Poverty – an economic blight

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Introduction – fairness, not levelling

Those who live and work in this region have a much better understanding of poverty and its consequences than I can ever grasp. My perspective is from the comfort of research papers and statistics, but even these present a strong story.

The Port Phillip region has undergone huge structural change over the last fifty years. Its traditional heavy manufacturing and waterfront industries have shed labor. The areas immediately surrounding Melbourne's CBD, including the suburbs either side of the mouth of the Yarra, and the southern Mornington Peninsula are left with a strong concentration of low income households. At the same time, in these same suburbs, there is a new demographic developing of households with high incomes and light commitments. While such demographic mixing has its benefits, it sharpens the experience of inequality, and leaves many feeling that there is something intrinsically unfair in our economic arrangements.

I want to focus on inequality and unfairness. As a general proposition, I suggest we accept a degree of inequality in our societies, provided there is equality of opportunity. Social research across many countries confirms acceptance of such a normative standard.

This acceptance of inequality within bounds may seem to be obvious, but it's an important point, because those who argue for fairness are often portrayed as "levellers", or advocates of some Soviet ideal of a deadening equality of misery.

Even in an ideal society with equality of opportunity there will be variations in income and wealth. Some will choose to work harder, others will choose more leisure. Some will have large families, some will remain childless. Some will seek excitement and will take risks, others will seek security. Some will value material possessions, others will value a simple life.

These choices will result in differences in income and wealth, but we would expect such variations to be within reasonable bounds, certainly far more constrained than the 1000:1 ratios we are seeing between minimum wages and top executive pay. And we would expect such variations to be a consequence of freely made choices, rather than a result of circumstances over which people have no control, or privilege gained through exploitation of the contributions of others.

So arguments for fairness are not arguments for complete equality. Rather they are arguments for an acceptable range of inequality that reflects people's freely made choices and their contributions to society. Research supporting greater equality, such as the work of Richard Wilkinson and Kate Pickett (authors of *The spirit level: Why more equal societies always do better*) and of Andrew Leigh at the ANU, is based on the range of inequality between the USA at one end and the Nordic countries at the other end of the spectrum. Even these Nordic countries are a long way from a flat distribution of wealth and income.

On that spectrum Australia is nearer the USA end than the Nordic end. Table 1 shows that in terms of poverty, as measured by the proportion of people with 60 percent or less of median income, Australia has a comparatively high level of inequality. Most developed European countries, even the UK which we have traditionally considered to be a class-bound society, do better than Australia. This is in spite of our younger age structure and our low level of unemployment in comparison with those countries. And it's in contrast to our self-image as an egalitarian society governed by a value of a "fair go".

Table 1. Relative poverty rates at 60 percent of median income, mid 2000s, OECD countries

Sweden	11.4%
Czech Republic	11.5%
Iceland	12.3%
Denmark	12.3%
Hungary	12.3%
Norway	12.4%
Luxembourg	13.2%
Austria	13.4%
Slovakia	13.7%
France	14.1%
Netherlands	14.4%
Finland	14.8%
Switzerland	15.2%
United Kingdom	15.5%
Belgium	16.2%
Germany	17.2%
Canada	19.0%
Greece	19.6%
Italy	19.7%
Australia	**20.3%**
Portugal	20.7%
Poland	20.8%
Korea	20.8%
Japan	20.8%
Spain	21.0%
New Zealand	22.7%
Ireland	23.3%
United States	23.9%
Turkey	24.3%
Mexico	25.3%
OECD-30	17.4%

Source: OECD

And we have been becoming more unequal over time. Figure 1 shows how Australia's inequality, as measured by the share of income taken by the top ten percent, has moved since 1942. That figure shows data for the USA and Australia only, but the experience in most other developed countries is similar. (Leigh finds that different indicators of inequality, such as income shares and wealth distribution, tend to move in tandem.)

It is notable that inequality in Australia, after closing for many years, started to widen again in the 1980s. That coincides with the rise of what is generally known as "neoliberal" economic policies, in particular as put in place by the Reagan Government in the US and the Thatcher Government in the UK. Although Australia had a Labor Government in the mid 1980s, those ideas were influential here, and were pursued even more vigorously by the Howard Government from 1996. I want to spend a little time describing the theoretical underpinning of these policies, and to show that they are seriously flawed. Everyone at this forum will know how they are flawed from a social justice perspective, but they are also flawed from an economic perspective.

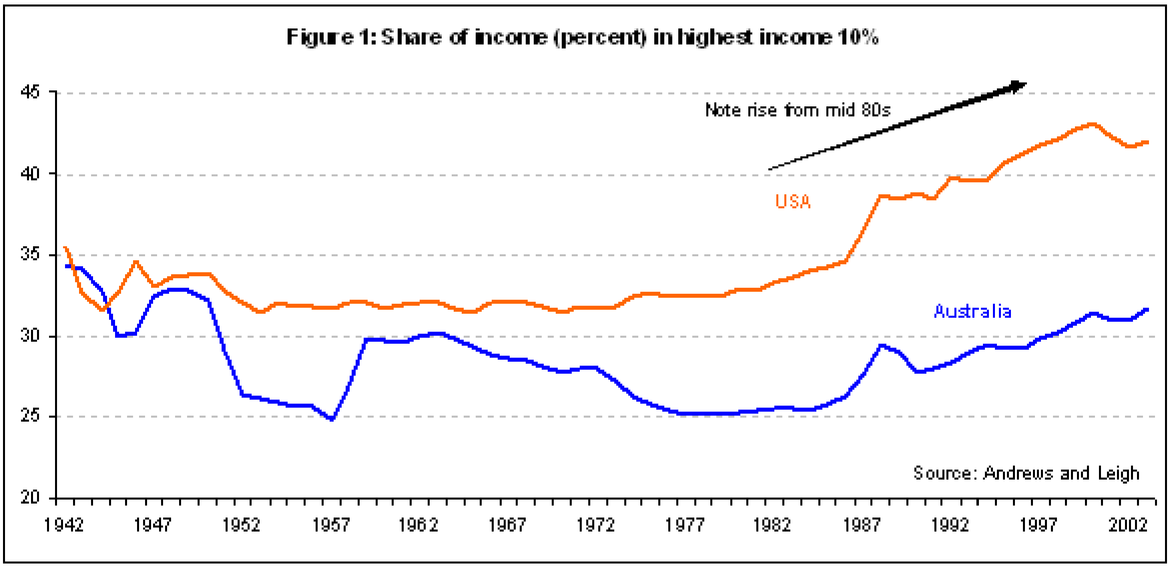


Figure 1: Share of income (percent) in highest income 10%

Rising tides and greed

I don't know of any economist, even on the far right, who says that poverty is desirable. Rather, the attitude among neoliberal economists and policy makers is that poverty is an unfortunate but unavoidable by-product of economic progress. What soldiers may call "collateral damage". In any event, the argument goes, while disparities may be opening up in the brave new world of neoliberalism, everyone's standard of living has been rising.

At one level this logic stands up. If any of us contemplate how we lived, say, two generations ago, when it was commonplace to see children at school without shoes, when a car was an extravagant luxury, and when the night soil collector came to the outside lavatories, it is obvious that material living standards have improved for all, or almost all. The slogan to explain (and justify) such progress is "a rising tide lifts all boats".

But the flaw in such logic is that it ignores fairness (as well as some of the other costs of individual material progress).

Fairness does not make it into the mainstream of economics, and is therefore not a prime concern of public policy makers in economic portfolios.

The study of economics starts with a set of assumptions about human behavior, one key assumption being that we are motivated entirely by self-interest.

This assumption is useful as a teaching tool, in particular in terms of explaining the role of prices and the behavior of competitive markets. It does a reasonable job at explaining how markets for tomatoes and Toyotas work, but when it comes to macroeconomic issues, such as income distribution and poverty, it is seriously inadequate.

It's a convenient assumption, however, to justify inequality.

If I care only about myself, then I don't care about others, be they better off or worse off than me. If they are worse off than me, that's their problem. If they are better off, I don't care – if I did care then I would be an irrational whingeing socialist, gripped by the "politics of envy", or worse, guilty of the sin of envy – one of the seven deadlies. If my wage remains frozen (in real terms) while the CEO's income doubles, it's none of my business.

It is easy to see the weaknesses in this view of human behavior, which completely ignores inequality. It has been a convenient justification for rising inequality in times of strong economic growth, however, for it absolves the privileged from being concerned with inequality – if I become better off then society is better off. What's good for me is good for Australia.

This barren philosophy, however, has become exposed over the last two years, when the tide stopped rising and started to go out. It is morally repugnant to many people, and it fails to recognize the economic cost of inequality. There is an economics of inequality, to which I wish to turn.

The economics of inequality – perspectives of an errant economist

The "errant economist" is Thomas Schelling, a pioneer in behavioral economics, particularly in applying game theory to economics, and winner of the 2005 Nobel Prize in economics.

Let's look at some of the games and simulations typical of those Schelling has applied to his experimental subjects and which we demonstrate in the classroom.

The first is the *ultimatum game*. Player A, the "offerer", has temporary control over $10. She is to propose division between herself and Player B, the "acceptor". If player B accepts the proposed division, then the division occurs. If player B rejects the proposed division, then both parties forfeit.

By the logic of economics based on self-interest, Player B, the "acceptor", should accept *any* division – $1.00/$9.00, or even $0.05/$9.95. But, in repeated round experiments, researchers find that "acceptors" reject such imbalanced divisions, preferring to walk away empty-handed. And, unless prompted, "proposers" tend to offer divisions close to a 50:50 split.

Another simulation is an experimental pair of questions:

A) You are going to buy a good quality digital camera. It is available at a local camera store for $1000. It is also available at a store, twenty minutes drive away, for $970.

You have no prior relationship with either store. Do you travel across town to buy the cheaper camera?

B) You are going to buy a radio. It is available at a local store for \$70. It is also available at a store, twenty minutes drive away, for \$40. You have no prior relationship with either store. Do you travel across town to buy the cheaper radio?

Now the calculating economist, *homo economicus*, should apply the same decision to both these situations, based on whether he or she estimates the personal cost of a journey to be greater or less than \$30. But many more people travel in situation B than in situation A.

These and similar simulations demonstrate that most of us are willing to bear some personal cost in order to avoid a transaction which we consider to be unfair. In the ultimatum game we lose the amount we may have gained from agreeing to an unfair division. In the travel simulation we may consider a three percent price differential to be reasonable and not bother travelling across town, but a 75 percent price differential suggests that the local supplier is trying to rip us off.

We punish unfair behavior, at personal cost, in the first case by denying the proposer her share, and, in the second case, by denying our custom, even if we incur more than \$30 in travelling costs in doing so.

And another simulation:

For each of the situations below, indicate on a scale from 0 to 10 how upset you would be.

1. On an unsealed country road you put a stone through the muffler on your car, which will cost \$500 to repair.	0 ________ 10
2. At work you act in a higher position for four weeks, for which there is usually a \$125 a week extra pay, but you don't get the extra pay.	0 ________ 10
3. At a crowded venue you discover your wallet/purse has been taken. It had \$500 cash in it; fortunately your driver's licence, credit cards etc were elsewhere.	0 ________ 10
4. You take an overseas trip, spending \$2500. On the plane you discover the person in the next seat has bought the same package for \$2000.	0 ________ 10
5. You have been trying to sell a used car for \$7500. Two buyers have inspected it and gone away. One has phoned you back with an offer of \$7000, which you have accepted. Ten minutes later the other buyer phones offering \$7500.	0 ________ 10

6. You have an operation which requires an anaesthetic. The schedule fee for an anaesthetic is $400. The bill you get from the private anaesthetist is $900.

0 ________________ 10

7. In a violent storm the roof of your house develops a leak and the damage costs $500 to repair. (Your insurance deductible is $1000.)

0 ________________ 10

8. You make a donation of $500 to a charity devoted to children who have been injured by landmines. A week later you read in the paper that the charity was a scam. The money will never leave Australia, and will be absorbed in “consulting fees”.

0 ________________ 10

If you score every situation identically, on the basis that each one involves a loss of $500, then you must be a very well-conditioned economist.

But, of course, you probably don’t see these situations identically. You probably dismiss a leaking roof or a punctured muffler with a couple of curses, but the discovery that you have been scammed keeps you awake at night in anger. We are not passive creatures carrying a personal ledger measured by cash flows, but we are very concerned by the legitimacy of transactions.

Lest we believe these findings relate only to laboratory findings, we can find them manifest in everyday life. We need look no further than the anger at business executives who take large payments even when they have been demonstratively incompetent. For example, there has been huge anger at the $250 million bonuses paid to the AIG executives. In relation to what they have cost due to their incompetence, the $250 million bonuses are trivial – about one tenth of one percent of the federal bail-out money. But our disproportionate anger arises because we consider these bonuses to be unfair. And more generally, people are furious at the way in the current financial turmoil financiers have been bailed out with public money, while most people have to suffer the consequences of economic events over which they have no control.

It is a misrepresentation to call such anger “envy”. But we are far more accepting of the fortunes of genuine entrepreneurs such as Bill Gates, whose personal fortune is in the billions, than of the much smaller sums appropriated by incompetent or corrupt business executives. Nor is such anger motivated by a call for redistribution. As French and Russian revolutionaries learned, confiscation and re-distribution of ill-gotten wealth does not go very far. Our anger is based on more basic moral values – a repugnance at the notion that some should use their power to gain privilege, or in Biblical terms, to reap where others have sown.

Knowing that we value fairness over self-interest may displace the simplistic assumptions of elementary economics, but is it possible that our concern for fairness is at the expense of our long-term economic welfare? Many economists would argue that we do best through letting self-interest have its way, and to use the dividends of economic growth to compensate those who lose out.

In practical terms, that dictates a *laissez faire* approach to public policy. Let markets dominate. Keep government small. Let wages fall to a "market" level (the approach of *Workchoices*).

Those who advocate such a policy approach aren't callous. Their practical solution is to use welfare payments to compensate for the failure of private markets to prevent severe poverty, particularly among those who are in employment – to avoid the development of a class of "working poor". Contrary to some common misconceptions, governments of neoliberal persuasion tend to spend more on social security transfers than governments of a more "left" persuasion – not because they are more compassionate, but because they have to in order to prevent severe poverty from developing.

The hardheaded economics of fairness

This neoliberal model fails because it's poor economics. It does not account for:

- the benefits of social cooperation supported by norms of fairness;
- the costly health consequences of poverty;
- the lost productivity associated with poverty;
- the diversion of public revenue to poverty alleviation.

Social cooperation

When open-minded economists such as Schelling, systems theorists such as Natalie Glance and Bernado Huberman, and social scientists such as Robert Axelrod, bring together the multidisciplinary approaches of economics, sociology, anthropology, psychology and game theory, they find that social cooperation can be a significant asset in evolutionary adaptation.

In simple terms, groups which cooperate can accumulate more resources than those in which each individual looks only after himself or herself. In groups without cooperation individuals must devote significant resources protecting their own interests, for fear of predation by other group members. We can see this most clearly in so-called "failed states", where trust and therefore social cooperation have evaporated.

Groups with strong norms of cooperation are more productive, because individuals can spend less effort protecting their own interests and can spend more effort contributing to their own and collective interests. In other words, if we are not fending off marauding competitors we can actually do something useful. Groups with strong norms of social cooperation can accumulate more resources in the form of both individual and collective wealth than groups with weak cooperation. One such set of norms relates to fairness.

Of course cooperation can be enforced without regard to fairness. There can be systems of enforced cooperation ranging from strong anti-union legislation through to slavery. But, particularly as shown in research in the US comparing productivity before and after Emancipation, slave labor is much less productive than free labor. There are two reasons.

One is that coercion is costly: as people lose trust in one another they have to spend more on coercive mechanisms. In a slave society those mechanisms are guards and supervisors; in a modern society those mechanisms are contracts, legal services, accountants, audits, police forces etc. This evolutionary model is confirmed by the work of Wilkinson and Pickett, who find that levels of trust are stronger in countries with less income inequality.

The other reason is that, as psychologists know, coercion through punishment elicits at best sullen compliance, rather than productive effort. Even the much-maligned Frederick Winslow Taylor pointed this out: when the laborer Schmidt found he could share in the rewards from his effort, his output rose strongly. If we believe the benefits of our effort or creativity will accrue unfairly to others, then our incentives are diminished. That's why high executive pay is economically damaging: it's not so much that it redistributes income, but, rather, that it sends a strong and incentive-destroying message of unfairness.

Social cooperation also allows for role specialization. When people feel they can trade in fairly constructed labor and commodity markets they are likely to engage in specialization and trade, thereby realizing further economies. Note, for example, that in societies with underdeveloped markets or with markets dominated by strong parties, there is often reliance on inefficient means of production, such as barter and attempts at household self-sufficiency. While we may have a romantic attachment to such arrangements, they do involve a large cost – what economists refer to as an "opportunity cost".

These arguments are not a soppy "left" defense of fairness. Rather, they provide a hardheaded description of why norms of fairness are basic economic assets. They help explain why it makes evolutionary sense for individuals to exert effort to punish those who violate such norms. They explain the value of unrequited altruism, ranging from giving way to others in a traffic jam through to sacrifice in battle.

Health consequences of poverty

Public health research, such as Michael Marmot's famous Whitehall studies, and the more recent work by Wilkinson and Pickett, finds that societies with fairer distribution of income and of economic power, such as the Nordic countries, have less violence, lower imprisonment rates, less drug dependence, better health, higher school retention, higher levels of trust, and longer life expectancy. These are mainly health benefits, which means they are economic benefits, as such societies need to spend less on services such as rehabilitation and health care, and healthy people are more likely to be engaged in productive activity. By quirks of national accounts (which record the costs of running jails, for example, as economic "output"), these benefits do not show up easily in annually published national accounts, which do not distinguish between productive and unproductive activity.

One may be tempted to dismiss the work of Wilkinson and Pickett on the basis that more equality tends to be found in societies that are already prosperous (suggesting that equality may be a luxury that can be afforded only once a level of prosperity is reached, rather than the notion that equality promotes prosperity). But they carefully test this possibility, and reject it. Among the dimensions they study, prosperity, in itself, does not appear to be a causal factor in improving health and other social indicators. It's equality that counts.

Marmot's work in the UK Civil Service (the equivalent of our Public Service) gives some insight into the dynamics of poverty. He found, unsurprisingly, a causal relationship between stress and ill-health. His most illuminating finding was that, contrary to popular views which see more stress in more senior jobs ("executive stress"), the most stressful jobs are to be found down the line. Senior public servants enjoyed more autonomy, and had more capacity to control their work – even if this did mean some long and difficult sessions. Those down the line had less autonomy and less capacity to control their work, and therefore more stress.

As psychologists point out, a capacity to make choices ("agency" in the jargon of psychology) is an essential human need. If poverty results from choice, then it is less painful, and less destructive of health, than poverty which results from entrapment. We do not need to fret about the poverty of Trappist monks, or of those who choose a post-materialist life style on a commune. When poverty stems from powerlessness it's stressful.

Lost productivity

One strong neoliberal argument, supported by simplistic economic models of the labor market, is that poverty, or at least the threat of poverty, is a strong motivator for people to better themselves through improving their skills and seeking work. The argument has appeal: everyone has an anecdote about one or more "dole bludgers". But it's flawed, for it disregards people's desire to be productive contributors to society, and it overlooks the fact that poverty itself is entrapment.

If the neoliberal argument were correct, we would expect societies characterized by inequality to show higher intergenerational mobility than more equal societies; the threat of poverty would motivate more people to better themselves. But empirical research by Andrew Leigh finds just the opposite: in countries with high inequality there is less social mobility between generations than in more equal societies. Poverty begets poverty.

Wilkinson and Pickett also find that more equal societies are more innovative. This also tends to discredit the simplistic economic models.

We know too little about the mechanisms that drive people to work, to contribute to society and to innovate. The simple "carrot and stick" models of Economics 1, however, do little to explain people's individual or aggregate behavior.

It may be that in a more equal society it's safer to innovate. We know from behavioral research that people's fear of failure can override their willingness to take a risk with beneficial payoffs. If you have a great idea, such as setting up a new company to make a better mousetrap, you are more likely to do so if you know there is a cushion in the event of failure, even if the benefits of success are less than they would be in a *laissez faire* market.

Also, to turn the neoliberal argument back on itself, large inequalities in income lead, in time, to even larger inequalities in wealth, and the eventual growth of a leisure class, where there is no financial motivation to work, particularly among those who inherit wealth. Also, a wealthy class can divert resources from socially useful production into indulgent private consumption for the few, such as luxury vehicles, private planes, and the services of builders, domestic servants, gardeners and chauffeurs.

The diversion of public revenue

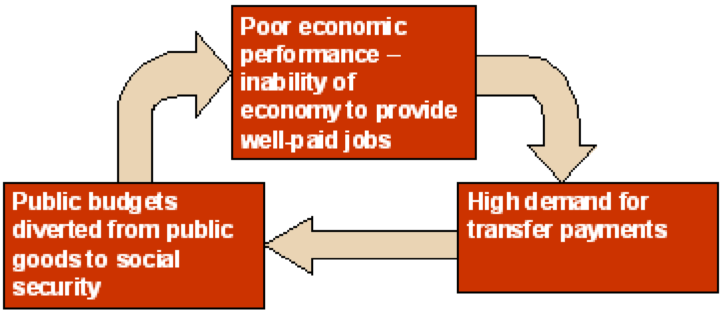
As pointed out above, neoliberal economists may still contend that welfare payments can compensate for inequality in private incomes; indeed this has been a trend in Australian public policy over the last fifty years. As pointed out by Michael Keating, former head of the Department of Employment and Industrial Relations, in 1983 social security transfers accounted for only four percent of the disposable income of a low income family; by 2005 transfers accounted for half the disposable income of such a family.

There are two economic shortcomings in using welfare to top up wages or to compensate for "inevitable" bouts of unemployment.

First, if people's private income is too low to support a decent standard of living, it's a fair bet that they are not working as productively as they could be. They may lack the education or training which would allow them to engage in more productive and better-paid employment, they may be working inefficiently because of poor management, or in other ways poverty itself may be limiting their choices (e.g. constraints on transport). Whatever the cause, they are not able to contribute to their full capacity; there is what economists call an "output gap".

Second, social security transfers tend to crowd out other aspects of public expenditure – expenditure on health care, transport, research, and, above all, education, which can increase a nation's productive capacity. A country can get caught in a positive feedback cycle of declining private incomes, supplemented by higher social transfer payments at the expense of productive public expenditure, which results in lower private incomes, in turn resulting in higher demand for social security payments. This is essentially what brought down Argentina in the mid twentieth century, under the policies of the Perón Government. It's a loop of fiscal misery.

Figure 2: The loop of fiscal misery



Conclusion

To summarize, I suggest that policies that promote fairness can be policies that promote economic growth.

The title of this Forum "An Unequal society is an Unhealthy Society" therefore is truly apt. I would even widen the concept to say "An unequal Society is an Unproductive Society".

But there is an impediment to the adoption of such policies. We tend to see a tradeoff between economic and social goals: if we want better social outcomes we must incur some cost in terms of our economic progress. And conversely we are led to believe that economic progress comes at the cost of some collateral damage to our social aspirations.

We see this thinking encapsulated in notions such as the "triple bottom line", which puts social, economic and environmental outcomes alongside one another.

Such a construction allows public policy debates to be framed in terms of tradeoffs. Real men attend to the economy, while the mendicants on the "left" beg for the crumbs on the table.

The tradeoff makes no sense, however. To suggest that economics sits alongside society is to misplace it, for economic progress is meaningless unless it serves social ends. To say we have to sacrifice social outcomes to serve economic goals makes no more sense than the statement, attributed to a general in the Vietnam War: "We had to destroy the village in order to save it".

In 1944 the economic philosopher Karl Polyani warned of the emergence of a destructive disconnection between economics and society. We have all contributed to that disconnection – the "right" through its presentation of false tradeoffs, and the "left" through not challenging them.

There are many ways in which enlightened public policy can strengthen economic outcomes through reducing poverty. Not through passive welfare payments, though welfare outlays may be necessary as a transitional measure. Rather they should strengthen the capacity for all to contribute through investment in public goods to improve the nation's productivity and to widen the opportunities for people to participate in socially useful employment. In this regard I would single out investment in education; its benefits may be slow to materialize but they are enduring.

This may sound like a bias of a university lecturer, but I would suggest education at all levels, particularly pre-school and early primary school, where some of the disadvantages of a childhood in a poor household can be addressed.

Then we can look forward to a prosperous Australia with less need for welfare payments.

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