Inequality the Biggest Problem

Keith Rankin, 22 Jan 2014

Ahead of the annual World Economic Forum in Davos Switzerland, the biggest issue and challenge has been identified as inequality. Not just inequality of income or unequal access to goods and services; the Herald article "Ahead of Davos: The $1.7 trillion question" (21 Jan) emphasises inequality of wealth. The 85 richest people in the world have as much financial wealth as the poorest half of the world's population.

Bill English is attending the Davos summit. He was reported on Radio New Zealand ("Wealth gap economic threat - forum"; 20 Jan) as saying that "creating jobs is the answer". Actually, it's not the answer.

First, jobs are only "created" when people (including businesses and governments) buy things. As Paul Krugman said "My spending is your income and your spending is my income". Thus the emphasis placed on saving – non-spending by definition – does nothing to boost employment.

Second, the whole story of economic development has been one of rising labour productivity. This means, essentially, that it was the employment of capital rather than the employment of labour that has brought about historical growth.

Individual workers can only gain a substantial share of this capitalist income if labour is scarce. If global labour supply decreases substantially, then workers can get a good price for their labour. Indeed labour supply did decrease (relative to economic growth) in the developed world from around 1850 to 1960, as women disengaged from the labour force, older people retired, younger people sought more education, and working hours were slashed. Hence there was no trend increase in inequality in those years, despite massive capitalist growth.

There is no indication that labour supply will contract in the next decade. Poverty itself adds to labour force participation. More family members seek employment when the principal income earner in a household experiences low, falling or uncertain income. Desperate people will offer to work 16 hours a day 7 days a week if that's the only way that they can feed themselves and their close relatives.

Thus labour supply suffers from positive feedback. Increased labour supply is a cause of the inequality problem; not a solution to it.

The solution to the inequality problem in a capitalist society is to ensure an equitable distribution of capital income; focusing on labour income is just burying one's political head in the sand. It is capital income that is growing fastest, and is much more unequal than labour income. While some of our billionaires may well receive multi-million dollar salaries, it is certainly not their salaries that made them so rich. Rather, their wealth is due to their equity in the firms that they are most associated with.

Capital comes in many forms. The private capital investments that creates wealth are essentially physical capital (such as factories and machinery), the acquisition and development of land, the acquisition of specialised skills, and forms of intellectual capital that are subject to patents and copyright.

Wealth is, in some portion, also derived from public capital. Examples are environmental capital, infrastructure, intellectual capital that is in the public domain, social capital, cultural capital and institutional capital. Economic wealth is in fact derived from the combination of labour, private capital and public capital. It means that incomes shares go to labour, holders of private equity, and holders of public equity.

Holders of public equity do get an income share in all capitalist societies. Unfortunately our accounting systems do not properly acknowledge this. And, arguably, that share is smaller than it should be. Certainly, by increasing the economic returns payable to the holders of public equity, we have a means of reducing (but never eliminating) inequality.

Essentially public equity income is the revenue of the sovereign. Further, the revenue of the sovereign, if accounted for in a more equitable way, is more than we think it is.

A good way to see that public equity share is to apply the rules of 'horizontal' equity to a country's tax system. The only equitable tax rates are proportional taxes; popularly known as flat taxes. In New Zealand, if we change the way that Inland Revenue accounts for income taxes, we do have a flat tax rate of 33 percent. We can then think of the tax concessions that we gain on incomes under $70,000 – let's call them 'cash backs' – as being public equity returns.

We can also think of public expenditure on health, education defence etcetera as being drawn from public equity income.

The secret to reducing inequality is to raise the public equity share of national income. That is quite different from enlarging the state. More likely, the route to less inequality is to increase both the amount of and the equality of these 'cash back' provisions that are already implicit in our tax system.

The inequality problem is not insoluble. Just don't expect it to be solved through increased employment.
