Measuring Income Inequality: Comments on "Do Nations Just Get the Inequality They Deserve? The 'Palma Ratio' Re-examined" by José Gabriel Palma

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José Gabriel Palma has identified an important empirical regularity that has not been recognized in the past: the share of the middle is relatively constant across countries. He doesn't really provide an explanation of this regularity, but even without such an explanation, it should be clear that it's an important empirical observation with implications for both empirical work and policy. It says that the Gini coefficient may not best capture what is really going on when making comparisons of distributions across countries or over time. In the case of any measure, the focus ought to be on where there is variability and if this regularity is really true in the way that he has described it, then it means that variability can be found in the share at the top and the share at the very bottom. The middle, he demonstrates, just takes the same fraction of the pie. Differences across countries are, thus, to be found in the ratio of the share at the top to that at the bottom.

This has led to a very interesting discussion on the post-Millennium Development Goals, post-2015 agenda. Given the importance being ascribed globally to inequality, one suggestion has been that there ought to be a goal of reducing *extreme* inequality. The Palma ratio has been put forward as the metric that should be used, because that ratio really captures what is going on in inequality at the extremes – and movement in the extremes is where all the "action" is.

Palma's paper in this volume raises some very deep questions about the determination of inequality. There is no theory, at least none based on the standard neoclassical model, which provides any explanation for why different countries have these very different patterns at the top and bottom, just as there is really no theory that can explain why the share of the middle should be so constant. Palma argues very strongly, and I think convincingly, that the neoclassical model does not provide a good way of interpreting what is going on, and that one needs other models. However, I'm a bit more receptive to the use of neoclassical models as a benchmark than Palma. I believe that it is useful

to begin the analysis by explaining to what extent the neoclassical model does or does not provide an explanation, and, to the extent that the neoclassical model fails, to determine where it goes wrong or where it is simply inadequate.

In fact, though he dismisses the neoclassical model, he uses it in a very forceful way – to argue that education is *not* the critical variable, as many analyses of income distribution using the neoclassical approach conclude. He points out that looking across countries, there is diversity in the education provided to the middle, and yet there is uniformity in the share of national income that goes to the middle. By contrast, those at the top all across the world are well educated, and those at the bottom have very poor education, and yet it is at the extremes that one finds the diversity of outcomes. This suggests that education is not really the explanatory variable that can provide an answer to the question of why countries differ so much in the distribution of income. His analysis is persuasive.

What I think plays a more important role – and Palma hints at this – is rent-seeking. The standard neoclassical model focuses on marginal productivity theory, *assuming* a competitive equilibrium. It is clear, however, that there's something else going on. There is a whole set of deviations from the standard competitive equilibrium, which give rise to income sources that can broadly be described as "rents," as I discuss in my contribution to this volume. These include monopoly rents, the rents accruing to CEOs as a result of their ability to take advantage of imperfections in corporate governance to divert corporate revenues to their own benefit, and the rents accruing to the financial system. The worst forms of rents are associated with moving money from the very poor to the very rich, as occurs when banks engage in predatory lending and abusive credit card practices. Understanding how these rents are generated, and how changes in the economy and in politics can lead to a change in these rents, is vital to understanding these extremes of inequality and how they change over time.

Palma also touched on one topic in his paper: the existence of a ratchet effect. There are certain periods when inequality increases, but then doesn't go down again at the termination of the "episode." That is something that has been observed in the United States: In the late 1970s and early 1980s we had a ratcheting up of inequality at the top; this showed up as an increase in the Palma ratio. There was no change in the pace of globalization at the time that could account for this, nor was there any major change in technology in that short period of time. Moreover, both these forces (changes in technology and changes in globalization) were *global*.

My interpretation of what happened in that episode was that it was a period of high inflation in which wages did not keep up. The CEOs discovered that they were able to seize a larger fraction of the corporate pie for themselves. Unsurprisingly, they then decided that that this was not a bad situation and worked to keep it this way. These changes cannot be explained by conventional

neoclassical theory; they cannot be explained in terms of skill-biased technical change or in terms of globalization. New norms were created; and even the old CEOs in the 1950s and 1960s looked – perhaps with a little envy – on what had happened to their successors, and said it was wrong. They had been indoctrinated with the old norms, and they said what's going on was "not right."

The most fundamental point of Palma's paper is to attribute the differences in outcomes to differences in what he refers to as the "political settlement". I absolutely agree that it is not just economics that is determining the outcomes – economic forces are operating everywhere, but there are nevertheless very marked differences in the outcomes across countries. (This was one of the main points that I raised in my books *The Price of Inequality* and *The Great Divide*.)

But there is still the crucial question of how we should explain these differences in the political settlement. Why are the political settlements in South America and South Africa so different from those observed in the rest of the world? And in answering it, one has to go beyond economics and into politics and sociology. Palma does provide some suggestions as to why it might be the case that the Latin American "settlement" entailed more inequality than elsewhere. But his analysis does not explain why among the OECD countries there are such large differences; why, for instance, the political settlement in the United States has so much higher levels of inequality than in Scandinavia.

In coming to terms with why countries might differ so much in their levels of inequality, one has to distinguish between inequalities in market income, and inequalities in after-tax and transfer income. Most analyses invoke standard neoclassical theory to explain market income; and then there is a *political* process that translates market income into disposable income, into what individuals actually have to spend (into income after taxes and transfers). There are differences across countries in the distribution of market income – explained, at least in part, by differences in the rents to which I referred earlier, but there are also marked differences in how the tax and transfer systems work. For instance, the United States has a high level of market income inequality, but what really distinguishes the United States is that it doesn't correct for the inequalities in market income, which then leads to a high level of inequality in income after taxes and transfers. Both aspects of inequality have to do with the political system.

Finally, this discussion provides an interesting segue into thinking about some of the issues that were raised by Piketty's analysis concerning the nature of capitalism, and in particular whether inequality is inevitably associated with capitalism. The fact that there is such diversity of outcomes, all within market economies, suggest that inequality is not an inherent property of capitalism. Inequality really has something to do with the political system, and that is where we ought to be focusing our attention. But it's also the case that Palma's

analysis, by critiquing the ability of the neoclassical model to explain what's going on, implies that Piketty's theoretical analysis, which relies heavily on a neoclassical model, is misguided. I concur with Palma that there are limits on the neoclassical model, but I think there are important extensions of that model, incorporating land and credit, which can provide further insights into the distribution of income and wealth among individuals. My paper in this volume attempts to provide such an analysis.