July 2016

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The keynote speech at the 24th IPSA World Congress of Political Science in Poznań, Poland on 28th of July 2016

Institutional Systems, Policies, Inequalities

I. Introduction

1. ”Inequality” refers to very important aspects of social life. But the debate on equality is full of confusion because of its many meanings, methodological and empirical errors and very strong emotions which “inequality” evokes.

2. Conceptual confusion includes the lack of precise distinction between the inequality of situation (income, wealth, power) and the inequality of opportunity. In the discussion of the former the “capitalistic” inequalities of income and wealth are emphasized while the “socialist” inequalities in political power are usually neglected. To be sure, large inequalities in wealth may contribute to the inequalities in political power. But the most extreme and extremely dangerous concentration of political power (Stalin, Mao, Pol Pot, Castro) were not linked of the concentration of wealth.

3. Reducing income inequality should not be confused with the eradication of poverty. Some persons worry that there are too many rich individuals while other persons worry that these are too many poor people. Both the motives and the policy recommendations of these two groups of persons differ very much. Trying to reduce the top incomes does not always help the poor. The most important reason for the existence of poverty in the world are anti-market regimes (socialism, oligarchic capitalism etc.). And there is no good substitute for the market-oriented reforms of those systems.

4. Some errors are due to the lack of a comparative analysis of the questions of freedom and inequality in the various institutional systems (see sec. II). Lamping together many countries with different regimes and making simple correlations is likely to lead to the misguided conclusions and wrong policy recommendations. Correlation should not be confused with causation.

5. Much of the debate on inequality is <u>Western-centric</u>, ignores the global issues and focuses on the losers in the developed world. This narrow perspective can lead to <u>morally dubious conclusions</u>, i.e. recommending protectionism to help these losers. Such an attitude ignores the basic fact that globalization in conjunction with the market reforms in China, India and some smaller counties, has accelerated their economic growth and – thus – radically reduced the cope of poverty. And the appearance of the losers in the developed world has been due not only to globalization but also to the nature of the contemporary technical change (IT technology) linked to pockets of deficient education in the developed economies, hampering the adjustment of the skills and the restructuring of the economy.

II. <u>Economic freedom, inequality of opportunity, inequality of income</u>

1. We speak of inequality of opportunity when individuals with similar important characteristics (talent, skills, persistence, etc.) have different chances of achieving the same professional goals. We do not expect that different individuals would have the same chances of achieving the same professional goal.
   In the empirical research inequality of opportunity is substituted by the upwards mobility even though these two concepts re not identical. They would overlap if the statistical distribution of individuals' s important characteristic were identical in each income group. However, it is an acceptable approximation to treat the measures of upward mobility as proxes for inequality of opportunities.

2. There is a <u>fundamental difference regarding what is the ideal inequality of opportunity versus the ideal degree of income inequality.</u> Most people in the modern world agree that the inequality of opportunity should be close to zero, i.e.

that similar individuals should have similar chances to achieve their professional goals. Such an intersubjective agreement does not exist in the case of inequality of income. Only the extreme collectivists (e.g. monks) would agree that it should be close to zero. Therefore, the debate on the income inequality is inherently subjective. It s also very different from the moral discussion on poverty: most people agree that it should be eradicated. They differ in their views how to achieve this, which is a technical issue.

3. There are correlations between income inequality and upward mobility which reflect certain causal links: extreme income inequality is likely to limit upward mobility and very limited upward mobility contributes to income inequality. In considering the corrective measures the emphasis should be put on the factors which cause persistent poverty (which contributes both to income inequality and to the inequality of opportunity) and on institutions and policies which widen these inequalities without any benefit to economic growth. Finally priority should be given to measures which increase mobility, as they are likely to strengthen economic growth and are in line with modern ethics.

4. It is impossible to have a sensible debate on inequalities without considering a fundamental institutional variable: <u>the extend and the distribution of economic freedom in a country.</u> There are many different states of this variable in the world from which I will focus on the three:

   a. <u>Socialism</u>: banning economic freedom, i.e. private ownership of the productive assets and the markets.
   b. <u>Oligarchic capitalism</u>: very unequal distribution of economic freedom, i.e. very unequal protection of property rights.
   c. <u>Entrepreneurial capitalism:</u> wide extent of economic freedom, high and reasonably equal protection of property rights.

   <u>Under socialism</u> the range of opportunities (i.e. freedom) is extremely limited. The ban on economic freedom eliminates the position of an entrepreneur and other

professionals related to the private sector's. Besides, the elimination of economic liberty requires the ban on other freedoms too. Therefore, positions of independent journalists, social activists, opposition politicians are also eliminated. As a result people can move up within a very limited set of opportunities – basically within the party-state hierarchy. As one can see the discussion of the upward mobility should consider the set of opportunities, i.e. the extend of freedom.

The elimination of economic freedom may suppress the income inequality but at the huge costs of slowing down economic growth and of an extreme concentration of political power, which produces the risk of catastrophic policies. Contrary to a popular belief the deepest crises (sometimes including genocide) have occurred under inherently non-market socialism and not under capitalism.

Under the oligarchic (crony) capitalism people linked to political rulers (or the rulers themselves) enjoy much higher protection of their wealth (and to have other privileges) than other people. This produces sharp inequality of opportunity which leads to a wide income inequality. Besides the unequal protection of property rights reduces or eliminates market competition, and as, a result, economic growth, which in turn contributes to poverty.

The entrepreneurial capitalism, by definition, is characterized by a wide extent of economic freedom which is highly and reasonably equally protected. The entrepreneurial opportunity produced high incomes for the successful entrepreneurs, but the market competition prevents the extremes typical of crony capitalism. As a result, compared to this regime upward mobility and economic growth are higher under the entrepreneurial capitalism while income inequality is lower, but not as low as under socialism.

III. Institutional Transitions, Economic Freedom, Inequalities

1. The inequalities change during institutional transitions. The direction of change depends on initial institutional regime and on the type of the system towards which the transition is heading. There are many different systems and many actual or potential transformations. I consider only a few which are empirically most relevant:

a. Socialism -> entrepreneurial capitalism (Central and Eastern Europe) -> moderate increase in Gini coefficient a large increase of the range of opportunities , economic catching up.
b. Socialism -> oligarchic capitalism (e.g. Russia, Ukraine) -> sharp increase in Gini, inequality of new economic opportunities, no or little catching up.
c. Entrepreneurial capitalism -> crony or rent-seeking capitalism (M.Olson) -> increased income inequality, slower growth.
d. Rent-seeking or crony capitalism -> entrepreneurial capitalism -> strengthened economic growth, reduced inequality of income and of opportunity.

IV. Policies in the OECD counties and inequality

1. One should be very careful in drawing policy conclusions from one set of countries to another one, e.g. form Scandinavian to the US. First, given huge differences in the size and heterogeneity of the populations, some lessons from Scandinavia may be simply non-applicable to the US or, if applied, would bring about the unexpected results. Second, new empirical research reveals that the actual differences are not as huge as popularly perceived. For example, Hackman and Landers (2016) show that Denmark displays higher income mobility than the US but not higher educational mobility; the latter because of much weaker incentives to get education in Denmark, resulting from the suppressed educational premiums.

2. Nevertheless, there are some empirically based lessons which policies (including certain institutionally-based arrangements) reduce upward mobility and/or increase income (wealth) inequality while being neutral with respect to economic growth or even hurting it.

   These policies include:

   - Very restrictive zoning regulations which limit the supply of urban land and thus increase the wealth of the real estate owners (see: Britain).
   - Continued unconventional monetary policy (UMP), which inflates the prices of the financial assets and favours large incumbent firms relative to the new ones

(Rzońca 2014). Both tend to widen wealth inequalities and endanger long term economic growth.

- Protectionist measures which shield the domestic monopolies thus slowing down economic growth and increasing inequalities via creating the monopolistic rents Western protectionism, e.g the CAP, also hurts people in the poor countries.
- The welfare states with large and generous PAG pension systems which are financed at the cost of the growing public debt. This creates an inequality between the present older generation and the younger generations which would bear the cost of the large public debt and/or would have much lower pensions.

3. Measures which would reduce inequalities and foster economic growth consist first of all, in the reversal of the above policies. One should add to them steps which would improve the quality of education in those places and groups where it is very low.

4. Chetty at all (2014) have shown that there are large differences in upward income mobility <u>within the US</u>. They link them empirically to factors that affect children before they start working, specially to education and the type of the family. In high mobility areas like Salt Lake City children from low income families are more likely to attend college and less likely to have a teen pregnancy.

5. The main factors which hamper upwards mobility and increase income equality both across countries and within the US (rent-seeking, state capture, monopolies, poor education for the poor people) are not the features of free markets but rather of the public sphere and possibly of culture.

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