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Economics After the Crisis

Objectives and Means

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The MIT Press
Cambridge, Massachusetts
London, England

Economic Growth, Human Welfare, and Inequality

Let us begin with the objectives of economic activity and policy.

In the second half of the twentieth century, the idea became increasingly dominant that attaining a superior growth rate and thus increased prosperity should be the central objective of public policy.

Other issues—culture, morals, religion, national identity—were not entirely absent, but, in contrast with nineteenth-century or early-twentieth-century politics, the main electoral battleground was often the issue of which political party would best deliver material prosperity. Harold Macmillan's election campaign in 1959 was built on the assertion "We've never had it so good." In the 1960s, Harold Wilson's Labour government was determined to boost the UK's rate of growth to that being achieved in Continental Europe. Margaret Thatcher's promise was essentially that, after some tough medicine, prosperity would grow faster under the Conservatives than under Labour.

The shared assumption across the political spectrum was that economic growth—both in GDP and in per capita GDP—would result directly in increasing well-being, welfare, happiness, contentment, or whatever word we use, and therefore would lead to political success for the party best able to deliver it. The debate was essentially about what policies would achieve that end, how large a role markets should play in delivering prosperity, and what level of inequality was required to ensure economic success and was acceptable as a by-product.

The conservative narrative, asserted with increasing confidence toward the end of the century, was that free markets were the best way to deliver prosperity, and that significant inequality was acceptable—indeed required—because it gave entrepreneurs, executives, and ordinary workers incentives that would ensure innovation, competitive success in

global markets, high productivity growth, and thus increasing prosperity. Whereas in the nineteenth century conservatives defended inequality and property rights as elements of a natural order, in the late twentieth century conservative parties tended to advance an instrumental justification of both markets and inequality: that flexible markets and low taxes on the rich were good because they would make the average citizen richer. As a result, parties of the right (to different degrees in different countries) tended to be defined less by the classic parameters of conservatism—nation, social order, religion, received morals and culture—than in the past, becoming instead parties of liberal economic ideology.

Meanwhile, parties of the left had to decide how much of this narrative they accepted and how much of it was compatible with egalitarian instincts. Reactions differed by country and between parties with strong Marxist traditions and those more willing to accept the amelioration of workers' conditions within capitalism as an acceptable objective rather than as either a stepping stone or an impediment to revolutionary change. But the direction of change everywhere was toward at least a partial acceptance, and in some countries a positive embrace, of liberal economic ideology. The role of social-democratic parties was to smooth the rough distributional edges of the market economy, but three assumptions spread across the political spectrum: that markets helped to create growth in GDP, that growth in GDP led to improved social well-being and individual welfare, and that significant inequality was acceptable because and to the extent that it helped deliver enterprise, competitive success, productivity growth, and increasing per capita GDP.

But even as that consensus has grown, it has become increasingly unclear whether there is a strong link between average per capita GDP and people's average happiness or welfare once the levels of average income already attained in rich developed countries have been reached. And that has profound implications for how we should think about the objectives of economic policy and about the validity of what I have labeled the instrumental justification of markets and inequality.

Of course, any discussion of the relationship between income and happiness raises questions about whether happiness should be the objective and, if so, whether happiness can be measured. On these two issues I am somewhat more skeptical about the precision of what we can assert than are Richard Layard and some other economists.¹ On the first, the problems

of aggregation and of possible competing objectives—justice, virtue, freedom—seem to me significant. Suppose that people are “happy” under a dictatorial regime. Would we accept that as a good result? Or suppose that 99.9 percent are made ecstatically happy by the human sacrifice of a minute minority. Would we say that was OK? And is happiness the same as welfare? If it isn't, precisely how does it differ? And when we use surveys of self-perceived happiness in different time periods and in different countries, how certain are we that there aren't important differences in how people answer those questions?

These are all non-trivial problems, but I don't believe they are fatal to the limited proposition I will assert, which is not that we can define a gross national happiness index as the objective and measure our achievement of it, but simply a negative hypothesis with two components:

- We have no good reason for believing that additional growth in average income, as measured by national income accounts, will necessarily and limitlessly deliver increased happiness, well-being, welfare, or whatever we define as the objective.²
- There are fairly strong grounds for believing that rich developed countries are now in the zone where further increases in average income are of uncertain and in some respects diminishing importance.

With all due caveats about difficulties of definition and measurement, I will argue that a combination of empirical evidence, *a priori* logic, and common-sense observation of human nature strongly supports those conclusions.

1.1 Empirical Evidence: Contesting Claims

The empirical evidence is contested. In 1995 Richard Easterlin challenged the axiomatic assumption that increasing income necessarily and limitlessly increases human satisfaction, arguing that beyond some level of average per capita income no such relationship exists.³ Bruno Frey and Alois Stutzer's work has appeared to confirm Easterlin's proposition.⁴ Richard Layard's book *Happiness* accepted the lack of correlation between happiness and average income, beyond some level of income, as an established fact. But the work of Justin Wolfers and Angus Deaton (among others) has challenged this.

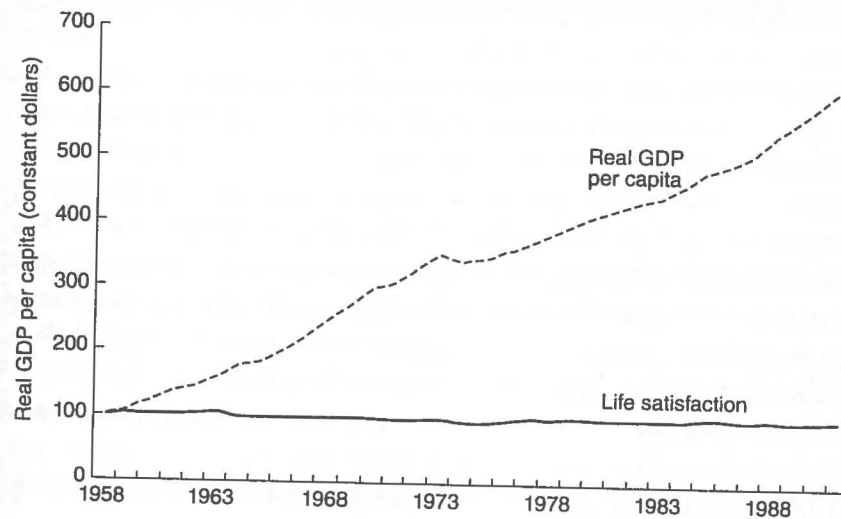


Figure 1.1
Satisfaction with life and growth of income in Japan. Source: Penn World Tables and World Database of Happiness, as referenced in Bruno Frey and Alois Stutzer, *Happiness and Economics* (Princeton University Press, 2002).

The empirical case against the value of growth is that surveys of self-assessed “life satisfaction” or “happiness” from several rich developed countries with different cultural characteristics suggest that over the last 40 to 50 years there has been no improvement, despite very significant increases in per capita GDP. Figures 1.1 and 1.2 show the results for Japan and the United States. Meanwhile, cross-country comparisons, such as those in figure 1.3, suggested that there was a fairly strong relationship between income and self-perceived happiness or “contentment with life” for per capita incomes up to about \$15,000 or \$20,000, but that further increments in average income make little difference.⁵ In stylized form, the empirical evidence has therefore seemed consistent with the pattern shown in figure 1.4—a pattern applicable in a time-series sense as well as in a cross-sectional sense: it seems that countries experience major increases in human welfare and self-perceived contentment as their income grows from low levels to about the equivalent of \$20,000 per year, but beyond that level measured income continues to increase without significant aggregate welfare benefit.

The transition from very low income levels to those seen in rich developed countries today is, of course, a great and historically unique

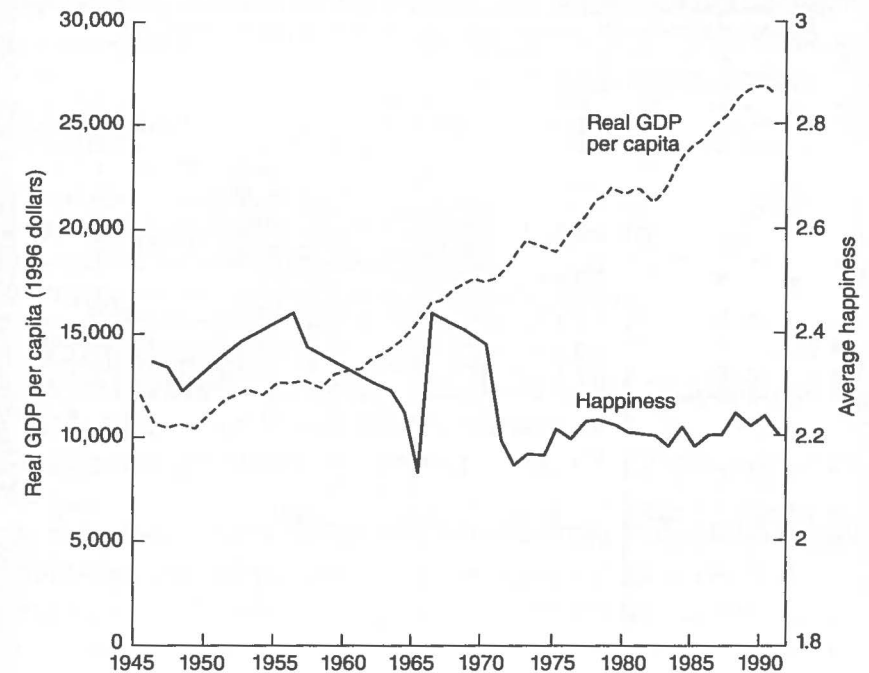


Figure 1.2
Happiness and per capita income in the United States. Source: World Database of Happiness, U.S. Department of Commerce Bureau of Economic Analysis, and U.S. Census Bureau, as referenced in Frey and Stutzer, *Happiness and Economics*.

achievement of the last 200 years. (See table 1.1.) For the whole of human history until about 1000 AD, average standards of living showed no sustained tendency to increase. Though any quantification is highly uncertain, Angus Maddison’s estimate that in most parts of the world per capita GDP was about \$400 per capita still probably captures the essence of reality.⁶ Quality of diet and life expectancy varied with the vagaries of disease, war, and climate. Fluctuations in political regimes and culture produced changes in the level of sophistication of elite groups, reflected in their art, their household possessions, and their architecture. But the modern assumption and reality that each century—indeed each decade—would bring new technologies, new products, increased income, and significant changes in lifestyle were entirely absent in the pre-modern world.

The change that then occurred, first in Western Europe and then elsewhere, glacially from 1000 to 1500, very gradually from 1500 to 1800,

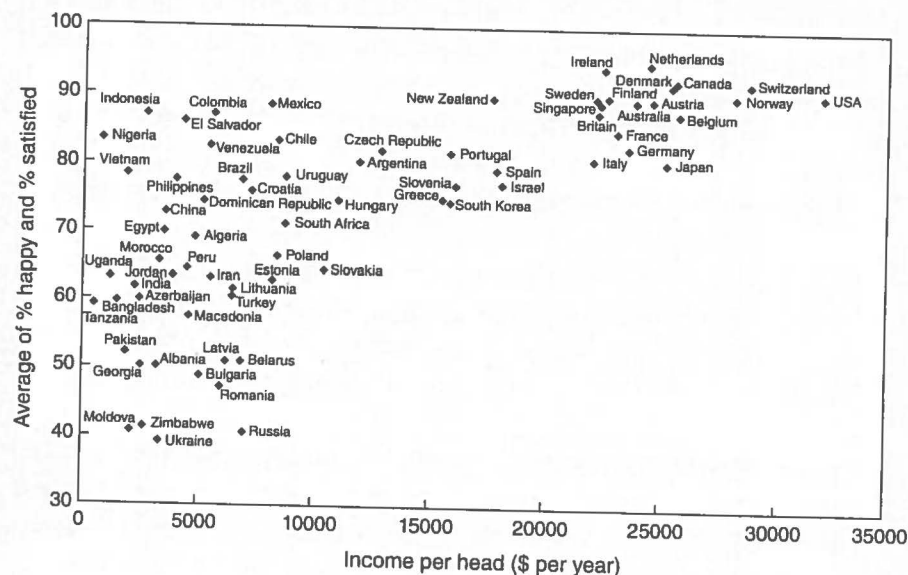


Figure 1.3
Comparison of income and happiness in various countries. Source: World Values Survey, as referenced in Richard Layard, *Happiness* (Penguin, 2005).

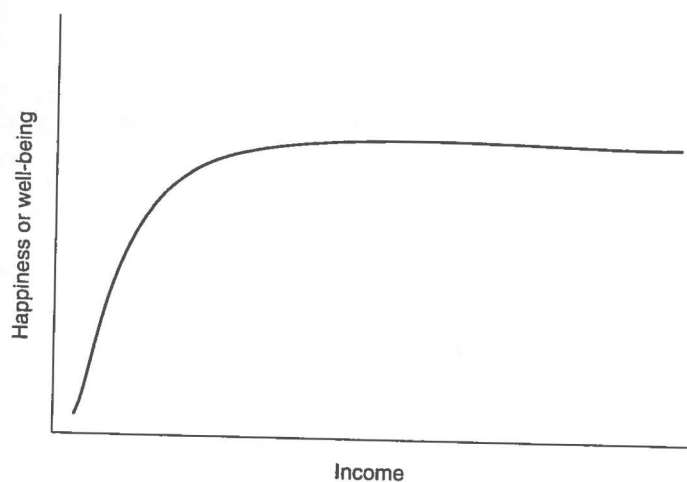


Figure 1.4
Possible stylized pattern of average income and happiness or well-being.

Table 1.1

Average per capita GDP in 1990 dollars. Source: Angus Maddison, *The World Economy: A Millennial Perspective* (OECD, 2006).

	1000	1500	1870	1998
Western Europe	400	775	1200	18000
Western offshoots	400	400	1200	26000
Japan	420	500	670	20000
Asia (excluding Japan)	450	570	575	3000
Africa	400	400	400	1400

and then explosively over the last two centuries, was the second great transformation in human economic history, equivalent in impact to the development of agriculture from the eighth millennium BC on, though far more sudden.⁷

The empirical evidence presented by Richard Easterlin, Richard Layard, Bruno Frey, and Alois Stutzer appears to illustrate that the early stages of this transition were strongly positive for human well-being, but that beyond some level of income there is a flattening of the relationship between income and well-being. (See figure 1.5.) And it seems intuitively obvious that increasing productivity and income from pre-modern levels to those enjoyed by rich developed countries should have had a major effect on human well-being.

That increase has raised life expectancy, has freed people from the drudgery of manual labor, has abolished (in most societies) such primary detriments to human happiness as hunger, inadequate clothing, and inadequate housing, and has delivered a cornucopia of material goods and services that delight and stimulate us. It is an extraordinary achievement. And as best we can tell, it has increased human happiness and self-perceived contentment.

I will therefore accept it as given that further growth is still a priority for human welfare in the many societies that have not yet completed this transition—a high priority for China, still at an early stage in the transformation, and even more so for what Paul Collier has called “The Bottom Billion”⁸—the many people, particularly in certain African countries, who have yet to enjoy much economic progress at all. However, my subject here is not how to achieve an economic growth transformation in the bottom billion, important though that is, but what we can say about the

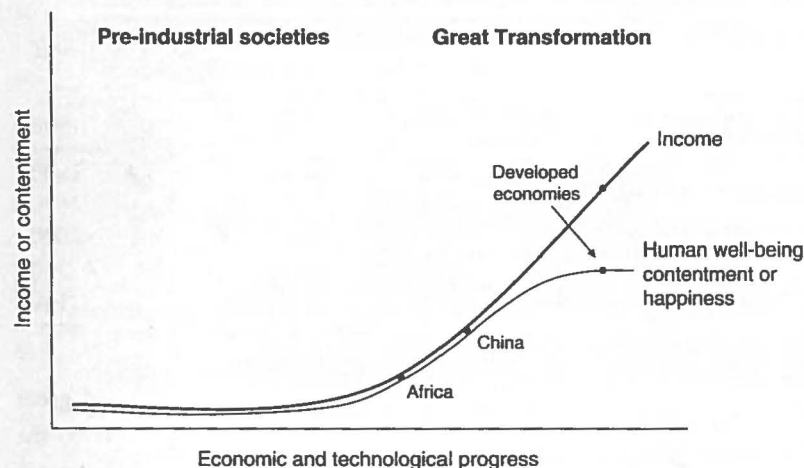


Figure 1.5
Possible stylized pattern of income, contentment, and economic and technological progress.

objectives of economic activity and economic policy once countries have achieved the great transformation.

Figures 1.1–1.3 imply that increasing average per capita GDP has no ability to produce increases in human well-being in countries that have achieved the transformation.

That conclusion is, however, strongly contested by some researchers. Daniel Sacks, Betsey Stevenson, and Justin Wolfers, for instance, argue in a recent paper that both cross-country and time-series data illustrate continuing increases in human satisfaction or happiness even as incomes rise above what other researchers have identified as possible points of inflection.⁹ Plotting life satisfaction versus real per capita GDP with a log scale for per capita GDP (figure 1.6), they argue that the evidence is consistent with the interpretation that doubling average annual income from \$16,000 to \$32,000 is as important to life satisfaction as increasing it from \$1,000 to \$2,000, and that the difficulty previous researchers have had observing this fact may have been attributable to the fact that differences between the per capita incomes of rich developed countries are, in proportional terms, extremely slight. Similarly, they argue that time-series data do suggest a positive upward slope of average life satisfaction, at both high and low income levels, as average income rises.

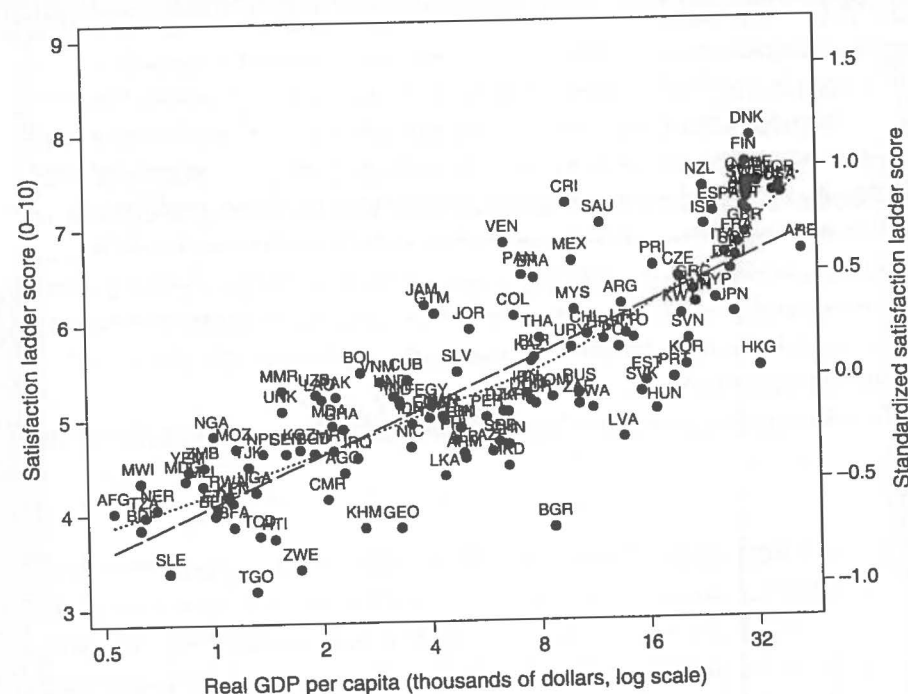


Figure 1.6
Life satisfaction and real per capita GDP. Source: Daniel W. Sacks, Betsy Stevenson, and Justin Wolfers, Subjective Well-Being, Income, Economic Development and Growth, NBER working paper 16441, 2010.

This counter-evidence casts some doubt on previous assertions that the relationship between average income and average life satisfaction flattens out entirely above a certain income level. And, as I will argue later in this chapter and in chapter 3, the proposal that there might be *no* net life-satisfaction benefit from increasing absolute income beyond some threshold has always seemed counter-intuitive.¹⁰ For instance, since average income growth is capable of delivering improvements in health and in life expectancy (and reductions in the incidence of early death), and since evidence has always suggested that better health is strongly correlated with perceived well-being, it would be surprising if this potential positive effect were not achieved and apparent.

But the new evidence leaves intact the finding that the relationship between average income and human well-being is, at least for rich developed countries, uncertain and complex. It is, for instance, noticeable in

Sacks, Stevenson, and Wolfers's analysis that long-term changes in average income appear to have much less of an effect than changes over shorter time periods. This is consistent with the hypothesis that individuals adjust to new circumstances and that their aspirations change over time, so that well-being gains from increased income eventually dissipate.¹¹ And the time-series findings drawn from the Eurobarometer survey (which ought to provide some of the best empirical evidence, since they are based on consistent questions and since they compare culturally similar countries) suggest a complex and uncertain relationship between average income and life satisfaction. The overall correlation of decadal changes in life satisfaction (shown on the vertical axis of figure 1.7) to per capita GDP (shown on the horizontal axis) is weak. And the comparisons of the results for different countries are not at all consistent with the assumptions of the instrumental conventional wisdom. The correlation suggests, for instance,

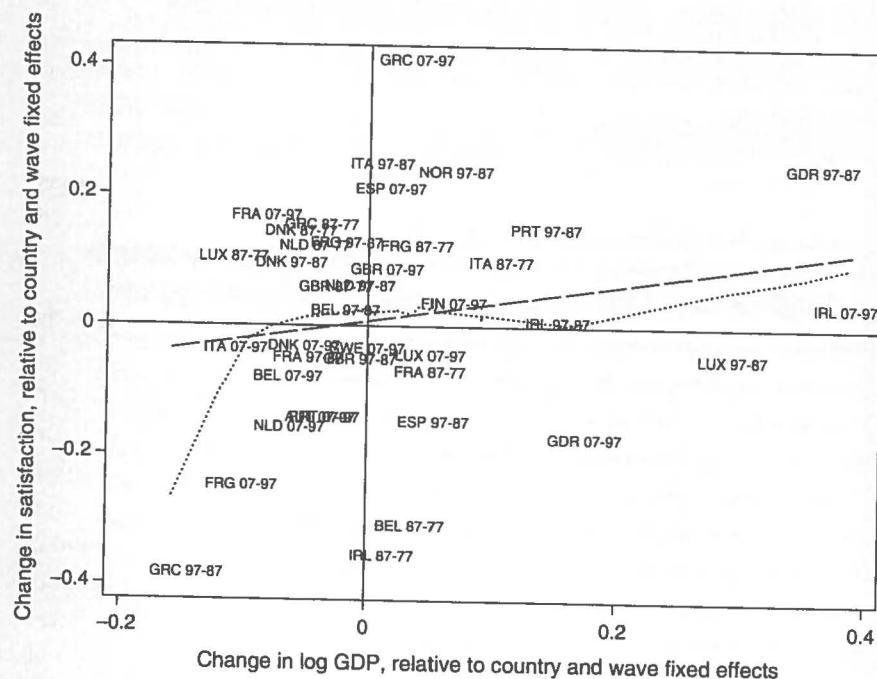


Figure 1.7
Decadal differences in life satisfaction and log GDP. Source: Sacks, Stevenson,
and Wolfers, Subjective Well-Being, Income, Economic Development and Growth,
NBER working paper 16441, 2010.

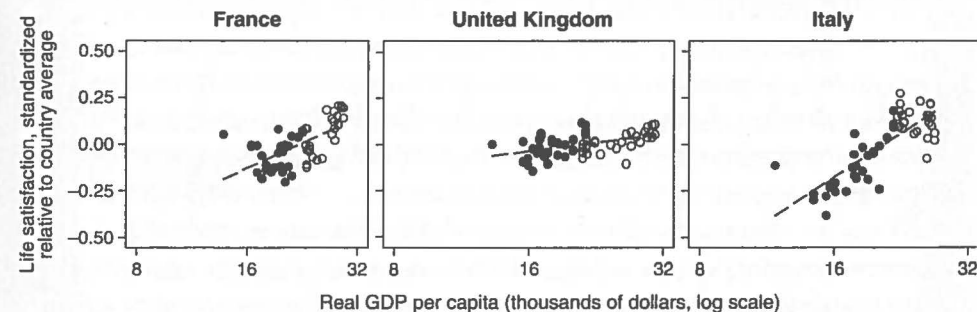


Figure 1.8
Changes in life satisfaction and economic growth in Europe.

that France and Italy have been much more successful than the United Kingdom at turning growth in per capita GDP into increased life satisfaction. (See figure 1.8.) If these figures are truly telling us what they appear to be telling us, a British government that wished to ensure increasing life satisfaction for its citizens would devote very little attention to increasing per capita GDP growth, and most of its attention to understanding what it is about the pattern of growth being achieved in France and Italy that appears to be producing more significant increases in life satisfaction.

Thus, while we should be careful before leaping from the assumption that growth necessarily drives happiness to its opposite—i.e., Richard Easterlin’s apparent certainty that there is no relationship between average income and average life satisfaction above a certain level—the evidence is certainly compatible with the conclusion that there are many drivers of life satisfaction other than measured income growth, and that the precise pattern of growth matters at least as much as its absolute level. We certainly do not have good reason for believing that further growth in measured per capita GDP will *necessarily* deliver further significant increases in human contentment.

1.2 Explanations for the Disconnection between Average Income and Happiness

Why might a breakdown occur in the relationship between average income growth and human contentment? There are several easily identifiable reasons. Indeed, given the factors that could support Richard Easterlin's and

Richard Layard's assertions, it is difficult to see how economic growth could be expected to deliver increments in human contentment limitlessly, for both the very process of becoming rich and the changing nature of what a rich economy produces and consumes are likely to undermine the logical linkages between average income and average utility.

One major change that has occurred as we have become richer has been the transition from a primarily industrial economy to a service-dominated economy in which an increasing proportion of total consumption is devoted to services rather than to goods. But that transition in itself, and the distinction between material goods and immaterial services, is not fundamental to the issues I am discussing here. Indeed, Lionel Robbins made that point in his 1932 lecture.¹² If increments to happiness are produced by increased measured prosperity, happiness is as likely to be produced by more restaurant meals and more gardeners as by more washing machines and more cars.

The most obvious reason why increasing income may not deliver significant increases in contentment is the simple theory of satiation—of declining marginal benefits. One winter coat keeps you warm; two winter coats don't keep you warmer, but give you a second-order benefit of fashion and style. This common-sense assumption about human preferences is expressed in the formal economic concept of diminishing marginal utility (figure 1.9). But although this concept might help explain a steadily weaker relationship between income and increased contentment, it could not explain the complete disappearance of the relationship.

Indeed, it can be argued that the formal economic concept of diminishing marginal utility doesn't even necessarily explain declining *aggregate* marginal utility with respect to all income and all consumption. Strictly applied, the concept of declining marginal utility relates to the consumption of a particular good, and determines the price of that particular good, given the alternative of consuming other goods.¹³ In a continually creative economy, there could be many products the consumption of which is approaching satiation, but a continual flow of new products and services such that each individual's consumption is still on the steep early section of the curve (figure 1.10). An assumption of potential aggregate declining utility can still be reasonable, given a hierarchy of human needs—an iPad must be less important to human contentment than freedom from hunger. But declining marginal utility as a result of increasing satiation

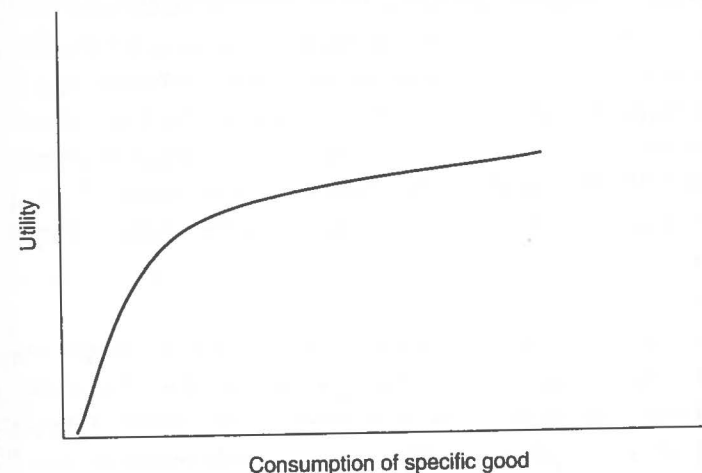


Figure 1.9
Diminishing marginal utility.

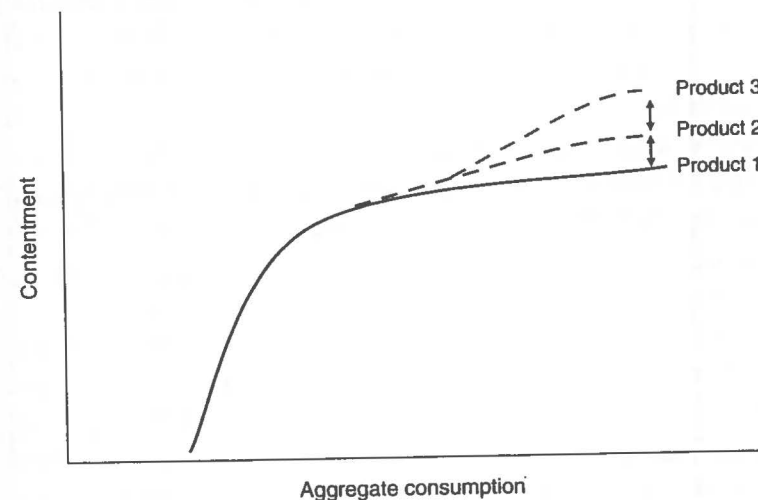


Figure 1.10
Contentment and aggregate consumption: the effect of new products and services.

would still be an inadequate explanation of a *complete* disappearance of any link between income and contentment.

The flattening of the aggregate curve suggested by some empirical evidence becomes more understandable, however, if we consider three ways in which the nature of consumption and its relationship to human well-being is in itself changed by the very fact of rising income:

- The richer people become, the more they choose to devote their income to buying goods delineated by style, fashion, and brand, so as to signal that they are in with or ahead of the crowd. But the higher other people's income becomes, the wider the range of goods and services over which this relative-status competition occurs. There has, for instance, been significant growth in families' expenditures on children, driven in part by the desire to ensure that one's child doesn't feel deprived of relative status as a result of lacking the latest fashionable toy, electronic gadget, or item of branded clothing. There is no evidence that this has made childhood a happier, more pleasant experience; indeed, some would argue that it has done the inverse. Whether or not relative-status competition may have a negative effect, increased expenditures on relative-status goods, made possible by higher income, are very unlikely to drive a sustained increase in contentment. And that must also be true of the large slice of income expended on branded and fashion goods for adults.
- In addition, as people get richer, they devote a higher percentage of their income to competing for the enjoyment of locationally specific amenities that are inherently in short supply, and each person's ability to afford those amenities is determined by relative income, not by absolute income. To be able to stay at the hotel on the beach rather than at one a mile away, or at the hotel on the ski slope rather than at one down the valley, what matters is not your absolute income, but your income relative to everyone else, and an increase in average per capita GDP can make no difference to that. And although skiing and beach hotels may seem to be minor issues, competition for housing amenities is clearly not minor. As we get richer, we devote an increasing percentage of our income to competing to buy houses in more pleasant places, and our ability to win in that competition is driven entirely by relative income, not absolute income.

- Increases in aggregate income can produce environmental externalities that are detrimental to human well-being. Some of these effects can be overcome through the achievements of growth itself—that is, through improvements in technology. For example, local air quality has improved steadily in most rich countries over the last 30 years. But some externality effects are inherently difficult to deal with. (I will address climate change in chapter 3.) And important congestion effects are almost inherent in the very process of getting richer. As we get richer, more people can afford skiing, beach, or countryside holidays, and the ski slope, the beach, and the countryside get more crowded, which degrades the experiences people seek to enjoy. Driving a car along country roads in 1950s Britain—for the minority that could then afford it—was a more pleasant experience than doing so today, simply because one was much less likely to be driving bumper to bumper. And a large proportion of the car advertisements on British television today—apparently shot on rural roads in Scotland or Scandinavia at 4 o'clock on a summer morning—are almost bound to produce frustration, since they entice you to buy an experience—driving along an open road—that can almost never be delivered. In many ways, therefore, as we get richer, if we don't manage the process very carefully, increasing wealth degrades the very benefits it seems to make more generally available.

Each of these three factors helps to explain why, beyond some income level, further average income growth is not certain to deliver significant sustained increases in contentment. And each has specific characteristics and effects.

The first factor is relevant only if relative status, as evidenced by consumption of fashion or branded goods or by being an early adopter of the latest gadget, is an end in itself. And it is therefore a factor from which some people could escape: if you don't care what label your clothes bear, it doesn't apply. But for many people it does apply.

The second factor, however, makes relative income a crucial driver of absolute standard of living, even for those not concerned with relative status. Even if you are unmoved by relative status *per se*, and perfectly happy if everyone else has a house as nice as yours, if the supply of pleasant houses is restricted then you have to seek to win in the relative-income competition. And the closer we come to satiation of basic needs, the higher the percentage of our income we devote to such competition.

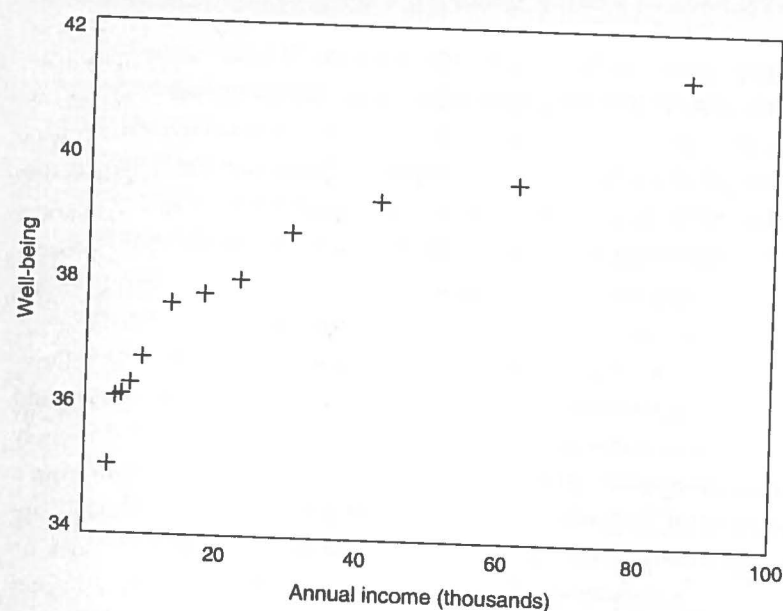


Figure 1.11
Income and well-being in the United States, 1981–1984). Happiness is measured on a scale from 0 (extremely unhappy) to 55 (extremely happy). Points represent averages for income categories from a sample of 4,942 individuals. Source: Ed Diener et al., “The Relationship between Income and Subjective Well-Being: Relative or Absolute?” *Social Indicators Research* 28, no. 3 (1993): 195–223.

The third factor, meanwhile, means that in some ways the total available utility for which we compete is itself diminished by the very fact of increased aggregate income.

So these are three distinct factors, but they have a common implication. It is that the implicit assumption of any simply presented marginal-utility curve—that my utility is a function of my income alone—is clearly wrong. My utility is clearly also a function of other people’s income and of my income relative to that of others. And together the first two factors mean that the empirical finding that richer people in any one country are on average happier than poorer people (figure 1.11) is both what we would expect and entirely compatible with a finding that, when considered on a time-series basis, an increase in *average* income doesn’t certainly and strongly translate into an increase in *average* contentment.¹⁴

1.3 Distributive and Creative Activities

As I have just discussed, the changing pattern of consumption, a direct result of increasing income, itself changes the logically expected relationship between income and human contentment. It seems likely, in addition, that important and subtle changes in the pattern of production activity—of how people earn income—are also at work.

A crucial distinction here is between what Roger Bootle, in his recent book *The Trouble with Markets*,¹⁵ labels “creative” and purely “distributive” activities—a distinction close to what William Baumol highlighted in his delineation of “Entrepreneurship: Productive, Unproductive and Destructive.”¹⁶

That distinction has always been present in market economies, and indeed in all human societies. The clever lawyer who wins a case for his client achieves a redistribution of money from the opposing client but doesn’t create greater social value. The financial trader who bets well makes money at the expense of the one who bets badly. Indeed, though it may be possible to describe some jobs as, in Bootle’s terms, almost entirely and directly “creative” (e.g., a doctor directly providing the value of better health), the majority of jobs in a developed market economy are partly distributive and partly creative, though often creative in indirect ways. The salesman who gains an order for company A is involved in an activity whose first-order effect is distributive, but it may be indirectly creative if company A is more efficient than company B, so that its growth relative to company B will help make the economy more productive.^{17,18} The market economy creates growth not because every person is continually involved in activities that, in classic income-accounting terms, “create value,” but because on average competition between individuals and firms, many of whose day-to-day activities are in their direct effects purely distributive, tends over time to deliver improvements in productive efficiency and to deliver new products that consumers value.

So the existence of “distributive” activity is not new. Bootle, however, suggests that “the more developed a society becomes . . . the more it is at risk of behavior that merely redistributes rather than creates.” And there are certainly many ways in which we could expect purely distributive activities to become more prevalent as average income increases:

- Financial services (particularly wholesale trading activities) include a large share of highly remunerated activities that are purely distributive in their indirect effects—and the share of financial services in our economy has grown.
- Richer societies tend to be more litigious societies. Litigation is essentially a zero-sum distributive activity, and lawyers are highly paid.
- In rich societies, consumers are able to devote a significant slice of income to buying goods solely because they bear a brand—for example, celebrity A's perfume versus celebrity B's. But brand competition of this sort is essentially distributive rather than value-added. It is therefore distinct in its economic function from the early development of branding, which performed an important function in enabling products of consistent quality to dominate over the multiplicity of lower-quality and sometimes dangerous products.

I do not know how far such distributive activities—in marketing and public relations, in much of financial services, in legal services—have increased as a percentage of the total economy; it would be an interesting subject for research. But I regard Bootle's hypothesis that they will tend to become more extensive as society gets richer as reasonable. It has two important implications:

- The richer we get, as measured by per capita GDP, the more arbitrary and uncertain some of the conventions required to calculate GDP become.¹⁹ In principle, measures of per capita GDP exclude purely distributive activities (for example, the gains of one poker player at the expense of others); in practice, however, their ability to do so is highly imperfect. In particular, the ability of national income accounts to distinguish within financial services between activities that are meaningfully value-creative and activities that are essentially distributive rent extraction is far from perfect (an issue explored by Andrew Haldane and others in their chapter in the recent London School of Economics report *The Future of Finance*).²⁰
- For reasons I will explore below, it is noticeable that many of the most highly paid and presumably most highly skilled people earn their living from essentially distributive activities in which the application of still higher skills must simply increase the intensity of distributional competition rather than deliver benefits that are at all likely to deliver sustained improvements in average contentment. If over a period of time the

intensity of divorce litigation increases, and the income of divorce lawyers increases, and if as a result more highly skilled people seek to become divorce lawyers, we should not expect society to gain from that reallocation of skilled human resources, even though the output of divorce lawyers shows up in GDP calculations as much as that of highly skilled doctors.

1.4 Increasing Inequality and Its Implications

An increasingly rich economy is therefore likely to be one in which both more of consumption and more of productive activities are devoted to zero-sum and distributive competition. It is also one in which relative income and status are crucial to an individual's sense of well-being and in which relative skill is crucial to success in the competition for higher income. In view of these changes, it should not surprise us that the relationship between income growth and self-perceived well-being is uncertain in rich developed societies—particularly since in rich developed countries, with relative income becoming more important, inequality has tended to increase. This increase in inequality has two dimensions. First, there is a tendency, most prominent in Anglo-Saxon countries and especially in the United States, for the bottom of the income distribution to fall further behind the median. Second, there is a very strong tendency, most extreme in the United States but also pronounced in the United Kingdom and significant throughout the developed world, for the top to pull away from the middle and for the very rich to pull away from the moderately rich. Over the last 30 years, increases in the income of the top decile have far exceeded those of the median, the top percentile has done better than the rest of the top decile, and the top 0.1 percent of the population has pulled far away from the rest of the top 1 percent.

The decline in the relative position of the poorest has been analyzed extensively. The most likely explanation is a number of interlocking primary and secondary causes. One of the primary causes is technology, which, by reducing the need for unskilled or semi-skilled manual labor, has reduced the relative marginal product of relatively less skilled people. Two other causes are globalization and more mobile factors of production—more open trade, freer movement of capital, and freer movement of people (for instance, the end, in the 1960s and the 1970s, of the restrictions on immigration into the United States put in place in the 1920s). Each of

these forms of easier factor movement would be predicted by economic theory to produce aggregate income benefits but also to produce distributional effects—that is, an increase in the average income level of people in richer countries but a decline in the relative income of the less skilled. In addition to these primary effects, however, the erosion of trade unions' power and of collective bargaining structures, itself partly an endogenous consequence of greater openness to trade and capital movements, has certainly played a role.

Increasing inequality at the top of the income and wealth distribution of society has been less extensively analyzed. However, it seems likely that it is driven, at least in part, by the changes in the nature of consumption and production that occur naturally as societies become richer on average. Even while increasing average income makes relative income more important to human contentment, it may also unleash tendencies that, unless counteracted, will automatically tend toward increasing income dispersion.

At least four interlocking forces combine to make increasing inequality at the top an almost inevitable consequence of rising average prosperity. Three are in some sense inherent, driven by changes in the underlying equilibrium value of private marginal product; the fourth is a social phenomenon that is in part exogenous but in part an endogenous consequence of the first three.

- One striking development at the top of the distribution is increasing returns to stardom or celebrity achieved through high sporting or artistic skill. Stanley Matthews, one of the football greats of 1950s Britain, earned an adequate middle-class living; David Beckham is among the super-rich. As a novelist, C. S. Lewis made adequate money; J. K. Rowling became a billionaire. Technology and globalization are among the forces at work here: television and the Internet made David Beckham and Harry Potter global brands.²¹ But rising average income is also important. As people's income rises, they devote more of it to providing themselves or their children with the latest branded merchandise, without which relative status is lost. And buying that merchandise puts more money in the hands of celebrities. One reason why David Beckham is far richer than Stanley Matthews is that the average income of his fans is high enough to allow significant discretionary expenditures both on more expensive tickets and on goods that bear his brand or which he endorses. And although superstars are

few, once the minor stars, the passing celebrities, the agents, the lawyers, the PR firms, and the executives of the media channels are included, and the party organizers, and the providers of luxury goods, and up-market hoteliers and restaurateurs, we have a phenomenon that helps to accelerate income growth throughout the top income decile, as well as at the pinnacle of enormous wealth. As Lionel Robbins perceptively noted in 1932, "a substantial proportion of the high incomes of the rich is due to the existence of other rich people."²²

- In parallel, meanwhile, the changing nature of consumption, and its increasing devotion to goods or services that are not essential in the hierarchy of human needs but nice to have, demand for which is driven by fashion or caprice, means that in some areas of economic activity highly talented individuals can make their companies successful more rapidly and in a highly measurable way. A talented retailer with a flair for store design and ambience, for range selection, and for marketing can make a huge difference to a retail chain's success quite quickly, whereas a talented manufacturing manager can do so only over many years, as research and development or improvements in manufacturing efficiency slowly reach fruition. And the shorter the time period over which results are achieved, and the more easily those results seem to be identifiable with the individual rather than the team, so the more likely they are to be reflected in individual remuneration. The higher the percentage of our consumption devoted to goods and services for which style, ambience, and brand matter, the higher may be the naturally arising inequality at the top of the distribution.

- This phenomenon of highly measurable and immediate economic impact is particularly present in some of the activities that are most clearly—in Roger Bootle's terms—distributive rather than creative. The successful divorce lawyer redistributes income in favor of his or her client and away from the other lawyer's client, and the lawyer's success in doing so is immediately apparent in a way that the success of a research scientist working alongside many others on a new drug that will reach patients many years hence is not. Top lawyers therefore typically earn more than top scientists; and the more litigious a society is, in either personal or commercial cases, the larger the number of high-earning lawyers will be. The reason why successful financial traders are paid so much is that their distributive economic impact—the extent to which they have made their firms richer

at the expense of others—appears to be very large and immediately measurable. Sometimes, of course, that is because success this year is at the expense of a trail of toxic liabilities in the future, and financial regulators are trying to fix that problem by demanding bonus deferral and claw-back arrangements. But even when we regulators have done that, I suspect, we will still see financial traders paid highly for activities that are, at least in part, distributive rather than creative. As a result, a large financial-services sector within the economy will tend to result in a wide income disparity between the top few percentiles and the median of the distribution.

- The three forces already mentioned help to change attitudes, and that in itself unleashes further change. If the worlds of celebrity, fashion, and media generate very high pay, and if there are more highly paid corporate lawyers and investment bankers than there once were, and if there are some businesses (e.g., fashion retailing) in which a star CEO can make a big difference and get highly rewarded, then the sense among highly paid people of what is normal and justifiable shifts.²³ In addition, the income they need in order to afford houses in the best part of town increases because the prices of those houses are set by the average income of the rest of the income elite. If we then add the impact of a partly global market in executive talent, and the activities of remuneration consultants with their comparisons between this CEO and that, and the role that relative-status competition plays in the motivations of high talented people, we have the ingredients for the relentless rise in the relative income of not just the few top stars but the top 1 percent of the population that we have seen over the last 30 years.

What the balance is between these four forces, and in particular between those that are in a sense inherent and those that reflect changing social attitudes and business practices, I do not know. But I think it is clear that a complex combination of narrowly economic and wider social factors, with the latter somewhat driven by the former, has produced a significant increase in inequality at the top of the income distribution. In the dominant narrative of the last 30 years, this increase was justified because and to the extent that it had made the economy more efficient, more competitive, and thus faster growing. But there is no clear evidence that it had that supposedly beneficial effect, nor is it clear whether higher measured growth, if achieved, implies rising average well-being.

Thus, we have increases in inequality that seem likely to be, in part, inherent consequences of the very fact that we are getting richer, rather than themselves drivers of increased prosperity. Does this matter? If it does, can we do anything about it? I will return to the second question in chapter 3. Here I will concentrate on the important and highly contentious debate as to whether, and if so how much, inequality and increasing inequality matter to human well-being.

1.5 Does Inequality Matter?

Why is there such an uncertain relationship between increasing average income and average contentment? Is it partly explained by increasing inequality in rich countries? The easy part of the answer is surely that when inequality takes the form of the bottom of the income distribution falling far away from the median, and when this fall away is so extreme that the bottom not only falls in relative terms but receives either no or very little increase in absolute income, it must matter a lot to the people at the bottom of the distribution. And that is not just a theoretical case; it is pretty much what has happened in the United States over the last 30 years, with the bottom 20 percent or so of the income distribution hardly participating in rising average prosperity. Even if we ignore any issues arising from relative-status anxiety, from competition for positional goods, or from congestion externalities, and simply allow for the fact that marginal units of income must be less important to the already rich than they would have been to the poorest, then, as Tony Atkinson has pointed out, the increase in the geometric mean of income is a better measure of increased welfare than the increase in the arithmetic mean.²⁴ (See figure 1.12.) And on that measure the US economy has delivered no improvement at all in the last 20 years.

Increasing US inequality at the lower end of the distribution, moreover, has had consequences that undoubtedly have contributed to a major setback to human welfare for many people around the world. As Raghuram Rajan points out in his recent book *Fault Lines*,²⁵ increasing inequality in the United States, which in the American political culture could not be offset by a distributional response, led instead to the deliberately encouraged palliative of risky credit extension to lower income groups. This explosion of sub-prime lending was a substantial contributor to the

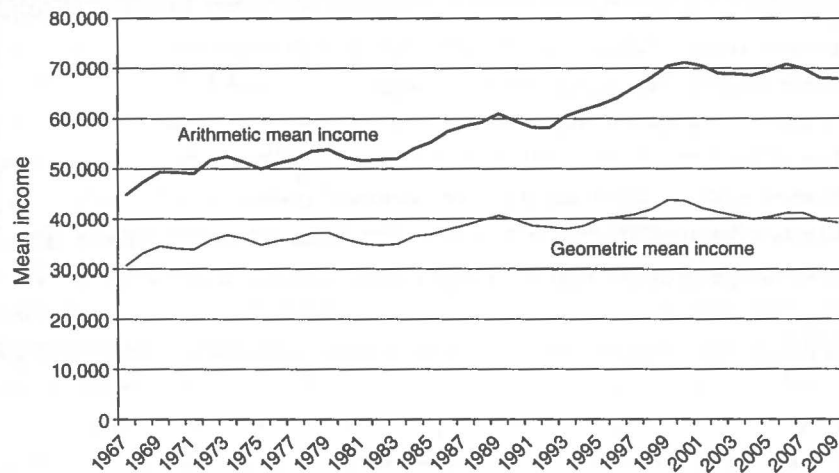


Figure 1.12

Two different perspectives on the growth of average US income. Source: Tony Atkinson, "Economics as a Moral Science," Joseph Rowntree Foundation Lecture, University of York, 2008.

financial crisis. Increasing inequality at the lower end of the income distribution as severe as that experienced in the United States in the last 30 years must matter a lot.

But increasing inequality could matter more generally, even if the poorest groups participate, at least to some degree, in rising absolute income. That is the proposition put forward by Kate Pickett and Richard Wilkinson in their recent book *The Spirit Level: Why More Equal Societies Almost Always Do Better*.²⁶ Across a whole range of indicators—including life expectancy, obesity, levels of community trust, violent crime, teenage pregnancy, and environmental sustainability—Pickett and Wilkinson find and illustrate with scatter diagrams (see, e.g., figures 1.13 and 1.14 here) adverse effects of income and wealth inequality. Those impacts, in turn, are explained both by the direct consequences for individual health, well-being, and social trust of intense relative-status competition and by the diminished ability of unequal societies to coalesce around the achievement of those elements of increased welfare that can be delivered only through collective action. Pickett and Wilkinson argue that the adverse consequences of inequality are so fundamental as to make unequal societies less attractive even for the winners at the top of the unequal pile.

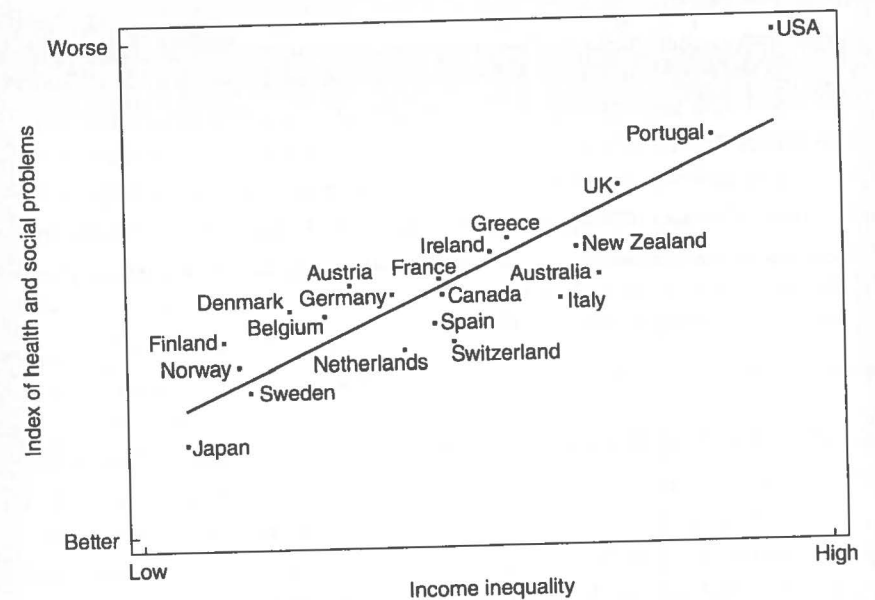


Figure 1.13

Health and social problems. Source: World Bank data, as referenced in Richard Wilkinson and Kate Pickett, *The Spirit Level* (Penguin, 2009).

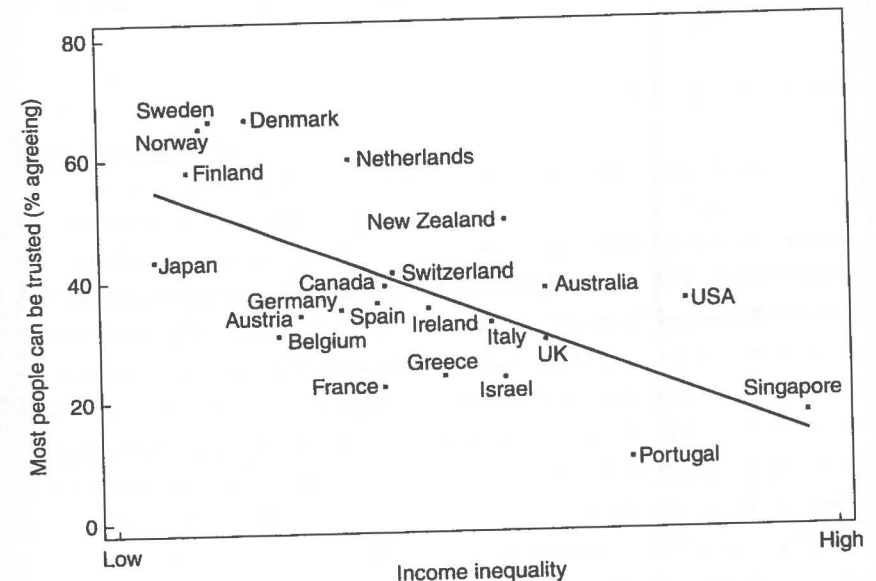


Figure 1.14

Most people can be trusted. Source: European and World Values Survey, as referenced in Wilkinson and Pickett, *The Spirit Level*.

The Spirit Level has been hailed by commentators across the political spectrum but has also been roundly criticized. David Cameron, in his Hugo Young lecture, endorsed its findings:

Research by Richard Wilkinson and Kate Pickett has shown that among the richest countries, it's the more unequal ones that do worse according to almost every quality of life indicator. In *The Spirit Level*, they show that per capita GDP is much less significant to a country's life expectancy, crime levels, literacy and health than the size of the gaps between the richest and poorest in the population. So the best indicator of a country's rank on these measures of general well-being is not the difference in wealth between them, but the difference in wealth within them.²⁷

To the conservative (and Conservative) commentator Charles Moore, however, *The Spirit Level* is "more a socialist tract . . . than an objective analysis of poverty."²⁸ My own assessment is that the more thoughtful critics have made some valid points but have not by any means illustrated that inequality doesn't matter. Like John Kay (in the *Financial Times*), I think four reservations are appropriate²⁹:

- It is clear from the scatter diagrams that the strength of the observed correlations varies greatly.
- Which way the causation flows is often debatable. For example, do high schools in the Southern states of the US have high dropout rates because there is great income inequality, or do those states have great income inequality because the dropout rates are high?
- We must always be cautious of believing that we have found *the* explanatory variable. Simply looking at many of the scatter diagrams makes one immediately aware of other possible factors. The Scandinavian countries, for instance, score far higher on many of the community and social relations factors than even Pickett and Wilkinson's equality-driven model would suggest. When we make comparisons with the United States, this raises the troubling issue of whether relative ethnic homogeneity is a powerful driver of trust.³⁰
- I cannot see that Pickett and Wilkinson have managed to prove that unequal societies are bad for everyone's happiness, including that of the winners. Like John Kay, I feel that, although it would be satisfying to believe that excessive bank bonuses could, through their impact on society's cohesion, make even the recipients unhappy, I really doubt that such is the case. Particularly among the top few percent of the very well off, money enables people to isolate themselves and their families from many of the disadvantages an unequal society may bring.³¹

But with all these reservations noted, it remains a reasonable assessment that *The Spirit Level*, together with the huge body of evidence to which it makes reference (for instance, the work by Michael Marmot on the links between relative status and health), makes a powerful case that the degree of inequality in a society must have non-trivial consequences for many important aspects of human welfare.

And more generally, it is simply intuitively obvious that one's relative position in the income and status hierarchy matters a lot to one's sense of well-being. We know that people care about relative status: I certainly do to a significant extent, and I think almost everybody I have ever met does so to some degree. So if I ask myself whether I would rather live in Britain today on the average income of around £25,000 or in 1950 on an income of £20,000 per annum in today's real terms (a figure that would then have put me toward the top of the income distribution), I have no difficulty in imagining that I might prefer the latter even though it entails a lower absolute income. And it is easy to imagine that someone might prefer to live on £10,000 a year in a land where the average was £10,000 rather than on £11,000 a year in a land where the average was £20,000. Beyond some level of income that ensures the basic requirements of a good life (an adequate home, adequate clothing, good food, good health care, working hours that leave significant opportunities for leisure), one's relative income is an important driver of one's contentment, and concern about relative status is a significant driver of many people's anxiety. Inequality must matter, even if we conclude that there are no straightforward policies that will reduce it.

Of course, that leaves the issue of whether it *should* matter—whether relative-status anxiety should be treated as an understandable concern or dismissed as undesirable envy. After all, if the person imagined above prefers £10,000 per year when others have £10,000 rather than £11,000 when others have £20,000, then what is going on is that the additional £10,000 of everybody else's income is entering as a *negative* factor in the poorer person's utility function—a phenomenon that Martin Feldstein, in his 2005 presidential address to the American Economy Association, labeled "spiteful egalitarianism."³²

That dismissal of the egalitarian case is debatable in philosophical terms. And it is particularly debatable if the less well off believe, sometimes with justification, that some of the highest incomes derive from activities that are more distributive than creative. People's attitudes toward inequality

often seem to depend crucially on whether they intuitively understand and respect as worthwhile the “value” the highly skilled or the highly entrepreneurial have delivered. But even if we accept, with Feldstein, that envy is undesirable, and even if people feel relative-status anxiety in the face of *all* inequality, not differentiating between justified and unjustified, it would still be important for us to understand that this was the case. And this reality would carry consequences for whether economic growth, accompanied by increased inequality, is likely to deliver increased contentment. If people care a lot about relative status, that is a highly relevant fact for economists to understand, whether or not we think they should care.

Economists need to understand human behaviors and preferences as they are, not as they assume or wish them. And that indeed is the general conclusion I reach in this chapter. Economics must address the world as it is, not the world as we have assumed it to make our mathematics easy. It must ask questions about the end objectives of economic activity, even if answering these questions requires us to make judgments on the basis of imperfect empirical data, and even if the questions are only susceptible to incomplete and uncertain answers. Yes, the measurements of self-perceived happiness reported in Layard’s book *Happiness*, or in Frey and Stutzer’s book *Happiness and Economics*, are subject to significant methodological uncertainties, but at least they are asking the right questions, rather than simply assuming that we know the answer and that the answer is that growth is necessarily desirable.

In defining the objectives of economic activity, the instrumental conventional wisdom, which has dominated the policy application of economics for several decades, has simply assumed that maximizing growth in per capita GDP is an axiomatically desirable objective, and that inequality is justified because it helps maximize growth. But those assumptions are not clearly valid for already rich developed countries.

1.6 Revisiting Basic Frameworks

Deep inquiry into the objectives of economic activity and into the links between economic variables (such as income) and fundamental objectives (such as human well-being or welfare) is, therefore, essential to good economics, no matter how difficult. And once we pursue such inquiry,

we may have to completely revise our assumptions about the framework of the marginal-utility curve:

- We begin with the standard assumption that, for any product or service, increasing value consumed delivers increasing utility, but subject to declining marginal returns. (See figure 1.9.)
- This tendency toward declining marginal utility may, however, be partially offset by the fact that entirely new products and services can create new demands to be satisfied, and new utility to be delivered by their consumption. (See figure 1.10.) But if we introduce behavioral assumptions relating to satiation, and to a hierarchy of human needs of changing nature and decreasing importance, we may still end up with an aggregate marginal-utility curve that is increasing but at a declining pace. (See figure 1.15.)
- But a number of mutually reinforcing factors then flatten, complicate, and kink the curve. First, it is highly likely, as Frey and Stutzer argue, that people adapt to levels of consumption already achieved, and that, once they have enjoyed a higher consumption level for a time, they need that higher consumption to deliver the same satisfaction as before. Aspiration levels increase, so that, although in the short term we are on a

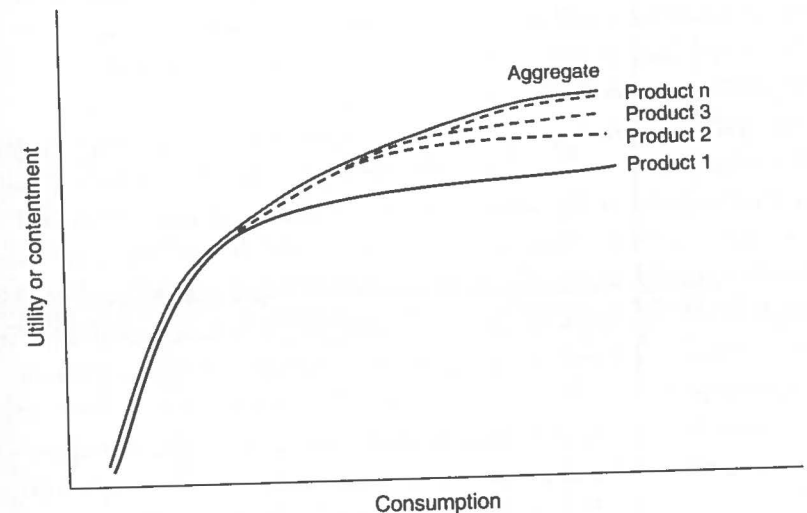


Figure 1.15
Aggregate diminishing marginal utility, driven by aggregate satiation.

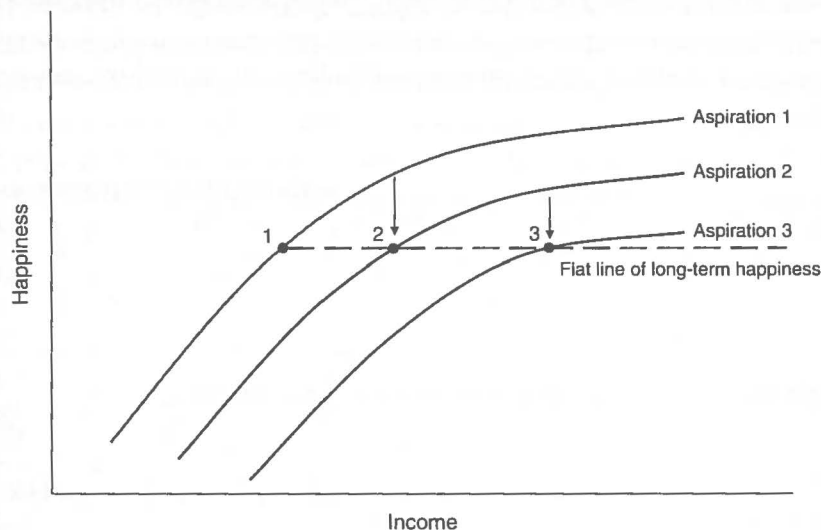


Figure 1.16
Happiness, income, and changing aspirations.

rising curve, in the long run we may be stuck on a horizontal line, as the curve itself adjusts. (See figure 1.16.) Second, it is clear that the idea that one person's utility is a function of that person's consumption alone is invalid. Our utility is also a function of others' income and consumption, both in some ways that even Feldstein would have to accept as relevant (competition for positional goods and congestion effects) and through the direct impact of relative-status competition, which Feldstein dismisses as "spiteful egalitarianism" but which may be a simple fact of life. Third, the tendency to adjust aspiration to achieved wealth and income may be so strong that at any one time any reduction in income or wealth is very strongly negative for welfare, even if increases are only slightly valued. (See figure 1.17.)

- Combining the first and the third factor, the long-term curve could therefore become closer to the shape shown in figure 1.18, with further increments in income delivering no necessarily permanent improvement in self-perceived well-being, but with any setback strongly negative, and with a factor that (for me at least) defies two-dimensional representation: my well-being dependent on my position relative to others as well as on my absolute income.

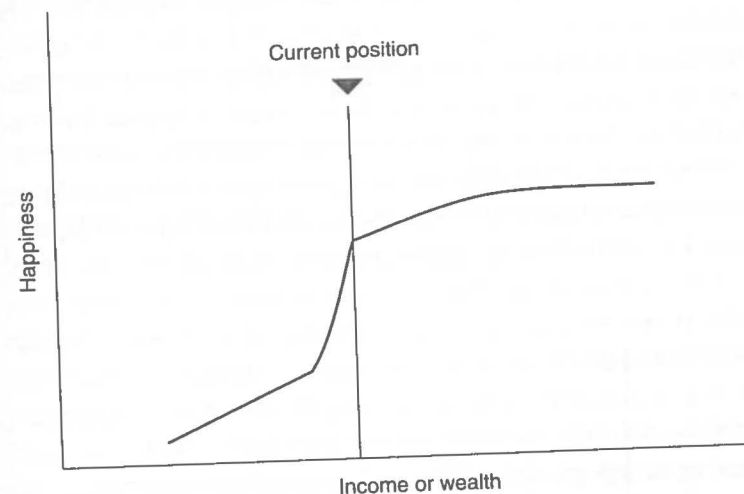


Figure 1.17
Happiness and already achieved income or wealth.

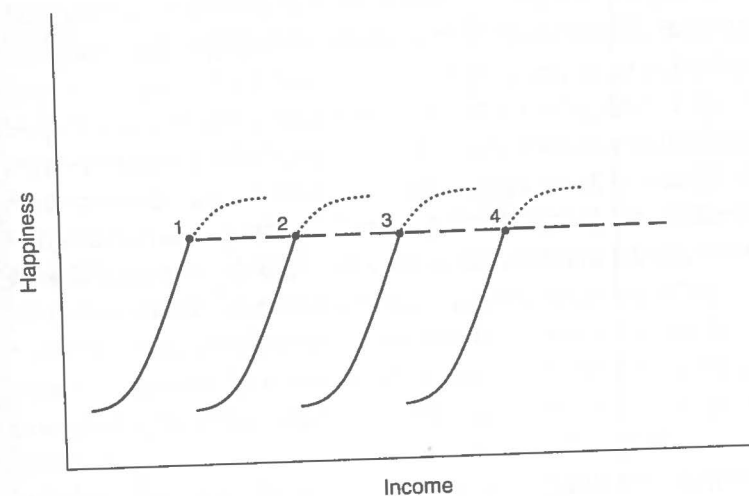


Figure 1.18
Happiness, already achieved income, and changing aspirations.

- But even this more complex shape may still seriously understate the complexity we face, since it still assumes that it is possible to plot a relationship between rising income and well-being without specifying the mix of consumption on which income is spent. Implicitly it therefore assumes that the marginal benefit of each different unit of additional consumption (whether spent on better health care, on more branded fashion goods, or on more road travel) is equal—an assumption apparently justified by the logic that if there were any difference between the marginal benefit of different categories of consumption, rational satisfaction-maximizing consumers would adjust their mix of consumption to bring marginal benefits into line. But this assumption may well not be valid: it is possible that the relationship between life satisfaction and income is different for different categories of consumption. If that were the case, we might expect to see different relationships between income and recorded life satisfaction in different countries that had (whether through private or public choice) made different decisions on how to spend the income benefits of economic growth. In those circumstances, economic growth would have the *potential* to deliver increases in life satisfaction, but there would be no certainty that it would do so.³³

- We need to recognize that income alone is not the sole or indeed anything like the main determinant of self-perceived well-being. Even if we leave aside the many essentially non-economic factors that clearly are important—the vagaries of luck in family life, success in love and friendship, genetic predisposition—it is clear that access to employment should enter our framework as a crucial driver of happiness in itself, above and beyond the fact that employment helps deliver income.³⁴ Contrary to any free-market concept that unemployment imposes no utility loss because it results from a voluntary tradeoff between reduced income and increased leisure hours, all studies find that unemployment causes major unhappiness for the person affected, because work is for most people crucial to a sense of status and social relationships, and unemployment is a driver of low esteem and isolation. As I will argue in chapter 3, this has important consequences for many tradeoffs in public policy—for instance, in financial regulation, between policies that might maximize long-term growth and policies that maximize economic stability.

In sum, therefore, many of the assumptions and analytical frameworks that underpin the instrumental argument for free markets and inequality are either invalid or much weaker than is commonly supposed.

There is much uncertainty about what the objectives of economic activity should be and about how to pursue them: whether it is most useful to define the objective as happiness, and if it is, just how we measure and achieve happiness or well-being. And there are uncertainties about the implications of the empirical evidence of relationships between income and self-perceived well-being. But one thing we know with reasonable certainty is that increasing average per capita GDP beyond the levels achieved in rich developed countries doesn't, by itself, ensure significant increases in self-perceived well-being, and therefore is not a useful definition of the overriding objective of economic activity. As a result, the instrumental justification of free markets and inequality, which has played a major role in the political discourse of both right and left for the last 30 years, has largely lost its validity.