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THE WAY WE LIVE NOW

The Inequality Conundrum

By ROGER LOWENSTEIN

In 1976, Richard Freeman wrote a book called “The Overeducated American.” So many Americans had been getting college degrees that the relative wages of white-collar professionals had started to fall. It no longer paid to go to college and, for most of the ’70s, fewer people did. Just so, incomes of the educated began to rise again.

People like Freeman, a labor-market economist, waited for the cycle to turn. They expected that with white-collar types riding high again, more people would stay in school, and incomes at the top would level off once more.

But they never did. Instead, the rich kept getting richer. Across the spectrum of American society, the higher your income category, the more your income continued to grow. And for a quarter-century, albeit with zigs and zags along the way, that rich-get-richer pattern has held. The figures are striking. In 2004, according to the [Congressional Budget Office](#)’s latest official analysis, households in the lowest quintile of the country were making only 2 percent more (adjusted for inflation) than they were in 1979. Those in the next quintile managed only an 11 percent rise. And the middle group was up 15 percent. Do you sense a pattern? The income of families in the fourth quintile — upper-middle-class folks with an average yearly income of \$82,000 — rose by 23 percent. Only when you get to the top quintile were the gains truly big — 63 percent.

Numbers like that have made inequality a hot topic, not only for liberals but also for Bush administration officials like Henry Paulson, the secretary of the Treasury. The press is full of stories of the outlandish wages of the superrich, like the 25 hedge-fund managers who each earned at least \$240 million last year (the top dog took home \$1.7 billion). Democrats are giving tougher scrutiny to trade bills and are now thinking the unthinkable: tax hikes for the rich. Inequality “isn’t good as an economic matter,” says Steven Rattner, an investment manager and contributor to Democratic politicians, “and it’s not good as a moral or social matter.” Writing in *The Boston Globe*, the columnist James Carroll said the current economic system is “eroding democracy” by awarding a larger share of the economic pie to the very rich and “impoverishing more and more human beings.”

The evidence for the last point is rather scant. The millions made by hedge-fund traders, or by entrepreneurs who founded companies like [Google](#), don’t diminish other people’s wages. Indeed, each helps to make the pie bigger. But what puzzled Freeman remains a mystery to this day. Why isn’t prosperity spreading more equally? The leading theory has been that a global, high-tech economy creates big winners and losers. That is surely part of it. But Europe has computers, too, so where are all of its billionaires?

Countries like Sweden are more equal, but to some economists, they are probably too equal. There is a rough trade-off between equality and growth: if you try too hard to make everyone equal, you get fewer

entrepreneurs, fewer Silicon Valleys and a lower standard of living. Freeman, who is generally pro-union, says Sweden's converging pay scales led to unemployment and deficits in the early '90s, when it belatedly moved to create more incentives. Similarly, Gary Becker, a Nobel-winning economist, recalls visiting factories in Communist China in 1981: the workers were all lazing around. Now China has billionaires and the country is growing like Topsy.

You can boil down most economic policy debates — starting with Hamilton versus Jefferson and moving to Bush versus the Democrats — to this tension: how can you promote equality without killing off the genie of American prosperity? The trade-off is clear at the extremes but fuzzier in the middle. A little redistribution, cleverly designed, doesn't hurt. One example might have occurred during the late '90s. The stock market was crowning multimillionaires, but the poor also did a little better. Among households with children, cash earnings of the poorest quintile doubled (though their earnings, at \$13,000, remained meager and have tapered off more recently).

Most of the improvement at the bottom was because of people working more hours rather than for higher wages: a red-hot economy provided more jobs. The retooled federal welfare program, however, as well as the expansion of the earned-income tax credit (E.I.T.C.), gave people an added financial incentive to work.

Some redistribution is clearly good for the entire economy — providing public schooling, for instance, so that everyone gets an education. But public education aside, the United States has a pretty high tolerance for inequality. Americans care about "fairness" more than about "equalness." We boo athletes suspected of taking steroids, but we admire billionaires.

The extreme divergence of American incomes we see today, however, is actually rather new. For most of the 20th century, America was becoming more egalitarian. The United States seemingly conformed to the standard theory of development, which held that industrialization produces fat cats at first (as factory owners rake it in) and then a more general prosperity as workers become more productive. It's a feel-good theory that says, "Don't worry if the rich are prospering; the poor will have their day."

Emmanuel Saez, a French economist at the [University of California](#) at Berkeley who studies American inequality, looked more closely and discovered that theory and history didn't quite mesh. Saez and his colleague, Thomas Piketty (who is based in Paris), plotted income distributions in America back to 1913. The share of income enjoyed by the rich was high in the 1920s, then stable or falling during most of the next half-century. In the '70s, the cycle seemed to start again — perhaps because "a new industrial revolution" (in technology) inspired a renewed period of inequality.

But Saez noticed some inconsistencies. During the '40s, the share of those at the top fell very steeply. He doubted that a gradual process like industrialization could have caused it. More likely, the culprit was the combined shock of the Great Depression and World War II, when the United States imposed wage controls. That left a puzzle: Why didn't top earners recover their shares soon after the war?

Saez hypothesized that the answer lay with various nonmarket factors. Some were institutional, like the strength of postwar labor unions. Some were cultural, like the reluctance of boards to pay their chief executives an unseemly amount. The progressive tax code prevented accumulations by the upper crust and thus reduced how much they could earn in the future.

By the '70s, the share of income earned by those at the top was far lower than when Woodrow Wilson was president. The social and institutional forces alluded to by Saez, however, were already moving in reverse. This might explain why inequality grew in the United States but not in Europe. In the United States, the marginal tax rate was sharply reduced (during the Reagan years, from 70 percent to 28 percent) and unions gradually lost their clout. Also, beginning in 1979, the minimum wage (in real terms) began to decline.

Before you get too misty-eyed over the '70s, remember that while the decade may have been a high-water mark for American egalitarianism, the country was also in its worst economic funk since the Great Depression. Unemployment and inflation were raging, growth was tepid and the stock market was depressed. An economist named [Alan Greenspan](#) termed it “the Great Malaise.”

You can think of most of what has contributed to rising inequality since then as a reaction against the '70s. A number of industries — banking, trucking, airlines, energy, telecommunications — were deregulated. Trade barriers were loosened, which had a similar effect on other once-protected industries like autos and steel. Antitrust regulation diminished, permitting more big-time mergers. The elimination of controls and the creation of new financial instruments let risk-takers make bets on everything from interest rates to foreign currencies. The purpose was to unshackle the economy, but it also created a society of multimillionaires.

In one specific case, the link was quite explicit. After the weak stock market of the '70s, academics like Michael Jensen of [Harvard](#) began to promote stock options and other incentives as a means of motivating corporate executives. Boardroom notions of propriety underwent a sea change. Lee Iacocca once told Larry King that no executive was worth \$1 million. That wouldn't cover fringe benefits for C.E.O.'s nowadays.

Indeed, executive pay is probably a glaring example of an overreaction to the '70s. Executive compensation isn't set in a pure market; it is administered by (often-friendly) directors. That C.E.O.'s have been very handsomely rewarded for failure, while many more have become exceedingly rich almost irrespective of their performance, violates every conservative piety about designing the right incentives.

It's harder to make that case against high-income earners generally, because most are claiming market rewards. If Bono sells a lot of CDs, or if a leading cardiologist sets high rates and wealthy patients agree to pay them, it's difficult to say that they are “wrong.” It's simply the market.

And the market has helped them prosper. In 1979, the upper 1 percent of the United States collected 9 percent of total income. Now they get 16 percent. That's an enormous increase. But beneath the very top, the trend toward inequality has been less marked. For instance, those in the middle of the income spectrum used to earn 3.2 times as much as those at the bottom; that ratio has widened, but only to 3.65 times as much. The real action has occurred between folks in the top percentile — those who, in 2004, earned an average of \$1.3 million — and everyone else. (A little thought exercise: if the very upper crust were banished to a Caribbean island, the America that remained would be a lot more egalitarian.)

But whether [Roger Clemens](#), who will get something like \$10,000 for every pitch that he throws, earns 100 times or 200 times what I earn is kind of irrelevant. My kids still have health care, and they go to decent schools. It's not the rich people pulling away at the top who are the problem; it's that so many have been stuck for so long at the bottom and in the middle. This is why one of the really good books on the subject, “Inequality in America,” by the economists James Heckman and Alan Krueger, is all about raising the incomes of people at the bottom. Punishing those at the top doesn't help.

When it comes to raising the bottom in the short term, Washington basically has two choices: it can try to change market outcomes or it can redistribute after the market results are in. The first method is more intrusive. It includes limiting trade, regulating the workweek or restricting access to certain jobs, through mechanisms like licensing. Since the '70s, the United States has moved away from such market interventions, but Congress seems to be acting on two of them. It just voted to raise the minimum wage, for the first time in 10 years, and it is seeking a compromise to revise the [immigration](#) laws.

And what about redistribution after the fact? The United States does less of it than Europe, and less of it than we used to. Even though the United States is richer than Belgium, a poor person in Belgium is better off than one here. On the other hand, the price for being Belgian is steep: Belgium's median disposable income — what people have left to spend after they pay taxes and collect welfare-type payments — is only 72 percent as high as ours.

Even in the United States, the rich pay a disproportionate share of the federal income tax, which mildly reduces inequality. Other taxes, however, like Social Security, are regressive: the rich pay a lesser share. Thus, the upper tenth of households pay 70 percent of the income tax, but only 52 percent of all federal taxes. State sales taxes make the system even more regressive, because poorer people spend a higher share of their total income on them. Kevin Hassett, of the American Enterprise Institute, estimates that a family of four earning \$50,000 pays exactly the same share of its income (30 percent) on taxes as one earning \$150,000.

There is little agreement on how much redistribution is too much. But common sense tells you that a small increase in taxes when rates are relatively low, as they are now, isn't going to curb people's animal spirits. Higher taxes in and of themselves, however, won't cure inequality. The point of taxing, as Becker is quick to point out, isn't to confiscate: it's to raise revenue for things that will benefit society, in this case helping those at the bottom. Though such thinking is a good argument for further expanding the E.I.T.C., which rewards people for working, in the long run you want to get folks moving up the skills ladder, so fewer people are in need of wealth redistribution. That this hasn't happened is rather a conundrum. The incentives are certainly there. College grads make more than 40 percent more than high-school grads. Those with postgraduate degrees earn twice as much.

To Becker, this is a good thing; it offers an incentive for people to pursue education. The trouble is, it hasn't worked. The Americans that Freeman once called overeducated are plainly undereducated today. Only about a third of the population graduates from college. Among the poor, there has been only a very slight increase in college-graduation rates.

To get more Americans to enroll in and complete college, the theory goes, you can either fix the schools (more teachers, longer school years, more [student loans](#)) or fix the students (more nurturing of kids from disadvantaged homes). Both approaches would cost a lot. But if you're worried about inequality, it's hard to see any alternative. Hamburger flippers simply don't command a high wage. We can pass laws to change that — a minimum price for cheeseburgers, maybe — or we can, finally, invest in teaching the flippers to do something else.

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