PRELIMINARY
October 8, 2003

Why we all do care about inequality (but are loath to admit it)

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ABSTRACT

This note is motivated by recent arguments made by Martin Feldstein in which the relevance of inequality is dismissed (if everybody's income goes up, who cares if inequality is up too?), and the argument is made that only poverty alleviation should matter. This note shows that we all do care about inequality, and to hold that we should be concerned with poverty solely and not with inequality is internally inconsistent.

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This note addresses the argument recently put forward by Professor Martin Feldstein (1998, 1998a, and virtually identically in Feldstein, 1999) regarding the irrelevance of inequality issues as opposed to poverty. No one should be worried, Professor Feldstein argues, about greater inequality so long as everybody's income is increasing. It is only with incomes of those who are poor that economists need to be concerned. This is an argument not infrequently heard. As someone who has worked on the issues of inequality for more than twenty years, I had had a chance to see it expressed quite a few times. In the early 1990's, the then director of research in the World Bank dismissed my proposal for a study of inequality in post-Communist countries arguing that these countries were "victims" of unreasonable egalitarianism, and all increases in inequality, linked as they must be to higher returns to more productive members of society (yes! that was the belief at the time) should be welcome. Four or five years later, with the greatest recorded peacetime increase in poverty, and inequality hitting the ceiling, the subject did not seem so unreasonable. In many social parties or professional meetings in Washington and elsewhere, when introduced to and informed that I worked on inequality, my (more polite) interlocutors would make a point similar to Feldstein's ("why should inequality matter at all"); others, perhaps less polite, would wave their hands basically ascribing the fact that anyone would pay a person to study inequality to profligate ways of international bureaucracy. I will allow myself to speculate at the end of the note, why the topic of inequality produces such strong reactions among many people from various lands and backgrounds. But before I do so, I will try to make a few more substantive points, although, following Professor Feldstein, I too will eschew to base my case on the functionalist arguments in favor of low inequality of the median-voter, social stability or perversion of political process, or market failure[2] (lack of wealth which prevents people from making successful investments in their own education or a project) type.[3]

[2] I am grateful for this to Karla Hoff who surveys the market failure literature in Hoff (1996).

[3] Two excellent reviews on the effects of inequality on a wide range of economic and social issues are Thornbecke and Charumilind (2002) and Jencks (2002).

Is it envy or is it justice? Consider Professor Feldstein's example. If each of us were given $1,000, inequality (in the US) would go up, and yet we, gathered here, would be better off and no-one would be worse off. So, what is wrong with it? Apparently, nothing. Let us now modify his example just a bit. Let us suppose that Feldstein's fairy gives me $20,000 and each of you is given variously between 25 and 75 cents. Professor Feldstein's previous conclusions still hold: everybody's welfare should be greater. Yet, the effects, I dare suggest, would be quite different. Many of you might refuse to accept your quarter, some might leave it in the room, other throw it away in disgust. Many would comment (unfavorably) upon fact that I have received, for some unfathomable reason, $20,000, while other, much more worthy members of the group, would have to do with less than 1/1000th of that amount. Most of you would speculate on the reasons which lie behind such an extravagant largesse on the part of the fairy.

What this story illustrates? First, that many (most) of those who would have received 25 cents would not merely not feel better—as professor Feldstein suggests they should—but would rather feel worse. They would feel worse off because their feeling of justice and propriety would have been hurt. And it will have been hurt because people always compare themselves to (what they hold to be) their peers. Thus income they receive is not only a means whereby to acquire more goods and services, it is also a tangible recognition of how society values them. It is a social expression of their own worth. Hence a large (and particularly if unjustified or unclear) difference in income will be viewed as a slight on their own worth.[4] The key point is that income of others enters our own utility function. And once we allow for it, inequality affects our own welfare and the arguments regarding irrelevance of inequality come to naught.

[4] It is an intriguing language point that one would have expected that the correct question one asks in English regarding a person's wealth would be "how much are Mr. X's assets worth." This however is abridged to "how much is Mr. X worth." The intrinsic worth of the individual and his extrinsic wealth are conflated.

Note that the concept of a peer group is crucial for all studies of inequality. [5] There is no point in studying inequality between two groups that do not interact or ignore each other's existence. Suppose that we combine all Japanese and all Maya of the 15th century and study their combined inequality. The two groups might overlap quite a lot, their mean incomes being similar. But this exercise is devoid of any meaning since the two groups have never interacted. It is only when (say) a nation state appears and when people tend to view their co-citizens as their equals that conventional studies of within-country inequality started making sense. This is why, I think, that studies of global inequality make sense now, but much less so for the earlier periods. In other words, only if there were no peer groups—that is, if there were no society—would inequality be irrelevant and would only our own income matter for our welfare.[6]

But let me try to find some other, perhaps, more convincing examples. Let us assume that the organizer of this conference has decided to pay each of the participants a fee reflecting his or her position in the profession and thus the expected quality of the paper. And let us assume that such honoraria are widely skewed, but are all, of course, positive. Let me now assume that I among all of you got the least, and by a large fraction. Would this not affect my own sense of justice? I would quickly begin comparing fees received by other authors to their published record or to what I have heard of them; I would inquire from my friends, and I might end up being deeply offended. Again, my feelings of (1) justice and (2) self-worth would be affected. In the first example, many people might dismiss in disgust their quarter of a dollar; in this case, I would accept my honorarium but would be quite upset and perhaps offended. Even if my welfare is greater after the honorarium (because my income would be higher) it will have increased far less

[5] The same point is made by Sen (2000, p.64) who uses the concept of "reference group": "the focus [of welfare measurement] is on the utilities of the individuals only in that group, without any direct note being taken of the utilities of others not in the group."

[6] A nice example how peer groups matter is provided by the following example. World Bank has many local offices in different parts of the world. Staff who are recruited to work there are generally paid much more than their local peers. So, they are very happy to work for the World Bank. But, after a few years, they realize that they are paid only a fraction of what an identical economist is paid if hired by the headquarters in Washington. Then locally-recruited staff become very unhappy and demoralized, their peer group having changed.

than if everyone received the modest fee that I got, or if the fees were more in line with what I perceive to be just. And again, once we accept the fact that my welfare is reduced by the knowledge of how much other participants received, we conclude that other people's income enters my utility function, and thus that inequality matters.

If this were not the case, how would we explain the fact that in the ultimatum games, where participants are asked to share an amount of money, offers perceived as unfair are rejected out of hand, and both people end worse off (Fong, Bowles and Gintis, 2003). [7] Why do people reject offers they hold unfair if thereby they reduce, not only the income of the other participant, but their own too? Simply because the utility gain from higher income is outweighed by the utility loss, that is by the feeling of injustice stemming from the realization that the other person would receive a much greater, and in our view, undeserved income. But clearly we should never behave like that if we were unconcerned with incomes of others.

Notice that in all three examples, we have shown that people's welfare depends on income of others, but that the mechanism by which this is expressed varies. In the first ("the good fairy") example, we were puzzled by the capriciousness of the fate; in the second example ("the fee") we called upon justice; in the third example, we were simply disgusted at the behavior of our partner—neither justice nor fate entered there: pure human disgust or anger.

More arguments. Some economists tend to regard all statements that other people's incomes influence our welfare as statements of envy. Professor Feldstein speaks of "spiteful egalitarianism." Two points are, I think, worth of note here. First, ethics is not the province of economists. The use of value-laden terms like "envy" is supposed to shut us up by basically telling us that only green-eyed envious monsters are likely to covet

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[7] In the ultimatum game, two people are supposed to divide a given amount of money. Person A makes a proposal. Person B accepts it or rejects it. If he rejects it, both participants receive nothing. Overwhelming experimental evidence shows that offers amounting to less than 30 percent of the pie are rejected. The experiments have been conducted in a number of countries and settings with stakes as high as three months' earnings (quoted in Fong, Bowles and Gintis, 2003, p.8).

other people's money. Let us grant them this point: envy is not nice. But if most, many, or a significant percentage of people do feel envious of other people's money, this is the only thing with which economists need to concern themselves. (And recall, that envy simply means that other people's income enters our utility function). Envy, whether economists approve of it in private or not, must enter into their analysis. Perhaps, ethicists and religious ministers would disprove of such practices, and we leave the field open to them to improve the human race. When the ministers have done so, economists should go back to their assumptions, and wipe out income of others from their welfare functions. But not before we are informed that envy has been rooted out.

Second, what some people call envy is, as I believe the above examples have shown, not (the bad) envy but (the good) sense of justice. We are affected by income of others not solely because we are envious but because we think that injustice has been done. And sometimes—reinforcing my point—we are affected by low income of others in comparison to some yet different group although none of that affects us directly at all: it is simply that we feel that somebody has been taken advantage of or has been treated unfairly.

In other words, one person's envy is another person's justice. But whatever name they come in, whatever rubric we write them in ("desirable " or "non-desirable" feelings), such feelings can be shown, I think, overwhelmingly to exist, and that is all that matters to people who deal with human nature as it is.

Let me close this section with two quotes that illustrate very well the difference in economists' views regarding inequality. First, a fairly recent quote by Ann Krueger, currently the vice-president of the IMF:

> *Poor people are desperate to improve their material conditions in absolute terms rather than to march up the income distribution. Hence it seems far better to focus on impoverishment than on inequality.*

a position echoed by Professor Feldstein. And then the one by Simon Kuznets (1965, p. 174), an old quote from 1954:

> *One could argue that the reduction of physical misery associated with low income and consumption levels…permit[s] an increase rather than a diminution of political tensions, [because] the political misery of the poor, the tension created by the observation of the much greater [income] growth of other communities... may have only increased.*

Why people don't like inequality? When I started working on inequality I lived in a Communist country. My dissertation was on the topic of inequality. This was, what was then euphemistically called, a "sensitive topic." The rulers and their acolytes did not like it because it exposed their myth of universal equality under socialism. They wanted socialism to be perfect and equal, and it was shown to be imperfect and unequal. When I came to live in a capitalist society, rich people (and their supporters) similarly tended to object to the topic. They felt that any inequality that existed was right, since in their view every income was fine, just and necessary, as if God-ordained (market having taken over the role of God). Empirical studies were superfluous. The studies could merely sow trouble and discord and possibly lead to the questioning of the existing social order. As under Communism, they were subversive. Thus the elites in both systems tended to agree that studies of inequality are unnecessary: in one case because they revealed that there was inequality, in the other because they implicitly questioned whether its level was acceptable.

But such a high level of sensitivity toward empirical work on inequality shows, I think, that our implicit assumption, probably derived from the centuries of religious upbringing and Enlightenment, is that all people are basically the same and that it is every *departure* from equality that needs to be justified. In other words, the elites are not unreasonably concerned about studies of inequality: because every mention of inequality raises in our minds questions about its acceptability.

Why caring about poverty and not about inequality is implausible? If inequality were not something we cared about, it is also very difficult to explain the concern with poverty. For if (1) all incomes are just, or if (2) other people's incomes do not enter my welfare function, why should I care if there are many poor people? Or even if only (2) holds, why should existence of poverty matter to me? A person might reply that one might still disprove of studying inequality but find that concern with poverty is worthwhile because welfare of the poorest could be of concern since we hold that everyone should be endowed with some minimum standard of living. But if this is the case, isn't this equivalent to saying that it is only the welfare of some (viz. the poor) that enters my utility function and nobody's else (except mine or my family's). So a proponent of concern with poverty does not disagree that other people's incomes enter his utility function; he just wants his *homo oeconomicus* to limit his attention to some people (the poor) and to disregard others. The inconsistency of a position which cares about poverty and does not care about inequality is readily spotted if we write *i*-th person's welfare function as

$$Wi = fct(\underbrace{ya, yb, yc...}_{\longleftarrow \text{Concern}}yi, \underbrace{yj, yk...yx, yw, yz}_{\text{Envy} \longrightarrow})$$

where all individuals' incomes are ordered so that $y_b > y_a$ etc. To say that one cares about poverty means that his (*i*-th) welfare function is affected by everything that happens below some arbitrary income level (say *d*) where the poor dwell, while any income change above *d* (except his own y_i) leaves him indifferent. This of course is not entirely impossible but seems to me quite implausible. As soon as we extend our gaze toward other people, richer than y_d, and let their incomes influence own welfare too, we move from concern with poverty alone to concern with inequality as well.

To reinforce the argument for this rather implausible concern with $y < y_d$ only, a moralistic gloss is put over it whereby the concern for all incomes less than y_d is deemed "good" since it shows a person to be concerned with the plight of the poor, while his concern with all incomes greater than his is deemed to be morally reprehensible. In reality, however, people are much more likely to think and be concerned with those who have more than they than with those who have less. In other words, it is “envy” which is much more likely to enter our welfare function that “concern.”

I would be willing to venture an even stronger statement, namely that a very different treatment of poverty and inequality favored by some economists, a sharp distinction drawn between the two, is a way of deflecting possible raising of the issues of social desirability of a given distribution of income into a much more benign channel: ostensible concern with the very poor. The concern with poverty is a price that the rich are willing to pay so that no one questions their incomes. In other words, concern with poverty works like an anesthetics to the bad conscience of the many. It is basically “social money laundering”, an activity engaged into by those who have either acquired wealth under dubious circumstances, or have inherited it, or might have made more money than seems socially acceptable. It could well be that less than savory ways of acquiring wealth are unavoidable and that this is the price we have to pay for progress and civilization. “A world without poverty” is a world that would underwrite all kinds of injustice. Unavoidable it may be—but it still should not stop us from recognizing it for what it is.

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