

Equal to Us (also means: worthwhile)
By Gideon Eshet, Yedioth Ahronoth 2/27/2007
(Translated from Hebrew. See original article below)

Conventional wisdom is that growth is the most important thing, and steps that aim at reducing inequality are perceived as measures that hurt it. A new research found the opposite: the economic benefit from reducing inequality is far greater than the economic benefit of growth.

“After a long period in which growth rates in the economy were lower than growth rates in the world, the trend reversed and starting from 2004 the Israeli economy grows in higher rates”, This is how the document “The Fiscal Policy for Year 2007” opens. The Bank of Israel also opens its most recent economic developments document by stating the positive growth. All other economic publications also express the view that growth is the most important indicator for an economy’s wellbeing, and the first question that an economist is interested in when visiting a foreign country is its growth rate.

This attitude clearly testifies that in economics the right won over the left. It is clear to any reasonable person that growth – the increase of the economic pie – is very important in Zimbabwe, for example, but the victory of the right is reflected in that growth is conceived as good also in the United States, Israel and generally in the world’s richest countries. Benjamin Netanyahu, until recently the Treasury Minister, often explained that we first grow and then allocate the pie. And there is no one in the country that better expresses this rightwing view better than him.

Recently the prime minister has constructed a team led by the government statistician, Shlomo Yitzhaki. The team is supposed to examine other methods for measuring poverty. One of the team members, Omer Moav from the Hebrew University, a prominent rightwing fellow, explained that for purposes of economic policy another measurement of poverty is needed. The current measurement is not good enough. The idea is clear: one need to find a measurement

method that will show reduction in poverty even when it expands according to the current definition. Therefore Ehud Olmert invented the team, filled it with people that are recognized with this view (with the exception of two) – and one may assume that soon he will receive recommendations accordingly.

To allocate or to grow – this is the central question that separates right from left in economics. One of the central figures of the rightwing is Nobel Prize winner (that is not a Nobel but rather a prize of the Swedish Academy of Science) in economics in 1995 – Robert Lucas. Lucas wrote, “of the tendencies that are harmful to sound economics, the most seductive, and in my opinion, the most poisonous, is to focus on questions of distribution [of the economic pie]”. Later Lucas describes two children that are born at the same time. One in the United States and the other in India, and asks what would they prefer: growth or distribution? He answers: “the potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production”.

Go back to the government policy document: “output per capita in Israel is still low relative to advanced countries. Therefore one should attempt to lead a policy that would support the continuation of achieving a target of at least three percent per capita growth in the next five years”. Here is the expression of Olmert’s government to Robert Lucas’s philosophy.

In an interview to “Yedioth Ahronoth” another Nobel Prize winner, Daniel

Kahneman (he will speak tonight in Tel Aviv University about the psychology of decision making), pointed out that findings from different countries show that people do not improve their happiness when economic growth is over \$12,000 per capita (in Israel today – \$20,000). But maybe there is benefit in increasing wealth even without greater happiness? Lucas's answer is decisive: the benefits from distribution of the pie are dwarfed by the benefits of growth.

A new and punchy research* shows that Lucas misses an important economic point. Lucas wrote about the poison of distribution in 2004. The two researches used the economic model that Lucas built in 1997, and adjusted it to somewhat more realistic assumptions, at least in the eyes of the researchers. The question remained as Lucas presented it: Two children are born, one in a rich country and the other in poor. When trying to calculate their economic interest, what is better: growth or distribution? Notice that the point of view is one of the children, meaning that of the future. The researches examine this question for both the Indian child, and the America, and also – an interesting issue by itself – a child that its place of birth will be determined randomly.

The researchers' answer will surprise any student of economics. If our hypothetical child does not know its place of birth, it would willingly give up all future growth so as to avoid the risk of life in poverty. But even if it knows its expected place of birth, the United States for example, it would give up most of the growth, and even all of it, so as to avoid the risk of poverty to its family. The researchers show, to their method, that the economic price of inequality is far greater than commonly thought.

From an American point of view – a country that competes with Israel on the first

place in inequality – the optimal state is a minimal inequality, like in Scandinavia. It is important to understand the findings as were measured by the researchers: the economic benefit from reducing inequality is far greater than the economic benefit of future growth.

“Countries debate about the relative benefit of distribution versus growth and efficiency. The marginal rate of income tax reflects the relative preference between the two... so is the preference regarding free trade [over limiting it], so is the preference regarding greater labor market flexibility – these are perceived as supporting efficiency and tampering equality. This is also the case in the debate on enforcing laws to prevent tax frauds...” In all these debates, the researchers explain, it is always argued that an inequality-reducing policy tampers efficiency. But people forget to mention that what the researchers found: the economic benefit of from equality is greater than the benefit of higher growth and efficiency.

What is somewhat surprising in the research is the institute in which it was conducted: The International Monetary Fund. There is no danger that the fund would suddenly announce that an equality-promoting policy is preferable to rapid growth. But maybe the publication of such views will bring some of the supporters of growth here to rethink.

* Juan Carlos Cordoba & Genvieve Verdier: Lucas vs Lucas: On Inequality & Growth. IMF Working paper wp/07/17 January 2007.

