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The Price of Inequality: Why inequality matters and what can be done about it

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It is a great pleasure for me to discuss with you one of the critical issues facing our country, its growing inequality, the effect it is having on our economy, and the policies that we might undertake to alleviate it. America has achieved the distinction of becoming the country with the highest level of income inequality among the advanced countries. While there is no single number that can depict all aspects of society's inequality, matters have become worse in every dimension: more money goes to the top (more than a fifth of all income goes to the top 1%), more people are in poverty at the bottom, and the middle class—long the core strength of our society—has seen its income stagnate. Median household income, adjusted for inflation, today is lower than it was in 1989, a quarter century ago.[2] An economy in which most citizens see no progress, year after year, is an economy that is failing to perform in the way it should. Indeed, there is a vicious circle: our high inequality is one of the major contributing factors to our weak economy and our low growth.

As disturbing as the data on the growing inequality in income are, those that describe the other dimensions of America's inequality are even worse: inequalities in wealth are even greater than income, and there are marked inequalities in health, reflected in differences, for instance, in life expectancy. But perhaps the most invidious aspect of US inequality is the inequality of opportunity. America has become the advanced country not only with the highest level of inequality, but is among those with the least equality of opportunity—the statistics show that

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[2] For large segments of the American population, matters are even worse. The inflation adjusted median income of a male worker with only a high school degree has fallen by 47% from 1969 to 2009. For additional data sources and explanation of these trends, see my "Reforming Taxation to Promote Growth and Equity," forthcoming as a Roosevelt institute working paper, which is submitted along with this written testimony. Inequality is discussed in even greater detail in my 2012 book, *The Price of Inequality: How Today's Divided Society Endangers Our Future*, New York: W.W. Norton.

the American dream is a myth; that the life prospects of a young American are more dependent on the income and education of his parents than in other developed countries. We have betrayed one of our most fundamental values. And the result is that we are wasting our most valuable resource, our human resources: millions of those at the bottom are not able to live up to their potential.

This morning, I want to make eight observations concerning this inequality. The first is that this inequality is largely a result of policies—of what we do and don't do. The laws of economics are universal: the fact that in some countries there is so much less inequality and so much more equality of opportunity, the fact that in some countries inequality is not increasing—it is actually decreasing—is not because they have different laws of economics. Every aspect of our economic, legal, and social frameworks helps shape our inequality: from our education system and how we finance it, to our health system, to our tax laws, to our laws governing bankruptcy, corporate governance, the functioning of our financial system, to our anti-trust laws. In virtually every domain, we have made decisions that help enrich the top at the expense of the rest.

The second observation is that much of the inequality at the top can't be justified as "just deserts" for the large contributions that these individuals have made. If we look at those at the top, they are not those who have made the major innovations that have transformed our economy and society; they are not the discoverers of DNA, the laser, the transistor; not the brilliant individuals who made the discoveries without which we would not have had the modern computer. Disproportionately, they are those who have excelled in rent seeking, in wealth appropriation, in figuring out how to get a larger share of the nation's pie, rather than enhancing the size of that pie. (Such rent seeking activity typically actually results in the size of the economic pie shrinking from what it otherwise would be.) Among the most notable of these are, of course, those in the financial sector, who made their wealth by market manipulation, by engaging in abusive credit card practices, predatory lending, moving money from the bottom and middle of the income pyramid to the top. So too, a monopolist makes his money by contracting output from what it otherwise would be, not by expanding it.

Thirdly, the idea that one shouldn't worry about inequality because everyone will benefit as money trickles down, has been thoroughly discredited. In some ways, I wish it were true, for if it were, it would mean that the average American would be doing very well today, because we have thrown so much money at the top. But the statistics I gave a few minutes ago shows that it is not true: while the top has been doing very well, the rest has been stagnating.

Fourthly, this recession—while in no small measure caused by the financial sector which itself is responsible for so much of our inequality today—has in turn made inequality so much worse. 95% of the gains since the so-called recovery have gone to the top 1%.

Fifth, it is not the case that our economy *needs* this inequality to continue to grow. One of the popular misconceptions is that those at the top are the job creators; and giving more money to them will thus create more jobs. America is full of creative entrepreneurial people throughout the income distribution. What creates jobs is *demand*: when there is demand, America's firms (especially if we can get our financial system to work in the way it should, providing credit to small and medium-sized enterprises) will create the jobs to satisfy that demand. And unfortunately, given our distorted tax system, for too many at the top, there are incentives to destroy jobs by moving them abroad. This growing inequality is in fact weakening demand—one of the reasons that inequality is bad for economic performance.

Sixth, we pay a high price for this inequality, in terms of our democracy and nature of our society. A divided society is different—it doesn't function as well. Our democracy is undermined, as economic inequality inevitably translates into political inequality. I describe in my book how the outcomes of America's politics are increasingly better described as the result of a system not of one person one vote but of one dollar one vote. One of the prices we pay for the extremes to which inequality has grown and the nature of inequality in America—both inequality in outcomes and inequalities of opportunities—is that we have a weaker economy. Greater inequality leads to lower growth and more instability. These ideas now have become mainstream: even the IMF has embraced them. We used to think of there being a trade-off: we could achieve more equality, but only at the expense of giving up on overall economic performance. Now we realize that, especially given the extremes of inequality achieved in the US and the manner in which it is generated, greater equality and improved economic performance are complements.

This is especially true if we focus on appropriate measures of growth, focusing not on what is happening on average, or to those at the top, but how the economy is performing for the typical American, reflected for instance in median income. For too many—perhaps even a majority—the American economy has not been delivering. And if our economy is not delivering, it not only hurts our people, it undermines our position of leadership in the world: will other countries want to emulate an economic system in which most individuals' incomes are simply stagnating?

We pay a price not only in terms of a weak economy today, but lower growth in the future. With nearly one in four American children growing up in poverty,[3] many of whom face a lack of access to adequate nutrition and education, the country's long-term prospects are being put into jeopardy.

[3] See http://www.childstats.gov/americaschildren/eco1a.asp (accessed March 30, 2014).

The seventh observation is that the weaknesses in our economy have important budgetary implications. The budget deficits of recent years are a result of our weak economy, not the other way around. If we had more robust growth, our budgetary situation would be far improved. That's why investments in decreasing inequality and increasing equality of opportunity make sense not only for our economy, but for our budget. When we invest in our children, the asset side of our country's balance sheet goes up, even more than the liability set: any business would see that its net worth is increased. In the long run, even looking narrowly on the liability side of the balance sheet, it will be improved, as these young people earn higher incomes and contribute more to the tax base.

The final observation I want to make is that the role of policy in creating inequality means there is a glimmer of hope. Policy created the problem, and it can help get us out of it. There are policies that could reduce the extremes of inequality and increase opportunity—enabling our country to live up to the values to which it aspires. There is no magic bullet, but there are a host of policies that would make a difference. In the last chapter of my book, *The Price of Inequality,* I outline 21 such policies, affecting both the distribution of income before taxes and transfers and after. We need to move more people out of poverty, strengthen the middle class, and curb the excesses at the top. Most of the policies are familiar: more support for education, including pre-school; increasing the minimum wage; strengthening the earned-income tax credit; giving more voice to workers in the workplace, including through unions; more effective enforcement of anti-discrimination laws; better corporate governance, to curb the abuses of CEO pay; better financial sector regulations, to curb not just market manipulation and excessive speculative activity, but also predatory lending and abusive credit card practices; better anti-trust laws, and better enforcement of the laws we have; and a fairer tax system—one that does not reward speculators or those that take advantage of off-shore tax havens with tax rates lower than honest Americans who work for a living. If we are to avoid the creation of a new plutocracy in the country, we have to retain a good system of inheritance and estate taxation, and ensure that it is effectively enforced. We need to make sure that everyone who has the potential to go to college can do so, no matter what the income of his parents—and to do so without undertaking crushing loans. We stand out among advanced countries not only in our level of inequality, but also on how we treat student loans in our bankruptcy loans. A rich person borrowing to buy a yacht can get a fresh start, and have his loans forgiven; not so for a poor student striving to get ahead. The special provisions for capital gains and dividends not only distort the economy, but, with the vast majority of the benefits going to the very top, increase inequality—at the same time that they impose enormous budgetary costs: $2 trillion dollars over the next ten years, according to the CBO.[4] While the elimination of the special

[4] See Congressional Budget Office, 2013, *The Distribution of Major Tax Expenditures in the Individual Income Tax System,* May, p.31, available at http://cbo.gov/sites/default/files/cbofiles/attachments/TaxExpenditures_One-

provisions for capital gains and dividends is the most obvious reform in the tax code that would improve inequality and raise substantial amounts of revenues, there are many others that I discuss in the attached paper which I would like to submit for the record.

A final point is that we must be careful of how we measure our progress. If we use the wrong metrics, we will strive for the wrong things. Economic growth *as measured by GDP* is not enough—there is a growing global consensus that GDP does not provide a good measure of overall economic performance. What matters is whether growth is sustainable, and whether *most* citizens see their living standards rising year after year. This is the central message of the International Commission on the Measurement of Economic Performance and Social Progress, which I chaired. Since the beginning of the new millennium, our economy has clearly not been performing in either of these dimensions. But the problems in our economy have been manifest for longer. As I have emphasized, a key factor underlying America's economic problems today is its growing inequality and the low level of opportunity.

In the past, when our country reached these extremes of inequality, at the end of the 19th century, in the gilded age, or in the Roaring 20s, it pulled back from the brink. It enacted policies and programs that provided hope that the American dream could return to being a reality.

We are now at one of these pivotal points in history. I hope we once again will make the right decisions. You and your committee, in the budget decisions that you will be making, play a vital role in setting the country in the right direction.

Column.pdf (accessed March 28, 2014). This figure includes the effects of the "step-up of basis at death" provision, which reduces the taxes that heirs pay on capital gains. Not including this provision, the ten-year budgetary cost of preferential treatment for capital gains and dividends is $1.34 trillion.