robinson (2012); Banerjee and Duflo (2011); Karlan and Appel (2011) and Stiglitz (2013) among many others.

national and sub-national interventions can minimise the harms of rising inequalities, prevent their unchecked escalation and protect those being left behind: 'The world faces great problems, but *collectively* [our emphasis] we are not helpless in the face of forces outside our control. The future is very much in our hands' (Atkinson 2015: 1).

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