Accounting and Inequality

Inequality is the most pressing issue of our times. From Joseph Stiglitz and Oxfam's recent research to the IMF and the CEO of Goldman Sachs, many are citing it as a critical issue leading to poverty and unstable societies. However, it is not just the broad-brush issues that are affected by inequality. In *The Spirit Level*, Kate Pickett and Richard Wilkinson made a strongly evidenced and compelling argument that inequality contributes to a wide range of society's ills, from prison sentences to mental health, life expectancy to teenage pregnancy. It is becoming increasingly clear that it is narrower income differentials, rather than infinite economic growth, that produce happier, healthier and more resilient societies.

This problem of inequality is systemic and getting worse. In the UK between 1977 and 2013, inequality, measured by the Gini coefficient, increased by 42%.[1] In January, Oxfam announced the combined wealth of the richest 1% will overtake that of the other 99% in 2016. Whilst there are disagreements as to whether social mobility is decreasing, politics, journalism and legal professions in the UK are still dominated by people who have gone to private schools. And countries with higher levels of income inequality have lower levels of social mobility.

Inequality is also expensive – and economically inefficient. Research from The Equality Trust found that social impacts of inequality: poor mental health; high crime rates; and low life expectancy, costs the UK over £39 billion a year.[2] The rich increase spending on security services they wouldn't otherwise need. Inequality reduces wellbeing for both rich and poor with higher rates of depression and lower levels of trust. In the worst instances inequality leads to social and political instability.

The solutions are consequently unlikely to be straightforward or superficial. It will require a radical approach to change this broken system.

We believe that a major issue at the root of inequality is that of resource allocation. Currently, investment decisions that lead to capital flows and allocation of resources are made on the basis of the price signals that are sent to the investors. These price signals are informed by an organisation's financial accounts. So how are these accounts prepared? The current system is to prepare accounts with a supposed, hypothetical investor in mind. This hypothetical investor is assumed to be solely interested in the maximisation of wealth. The accounts therefore exclusively reflect this interest.

[1] Data from Gini Coefficient graph, the Equality Trust. Original data from DWP.
[2] The Cost of Inequality, The Equality Trust (2014).

So the first assumption is that our hypothetical investor is only interested in wealth. The second assumption is that this is an accurate reflection of real investors; that what matters to them is solely a financial return on their investment, and no other criteria are factored in to the decisions they make.

These assumptions are rooted in the model of neo classical economics. This operates on the idea that human beings are entirely rational, wealth maximising individuals who act in a consistently self- interested manner. In practice, the assumption clearly does not bear out. As well as most people's real life experience that humans do not behave in this way, there are countless psychological examples in decision theory that demonstrate a much more nuanced, complicated and 'irrational' decision making process in human beings. Whilst modern day economics has changed (to a certain extent) to adapt to these findings in behavioural psychology, accounting has not moved on; it is still stuck with this concept of a super rational, wealth maximising individual.

So where does this leave us with inequality? There are two questions that we can ask ourselves at this juncture. Firstly, does this hypothetical wealth maximising investor accurately reflect all investors? Secondly, even if it is an accurate reflection; do we really want to live in a world where accounts are prepared with this in mind? Or would a world where accounts are prepared in the public interests to enable companies to be held to account and encourage transparency be preferable?

To address the first question: investors surely do make decisions on evidence other than the financial impacts of a company. Many investors, and indeed consumers, would also make decisions based on a company's social and environmental impacts – does it use child labour? Does it poison the environment through dumping of toxic waste? If these sorts of impacts were included in the financial accounts of a company, and subjected to external auditing to examine whether the impacts were a true and fair representation of that company's accounts, investment and therefore resource allocation decisions would be reflective of these impacts. Companies which were more transparent and more accountable for their actions would demonstrate a better return on investment – where return means all material types of value, not just financial. Resources would therefore be directed towards ventures that demonstrated accountability to their stakeholders for all types of material value that were created and/or destroyed.

To address the second question from above: even if it is true that investors are solely interested in maximising their wealth, surely the world would be a better and more egalitarian place if accounts accurately reflected a range of impacts, rather than just the financial? If we would prefer to live in a world where resource allocation decisions are made on this wider basis, then it is time to change public policy to reflect this.

To make this world more equal, we need profound and systemic change. Resource allocation decisions lie at the root of current inequality, and changing the evidence used to make these decisions gives us a real chance at making this change and moving towards a more equal, and therefore healthier, safer and economically stable society.