# Finance and the Good Society

BY ROBERT SHILLER

Robert Shiller of Yale is probably best known by the public for his best-selling book, *Irrational Exuberance*, which predicted the collapse of the dot-com stock market bubble just months before the market tanked, and by finance professionals for the Case-Shiller Index, a path-breaking measure of housing price trends. But the overarching theme of his very distinguished career – Shiller was recently ranked the 67th most influential research economist in the world – has been the importance of financial innovation to the quality of life. ¶ In his new book, *Finance and the Good Society*,* Shiller worries that the mortgage bubble and the euro crisis will distract us from a great prize, the potential for modern finance to manage risks ranging from household disasters to the decline of empires. Here, we excerpt the preface, along with Shiller's analysis of the social psychology of income inequality and an über-Shilleresque proposal for managing it. — *Peter Passell*

EPA/JUSTIN LANE

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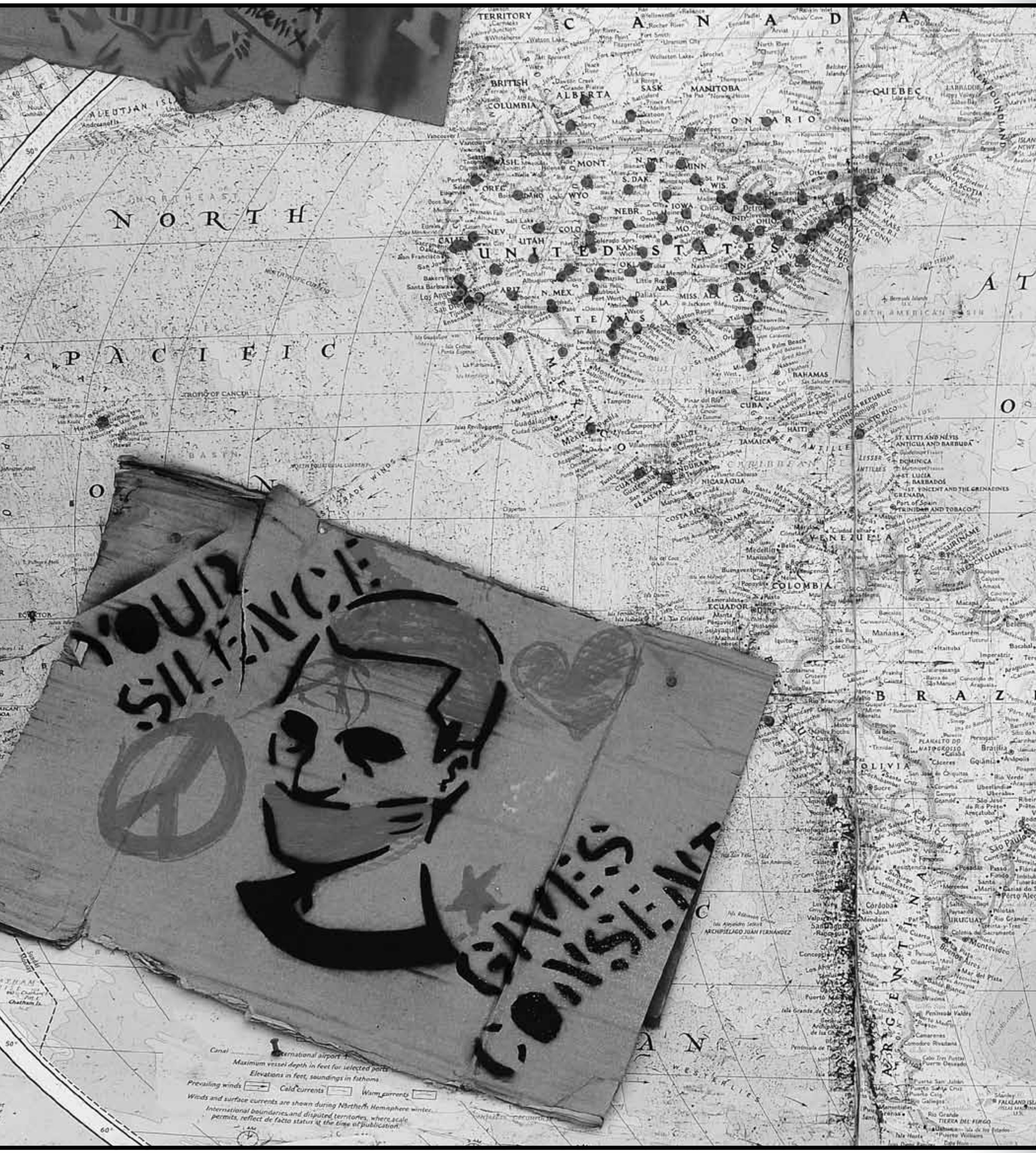
## Financial capitalism is an invention, and the process of inventing it is hardly over. The system has to be thoughtfully guided into the future.

Most important, it has to be expanded, democratized and humanized so that we may reach a time when financial institutions will be even more pervasive and positive in their impact. That means giving people the ability to participate in the financial system as equals, with full access to information and the resources, both human and electronic, to make active, intelligent use of their opportunities. It will mean that they truly consider themselves part of modern financial capitalism, and not the victims of the aggressive and selfish acts of a cynical financial establishment. It will mean designing new financial inventions that take account of the most up-to-date financial theory, as well as the fruits of research in behavioral economics and behavioral finance that suggest the real human limitations that inhibit rational decision-making. Creating and implementing new financial tools will be the best tactic to deal with economic inequality.

The matter seems especially urgent today, as many countries around the world are still struggling with the effects of the financial crisis that began in 2007. It is hard to be precise in dating this crisis, since as I write in 2012 we certainly do not believe that it is over, and the worst may be yet to come. Efforts by governments to repair the weaknesses responsible for the crisis have still not gotten very far, and the "stress tests" that governments have used to encourage optimism about our financial institutions were of questionable thoroughness.

Public street protests against both government and the financial establishment were front-page news in 2011, long after I'd begun this book. The protests apparently took their inspiration from those of the Arab Spring. They began with the Movimiento 15-M in Madrid, then with Occupy Wall Street in New York, along with Occupy Boston, Occupy Los Angeles, Occupy London, Occupy Melbourne, Occupy Rome and other variants. The December 2011 election protests in Russia reflected parallel dissatisfaction with the cozy situation of rich business oligarchs. The most consistent theme in all these movements has been a plea for better democracy, lamenting a perceived conspiracy between governments and their associated financial establishments. While their arguments and rhetoric are not always coherent, the protests represent a welcome assertion of democratic values and citizen responsibility.

The movements are not necessarily left-wing. Even those who consider themselves the ideological opposite of Occupy Wall Street in the United States – the right-wing Tea Party activists – also seem upset by the apparent concentration of wealth and power in New York and other financial centers, while Middle America does all the work. There seems to be almost universal agreement that wealthy financial interests should not use their influence over government to grab more wealth, as seems to have been the case in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events leading up to and following the crisis. But as to what should be done next, there is much less agreement.

Many people seem fixated on the idea that those responsible for the financial crisis should go to jail. In late 2011, I gave an evening talk, sponsored by the Chicago Council on Global Affairs, to an audience composed mostly of businesspeople. Some in the audience angrily criticized me afterward for failing to stress the many charges of fraud leveled against financial firms in the wake of the crisis. I was surprised to hear such anger from those in the business community – who were hardly street protesters and probably included Republicans as well as Democrats. I was equally surprised to see that my basic theme of the need to democratize finance by making the financial markets work better for all was not seen as more sympathetic to their concerns. For in my view, the democratization of finance is the best way to promote the deepest objectives of Occupy Wall Street.

While it is impossible to overlook illegality as one cause of the current financial breakdown, I believe that, in situating the problem there, we fail to appreciate the big picture. We have a financial system that malfunctioned because of a host of factors. If we do not address the deeper sources of these problems by improving the system, we will have missed the opportunity to correct them.

Certainly anyone who committed fraud should suffer penalties. But it is hard to blame the crisis on a sudden outbreak of malevolence. The circumstances were like that on a highway where most cars are going just a little too much over the speed limit. In that situation, well-meaning drivers will just flow with the traffic. In its final 2011 report, the U.S. Financial Crisis Inquiry Commission described the boom as "madness." But, whatever it was, it was not, for the most part, criminal.

Pursuing this highway metaphor a bit further, we may suggest that automotive designers would best stay focused on how new technology can help us better manage vehicular traffic with improved cruise control, external electronic feedback to cars and ultimately even self-driving cars with complex new systems that enable drivers to reach their destinations more safely. If that's the future for our highways, something like it should be the future for our financial institutions as well.

Despite the problems in the mortgage business and many large financial institutions – some based simply on over-enthusiasm and naiveté, others on outright efforts to manipulate and to defraud – I never felt these problems constituted a damning indictment of our entire financial system. Imperfect as the system is, I still find myself admiring it for what it does, and imagining how much more impressive it could be in the future.

I realize that critics think that preparing students for careers in finance merely exacerbates a trend toward greater economic travail for the many. Certainly some who work in finance and related fields reap great material rewards for their efforts, while others earn far less. Modern society is, indeed, on a trend toward higher levels of economic inequality. And the trend has been accelerated by the tendency to reward especially well some of those who go into finance even as the middle class and the poor lose ground. The government bailouts of well-to-do bankers have redoubled public concerns about inequality.

But finance should not be viewed as inherently elitist or as an engine of economic injustice. Finance, despite its flaws and excesses, is a force with the potential to help create a more prosperous and more equitable society. Finance has been central to the rise of prosperous market economies in the modern age. Indeed, this rise would be unimaginable without

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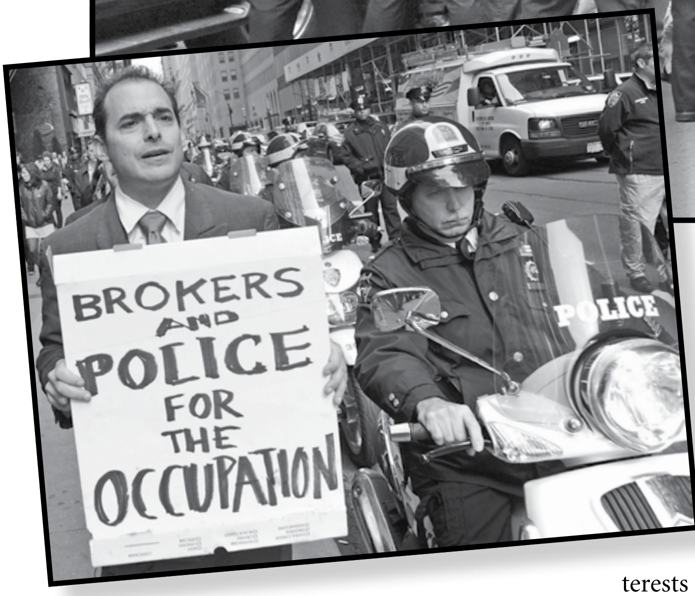


it. Beyond headlines incriminating bankers and financiers as self-aggrandizing perpetrators of economic dislocation and suffering, finance remains an essential social institution. It is needed for managing the risk-taking activities that enable society to transform creative impulses into vital products and services ranging from improved surgical protocols, to advanced manufacturing technologies, to efficient public welfare systems.

It seems paradoxical that the very financial system that is the facilitator of some of our greatest achievements can also create such disaster. Yet the best way for society to proceed is not to restrain financial innovation, but to release it.

When Adam Smith wrote *The Wealth of Nations* in 1776, the pressing economic issue of the day was a tariff on imports. Private interests lobbied governments to put their interests ahead of public interest and push tariffs up so high as to make it impossible for lower-cost foreign producers to compete. But Adam Smith and other economists who followed were successful in clarifying the importance of trade for the widespread wealth of nations. Since Smith, lobbyists for special interests have found it much harder to push up tariffs. Trade is substantially free today – a vital institution in creating the remarkable growth and widespread prosperity we have seen since the political and industrial revolutions of the 18th century.

LEFT: EPA/JUSTIN LANE, ABOVE: EPA/ANDREW GOMBERT


At this time of severe financial crisis, the point of contention is not trade, but finance itself. Hostility among the public generated by the crisis may have the unfortunate effect of inhibiting financial progress. Ironically, better financial instruments, not less activity in finance, is what's needed to reduce the probability of future crises. There is a high level of public anger about the perceived unfairness of the amounts of money people in finance have been earning, and this anger inhibits innovation: anything new is viewed with suspicion. The political climate may well stifle innovation and prevent financial capitalism from progressing in ways that could benefit all.

Socially productive financial innovation could be moving forward rapidly, given the information revolution and the diversity of economic institutions competing in the world marketplace. In coming decades we could see rapid development in the breadth of financial contracts, with extensions in the scope of markets for the purpose of safeguarding our fundamental economic assets. Innovations could include the implementation of new and better safeguards against economic depression, including insurance contracts that allow people to be more adventuresome in their lives without fear of economic catastrophe. We could also see measures to curtail the rising plague of economic inequality.

#### FINANCIAL FIXES FOR INEQUALITY

Public aversion to economic inequality is deep-seated and ancient. It has been shown that even our distant relatives, non-human primates, share an aversion to inequity. It is thus imperative that people feel society is basically fair to them.

We see this aversion clearly today in the worldwide protests associated with Occupy Wall Street. And a major theme is unfairness of the distribution of resources under financial capitalism. Rising inequality is certainly a valid concern, and one that must be addressed. But financial capitalism need not produce unjust wealth distribution. Public policy intervention can allow us to enjoy the benefits of modern finance without the accompanying inequality.

We seem able to live with – even admire – the wealthy. There is no sense of injustice if we believe that the wealthy earned or otherwise deserved their wealth. Indeed, public awareness of inequality itself does not seem to be strongly associated with overt signs of anger, such as terrorism or antisocial acts.

A college student with a good business idea who drops out, founds a company, raises the financing for it despite being an outsider to the system and quickly becomes a billionaire does not seem to inspire resentment. To most people, that is just an interesting story. The greatest resentment is reserved for the

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social classes who focus their attention exclusively on amassing fortunes and keeping them from the eyes of the tax collector, year upon year and generation upon generation. Moreover, there is widespread skepticism that those who become extremely wealthy through financial dealings, or from very high executive compensation packages, are sufficiently deserving of their wealth.

### HOW THE RICH ARE CONNECTED TO FINANCE

If we define finance broadly, then most of the richest people in the world may be classified as connected to the field of finance. Looking at the Forbes 400 list of the richest Americans (all of them billionaires), one sees only a quarter of them directly derived their wealth from investments, hedge funds, leveraged buyouts, insurance or other distinctly financial businesses. But the distinction is somewhat artificial: everyone running large businesses, including businesses producing or trading non-financial products, is involved in finance because they depend heavily on financial markets.

Forbes also maintains the Celebrity 100 list, where membership is not based on wealth but on public presence. Only three on this list – Oprah Winfrey, Donald Trump and Steven Spielberg – are also on the Forbes 400 list. They are on both lists only because they are leading double lives as both managers and entertainers, as each manages a massive entertainment empire. Being famous is not at all the same as being rich, and finance is not in itself a route to celebrity.

The Forbes 400 billionaires have usually made use of some kind of specialized knowledge to achieve their wealth, but they rarely stand out for important contributions in intellectual or creative fields. There appear to be no distinguished scientists on the list. Nor does there appear to be a single Nobel Prize winner on the list – though, of course, the Nobel Foundation might see little purpose in bestowing a mere $1.5 million on one of these billionaires. There are only a few best-selling authors on the list, and even they are on the list because of their business ventures rather than their writing. If one searches Amazon.com for Oprah Winfrey, Donald Trump or Steven Spielberg, many books come up (with numerous co-authors). But these books are part and parcel of their media and entertainment enterprises, not intellectual endeavors.

Their wealth depends on large-scale financial activities, not artistic creativity. For example, Oprah Winfrey now has her own cable network, the Oprah Winfrey Network, and her own magazine, *O*. Donald Trump is even more squarely situated in finance, with his Trump Organization and Trump Entertainment Resorts. Steven Spielberg is more than a producer and director of films; he was a co-founder (in 1994) of DreamWorks Studios, which has financed and distributed films, video games and television shows. DreamWorks, by the way, was sold to Paramount Pictures in 2005 for $1.6 billion.

Finance is a powerful tool because it has the ability to mobilize capital, pool information and coordinate and incentivize people.

It is no wonder that it is so central to the lives of the wealthiest. Their wealth comes not solely from their own efforts and talent, but often from their ability to form and lead huge, effective organizations utilizing the skills of many other talented people.

### BUBBLES IN FINANCIAL COMPENSATION?

Still, it remains a puzzle that those connected to finance can become so fabulously rich, to the seeming exclusion of everyone else. Wouldn't you think that at least one scientist could come up with a patentable idea that would top all their successes? But that never seems to happen – not even close. Why is that?

One reason is that finance has been going through an anomalous period. Perhaps the compensation that those in finance earn is the product of a speculative bubble or an adjustment to new technology that market forces will eventually correct. Indeed, as a 2008 study by Thomas Philippon and Ariell Reshef showed, salaries in finance have increased dramatically in recent decades. Philippon and Reshef found that compensation in finance was also unusually high at the 1929 peak in the stock market, and then fell dramatically over the next half-century.

They also found that the average education of people in the finance professions was likewise high around the 1929 peak, after which it decreased; it has recently returned to a high level. This implies that the inflation in financial salaries was not just a bubble phenomenon – that it also reflected changes in the composition of the financial labor force. In any event, their results suggest that, just because the compensation of people in finance is high now doesn't mean it will remain high.

But Philippon and Reshef were talking about the rank-and-file members of the finance professions, not the richest ones. It seems likely that finance will continue to produce a small number of super-rich unless public policy makes that impossible.


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And in considering the super-rich we have to come back to the fundamental nature of financial dealmaking: it enables the dealmaker to leverage his or her power via command over vast numbers of people. Scientists, in their capacity as scientists, are not dealmakers, and they depend largely on collegiality and professional courtesy to make the research progress they so value.

Although this division between the wealth of resource managers and the lack of it among scientists does often seem an injustice, in and of itself it is not extreme. Elite scientists mostly live comfortably doing what they really want to do, and their everyday lives are


enriched with products and services provided by people doing less gratifying work.

#### FAMILY DYNASTIES

Part of the reason we feel the unequal distribution of wealth is unjust is that some of the inequality is the result of family dynasties: the children of successful businesspeople become rich, whether or not they deserve it. Some of these children – for example, Donald Trump – keep working in the family business. But only about a third of family businesses are continued by the children of the founders, and only a tenth of them by the grandchildren. Nonetheless, the later generations remain rich.

Having one's children and grandchildren become wealthy, and perhaps continue the family business, is apparently a source of great meaning to many business founders. This sentiment endures despite the fact that heirs of large fortunes aren't especially content with their lives. Indeed, according to one authoritative study, children of the very rich exhibit elevated rates of substance use, anxiety and depression.

And yet the dream of the family dynasty persists, sometimes in the oddest places. Even though Karl Marx and Friedrich Engels cried "Abolition of the family!" in their Communist Manifesto, the leaders of today's hard-line Communist countries pursue the dream. In North Korea, for example, the dynastic urge drove Kim Il Sung to anoint his son Kim Jong Il, and he in turn to pass the crown to his son Kim Jong Un. It apparently even motivated Fidel Castro, a true Communist, to bequeath his rule of Cuba to his brother Raul.

#### POSITIONAL CONSUMPTION

The tendency for wealthy families to annoy others by spending extravagantly and wastefully is often a source of public resentment. Consuming conspicuously feeds their egos. It may also help the rich convey social status to the next generation by securing their children a headstart in the pecking order.

This tendency toward consumption for show has been dealt with for centuries (all the way back to ancient Greece and Rome) by

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means of "sumptuary" laws – that is, laws forbidding specific forms of wasteful consumption. For example, in 7th century BC Greece, women were forbidden by the Locrian code to wear extravagant clothing or jewelry unless they were prostitutes. Similarly, sumptuary taxes are special excise taxes on items of conspicuous consumption.

Sumptuary laws and taxes, however, are not always effective in preventing spending that invites the resentment of others. As one 18th century observer sized up these laws, "they are null, because luxury employs itself upon objects which the laws have not foreseen, and could not foresee." The laws' details were commonly ridiculed, and in modern times they are thought to be inconsistent with individual freedoms. They did, nevertheless, appear again and again for thousands of years, reflecting the persistence of public disgust with the extravagance of the rich.

There is an economic theory that would seem to justify something akin to sumptuary laws or taxes. That theory was described by Thorstein Veblen in his 1899 book, *The Theory of the Leisure Class*, and the economic part of it was expanded by George Alkerlof and others. Many people spend lavishly on consumption that they do not really enjoy merely to signal their status – a practice called "positional consumption" because its value to the consumer depends on how it establishes his or her position relative to others. As argued convincingly by social psychologist Leon Festinger, with his 1954 *Theory of Social Comparison Processes*, people instinctively compare themselves to others, and they delight when they are doing better. They tend to compare themselves with those close to them who are attempting to achieve similar things, and disregard those who are doing much better or much worse, or who have very different measures of success.

The comparisons are largely subconscious. And since such comparisons are generally frowned upon, many people deny to themselves as well as to others that they are making them. From Festinger's other theory, of cognitive dissonance, we see that people often manage to convince themselves that they enjoy the positional consumption goods because the items consumed are intrinsically good; they experience a sense of enjoyment as if the enjoyment were intrinsic rather than positional. This is not to say that people cannot make value judgments independent of status considerations, just that such considerations impose a bias that affects their judgments – often subconsciously.

This theory has always been controversial, and even repugnant to those who dislike being accused of low motives, even if the accusers recognize their good side as well. We should not overstress the theory of social comparisons, for people have sympathetic and communal aspects as well. But the theory is by now well-established. A 2007 study even identified a region of the brain (the ventral striatum) that is stimulated especially strongly after a reward if others nearby are seen as not receiving the same reward. There is thus a physical basis for social comparison theory.

A modern version of the sumptuary law is the progressive consumption tax – a tax based on the amount one consumes rather than the amount one earns, with higher rates on higher levels of consumption. Such a tax was proposed in the U.S. Senate by Democrat Sam Nunn and Republican Pete Domenici in 1995. Adding a progressive consumption tax is like adding a sumptuary tax, but one that is broadly applied to all consumption, not just consumption of particular items. Recently, Cornell economist Robert Frank advocated replacing the income tax with such a tax to help reduce the tensions created by positional consumption.

Switching from a progressive income tax to a similarly progressive consumption tax might be a good idea, for such an approach would not penalize one from earning a large income; it would simply discourage excessive spending from that income, and might encourage saving, philanthropy or both.

However, a progressive consumption tax would be difficult to implement. For example, in the process, it would be hard not to effectively reduce taxes on the highest-income people since they generally consume a smaller share of their incomes. And it would be hard to manage the calculation of withholding on income, since tax liability would depend on unknown future consumption. Neither a sumptuary tax nor a progressive consumption tax is an easy and obvious solution to the problem of waste and resentment-inducing positional consumption. We need to keep such ideas in mind, though, as fodder for public financial innovation – possibly in some altered form or through reliance on future advances in information technology.

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**ESTATE TAXES**

Whether or not rich people actually feel any sense of connectedness to others in their country, their countrymen generally believe that they ought to. Leaving their estates to their own children seems selfish, especially as their children may not seem particularly deserving – at least in the eyes of others. Thus levying estate taxes is one of the most effective ways of restoring a sense of fairness in society. Accordingly, many countries tax wealth heavily at the time of death.

If estate taxes were pursued aggressively, they would do much to reduce economic inequality. But there remains an issue: often the most important reason people try to make money is to pass it to their children.

Accordingly, estate taxes can seem extremely onerous to those who will be taxed. In late 2010, when a law abolishing the federal estate tax in the United States was set to expire and raise the maximum rate from nothing to 55 percent, we read stories in the media of elderly people in poor health asking their doctors to cut off further treatment so they would die before the year was over. Rep. Cynthia Lummis of Wyoming echoed the sentiment: “If you have spent your whole life building a ranch, and you wanted to pass your estate on to your children, and you were 88-years-old and on dialysis, and the only thing that was keeping you alive was that dialysis, you might make that same decision.”

She has a point: some people do spend their lives trying to promote their children’s welfare – a goal that, one has to admit, is far from evil. But here we have an essential conflict, for passing on great wealth to the next generation can create social resentment.

There is no way to eliminate this essential conflict, and so the best solution would seem to be compromise – setting estate taxes at some intermediate level that neither confiscates wealth at death nor allows it to be passed on intact. In fact, most people think about the issue in this way. Most believe that society should give in somewhat to the natural desire to make one’s children rich, but limit the exercise of that desire. A 1990 survey that Maxim Boycko, Vladimir Korobov and I conducted found that people in both the United States and the Soviet Union – two very different economic traditions – thought that the tax should take about one-third of an estate.

We may consider tragic the stories of people having to sell the family farm just to pay the estate tax, thereby upending a family’s


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way of life, possibly for generations to come. But we also have to consider the resentment caused by children holding such wealth indefinitely. In fact, the form of estate tax favored by most people allows the wealthy to leave their children a ranch or a family farm. In this case, parents are perceived as transferring not just wealth but a set of responsibilities and meaningful work to their children. But note that transferring responsibilities and work does not require a massive transfer of wealth. The family that Rep. Lummis talked about could probably have paid the estate tax by taking out a mortgage on the farm and paying it off over time. Finance offers many options, and if the ranching lifestyle is important to a family, it could probably find a financial strategy to allow it to continue.

### INEQUALITY INDEXATION

Besides estate taxes, one of the most important weapons society already has against economic inequality is the progressive income tax. Progressive income taxes levy higher rates on higher levels of income. So revenue is raised disproportionately from high-income people, and much of the benefit of the proceeds is shared with the poor. Moreover, government expenditures on many things (education, "public goods" like national defense) are shared among all people. Over the years, income tax systems have become more sophisticated in managing inequality. For example, the tax systems in the United States and other countries offer earned income tax credits that, in effect, serve as a negative tax on the wages of low-income workers.

But strangely, income taxes have never been expressly designed with the objective of managing inequality. So the system deals with economic inequality haphazardly, purely as a by-product of its stated goals.

I have proposed that taxes be indexed to offset pretax inequality. Under inequality indexation, the government would not legislate fixed rates for each income tax bracket, but would instead prescribe in advance a formula that would tie tax rates to statistical measures of pretax inequality. If income inequality were to worsen, the tax system would automatically become more progressive. This is a financial solution to the problem of inequality in the sense that we impose the indexation scheme before we know that income inequality will worsen – and before people know who might suffer by it. So the indexation scheme would deal with a risk, the risk of rising inequality before it happens, much as insurance contracts do. In fact, inequality indexation could be considered a kind of insurance – inequality insurance.

The inequality indexation scheme could be designed either to gradually reverse the existing degree of inequality in order to bring it back to a more acceptable level, or merely to cap inequality at the present level so that it does not get worse. The latter course may be more politically acceptable. A scheme could be designed that would allow substantial income inequality to persist forever, but would prevent a serious worsening of inequality. It would, after all, be easier to accustom people to inequality indexation of taxes if such a system had no initial impact, and no chance of changing the current social order. People would still be able to get rich, but we would plan in advance not to let income inequality get worse. The measure would be purely prophylactic: if inequality never worsened, then the inequality indexation scheme would never be triggered.

The combined wealth of the Forbes 400 in 2011 was $1.5 trillion, or 2.6 percent of total household net worth. As the percentage of total societal wealth is small, and as most of these people are seen as contributing to society by running large businesses, this degree of inequality may be acceptable – or at least there may not be the political will to address it. But inequality could get worse. How much of a concentration of economic blessings do we really want to allow? The possibility that the 400 could come to have a much greater share of our national wealth, in return for a contribution to society that is not proportionate, seems odious. If such changes were to occur, it would not be because the distribution of talents had suddenly changed. The change would no doubt be widely perceived as an injustice.

It would be easier to legislate contingency plans against any future worsening in income inequality than to wait until the greater inequality became a reality for the same reason that it is much easier to insure a house before it burns down. If the day comes when we have a much larger class of wealthy people, they would likely feel entitled to the aftertax income they already have, and would have the political clout to keep it. We need to put mechanisms in place now – not later – to prevent the entitlement cycle from ever starting.

An inequality indexation formula might be enacted as the political quid pro quo for some pro-growth policy that is controversial – say, a reduction in the corporate income tax – because of its possible adverse impact on income equality.

Leonard Burman (Syracuse University) and I did an analysis of the effects of inequality indexation, had it been imposed many years ago. If aftertax income inequality had been frozen in 1979, the marginal tax rate on high-income individuals would have since increased to an extraordinarily high 75 percent. We were concerned that full inequality indexation might be too much to be accepted, and so we also explored partial inequality indexation as part of a broader initiative to moderate the impact of random economic influences that create inequality. But let's not forget that the finding provides stark evidence of how much economic inequality has worsened in the past three decades.