



CHATHAM HOUSE

Chatham House, 10 St James's Square, London SW1Y 4LE
T: +44 (0)20 7957 5700 E: contact@chathamhouse.org
F: +44 (0)20 7957 5710 www.chathamhouse.org

Charity Registration Number: 208223

Transcript

The Top 1%: The Avoidable Causes and Invisible Costs of Inequality

Joseph Stiglitz

Professor of Economics, Columbia University; Nobel Laureate; Author of *The Price of Inequality*

Chair: Dr DeAnne Julius

Chairman, Chatham House

29 June 2012

The views expressed in this document are the sole responsibility of the author(s) and do not necessarily reflect the view of Chatham House, its staff, associates or Council. Chatham House is independent and owes no allegiance to any government or to any political body. It does not take institutional positions on policy issues. This document is issued on the understanding that if any extract is used, the author(s)/ speaker(s) and Chatham House should be credited, preferably with the date of the publication or details of the event. Where this document refers to or reports statements made by speakers at an event every effort has been made to provide a fair representation of their views and opinions, but the ultimate responsibility for accuracy lies with this document's author(s). The published text of speeches and presentations may differ from delivery.

DeAnne Julius:

We are very pleased, and indeed honoured, to have with us today Dr Joseph Stiglitz, a professor of finance and business at Columbia University, but also the winner of the Nobel Prize in Economics in 2001. In addition to his academic contributions, though, he is very much, I feel, in the Chatham House spirit in spending a good part of his life and his thoughts being involved in public policy issues. He chaired the US Council of Economic Advisors from 1995 to 1997, he was chief economist and senior vice president of the World Bank from 1997 to 2000, and a lead author of the 1995 report of the Inter-Governmental Panel on Climate Change.

So, Joe, welcome to Chatham House again, and the floor is yours.

[Applause]

Joseph Stiglitz:

Thank you.

It is a real pleasure to be here. In some sense, I wish I didn't have to talk about such a dismal subject, but it is something I think is very important, and in a way the news that came out yesterday and has gotten so much attention about the Libor Scandal is a good introduction – hopefully it will help promote the book [laughter] – because I think it illustrates much of... many of the themes of the book. Actually, it is also very much related to the work I did... for which I got the Nobel Prize, which is asymmetric information; if everybody has known what they were doing behind those closed doors, the Libor would not have played the role that it did, but it was that this market – which wasn't really a market – existed because of a lack of transparency, a lack of...because of the opaqueness of the market.

What those individuals were doing is what economists call and what I refer to in my book as 'rent-seeking.' 'Rent-seeking' are activities that we usually associate with those in developing countries, emerging markets, particularly oil, mineral resource rich countries. We don't think of rent-seeking as something that goes on in the United States, the UK, and other advanced industrial countries, but what I argue in the book is that much of the wealth, much of the inequality in our society, the income at the top, much of it is related to rent-seeking, activities that are connected to moving money around, getting a larger share of the national pie, rather than increasing the size of the national pie. And what we learned, of course, from the oil companies is that in the attempt to get a larger share of the national pie, the pie shrinks.

And that is illustrated by this problem with the banking sector because the banks, in focusing their attention on these kinds of activities and the other kinds of things we saw in the years before the crisis, they actually shrank our economy, they made our economy work less effectively. A financial sector that is functioning is absolutely essential for the functioning...the well functioning of an economy; but too much that were involved trying to grab a larger share of the national income.

Since I only have about 25 minutes, what I am going to try to do is just give you the main highlights of the book. What I begin is...let me outline what I try to do in the book is first describe the magnitude of the inequality, the way...the dimensions about the way that it has increased. Secondly, talk about the cause. Third: the economic consequences, which I think are very serious. And the fourth point is consequences go well beyond our economy to the nature of our politics, the nature of our effects on our democracy, our society, our system of justice. And finally, I want to talk – just a few words – about what can be done about it. I am going to argue that it is not inevitable, and there are things we can do to mitigate the problems of inequality, but I am not sure that they will be done. So, the final thing is: is there a hope? And I'm not sure what the answer to that is.

So, let me begin by talking about what are the... the magnitude of the inequality? It has grown enormously in the United States, in the UK...just to give you one statistic, the upper 1% now garners about 20% of all the income, and a third to 40% of all the wealth. But that inequality is growing. In 2010, the year of recovery, 93% of all the growth went to the upper 1%. So, it wasn't a recovery for most citizens; it was a recovery for the 1%. In fact, this book in a way grew out of an article I wrote for *Vanity Fair* – some of you may have seen it – it was called...and the article really summarized a lot of what the book was about in a few short pages. The title of the article was a paraphrase from a line in the Gettysburg Address; Abraham Lincoln in the middle of the Civil War talked about whether our democracy of government of the people, by the people, and for the people would survive, and that was what the...what he characterized the Civil War was about. So, the title of my article is: 'Government of the 1%, for the 1%, and by the 1%.' And it clearly had a certain amount of resonance; it became one of the refrains of the Occupy Wall Street. It is not an obviously standard place for an academic economist to publish, *Vanity Fair*, but my first...one of my first articles was in *Econometrica* on the distribution of income in 1969, and I have to say that my *Vanity Fair* article did get a bigger readership [laughter] than my *Econometrica* article.

The inequality, though, particularly in the United States, is manifested not just in income, but also in wealth – in fact, the inequality of wealth is even greater, as I mentioned – but also in health, particularly in the United States because we do not have a public health system, something you should appreciate that you do have. In the United States, life expectancy is lower than many emerging markets, female... you know, infant mortality, deaths in the first five years, are lower [sic] than in Cuba and in many other emerging and developing countries. Remarkable how bad things – and ‘remarkable’ in a bad way – how bad things are on the health score in the United States, and it is all from the lack of access to health at the bottom, and even at the middle.

This increase in inequality over the last 30 years has been dramatic. The share of the top 1% has doubled, the share of the top one tenth of 1% has tripled. It is... it would be one thing if... if the income... if the benefits that accrued to the top trickled down, and one of the arguments that has long been put by those who say, ‘Don’t worry so much about inequality’ is that everybody benefits, but the fact of the matter is that is not true.

Trickle-down economics has never had any theoretical or empirical support, but what has happened in the United States and some other countries in recent years really, very much shows that that is not true. While the top has done very well, most Americans today...median income today in the United States is lower than it was in 1997, 15 years ago. Put it even worse, if you focus... it extends so well only because so many Americans are working longer. If you ask the question, ‘What has happened to median income of a full-time male worker?’ It is lower than it was in 1968, more than 40 years ago. So, the country, for a male worker, the world has stagnated. And if you want to understand American politics, you have to understand that there is that kind of frustration from the fact that very large fractions of America – a majority, in some sense – have not participated in the growth that has occurred.

Again, it would be one thing if the issue were just inequality. People on the right, people like Paul Ryan in the United States, who is the head of the House Budget Committee, said, ‘We are not interested in equality of opportunity... err... equality of outcomes; we are interested in equality of opportunity’ [sic]. Well, the two are related, but what is so striking is the United States has become the country with the least equality of opportunity of all the advanced industrial countries, very much against the myth that many of you believe: that America is the land of opportunities. And that is because it is part of the myth that has been very successfully propagated, and because you know stories of immigrants who have made it to the top, individuals who

have succeeded in making it from the bottom. Those always resonate, those stories resonate; but, from an economists' point of view, a social scientists' point of view the issue is: 'What are the life chances? What are the probabilities?' And the fact that is the life chances of somebody in the United States are more dependent on the income and education of his parents than in any of the other advanced countries. But the UK, as you were saying, doesn't score well on this either. It is better than the United States, you can feel good about that, and things are better than they were a hundred years ago...data isn't very good, but there is a strong, you know, what we have suggests that things have gotten better over that long time-span; but the Scandinavian countries have a lot more opportunity.

The interesting thing is in the United States, in the period after World War Two – and World War Two brought the whole country together, they fought together – we passed legislation like the GI Bill of Rights that gave an education to everybody who fought, which is everybody in our society, and the result of that was the US economy grew faster than it did in the era after 1980, and it grew together; that is to say everybody grew, but the people at the bottom grew faster, and the differences between the top and the bottom reduced. But since [US President Ronald] Reagan, since 1980, the growth... the total growth has been slower, and almost all the growth has gone to the top, and those at the middle and the bottom have not done very well at all.

Finally, it would be one thing if... if those at the top had gotten where they were because they had added so much to the productivity of our society, to the wealth of our society, and so as the result of that they had made everybody better off, our economy grow. And that idea that people's compensation income was related to their productivity was a very important idea, was a central idea in the debate that began here in the UK in the 19th century of 'how do we justify inequalities?' And the theory that came up in talks by John Stuart Mill and others was called the Marginal Productivity Theory, that people's compensation income was related to their contribution. The evidence is, overwhelmingly, that that is not the case. You look at the bankers in the crisis of 2008, they walked off with huge bonuses when their contribution to the firm was negative – they had brought their firms to the brink of ruin – and their contributions to society, they brought the global society to the brink of ruin, their contribution to society was negative, and yet their bonuses were very large.

So, it was very clear that there was a disjunction between private reward and social return, and undermining this very important theory. But, if you thought about it for a minute and you look at the list of the people at the top, you do

not see names like...the people that made the basic mathematical innovations like [Alan] Turing that allowed for the computer, the people who invented the laser or the transistor, the people who...you know, [James] Watson and [Francis] Crick who discovered DNA, the people who provided the intellectual foundations for the internet that transformed the modern economy; none of these are in the top.

And that comes to the second part of my talk: what is the source of inequality? Well, there are many dimensions to inequality in any society, inequality at the top: how much goes to the very top? Poverty at the bottom, and increasingly in advanced industrial countries a hollowing out of the middle, the fact is that people in the middle are not doing very well, and the number of people in the middle is getting diminished, there is a polarisation of income distribution. There are many factors that go into this. Economists naturally begin by talking about market forces as shaping inequality: demand and supply. But there is something... market forces do not exist in a vacuum. Market forces are shaped, they are shaped by rules, regulations, by politics. And that is why if you look across countries you see vastly different... large differences in inequality.

If market forces were at play, similar countries, the advanced industrial countries would all be facing the same market forces and what would be going on would be similar in all of these countries; but, what we see is the same market forces – Sweden is responding to globalisation just as the UK and the United States – but the way we shape market forces is a matter of politics. And that is what we have been seeing is that even the increase in inequality is not inevitable. There are countries like Brazil that have decided that the levels of inequality are unacceptable, and they have been working to reduce inequality, and successfully so over the last 20 years. They still have a high level of inequality, but they have brought it down. There are countries that have succeeded in stabilising the level of inequality.

Let me just give you – set in the American context – some examples of how we shape markets in ways which increase inequality, and I would argue, lower efficiency, distort the economy. And it is not... it is in a myriad of pieces of legislation from bankruptcy law to [incoherent] competition to corporate governance, it is pervasive in our legal structure and our economic structure. So, take bankruptcy law in the United States, and I don't know the details in the UK, so this may... but it is still worthwhile understanding because these battles are going on everywhere. In the United States, when a company goes bankrupt, the first claimants are derivatives. Those risky securities who brought AIG to bankruptcy and to the brink of ruin that caused American

taxpayer to have to put out \$150 billion in corporate welfare, more money than we have given over a decade to poor people, to one company, they are given first priority; but meanwhile, students who get in debt cannot discharge their loans even in bankruptcy, they are a noose around their neck for the rest of their life. And we have introduced, in the United States, partial indentured servitude; they can, if they get indebted over a certain level, they can spend the rest of their life paying 25% of their income to the bank without getting anything back, just having every year, they pay their taxes and then...before they pay their taxes, the government...the bank takes 25% of their income. When you have laws like that it encourages derivatives, it encourages speculation. Take our tax laws – and here the UK is a little bit similar – the United States taxes speculators at less than half the rate that it taxes people who work for a living.

Now, you can argue that lowering taxes on entrepreneurship will lead to more entrepreneurship. One can make an argument, but do lowering taxes on land speculation lead to more land? Probably not. [Laughter] And lowering taxes on derivative speculation can lead to people attacking unstable markets, which is exactly what happened. Or take our competition laws, which have allowed in the United States, and until recently in New York, the banks that have a monopoly over the payments mechanism. Modern technology allows for an efficient electronic payment mechanism, it costs a fraction of 1¢ to transfer money from your bank account to the merchant's bank account when you buy something, but what the banks charge and the credit card companies charge is 1%, 2%, 3%, 4% of the transaction, leading to profits in the tens of billions of dollars a year. It is a tax on every transaction, it is a financial transaction tax; but it is a financial transaction tax that goes for the profits of the banks, not for public purpose. If we have good enforcement of anti-trust laws, you wouldn't have that.

Well, I could go on, but the point is when you have a set of laws like that, they shape the economy. And that is why we wound up before the financial crisis both in the United States and the UK with a financial that had garnered 40% of all corporate profits. You know, they were supposed to do certain functions, but they were supposed to do them at low transaction costs; they did them at high transaction costs, and we distorted their economy.

So, that leads me to really what I think is the most important economic theme in the book, that: we are paying a very high price for this inequality. A lot of the inequality, especially the top, comes from rent-seeking, and a lot of that rent-seeking is at the expense of the people at the bottom, ordinary individuals, homeowners. In the case of the banks in the United States, they

targeted Afro-Americans, Hispanics, the least educated. And this is not just my judgment, they paid hundreds of millions of dollars of fines, and this is 40 years after we passed civil rights legislation where there is a national consensus that discrimination is wrong. And the banks said, 'Oh, well, my responsibility is to try to make profits for myself. The invisible hand of Adam Smith says that the pursuit of self-interest was supposed to lead to the greater good of everybody.' Smith was wrong. We can talk later about why he was wrong, but the fact of the matter was that they saw this opportunity, they took advantage of it, to moving money from the bottom of the pyramid to the top, increasing inequality at both ends, that is to say increasing the concentration of wealth at the top, and increasing poverty at the bottom. The consequence, just to mention one more statistic that just came out after my book came out...between 2007 and 2010, the wealth of...the median wealth in the United States – people again in the middle, median, half above, half below – decreased almost 40% bringing... wiping out two decades of wealth accumulation.

So, the wealth today of most Americans is the same as it was at the beginning of the 1990s. All the increase in wealth that has occurred in the country in two decades has gone to the top. None of it has gone to not only the bottom, but the bottom or the middle. Obviously, something is wrong. What I try to argue here is that we are paying a very high economic price for this inequality. One of the arguments on the right is, yes they understand inequality is not a good thing, we would like to have less inequality, but the cost of getting rid of the inequality is too great, and if we did that everybody would suffer: the people in the middle, the people at the bottom, our economy would be weaker.

The argument of this book is quite the contrary; that if we attack the rent-seeking, the distortions, the discrimination, the sources of this inequality, the worst manifestations of this inequality, we would have a stronger economy, faster economic growth. Classical economics talked about a trade-off between growth and inequality, but I argue that is a fiction, it is not true. And there are several reasons that... or this; one of them is that one of the origins of our inequality is the lack of opportunity, and lack of opportunity means that we are not giving... letting those at the bottom live up to their full potential, we are wasting our human resources, our most important resource. There is another argument that I don't have time to go into that is increasingly being accepted that inequality is related to instability. Both the IMF and the UN commission that I chaired analysing the great recession of 2008-2009 argue that at the roots of that recession was growing inequality. That the attempt of

the Fed [US Federal Reserve] to offset the weak economy that results from growing inequality was to create a bubble; every bubble has to break, this bubble broke – as was inevitable – with disastrous consequences.

A natural question is why do we have this kind of inequality, particularly this artificial inequality – not market forces, but created inequality – in a democracy? We can understand in those corrupt oil dictatorships, but why in a democracy? Isn't it one-person-one-vote? And what I try to argue is you look more closely... just like the rules of the game shape our economy, the rules of the game shape our politics. If you have unbridled campaign contributions, revolving doors, lobbying, you get a politics that is closer to '\$1, one vote' than to 'one person, one vote.' And I tried to describe the process by which our democracy has been put in peril by our inequality. So, we have a vicious circle. More economic inequality leads to more inequality in political power, which breeds more inequality in our economic system, and it is self-reinforcing, and not good for either our democracy or for our economy.

Well that leads to the question: 'what can be done?' And actually, once you understand the sources of inequality, the prescriptions of what needs to be done follow very naturally. Start thinking about rent-seeking, start thinking about rent-seeking from monopolies to corporate governance. This is one area where the United States took the lead, but the UK has been trying to keep up. The CEOs over the last 15 years have been taking a larger and larger share of the corporate revenues. In the United States, the ratio of the CEO pay to that of the average worker has increased ten hundred fold.

Now, it would be nice if it were the case that, that reflected the fact that American CEOs were that much more productive. You did import one American to CEO one of your banks [reference to Bob Diamond of Barclays; audience laughter], and he did some clever things, but there is no evidence that... there is no evidence that those American CEOs are 100 times more efficient than European CEOs, or 1000 times more efficient than Japanese CEOs. They may be more efficient, but nowhere near that can be justified by these. And it is interesting that when I talked to CEOs from 20 years ago, they also think that their successors were not that much more efficient. What it is is that there has been a change in culture in which people to take advantage of deficiencies in our corporate governance.

So, in the United States, when it was proposed that there should be some say in pay, you know, if you own... if somebody works for you, you would think that you would have some say in the pay that people who work for you, I mean, it seems intuitive. And in theory shareholders own firms, and therefore

the management works for the shareholders, and you would think, therefore, that shareholders should have some say in the pay, just *some* say. But when that was proposed in the United States you would have thought from our CEOs that it was the end of capitalism as we know it. It would have been the end of capitalism as they know it [laughter]; but, in fact, other countries like Australia have had a say in pay and it has worked perfectly well. So the point is that this is another example of a rule that we could change, and the evidence is that already just voluntary say in pay is having a dampening effect in the excesses in that realm. Improving of education, and particularly access to education, fair access to education is really important and it is a complicated subject, and just let me highlight one aspect of it.

You know, American private colleges, which are among the best in the world, I think, including Columbia, are very proud of the fact that they have needs blinds admissions. Anybody can apply – any American can apply – and if they get admitted, the college/university will make sure that they can afford to go, they will make up the difference between the parents' ability to pay and what it costs. And yet, in spite of that needs blind admissions, only 8% of the students in these elite schools are from the bottom half of the population, only 8%. Why? Because they haven't gotten the grade schools and the high schools that train them to be qualified for admission to these elite schools. So the inequities in our education system are built in at a very ground level, and again the evidence is that in many ways the problems are getting worse.

I describe some remarks about our tax system. The upper 1% in the United States pays an average tax rate of 15%. Lower than those whose income is much lower. Warren Buffett talked about this and said that it was wrong that he was paying a lower tax rate than his secretary. He was going to take advantage of the law as long as it existed, but it was wrong that the law would be that way. One of the presidential candidates [reference to Mitt Romney] is among those who pay only 15%, but he has not said it is wrong. He thinks it is a fine way of running an economy. Well... so, the point that I am trying to raise here is that there are lots of policies that follow very naturally from a diagnosis of the sources of inequality in our economy.

And that leads to the final question: Is there hope? You know, here I have to admit some ambivalence. One of the things I found from one of my earlier books, *The Three Trillion Dollar War*, is that people don't like to read a book and leave it feeling depressed. [Laughter] You know, they don't like to go to a movie and leave it feeling depressed, it is just not... they want to leave it being uplifted. So, in *The Three Trillion Dollar War*, the message is depressing, and we were trying to be upbeat because we said we gave

numbers that were conservative [laughter], the actual cost we thought was going to be much greater and in the subsequent data that had come out in the next... in the following three years have shown how conservative we are. Close to 50% of Americans who fought in Afghanistan and Iraq are coming back disabled, and the cost of that disability payment alone and healthcare for the disabled is going to be \$1trillion, and that is well beyond what we had calculated there.

So, the negative story in this episode in inequality is there is a vicious circle and it is going to be very difficult to break out of it, but let me end on a positive note. The positive note is other countries, like Brazil, have broken out of this vicious circle, and the United States, at other times that it reached levels of inequality that were extraordinarily high, came back from the brink. The Golden Age was followed by the Progressive Era, the Roaring Twenties was followed by the important social legislation of the 1930s. So, my hope is that Americans, people in the UK will realize that this inequality is manmade, it is costly, there is a high for it, a price to our economy, a price to our society, and that we will pull back from the brink and change our polity, change our economics to try to create a more shared prosperity.

Thank you.

[Applause]