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THE PRICE OF INEQUALITY

HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE

Chapter One

AMERICA'S 1 PERCENT PROBLEM

THE 2007–08 FINANCIAL CRISIS AND THE GREAT RECESSION that followed cast vast numbers of Americans adrift amid the flotsam and jetsam of an increasingly dysfunctional form of capitalism. A half decade later, one out of six Americans who would like a full-time job still couldn't find one; some eight million families had been told to leave their homes, and millions more anticipate seeing foreclosure notices in the not-too-distant future;[1] still more saw their lifetime savings seemingly evaporate. Even if some of the green shoots that the optimists kept seeing were, in fact, the harbinger of a real recovery, it would be years—2018 at the earliest—before the economy returned to full employment. By 2012 many, however, had already given up hope: the savings of those who had lost their jobs in 2008 or 2009 had been spent. Unemployment checks had run out. Middle-aged people, once confident of a swift return to the workforce, came to realize they were in fact forcibly retired. Young people, fresh out of college with tens of thousands of dollars in debt, couldn't find any work at all. People who had moved in with friends and relatives at the start of the crisis had become homeless. Houses bought during the property boom were still on the market or sold at a loss; many more stood empty. The grim underpinnings of the financial boom of the preceding decade lay exposed at last.

One of the darkest sides to the market economy that came to light was the large and growing inequality that has left the American social fabric, and the country's economic sustainability, fraying at the edges: the rich were getting richer, while the rest were facing hardships that seemed inconsonant with the American dream. The fact that there were rich and poor in America was well known; and even though this inequality was not caused solely by the subprime crisis and the downturn that followed—it had been building up over the past three decades—the crisis made matters worse, to the point where it could no longer be ignored. The middle class was being badly squeezed in ways we'll see later in this chapter; the suffering of the bottom was palpable, as weaknesses in America's safety net grew obvious and as public support programs, inadequate at best, were cut back further; but throughout all this, the top 1 percent managed to hang on to a huge piece of the national income—a fifth—although some of their investments took a hit.[2]

There was greater inequality wherever one sliced the income distribution; even within the top 1 percent, the top 0.1 percent of income earners was getting a larger share of the money. By

2007, the year *before* the crisis, the top 0.1 percent of America's households had an income that was 220 times larger than the *average* of the bottom 90 percent.[3] Wealth was even more unequally distributed than income, with the wealthiest 1 percent owning more than a third of the nation's wealth.[4] Income inequality data offer only a snapshot of an economy at a single moment in time. But this is precisely why the data on wealth inequality are so troubling—wealth inequality goes beyond the variations seen in year-to-year income. Moreover, wealth gives a better picture of differences in access to resources.

America has been growing apart, at an increasingly rapid rate. In the first post-recession years of the new millennium (2002 to 2007), the top 1 percent seized more than 65 percent of the gain in total national income.[5] While the top 1 percent was doing fantastically, most Americans were actually growing worse-off.[6]

If the rich were growing richer and if those in the middle and at the bottom were also doing better, that would be one thing, especially if the efforts of those at the top were central to the successes of the rest. We could celebrate the successes of those at the top and be thankful for their contributions. But that's not what's been happening.

Members of America's middle class have felt that they were long suffering, and they were right. For three decades before the crisis, their incomes had barely budged.[7] Indeed, the income of a typical full-time male worker has stagnated for well over a third of a century.[8]

The crisis made these inequalities worse in innumerable ways, beyond the higher unemployment, lost homes, stagnating wages. The wealthy had more to lose in stock market values, but those recovered reasonably well and relatively fast.[9] In fact, the gains of the "recovery" since the recession have accrued overwhelmingly to the wealthiest Americans: the top 1 percent of Americans gained 93 percent of the additional income created in the country in 2010, as compared with 2009.[10] The poor and middle had most of their wealth in housing. As average house prices fell more than a third between the second quarter of 2006 and the end of 2011,[11] a large proportion of Americans—those with large mortgages—saw their wealth essentially wiped out. At the top, CEOs were remarkably successful in maintaining their high pay; after a slight dip in 2008, the ratio of CEO annual compensation to that of the typical worker by 2010 was back to what it had been before the crisis, to 243 to 1.[12]

Countries around the world provide frightening examples of what happens to societies when they reach the level of inequality toward which we are moving. It is not a pretty picture: countries where the rich live in gated communities, waited upon by hordes of low-income workers; unstable political systems where populists promise the masses a better life, only to disappoint. Perhaps most importantly, there is an absence of hope. In these countries, the poor know that their prospects of emerging from poverty, let along making it to the top, are minuscule. This is *not* something we should be striving for.

In this chapter, I lay out the scope of inequality in the United States and how it affects the lives of millions in different ways. I describe not only how we are becoming a more divided society but also how we are no longer the land of opportunity that we once were. I discuss the low chances that a person born at the bottom can rise to the top, or even the middle. The level of inequality and the absence of opportunity that we see in the United States today is not inevitable, nor is its recent rise simply the product of inexorable market forces. Later chapters will describe the causes of this inequality, the costs to our society, our democracy, and our economy of this high and growing inequality, and what can be done to reduce it.

The Rising Tide That Didn't Lift All Boats

Although the United States has always been a capitalist country, our inequality—or at least its current high level—is new. Some thirty years ago, the top 1 percent of income earners received *only* 12 percent of the nation's income.[13] That level of inequality should itself have been unacceptable; but since then the disparity has grown dramatically,[14] so that by 2007 the average after-tax income of the top 1 percent had reached \$1.3 million, but that of the bottom 20 percent amounted to only \$17,800.[15] The top 1 percent get in one week 40 percent more than the bottom fifth receive in a year; the top 0.1 percent received in a day and a half about what the bottom 90 percent received in a year; and the richest 20 percent of income earners earn in total *after tax* more than the bottom 80 percent combined.[16]

For thirty years after World War II, America grew together—with growth in income in every segment, but with those at the bottom growing faster than those at the top. The country's fight for survival brought a new sense of unity, and that led to policies, like the GI Bill, that helped bring the country even closer together.

But for the past thirty years, we've become increasingly a nation divided; not only has the top been growing the fastest, but the bottom has actually been declining. (It hasn't been a relentless pattern—in the 1990s, for a while, those at the bottom and in the middle did better. But then, as we've seen, beginning around 2000, inequality grew at an even more rapid pace.)

The last time inequality approached the alarming level we see today was in the years before the Great Depression. The economic instability we saw then and the instability we have seen more recently are closely related to this growing inequality, as I'll explain in chapter 4.

How we explain these patterns, the ebb and flow of inequality, is the subject of chapters 2 and 3. For now, we simply note that the marked reduction in inequality in the period between 1950 and 1970, was due partly to developments in the markets but even more to government policies, such as the increased access to higher education provided by the GI Bill and the highly progressive tax system enacted during World War II. In the years after the "Reagan revolution," by contrast, the divide in market incomes increased and, ironically, at the same time government initiatives designed to temper the inequities of the marketplace were dismantled, taxes at the top were lowered and social programs were cut back.

Market forces—the laws of supply and demand—of course inevitably play some role in determining the extent of economic inequality. But those forces are at play in other advanced industrial countries as well. Even before the burst in inequality that marked the first decade of this century, the United States already had more inequality and less income mobility than practically every country in Europe, as well as Australia and Canada.

The trends in inequality can be reversed. A few other countries have managed to do so. Brazil has had one of the highest levels of inequality in the world—but in the 1990s, it realized the perils, in terms both of social and political divisiveness and of long-term economic growth. The result was a political consensus across society that something had to be done. Under President Enrique Cardoso, there were massive increases in education expenditures, including for the poor. Under President Luiz Inácio Lula da Silva, there were social expenditures to reduce hunger and poverty.[17] Inequality was reduced, growth increased,[18] and society became more stable. Brazil still has more inequality than the United States, but while Brazil has been striving, rather successfully, to improve the plight of the poor and reduce gaps in income between rich and poor, America has allowed inequality to grow and poverty to increase.

Worse still, as we will show, government policies have been central to the creation of inequality in the United States. If we are to reverse these trends in inequality, we will have to reverse some of the policies that have helped make America the most economically divided developed country and, beyond that, to take further actions to lessen the inequalities that arise on their own from market forces.

Some defenders of the current level of inequality claim that although it's not inevitable, doing anything about it would be just too costly. They believe that for capitalism to work its wonders, high inequality is an inevitable, even necessary feature of the economy. After all, those who work hard should be rewarded, and have to be, if they are to make the efforts and the investments from which all benefit. Some inequality is indeed inevitable. Some individuals will work harder and longer than others, and any well-functioning economic system has to reward them for these efforts. But this book shows that both the magnitude of America's inequality today and the way it is generated actually undermine growth and impair efficiency. Part of the reason for this is that much of America's inequality is the result of market distortions, with incentives directed not at creating new wealth but at taking it from others. It is thus not surprising that our growth has been stronger in periods in which inequality has been lower and in which we have been growing together.[19] This was true not only in the decades after World War II but, even in more recent times, in the 1990s.[20]

Trickle-down economics

Inequality's apologists—and they are many—argue to the contrary that giving more money to the top will benefit *everyone*, partly because it would lead to more growth. This is an idea called trickle-down economics. It has a long pedigree—and has long been discredited. As we've seen, higher inequality has not led to more growth, and most Americans have actually seen their incomes sink or stagnate. What America has been experiencing in recent years is the opposite of trickle-down economics: the riches accruing to the top have come at the *expense* of those down below.[21]

One can think of what's been happening in terms of slices of a pie. If the pie were equally divided, everyone would get a slice of the same size, so the top 1 percent would get 1 percent of the pie. In fact, they get a very big slice, about a fifth of the entire pie. But that means everyone else gets a smaller slice.

Now, those who believe in trickle-down economics call this the politics of envy. One should look not at the relative size of the slices but at the absolute size. Giving more to the rich leads to a larger pie, so though the poor and middle get a smaller *share* of the pie, the piece of pie they get is enlarged. I wish that were so, but it's not. In fact, it's the opposite: as we noted, in the period of increasing inequality, growth has been slower—and the size of the slice given to most Americans has been diminishing.[22]

Young men (aged twenty-five to thirty-four) who are less educated have an even harder time; those who have only graduated from high school have seen their real incomes decline by more than a quarter in the last twenty-five years.[23] But even households of individuals with a bachelor's degree or higher have not done well—their median income (adjusted for inflation) fell by a tenth from 2000 to 2010.[24] (Median income is the income such that half have an income greater than that number, half less.)

We'll show later that whereas trickle-down economics doesn't work, trickle-up economics may: all—even those at the top—could benefit by giving more to those at the bottom and the middle.

A snapshot of America's inequality

The simple story of America is this: the rich are getting richer, the richest of the rich are getting still richer, [25] the poor are becoming poorer and more numerous, and the middle class is being hollowed out. The incomes of the middle class are stagnating or falling, and the difference between them and the truly rich is increasing.

Disparities in household income are related to disparities in wages and in wealth and income from capital—and inequality in both is increasing.[26] Just as overall inequality has been growing, so have inequalities in wages and salaries. For instance, over the last three decades those with low wages (in the bottom 90 percent) have seen a growth of only around 15 percent in their wages, while those in the top 1 percent have seen an increase of almost 150 percent and the top 0.1 percent of more than 300 percent.[27]

Meanwhile, changes in the wealth picture are even more dramatic. For the quarter century before the crisis, while everyone was getting wealthier, the rich were getting wealthier at a more rapid pace. As we noted, however, much of the wealth of the bottom and the middle, resting on the value of their homes, was phantom wealth—based on bubble housing prices—and while everyone lost out in the midst of the crisis, those at the top quickly recovered, but the bottom and middle did not. Even after the wealthy lost some of their wealth as stock prices declined in the Great Recession, the wealthiest 1 percent of households had 225 times the wealth of the typical American, almost double the ratio in 1962 or 1983.[28]

Given the inequality in wealth, it's not surprising that those at the top get the lion's share of the income from capital—before the crisis, in 2007, some 57 percent went to the top 1 percent.[29] Nor is it surprising that those in the top 1 percent have received an even larger share of the *increase* in capital income in the period after 1979—some seven-eighths—while those in the bottom 95 percent have gotten less than 3 percent of the increment.[30]

These broad-spectrum numbers, while alarming, can fail to capture the current disparities with sufficient force. For an even more striking illustration of the state of inequality in America, consider the Walton family: the six heirs to the Wal-Mart empire command wealth of $69.7 billion, which is equivalent to the wealth of the entire bottom 30 percent of U.S. society. The numbers may not be as surprising as they seem, simply because those at the bottom have so little wealth.[31]

Polarization

America has always thought of itself as a middle-class country. No one wants to think of himself as privileged, and no one wants to think of his family as among the poor. But in recent years, America's middle class has become eviscerated, as the "good" middle-class jobs—requiring a moderate level of skills, like autoworkers' jobs—seemed to be disappearing relative to those at the bottom, requiring few skills, and those at the top, requiring greater skill levels. Economists refer to this as the "polarization" of the labor force.[32] We'll discuss some of the theories explaining why this is happening, and what can be done about it, in chapter 3.

The collapse of the good jobs has happened during the last quarter century, and, not surprisingly, wages for such jobs have gone down and the disparity between wages at the top and those in the middle has increased.[33] The polarization of the labor force has meant that while more of the money is going to the top, more of the people are going toward the bottom.[34]

The Great Recession Makes

Hard Lives Even Harder

America's economic divide has grown so large that it's hard for those in the 1 percent to imagine what life at the bottom—and increasingly in the middle—is like. Consider for a moment a household with a single earner and two children. Assume that the earner is in good health and manages to work a full 40 hours a week (the average workweek of American workers is only 34 hours)[35] at a wage somewhat above the minimum: say, around $8.50 per hour, so that after paying his Social Security tax, he gets $8 per hour, and thus receives $16,640 for his 2,080 hours. Assume he pays no income tax, but his employer charges him $200 a month for health insurance for his entire family and picks up the rest of the $550 per month cost of insurance. This brings his take-home pay to $14,240 a year. If he is lucky, he might be able to find a two-bedroom apartment (with utilities included) for $700 a month. This leaves him with $5,840 to cover all other family expenses for the year. Like most Americans, he may consider a car a basic necessity; insurance, gas, maintenance, and depreciation on the vehicle could easily take up some $3,000. The family's remaining funds are $2,840—under $3 a day per person—to cover basic expenses like food and clothing, not to mention things that make life worth living, like entertainment. If something goes wrong, there is simply no buffer.

As America went into the Great Recession, something did go wrong, for our hypothetical family and millions of real Americans nationwide. Jobs were lost, the value of their homes—their major asset—plummeted, and, as government revenues fell, safety nets were cut back just when they were needed most.

Even before the crisis, America's poor lived on the precipice; but with the Great Recession, that became increasingly true even of the middle class. The human stories of this crisis are replete with tragedies: one missed mortgage payment escalates into a lost house; homelessness escalates into lost jobs and the eventual destruction of families.[36] For these families, one shock may be manageable; the second is not. As some fifty million Americans lack health insurance, an illness can push the entire family close to edge;[37] a second illness, the loss of a job, or an auto accident can then push them over. Indeed, recent research has shown that by far the largest fraction of personal bankruptcies involve the illness of a family member.[38]

To see how even little changes in programs of social protection can have big effects on poor families, let's return to our family, which had $2,840 a month to spend. As the recession continued, many states cut back on assistance for child care. In Washington State, for instance, the average monthly cost of childcare for two children is $1,433.[39] If there is no public assistance for child care, this would immediately eat up *half* of what our family had left over, leaving less than $1.30 a day per person for everything else.

A labor market without a safety net

But the hardship faced by those who lost their jobs and couldn't find another was even greater. Full-time employment declined by 8.7 million from November 2007 to November 2011,[40] a period during which *normally* almost 7 million new persons would have entered the labor force—an increase in the true jobs deficit of more than 15 million. Millions of those who couldn't find a job after searching and searching gave up and dropped out of the labor force; young people decided to stay in school, as employment prospects even for college graduates seemed bleak. The "missing" workers meant that the official unemployment statistics (which, by early 2012 suggested that the unemployment rate was "only" 8.3 percent) presented an overly rosy picture of the state of the labor market.

Our unemployment insurance system, one of the least generous in the advanced industrial world, simply wasn't up to the task of providing adequate support for those losing their jobs.[41] Normally, insurance extends for only six months. Before the crisis, a dynamic labor market at full employment meant that most of those who wanted a job could find one within a short time, even if the job wasn't up to their expectations or skills. But in the Great Recession that was no longer true. Almost half of the jobless were long-term unemployed.

The term of eligibility for unemployment insurance was extended (typically after a very hard congressional debate),[42] but, even so, millions are finding that they are still unemployed when the benefits expire.[43] As the recession and the weak job market continued into 2010, a new segment of our society emerged, the "99ers"—those who had been unemployed for more than 99 weeks—and even in the best states, even with federal assistance, they were left out in the cold. They looked for work, but there just weren't enough jobs to be had. There were four job seekers for every job.[44] And given how much political capital had to be spent to extend unemployment insurance to 52, 72, or 99 weeks, few politicians even proposed to do anything about the 99ers.[45]

A poll by the *New York Times* late in 2011 revealed the extent of the inadequacies in our unemployment insurance system.[46] Only 38 percent of the unemployed were then receiving unemployment benefits, and some 44 percent had never received any. Of those receiving assistance, 70 percent thought that it was very or somewhat likely that the benefits would run out before they got a job. For three-quarters of those on assistance, the benefits fell far short of their previous income. Not surprisingly, more than half of the unemployed had experienced emotional or health problems as a result of being jobless but could not get treatment, since more than half of the unemployed had no health insurance coverage.

Many of the unemployed who were middle-aged saw no prospect of ever finding another job. For those over forty-five, the *average* duration of unemployment is already approaching one year.[47] The only positive note in the survey was the optimistic response that, *overall*, 70 percent thought it was very or somewhat likely that they would get a job in the next twelve months. American optimism, it seemed, still survived.

Before the recession, the United States appeared in some ways to be performing better than other countries. While wages, say, in the middle might not be growing, at least everyone who wanted a job could get one. This was the long-vaunted advantage of “flexible labor markets.” But the crisis showed that even this advantage seemed to be disappearing, as America’s labor markets increasingly resembled those of Europe, with not merely high but long-lasting unemployment. The young are frustrated—but I suspect that upon learning what the current trend portends, they would be even more so: those who remain unemployed for an extended period of time have lower lifetime employment prospects than those with similar qualifications who have been luckier in the job market. Even when they get a job, it will be at a lower wage than that of persons with similar qualifications. Indeed, the bad luck of entering the labor force in a year of high unemployment shows up in the lifelong earnings of these individuals.[48]

Economic insecurity

It is easy to understand the growing insecurity that so many Americans feel. Even the employed know that their jobs are at risk, and that with the high level of unemployment and the low level of social protection, their lives could suddenly take a turn for the worse. The loss of a job meant the loss of health insurance and perhaps even the loss of their home.

Those with seemingly secure jobs faced an insecure retirement, because in recent years, the United States has changed how it manages pensions. Most retirement benefits used to be provided through defined-benefit retirement schemes—where individuals could be sure of what they would get when they retired, with corporations bearing the risk of stock market fluctuations. But now most workers have defined-contribution schemes, where the individual is left with the responsibility of managing his retirement accounts—and bearing the risk of stock market fluctuations and inflation. There’s the obvious danger: if the individual had listened to financial analysts and put her money into the stock markets, she took a beating in 2008.

The Great Recession thus represented a triple whammy for many Americans: their jobs, their retirement incomes, and their homes were all at risk. The housing bubble had provided a temporary reprieve from the consequences that would have followed from falling incomes. They could, and did, spend beyond their income as they struggled to maintain their standard of living. Indeed, in the mid-2000s, before the onset of the Great Recession, people in the bottom 80 percent were spending around 110 percent of their incomes.[49] Now that the bubble has broken, not only will these Americans have to live *within* their income; many will have to live *below* their income to pay back a mountain of debt. More than a fifth of those with mortgages are underwater, owing more on their house than it’s worth.[50] The house, instead of being the piggy bank to pay for retirement or a child’s college education, has become a burden. And many persons are at risk of losing their homes—and many have done so already. The millions of families that we noted lost their homes since the crashing of the housing bubble lost not only the roof over their heads but also much of their life savings.[51]

Between the loss on retirement accounts and the $6.5 trillion loss in housing valuations,[52] ordinary Americans have been hard hit by the crisis, and poorer Americans, who were just beginning to glimpse the American dream—or so they thought, as they bought a home and saw the value of their houses rise in the bubble—have done particularly badly. Between 2005 and 2009, the typical African American household has lost 53 percent of its wealth—putting its assets at a mere 5 percent of the average white American's, and the average Hispanic household has lost 66 percent of its wealth. And even the net worth of the typical white American household was down substantially, to $113,149 in 2009, a 16 percent loss of wealth from 2005.[53]

A standard of living in decline

The income measures on which we have focused so far, dismal as they are, do not fully capture the decline in the standard of living of *most* Americans. Most face not only economic insecurity but also health insecurity and, in some cases, even physical insecurity. President Obama's health care program was designed to extend coverage, but the Great Recession and the budget stringency that followed have led to a move in the opposite direction. Medicaid programs, on which the poor depend, have been scaled back.

Lack of health insurance is one factor contributing to poorer health, especially among the poor. Life expectancy in the United States is 78 years, lower than Japan's 83 years, or Australia's or Israel's 82 years. According to the World Bank, in 2009 the United States ranked fortieth overall, just below Cuba.[54] Infant and maternal mortality in the United States is little better than in some developing countries; for infant mortality, it is worse than Cuba, Belarus, and Malaysia, to name a few.[55] And these poor health indicators are largely a reflection of the dismal statistics for America's poor. For instance, America's poor have a life expectancy that is almost 10 percent lower than that of those at the top.[56]

We noted earlier that the income of a typical full-time male worker has stagnated for a third of a century, and that of those who have not gone to college has declined. To keep incomes from declining even more than they have, work hours per family have increased, mostly because more women are joining the workforce alongside their husbands. Our income statistics do not take into account either the loss of leisure or what this does to the quality of family life.

The decline in living standards is also manifested in changing social patterns as well as hard economic facts. An increasing fraction of young adults are living with their parents: some 19 percent of men between twenty-five and thirty-four, up from 14 percent as recently as 2005. For women in this age group, the increase was from 8 percent to 10 percent.[57] Sometimes called the "boomerang generation," these young people are forced to stay at home, or return home after graduation, because they cannot afford to live independently. Even customs like marriage are being affected, at least for the moment, by the lack of income and security. In just one year (2010), the number of couples who were living together without being married jumped by 13 percent.[58]

The consequences of pervasive and persistent poverty and long-term underinvestment in public education and other social expenditures are also manifest in other indicators that our society is not functioning as it should: a high level of crime, and a large fraction of the population in prison.[59] While violent-crime statistics are better than they were at their nadir (in 1991),[60] they remain high, far worse than in other advanced industrial countries, and they impose large economic and social costs on our society. Residents of many poor (and not so poor) neighborhoods still feel the risk of physical assault. It's expensive to keep 2.3 million people in prison. The U.S. incarceration rate of 730 per 100,000 people (or almost 1 in 100 adults), is the world's highest and some nine to ten times that of many European countries.[61] Some U.S. states spend as much on their prisons as they do on their universities.[62]

Such expenditures are not the hallmarks of a well-performing economy and society. Money that is spent on "security"—protecting lives and property—doesn't add to well-being; it simply prevents things from getting worse. Yet we consider these outlays part of the country's gross domestic product (GDP) as much as any other expenditure. If America's growing inequality leads to more spending to prevent crime, it will show up as an increase in GDP, but no one should confuse that with an increase in well-being.[63]

Incarceration even distorts our unemployment statistics. Individuals in prison are disproportionately poorly educated and come from groups that otherwise face high unemployment. It is highly likely that, if they weren't incarcerated, they would join the already swollen ranks of the unemployed. Viewed in this light, America's true unemployment rate would be worse, and it would compare less favorably with that of Europe; if the entire prison population of nearly 2.3 million was counted, the unemployment rate would be well above 9 percent.[64]

Poverty

The Great Recession made life for America's diminishing middle class harder. But it was especially hard for those at the bottom, as illustrated by the data presented earlier in this chapter for the family trying to survive on a wage slightly above the minimum wage.

An increasingly large number of Americans can barely meet the necessities of life. These individuals are said to be in poverty. The fraction of those in poverty[65] was 15.1 percent in 2010, up from 12.5 percent in 2007. And our discussion above should have made clear how low the standard of living is of those at that threshold. At the very bottom, by 2011 the number of American families in *extreme poverty*—living on two dollars a day per person or less, the measure of poverty used by the World Bank for developing countries—had doubled since 1996, to 1.5 million.[66] The "poverty gap," which is the percentage by which the mean income of a country's poor falls below the official poverty line, is another telling statistic. At 37 percent, the United States is one of the worst-ranking countries in the Organization for Economic Cooperation and Development (OECD), the "club" of the more developed countries, in the same league as Spain (40 percent), Mexico (38.5 percent), and Korea (36.6 percent).[67]

The extent of poverty is illustrated by the fraction of Americans depending on government to meet their basic food needs (one in seven); and even then, large numbers of Americans go to bed at least once a month hungry, not because they are on a diet but because they can't afford food.[68]

The measurement of poverty—like the measurement of income—is difficult and far from uncontroversial. Until 2011, standard poverty measures focused on income before the effects of government programs are taken into account, and those are the numbers that are given above. This is what life would be like in the absence of government safety nets. Not surprisingly, government programs *do matter.* And they matter especially in economic downturns. Many of the programs, like unemployment insurance, provide only short-term assistance. They are directed at those facing temporary hardship. With the reform of the welfare system in 1996 (Personal Responsibility and Work Opportunity Reconciliation Act), welfare payments, too, became time limited (federal funds are generally limited to at most five years).

Looking at these programs, and simultaneously examining more carefully the different needs of various groups in society—those in the rural sector face lower housing costs; the elderly face higher medical costs—yields a more nuanced picture of poverty, one in which there are fewer rural poor, more urban poor, fewer poor children, and more poor elderly than in the older measures, which didn't take into account the different circumstances of different groups of the poor. Under this new measure (as well as by the old), the numbers in poverty have been increasing rapidly, by some 6 percent just from 2009 to 2010 alone, and the numbers in poverty under the new measure are even higher than under the old, so that almost one out of six Americans is now in poverty.[69]

It may be true that "the poor always ye have with you," but that doesn't mean that there have to be *so many* poor, or that they should suffer so much. We have the wealth and resources to eliminate poverty: Social Security and Medicare have almost eliminated poverty among the elderly.[70] And other countries, not as rich as the United States, have done a better job of reducing poverty and inequality.

It is particularly disturbing that today almost a quarter of all children live in poverty.[71] Not doing anything about their plight is a political choice that will have long-lasting consequences for our country.

Opportunity

Belief in America's essential fairness, that we live in a land of *equal opportunity*, helps bind us together. That, at least, is the American myth, powerful and enduring. Increasingly, it is just that—a myth. Of course, there are exceptions, but for economists and sociologists what matters are not the few success stories but what happens to *most* of those at the bottom and in the middle. What are their chances of making it, say, to the top? What is the likelihood that their children will be no better-off than they? If America were really a land of opportunity, the life chances of success—of, say, winding up in the top 10 percent—of someone born to a poor or less-educated family would be the same as those of someone born to a rich, well-educated, and well-connected family. But that's simply not the case, and there is some evidence that it's getting less so.[72] Indeed, according to the Economic Mobility Project, "there is a stronger link between parental education and children's economic, educational, and socio-emotional outcomes" in the United States than in any other country investigated, including those of "old Europe" (the UK, France, Germany, and Italy), other English speaking countries (Canada and Australia), and the Nordic countries Sweden, Finland, and Denmark, where the results were more expected.[73] A variety of other studies have corroborated these findings.[74]

This decline in opportunity has gone hand in hand with our growing inequality. In fact, that pattern has been observed across countries—countries with more inequality systematically have less equality of opportunity. Inequality persists.[75] But what's particularly disturbing about this relationship is what it bodes for the country's future: the growing inequality over recent years suggests that the level of opportunity in the future will be diminished and the level of inequality will be increased—unless we do something. It means that the America of 2053 will be a much more divided society than even the America of 2013. All the social, political, and economic problems arising out of inequality that we discuss in subsequent chapters will be that much worse.

It is at the bottom and the top where the United States performs especially badly: those at the bottom have a good chance of staying there, and as do those at the top, and much more so than in other countries. With full equality of opportunity, 20 percent of those in the bottom fifth would see their children in the bottom fifth. Denmark almost achieves that—25 percent are stuck there. Britain, supposedly notorious for its class divisions, does only a little worse (30 percent). That means they have a 70 percent chance of moving up. The chances of moving up in America, though, are markedly smaller (only 58 percent of children born to the bottom group make it out),[76] and when they do move up, they tend to move up only a little. Almost two-thirds of those in the bottom 20 percent have children who are in the bottom 40 percent—50 percent more than would be the case with full equality of opportunity.[77] So too, with full equality of opportunity, 20 percent of the bottom would make it all the way to the top fifth. No country comes close to achieving that goal, but again both Denmark (with 14 percent) and the UK (with 12 percent) do much better than the United States, with a mere 8 percent. By the same token, once one makes it to the top in the United States, one is more likely to remain there.[78]

There are many other ways of summarizing the disadvantageous position of the poor. The journalist Jonathan Chait has drawn attention to two of the most telling statistics from the Economic Mobility Project and research from the Economic Policy Institute.[79]

- Poor kids who succeed academically are less likely to graduate from college than richer kids who do worse in school.[80]
- Even if they graduate from college, the children of the poor are still worse-off than low-achieving children of the rich.[81]

None of this comes as a surprise: education is one of the keys to success; at the top, the country gives its elite an education that is comparable to the best in the world. But the average American gets just an average education—and in mathematics, key to success in many areas of modern life, it's subpar. This is in contrast to China (Shanghai and Hong Kong), Korea, Finland, Singapore, Canada, New Zealand, Japan, Australia, Netherlands, and Belgium, which perform significantly above average on *all* tests (reading and mathematics).[82]

A stark reflection of the inequality of educational opportunity in our society is the composition of students in America's highly selective colleges. Only around 9 percent come from the bottom half of the population, while 74 percent come from the top quarter.[83]

So far, we have constructed a picture of an economy and a society that is increasingly divided. It shows up not only in income data but also in health, education, crime—indeed, in every metric of performance. While inequalities in parental income and education translate directly into inequalities of educational opportunity, inequalities of opportunity begin even before school—in the conditions that poor people face immediately before and after birth, differences in nutrition and the exposure to environmental pollutants that can have lifelong effects.[84] So difficult is it for those born into poverty to escape that economists refer to the situation as a "poverty trap."[85]

Even as the data show otherwise, Americans still believe in the myth of opportunity. A public opinion poll by the Pew Foundation found that "nearly 7 in 10 Americans had already achieved, or expected to achieve, the American Dream at some point in their lives."[86] Even as a myth, the belief that everyone had a fair chance had its uses: it motivated people to work hard. It seemed we were all in the same boat; even if some were, for the moment, traveling first-class while others stayed in steerage. On the next cruise positions might be reversed. The belief enabled the United States to avoid some of the class divisions and tensions that marked some European countries. By the same token, as the reality sinks in, as most Americans finally grasp that the economic game is stacked against them, all of this is at risk. Alienation has begun to replace motivation. Instead of social cohesion we have a new divisiveness.

A Closer Look at the Top: Grabbing a Bigger Slice of the Pie

As we've noted, the growing inequality in our society is visible at the top, the middle, and the bottom. We've already observed what's happening at the bottom and in the middle. Here we take a closer look at the top.

If struggling poor families get our sympathy today, those at the top increasingly draw our ire. At one time, when there was a broad social consensus that those at the top earned what they got, they received our admiration. In the recent crisis, however, bank executives received outsize bonuses for outsize losses, and firms fired workers, claiming they couldn't afford them, only to use the savings to increase executive bonuses still more. The result was that admiration at their cleverness turned to anger at their insensitivities.

Numbers on compensation of corporate executives—including those who brought on the crisis—tell the story. We described earlier the huge gap between CEO pay and that of the typical worker—more than 200 times greater—a number markedly higher than in other countries (in Japan, for instance, the corresponding ratio is 16 to 1)[87] and even markedly higher than it was in the United States a quarter century ago.[88] The old U.S. ratio of 30 to 1 now seems quaint by comparison. It strains credulity to think that over the intervening years CEOs as a group have increased their productivity so much, relative to the average worker, that a multiple of more than 200 could be justified. Indeed, the available data on the success of U.S. companies provide no support for such a view.[89] What's worse, we have provided a bad example, as executives in other countries around the world emulate their American counterparts. The UK's High Pay Commission reported that the executive pay at its large companies is heading toward Victorian levels of inequality, vis-à-vis the rest of society (though currently the disparity is only as egregious as it was in the 1920s).[90] As the report puts it, "Fair pay within companies matters; it affects productivity, employee engagement and trust in our businesses. Moreover pay in publicly listed companies sets a precedent, and when it is patently not linked to performance, or rewards failure, it sends out the wrong message and is a clear symptom of market failure."[91]

International Comparisons

As we look out at the world, the United States not only has the highest level of inequality among the advanced industrial countries, but the level of its inequality is increasing in absolute terms relative to that in other countries. The United States was the most unequal of the advanced industrial countries in the mid-1980s, and it has maintained that position.[92] In fact, the gap between it and many other countries has increased: from the mid-1980s France, Hungary, and Belgium have seen no significant increase in inequality, while Turkey and Greece have actually seen a decrease in inequality. We are now approaching the level of inequality that marks dysfunctional societies—it is a club that we would distinctly not want to join, including Iran, Jamaica, Uganda, and the Philippines.[93]

Because we have so much inequality, and because it is on the rise, what's happening to *income (or GDP) per capita* doesn't tell us much about what the typical American is experiencing. If Bill Gates and Warren Buffett's incomes go up, the *average* income for America goes up. More meaningful is what's happening to the *median* income, the income of the family in the middle, which, as we saw, has been stagnating, or even falling, in recent years.

The UNDP (the UN Development Program) has developed a standard measure of "human development," which aggregates measures of income, health, and education. It then adjusts those numbers to reflect inequality. Before adjustment for inequality, the United Sstates looked reasonably good in 2011—fourth, behind Norway, Australia, and Netherlands. But once account is taken of inequality, the United States is ranked twenty-third, behind all of the European countries. The difference between the rankings with and without inequality was the largest of any of the advanced industrial countries.[94] All of the Scandinavian countries rank much higher than the United States, and each provides not only universal education but also health care to its citizens. The standard mantra in the United States claims that the taxes required to finance these benefits stifle growth. Far from it. Over the period 2000 to 2010, high-taxing Sweden, for example, grew far faster than the United States—the country's average growth rates have exceeded those of the United States—2.31 percent a year versus 1.85 percent.[95]

As a former finance minister of one of these countries told me, "We have grown so fast and done so well because we had high taxes." Of course, what he meant was not that the taxes themselves led to higher growth but that the taxes financed public expenditures—investments in education, technology, and infrastructure—and the public expenditures were what had sustained the high growth—more than offsetting any adverse effects from the higher taxation.

Gini coefficient

One standard measure of inequality is the Gini coefficient. If income were shared in proportion to the population—the bottom 10 percent getting roughly 10 percent of the income, the bottom 20 percent getting 20 percent, and so forth—then the Gini coefficient would be zero. There would be no inequality. On the other hand, if all the income went to the top person, the Gini coefficient would be one, in some sense "perfect" inequality. More-equal societies have Gini coefficients of .3 or below. These include Sweden, Norway, and Germany.[96] The most unequal societies have Gini coefficients of .5 or above. These include some countries in Africa (notably South Africa with its history of grotesque racial inequality) and Latin America—long recognized for their divided (and often dysfunctional) societies and polities.[97] America hasn't made it *yet* into this "elite" company, but it's well on the way. In 1980 our Gini coefficient was just touching .4; today it's .47.[98] According to UN data, we are slightly more unequal than Iran and Turkey,[99] and much less equal than any country in the European Union.[100]

We end this international comparison by coming back to a theme we raised earlier: measures of income inequality don't fully capture critical aspects of inequality. America's inequality may, in fact, be far worse than those numbers suggest. In other advanced industrial countries, families don't have to worry about how they will pay the doctor's bill, or whether they can afford to pay for their parent's health care. Access to decent health care is taken as a basic human right. In other countries, the loss of a job is serious, but at least there is a better safety net. In no other country are so many persons worried about the loss of their home. For Americans at the bottom and in the middle, economic insecurity has become a fact of life. It is real, it is important, but it's not captured in these metrics. If it were, the international comparisons would cast what's been happening in America in an even worse light.

Concluding Comments

In the years before the crisis, many Europeans looked to America as a model and asked how they could reform their economy to make it perform as well as that of the United States. Europe has its problems, too, caused mainly by countries' joining together to form a currency union without making the necessary political and institutional arrangements to make it work, and they will pay a high price for that failure. But setting that aside, they (and people in countries around the world) now know that GDP per capita does not provide a good picture of what is happening to most citizens in society—and in a fundamental sense, then, of how well the economy is doing. They were misled by the GDP per capita data to thinking the United States was performing well. Today that is no longer the case. Of course, economists who looked beneath the surface knew back in 2008 that America's debt-driven growth was not sustainable; and even when all appeared to be going well, the income of most Americans was declining, even as the outsize gains of those at the top were distorting the overall picture.

The success of an economy can be assessed only by looking at what is happening to the living standards—broadly defined—of most citizens over a sustained period of time. In those terms, America's economy has not been performing well, and it hasn't been for at least a third of a century. Although it has managed to increase GDP per capita, from 1980 to 2010 by three-fourths,[101] most full-time male workers have, as we've noted, seen their incomes go down. For these workers, the American economy is failing to bring the increases in living standards that they had come to expect. It is not that the American economic engine has lost its ability to produce. It is that the way the American economic engine has been run has given the benefits of that growth to an increasingly small sliver at the top—and even taken away some of what had previously gone to the bottom.

This chapter has illuminated certain stark and uncomfortable facts about the U.S. economy:

(a) Recent U.S. income growth primarily occurs at the top 1 percent of the income distribution.
(b) As a result there is growing inequality.
(c) And those at the bottom and in the middle are actually worse-off today than they were at the beginning of the century.
(d) Inequalities in wealth are even greater than inequalities in income.
(e) Inequalities are apparent not just in income but in a variety of other variables that reflect standards of living, such as insecurity and health.
(f) Life is particularly harsh at the bottom—and the recession made it much worse.
(g) There has been a hollowing out of the middle class.
(h) There is little income mobility—the notion of America as a land of opportunity is a myth.
(i) And America has more inequality than any other advanced industrialized country, it does less to correct these inequities, and inequality is growing more than in many other countries.

The American Right finds the facts described in this chapter inconvenient. The analysis runs counter to some cherished myths that it would like to propagate: that America is a land of opportunity, that most people have been benefiting from the market economy, especially in the era since Reagan deregulated the economy and downsized government. Members of the Right would like to deny the facts, but the accumulation of data makes it hard to do so. They especially can't deny that those at the bottom *and in the middle* are doing poorly and that those at the top are grabbing an increasing fraction of the nation's income—so much of a larger share that what's left over for the rest is diminished; and that the chances that those at the bottom or in the middle will make it to the top are far lower than the chances that those at the top will remain there. Nor can the Right really deny the fact that government can help ameliorate poverty—it has done so especially effectively among the elderly. And that means that cutbacks in government programs, including Social Security, unless they are very carefully designed, are likely to increase poverty.

In response, the Right offers four retorts. The first is that in any year someone will be down and out and someone else will enjoy a bonanza. What really matters is lifetime inequality. Those with the lowest incomes will, by and large, have higher incomes in later years, so lifetime inequality is less than these data suggest. Economists have taken a hard look at differences in lifetime income—and, unfortunately, the wish of the Right doesn't conform to today's reality: lifetime inequality is very large, almost as great as income at each moment of time, and has increased enormously in recent years.[102]

The Right also sometimes claims that poverty in America is not real poverty. After all, most of those in poverty have amenities that are not available to the poor in other countries. They should be grateful for living in America. They have TVs, indoor plumbing, heating (most of the time), and access to free schools. But as a National Academy of Sciences panel found,[103] one cannot ignore relative deprivation. Basic standards of sanitation in America's cities lead naturally to indoor plumbing. Cheap Chinese TVs mean that even the poor can afford them—and indeed, even in poor Indian and Chinese villages, there is in general access to TV. In today's world, this is not a mark of affluence. But the fact that people may be enjoying a small TV doesn't really mean that they aren't facing stark poverty—nor does it mean that they are participating in the American dream.[104]

The third response is to quibble about the statistics. Some might claim that inflation may be overestimated, so growth in incomes may be underestimated. But, if anything, I suspect that the numbers under-estimate the travails facing the typical American family. As family members work longer hours to maintain their standard of living—"for the family"—family life often suffers. Earlier in this chapter, we described the increasing level of insecurity that the poor and the middle class in America face—and this, too, is not reflected in the income statistics. Plausibly, true inequality may be far larger than the measures of inequality of income would suggest. Indeed, as we noted earlier, when the Census Bureau recently took a more careful look at the poverty statistics, it found that the poverty rate for 2010 went up from 15.2 percent to 16 percent.[105]

The final retort by the Right makes reference to an economic and moral justification of inequality, accompanied by a claim that attempting to do anything about it will simply "kill the golden goose," and so weaken America's economy that even the poor will suffer.[106] As Mitt Romney put it, inequality is the kind of thing that should be discussed quietly and privately.[107] The poor, in this land of opportunity, have only themselves to blame. In later chapters we'll address these arguments. We'll show that, for the most part, not only should we not blame the poor for their plight but also that the claim of those at the top, that they earned their money "on their own," doesn't have much merit. We'll see that the 1 percent are by and large not those who earned their incomes by great social contributions—the great thinkers who have transformed our understanding of the world or the great innovators who have transformed our economy. We'll also explain why creating a more equal society can create a more dynamic economy.

The trauma of the Great Recession—with large numbers of people losing their jobs and homes—has triggered a chain reaction, affecting not just the lives of the individuals concerned but also society as a whole. We now see that, for most Americans, the economy wasn't really performing as it should even before the recession. We can no longer ignore America's growing inequality and its grave economic, political, and social consequences. But if we are to understand what to do about it, we have to understand the economic, political, and social forces that give rise to it.

RENT SEEKING AND THE MAKING OF AN UNEQUAL SOCIETY

AMERICAN INEQUALITY DIDN'T JUST HAPPEN. IT WAS created. Market forces played a role, but it was not market forces alone. In a sense, that should be obvious: economic laws are universal, but our growing inequality—especially the amounts seized by the upper 1 percent—is a distinctly American "achievement." That outsize inequality is not predestined offers reason for hope, but in reality it is likely to get worse. The forces that have been at play in creating these outcomes are self-reinforcing.

By understanding the origins of inequality, we can better grasp the costs and benefits of reducing it. The simple thesis of this chapter is that even though market forces help shape the degree of inequality, government policies shape those market forces. Much of the inequality that exists today is a result of government policy, both what the government does and what it does not do. Government has the power to move money from the top to the bottom and the middle, or vice versa.

We noted in the last chapter that America's current level of inequality is unusual. Compared with other countries and compared with what it was in the past even in the United States, it's unusually large, and it has been increasing unusually fast. It used to be said that watching for changes in inequality was like watching grass grow: it's hard to see the changes in any short span of time. But that's not true now.

Even what's been happening in this recession is unusual. Typically, when the economy weakens, wages and employment adjust slowly, so as sales fall, profits fall more than proportionately. But in this recession the share of wages has actually fallen, and many firms are making good profits.[1]

Addressing inequality is of necessity multifaceted—we have to rein in the excesses at the top, strengthen the middle, and help those at the bottom. Each goal requires a program of its own. But to construct such programs, we have to have a better understanding of what has given rise to each facet of this unusual inequality.

Distinct as the inequality we face today is, inequality itself is not something new. The concentration of economic and political power was in many ways more extreme in the precapitalist societies of the West. At that time, religion both explained and justified the inequality: those at the top of society were there because of divine right. To question that was to question the social order, or even to question God's will.

However, for modern economists and political scientists, as also for the ancient Greeks, this inequality was not a matter of a preordained social order. Power—often military power—was at the origin of these inequities. Militarism was about economics: the conquerors had the right to extract as much as they could from the conquered. In antiquity, natural philosophy in general saw no wrong in treating other humans as means for the ends of others. As the ancient Greek historian Thucydides famously said, "right, as the world goes, is only in question between equals in power, while the strong do what they can and the weak suffer what they must."[2]

Those with power used that power to strengthen their economic and political positions, or at the very least to maintain them.[3] They also attempted to shape thinking, to make acceptable differences in income that would otherwise be odious.

As the notion of divine right became rejected in the early nation-states, those with power sought other bases for defending their positions. With the Renaissance and the Enlightenment, which emphasized the dignity of the individual, and with the Industrial Revolution, which led to the emergence of a vast urban underclass, it became imperative to find new justifications for inequality, especially as critics of the system, like Marx, talked about exploitation.[4]

The theory that came to dominate, beginning in the second half of the nineteenth century—and still does—was called "marginal productivity theory"; those with higher productivities earned higher incomes that reflected their greater contribution to society. Competitive markets, working through the laws of supply and demand, determine the value of each individual's contributions. If someone has a scarce and valuable skill, the market will reward him amply, because of his greater contribution to output. If he has no skills, his income will be low. Technology, of course, determines the productivity of different skills: in a primitive agriculture economy, physical strength and endurance is what mattered; in a modern hi-tech economy, brainpower is of more relevance.

Technology and scarcity, working through the ordinary laws of supply and demand, play a role in shaping today's inequality, but something else is at work, and that something else is government. A major theme of this book is that inequality is the result of political forces as much as of economic ones. In a modern economy government sets and enforces the rules of the game—what is fair competition, and what actions are deemed anticompetitive and illegal, who gets what in the event of bankruptcy, when a debtor can't pay all that he owes, what are fraudulent practices and forbidden. Government also gives away resources (both openly and less transparently) and, through taxes and social expenditures, modifies the distribution of income that emerges from the market, shaped as it is by technology and politics.

Finally, government alters the dynamics of wealth by, for instance, taxing inheritances and providing free public education. Inequality is determined not just by how much the market pays a skilled worker relative to an unskilled worker, but also by the level of skills that an individual has acquired. In the absence of government support, many children of the poor would not be able to afford basic health care and nutrition, let alone the education required to acquire the skills necessary for enhanced productivity and high wages. Government can affect the extent to which an individual's education and inherited wealth depends on that of his parents. More formally, economists say that inequality depends on the distribution of "endowments," of financial and human capital.

The way the American government performs these functions determines the extent of inequality in our society. In each of these arenas there are subtle decisions that benefit some group at the expense of others. The effect of each decision may be small, but the cumulative effect of large numbers of decisions, made to benefit those at the top, can be very significanat.

Competitive forces should limit outsize profits, but if governments do not ensure that markets are competitive, there can be large monopoly profits. Competitive forces should also limit disproportionate executive compensation, but in modern corporations, the CEO has enormous power—including the power to set his own compensation, subject, of course, to his board—but in many corporations, he even has considerable power to appoint the board, and with a stacked board, there is little check. Shareholders have minimal say. Some countries have better "corporate governance laws," the laws that circumscribe the power of the CEO, for instance, by insisting that there be independent members in the board or that shareholders have a say in pay. If the country does not have good corporate governance laws that are effectively enforced, CEOs can pay themselves outsize bonuses.

Progressive tax and expenditure policies (which tax the rich more than the poor and provide systems of good social protection) can limit the extent of inequality. By contrast, programs that give away a country's resources to the rich and well connected can increase inequality.

Our political system has increasingly been working in ways that increase the inequality of outcomes and reduce equality of opportunity. This should not come as a surprise: we have a political system that gives inordinate power to those at the top, and they have used that power not only to limit the extent of redistribution but also to shape the rules of the game in their favor, and to extract from the public what can only be called large "gifts." Economists have a name for these activities: they call them rent seeking, getting income not as a reward to creating wealth but by grabbing a larger share of the wealth that would otherwise have been produced without their effort. (We'll give a fuller definition of the concept of rent seeking later in the chapter.) Those at the top have learned how to suck out money from the rest in ways that the rest are hardly aware of—that is their true innovation.

Jean-Baptiste Colbert, the adviser to King Louis XIV of France, reportedly said, "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing." So, too, for the art of rent seeking.

To put it baldly, there are two ways to become wealthy: to create wealth or to take wealth away from others. The former adds to society. The latter typically subtracts from it, for in the process of taking it away, wealth gets destroyed. A monopolist who overcharges for his product takes money from those whom he is overcharging and at the same time destroys value. To get his monopoly price, he has to restrict production.

Unfortunately, even genuine wealth creators often are not satisfied with the wealth that their innovation or entrepreneurship has reaped. Some eventually turn to abusive practices like monopoly pricing or other forms of rent extraction to garner even more riches. To take just one example, the railroad barons of the nineteenth century provided an important service in constructing the railroads, but much of their wealth was the result of their political influence—getting large government land grants on either side of the railway. Today, over a century after the railroad barons dominated the economy, much of the wealth at the top in the United States—and some of the suffering at the bottom—stems from wealth transfers instead of wealth creation.

Of course, not all the inequality in our society is a result of rent seeking, or of government's tilting the rules of the game in favor of those at the top. Markets matter, as do social forces (like discrimination). This chapter focuses on the myriad forms that rent seeking takes in our society, and the next turns to the other determinants of inequality.

General Principles

Adam Smith's invisible hand and inequality

Adam Smith, the father of modern economics, argued that the private pursuit of self-interest would lead, as if by an invisible hand, to the well-being of all.[5] In the aftermath of the financial crisis, no one today would argue that the bankers' pursuit of their self-interest has led to the well-being of all. At most, it led to *the bankers'* well-being, with the rest of society bearing the cost. It wasn't even what economists call a zero-sum game, where what one person gains exactly equals what the others lose. It was a negative-sum game, where the gains to winners are less than the losses to the losers. What the rest of society lost was far, far greater than what the bankers gained.

There is a simple reason for why financiers' pursuit of *their* interests turned out to be disastrous for the rest of society: the bankers' incentives were not well aligned with social returns. When markets work well—in the way that Adam Smith hypothesized—it is because private returns and social benefits are well aligned, that is, because private rewards and social contributions are equal, as had been assumed by marginal productivity theory. In that theory, the social contribution of each worker is exactly equal to the private compensation. People with higher productivity—a larger social contribution—get higher pay.

Adam Smith himself was aware of one of the circumstances in which private and social returns differ. As he explained, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[6] Markets by themselves often fail to produce efficient and desirable outcomes, and there is a role for government in correcting these market failures, that is, designing policies (taxes and regulations) that bring private incentives and social returns into alignment. (Of course, there are often disagreements about the best way of doing it. But few today believe in unfettered financial markets—their failures impose too great a cost on the rest of society—or that firms should be allowed to despoil the environment without restriction.) When government does its job well, the returns received by, say, a worker or an investor are in fact equal to the benefits to society that his actions contribute. When these are not aligned, we say there is a market failure, that is, markets fail to produce efficient outcomes. Private rewards and social returns are not well aligned when competition is imperfect; when there are "externalities" (where one party's actions can have large negative or positive effects on others for which he does not pay or reap the benefit); when there exist imperfections or asymmetries of information (where someone knows something relevant to a market trade that someone else doesn't know); or where risk markets or other markets are absent (one can't, for instance, buy insurance against many of the most important risks that one faces). Since one or more of these conditions exist in virtually every market, there is in fact little presumption that markets are in general efficient. This means that there is an enormous potential role for government to correct these market failures.

Government never corrects market failures perfectly, but it does a better job in some countries than in others. Only if the government does a reasonably good job of correcting the most important market failures will the economy prosper. Good financial regulation helped the United States—and the world—avoid a major crisis for four decades after the Great Depression. Deregulation in the 1980s led to scores of financial crises in the succeeding three decades, of which America's crisis in 2008–09 was only the worst.[7] But those governmental failures were no accident: the financial sector used its political muscle to make sure that the market failures were *not* corrected, and that the sector's private rewards remained well in excess of their social contributions—one of the factors contributing to the bloated financial sector and to the high levels of inequality at the top.

Shaping markets

We'll describe below some of the ways that private financial firms act to ensure that markets *don't work well.* For instance, as Smith noted, there are incentives for firms to work to reduce market competition. Moreover, firms also strive to make sure that there are no strong laws prohibiting them from engaging in anticompetitive behavior or, when there are such laws, that they are not effectively enforced. The focus of businesspeople is, of course, not to enhance societal well-being broadly understood, or even to make markets more competitive: their objective is simply to make markets work *for them*, to make them more profitable. But the consequence is often a less efficient economy marked by greater inequality. For now, one example will suffice. When markets are competitive, profits above the normal return to capital cannot be sustained. That is so because if a firm makes greater profits than that on a sale, rivals will attempt to steal the customer by lowering prices. As firms compete vigorously, prices fall to the point that profits (above the normal return to capital) are driven down to zero, a disaster for those seeking big profits. In business school we teach students how to recognize, and create, barriers to competition—including barriers to entry—that help ensure that profits won't be eroded. Indeed, as we shall shortly see, some of the most important innovations in business in the last three decades have centered not on making the economy more efficient but on how better to ensure monopoly power or how better to circumvent government regulations intended to align social returns and private rewards.

Making markets less transparent is a favorite tool. The more transparent markets are, the more competitive they are likely to be. Bankers know this. That's why banks have been fighting to keep their business in writing derivatives, the risky products that were at the center of AIG's collapse,[8] in the shadows of the "over the counter" market. In that market, it's difficult for customers to know whether they're getting a good deal. Everything is negotiated, as opposed to how things work in more open and transparent modern markets. And since the sellers are trading constantly, and buyers enter only episodically, sellers have more information than buyers, and they use that information to their advantage. This means that on average, sellers (the writers of the derivatives, the banks) can extract more money out of their customers. Well-designed open auctions, by contrast, ensure that goods go to those who value them the most, a hallmark of efficiency. There are publicly available prices for guiding decisions.

While lack of transparency results in more profits for the bankers, it leads to lower economic performance. Without good information, capital markets can't exercise any discipline. Money won't go to where returns are highest, or to the bank that does the best job of managing money. No one can know the true financial position of a bank or other financial institution today —and shadowy derivative transactions are part of the reason. One would have hoped that the recent crisis might have forced change, but the bankers resisted. They resisted demands, for instance, for more transparency in derivatives and for regulations that would restrict anticompetitive practices. These rent-seeking activities were worth tens of billions of dollars in profits. Although they didn't win every battle, they won often enough that the problems are still with us. In late October 2011, for instance, a major American financial firm[9] went bankrupt (the eighth-largest bankruptcy on record), partly because of complex derivatives. Evidently the market hadn't seen through these transactions, at least not in a timely way.

Moving money from the bottom of the pyramid to the top

One of the ways that those at the top make money is by taking advantage of their market and political power to favor themselves, to increase their own income, at the expense of the rest.

The financial sector has developed expertise in a wide variety of forms of rent seeking itself.

We've already mentioned some, but there are many others: taking advantage of asymmetries of information (selling securities that they had designed to fail, but knowing that buyers didn't know that);[10] taking excessive risk—with the government holding a lifeline, bailing them out and assuming the losses, the knowledge of which, incidentally, allows them to borrow at a lower interest rate than they otherwise could; and getting money from the Federal Reserve at low interest rates, now almost zero.

But the form of rent seeking that is most egregious—and that has been most perfected in recent years—has been the ability of those in the financial sector to take advantage of the poor and uninformed, as they made enormous amounts of money by preying upon these groups with predatory lending and abusive credit card practices.[11] Each poor person might have only a little, but there are so many poor that a little from each amounts to a great deal. Any sense of social justice—or any concern about overall efficiency—would have led government to prohibit these activities. After all, considerable amounts of resources were used up in the process of moving money from the poor to the rich, which is why it's a negative-sum game. But government didn't put an end to these kind of activities, not even when, around 2007, it became increasingly apparent what was going on. The reason was obvious. The financial sector had invested heavily in lobbying and campaign contributions, and the investments had paid off.

I mention the financial sector partly because it has contributed so powerfully to our society's current level of inequality.[12] The financial sector's role in creating the crisis in 2008–09 is apparent to all. Not even those who work in the sector deny it, though each believes that some other part of the financial sector is really to blame. Much of what I have said about the financial sector, though, could be said about other players in the economy that have had a hand in creating current inequities.

Modern capitalism has become a complex game, and those who win at it have to have more than a little smarts. But those who win at it often possess less admirable characteristics as well: the ability to skirt the law, or to shape the law in their own favor; the willingness to take advantage of others, even the poor; and to play *unfair* when necessary.[13] As one of the successful players in this game put it, the old adage "Win or lose, what matters is how you play the game" is rubbish. *All that matters is whether you win or lose.* The market provides a simple way of showing that—the amount of money that you have.

Winning in the game of rent seeking has made fortunes for many of those at the top, but it is not the only means by which they obtain and preserve their wealth. The tax system also plays a key role, as we'll see later. Those at the top have managed to design a tax system in which they pay less than their fair share—they pay a lower fraction of their income than do those who are much poorer. We call such tax systems regressive.

And while regressive taxes and rent seeking (which takes money from the rest of society and redistributes it to the top) are at the core of growing inequality, especially at the top, broader forces exert particular influence on two other aspects of American inequality—the hollowing out of the middle class and the increase in poverty. Laws governing corporations interact with the norms of behavior that guide the leaders of those corporations and determine how returns are shared among top management and other stakeholders (workers, shareholders, and bondholders). Macroeconomic policies determine the tightness of the labor market—the level of unemployment, and thus how market forces operate to change the share of workers. If monetary authorities act to keep unemployment high (even if because of fear of inflation), then wages will be restrained. Strong unions have helped to reduce inequality, whereas weaker unions have made it easier for CEOs, sometimes working with market forces that they have helped shape, to increase it. In each arena—the strength of unions, the effectiveness of corporate governance, the conduct of monetary policy—politics is central.

Of course, market forces, the balancing of, say, the demand and supply for skilled workers, affected as it is by changes in technology and education, play an important role as well, even if those forces are partially shaped by politics. But instead of these market forces and politics balancing each other out, with the political process dampening the increase in inequality in periods when market forces might have led to growing disparities, instead of government *tempering* the excesses of the market, in America today the two have been working together to increase income and wealth disparities.

Rent Seeking

Earlier, we labeled as *rent seeking* many of the ways by which our current political process helps the rich at the expense of the rest of us. Rent seeking takes many forms: hidden and open transfers and subsidies from the government, laws that make the marketplace less competitive, lax enforcement of existing competition laws, and statutes that allow corporations to take advantage of others or to pass costs on to the rest of society. The term "rent" was originally used to describe the returns to land, since the owner of land receives these payments by virtue of his ownership and not because of anything he *does.* This stands in contrast to the situation of workers, for example, whose wages are compensation for the *effort* they provide. The term "rent" then was extended to include monopoly profits, or monopoly rents, the income that one receives simply from the control of a monopoly. Eventually the term was expanded still further to include the returns on similar ownership claims. If the government gave a company the exclusive right to import a limited amount (a quota) of a good, such as sugar, then the extra return generated as a result of the ownership of those rights was called a "quota-rent."

Countries rich in natural resource are infamous for rent-seeking activities. It's far easier to get rich in these countries by gaining access to resources at favorable terms than by producing wealth. This is often a negative-sum game, which is one of the reasons why, on average, such countries have grown more slowly than comparable countries without the bounty of such resources.[14]

Even more disturbing, one might have thought that an abundance of resources could be used to help the poor, to ensure access to education and health care for all. Taxing work and savings can weaken incentives; in contrast, taxing the "rents" on land, oil, or other natural resources won't make them disappear. The resources will still be there to be taken out, if not today, then tomorrow. There are no adverse incentive effects. That means that, in principle, there should be ample revenues to finance both social expenditures and public investments—in, say, health and education. Yet, among the countries with the greatest inequality are those with the most natural resources. Evidently, a few within these countries are better at rent seeking than others (usually those with political power), and they ensure that the benefits of the resources accrue largely to themselves. In Venezuela, the richest oil producer in Latin America, half of the country lived in poverty prior to the rise of Hugo Chavez—and it is precisely this type of poverty in the midst of riches that gives rise to leaders like him.[15]

Rent-seeking behavior is not just endemic in the resource-rich countries of the Middle East, Africa, and Latin America. It has also become endemic in modern economies, including our own. In those economies, it takes many forms, some of which are closely akin to those in the oil-rich countries: getting state assets (such as oil or minerals) at below fair-market prices. It's not hard to become wealthy if the government sells you for $500 million a mine that's worth $1 billion.

Another form of rent seeking is the flip side: selling to government products at *above* market prices (noncompetitive procurement). The drug companies and military contractors excel in this form of rent seeking. Open government subsidies (as in agriculture) or hidden subsidies (trade restrictions that reduce competition or subsidies hidden in the tax system) are other ways of getting rents from the public.

Not all rent seeking uses government to extract money from ordinary citizens. The private sector can excel on its own, extracting rents from the public, for instance, through monopolistic practices and exploiting those who are less informed and educated, exemplified by the banks' predatory lending. CEOs can use their control of the corporation to garner for themselves a larger fraction of the firms' revenues. Here, though, the government too plays a role, by not doing what it should: by not stopping these activities, by not making them illegal, or by not enforcing laws that exist. Effective enforcement of competition laws can circumscribe monopoly profits; effective laws on predatory lending and credit card abuses can limit the extent of bank exploitation; well-designed corporate governance laws can limit the extent to which corporate officials appropriate for themselves firm revenues.

By looking at those at the top of the wealth distribution, we can get a feel for the nature of this aspect of America's inequality. Few are inventors who have reshaped technology, or scientists who have reshaped our understandings of the laws of nature. Think of Alan Turing, whose genius provided the mathematics underlying the modern computer. Or of Einstein. Or of the discoverers of the laser (in which Charles Townes played a central role)[16] or John Bardeen, Walter Brattain, and William Shockley, the inventors of transistors.[17] Or of Watson and Crick, who unraveled the mysteries of DNA, upon which rests so much of modern medicine. None of them, who made such large contributions to our well-being, are among those most rewarded by our economic system.

Instead, many of the individuals at the top of the wealth distribution are, in one way or another, geniuses at business. Some might claim, for instance, that Steve Jobs or the innovators of search engines or social media were, in their way, geniuses. Jobs was number 110 on the *Forbes* list of the world's wealthiest billionaires before his death, and Mark Zuckerberg was 52. But many of these "geniuses" built their business empires on the shoulders of giants, such as Tim Berners-Lee, the inventor of the World Wide Web, who has never appeared on the *Forbes* list. Berners-Lee could have become a billionaire but chose not to—he made his idea available freely, which greatly speeded up the development of the Internet.[18]

A closer look at the successes of those at the top of the wealth distribution shows that more than a small part of their genius resides in devising better ways of exploiting market power and other market imperfections—and, in many cases, finding better ways of ensuring that politics works for them rather than for society more generally.

We've already commented on financiers, who make up a significant portion of the top 1 or 0.1 percent. While some gained their wealth by producing value, others did so in no small part by one of the myriad forms of rent seeking that we described earlier. At the top, in addition to the financiers, whom we have already discussed,[19] are the monopolists and their descendants who, through one mechanism or another, have succeeded in achieving and sustaining market dominance. After the railroad barons of the nineteenth century came John D. Rockefeller and Standard Oil. The end of the twentieth century saw Bill Gates and Microsoft's domination of the PC software industry.

Internationally, there is the case of Carlos Slim, a Mexican businessman who was ranked by *Forbes* as the wealthiest person in the world in 2011.[20] Thanks to his dominance of the telephone industry in Mexico, Slim is able to charge prices that are a multiple of those in more competitive markets. He made his breakthrough when he was able to acquire a large share in Mexico's telecommunications system after the country privatized it,[21] a strategy that lies behind many of the world's great fortunes. As we've seen, it's easy to get rich by getting a state asset at a deep discount. Many of Russia's current oligarchs, for example, obtained their initial wealth by buying state assets at below-market prices and then ensuring continuing profits through monopoly power. (In America most of our government giveaways tend to be more subtle. We design rules for, say, selling government assets that are in effect partial giveaways, but less transparently so than what Russia did.)[22]

In the preceding chapter, we identified another important group of the very wealthy—

corporate CEOs, such as Stephen Hemsley from UnitedHealth Group, who received $102 million in 2010, and Edward Mueller from Qwest Communications (now CenturyLink, after a merger in 2011), who made $65.8 million.[23] CEOs have successfully garnered a larger and larger fraction of corporate revenues.[24] As we'll explain later, it is not a sudden increase in their productivity that allowed these CEOs to amass such riches in the last couple of decades but rather an enhanced ability to take more from the corporation that they are supposed to be serving, and weaker qualms about, and enhanced public toleration of, doing so.

A final large group of rent seekers consists of the top-flight lawyers, including those who became wealthy by helping others engage in their rent seeking in ways that skirt the law but do not (usually) land them in prison. They help write the complex tax laws in which loopholes are put, so their clients can avoid taxes, and they then design the complex deals to take advantage of these loopholes. They helped design the complex and nontransparent derivatives market. They help design the contractual arrangements that generate monopoly power, seemingly within the law. And for all this assistance in making our markets work not the way markets should but as instruments for the benefit of those at the top, they get amply rewarded.[25]

Monopoly rents: creating sustainable monopolies

To economists large fortunes pose a problem. The laws of competition, as I have noted, say that profits (beyond the normal return to capital) are supposed to be driven to zero, and quickly. But if profits are zero, how can fortunes be built? Niches in which there isn't competition, for one reason or another, offer one avenue.[26] But that goes only a little way to explaining sustainable excessive profits (beyond the competitive level). Success will attract entry, and profits will quickly disappear. The real key to success is to make sure that there won't ever be competition—or at least there won't be competition for a long enough time that one can make a monopoly killing in the meanwhile. The simplest way to a sustainable monopoly is getting the government to give you one. From the seventeenth century to the nineteenth, the British granted the East India Company a monopoly on trade with India.

There are other ways to get government-sanctioned monopolies. Patents typically give an inventor a monopoly over that innovation for a temporary period, but the details of patent law can extend the length of the patent, reduce entry of new firms, and enhance monopoly power. America's patent laws have been doing exactly that. They are designed not to maximize the pace of innovation but rather to maximize rents.[27]

Even without a government grant of monopoly, firms can create entry barriers. A variety of practices discourage entry, such as maintaining excess capacity, so that an entrant knows that, should he enter, the incumbent firm can increase production, lowering prices to the point that entry would be unprofitable.[28] In the Middle Ages, guilds successfully restricted competition. Many professions have continued that tradition. Although they argue that they are simply trying to maintain standards, restrictions on entry (limiting the number of places at medical school or restricting migration of trained personnel from abroad) help keep incomes high.[29]

At the turn of the previous century, concern about the monopolies that formed the basis of many of the fortunes of that period, including Rockefeller's, grew so great that under the trust-busting president Theodore Roosevelt, America passed a slew of laws to break up monopolies and prevent some of these practices. In the years that followed, numerous monopolies were broken up—in oil, cigarettes, and many other industries.[30] And yet today, as we look around the American economy, we can see many sectors, including some that are central to its functioning, where one or a few firms dominate—such as Microsoft in PC operating systems, or AT&T, Verizon, T-Mobile, and Sprint in telecommunications.

Three factors contributed to this increased monopolization of markets. First, there was a battle over ideas about the role that government should take in ensuring competition. Chicago school economists (like Milton Friedman and George Stigler) who believe in free and unfettered markets[31] argued that markets are naturally competitive[32] and that seemingly anticompetitive practices really enhance efficiency. A massive program to "educate"[33] people, and especially judges, regarding these new doctrines of law and economics, partly sponsored by right-wing foundations like the Olin Foundation, was successful. The timing was ironic: American courts were buying into notions that markets were "naturally" competitive and placing a high burden of proof on anyone claiming otherwise just as the economics discipline was exploring theories that explain why markets often were *not* competitive, even when there were seemingly many firms. For instance, a new and powerful branch of economics called game theory explained how collusive behavior could be maintained tacitly over extended periods of time. Meanwhile, new theories of imperfect and asymmetric information showed how information imperfections impaired competition, and new evidence substantiated the relevance and importance of these theories.

The influence of the Chicago school should not be underestimated. Even when there are blatant infractions—like predatory pricing, where a firm lowers its price to force out a competitor and then uses its monopoly power to raise prices—they've been hard to prosecute.[34] Chicago school economics argues that markets are presumptively competitive and efficient. If entry were easy, the dominant firm would gain nothing from driving out a rival, because the firm that is forced out would be quickly replaced by another firm. But in reality entry is not so easy, and predatory behavior does occur.

A second factor giving rise to increased monopoly is related to changes in our economy. The creation of monopoly power was easier in some of the new growth industries. Many of these sectors were marked by what are called network externalities. An obvious example is the computer operating system: just as it's very convenient for everyone to speak the same language, it's very convenient for everyone to use the same operating system. Increasing interconnectivity across the world naturally leads to standardization. Those with a monopoly over the standard that is chosen benefit.

As we have noted, competition naturally works against the accumulation of market power. When there are large monopoly profits, competitors work to get a share. That's where the third factor that has increased monopoly power in the United States comes in: businesses found new ways of resisting entry, of reducing competitive pressures. Microsoft provides the example par excellence. Because it enjoyed a near-monopoly on PC operating systems, it stood to lose a lot if alternative technologies undermined its monopoly. The development of the Internet and the web browser to access it represented just such a threat. Netscape brought the browser to the market, building on government-funded research.[35] Microsoft decided to squelch this potential competitor. It offered its own product, Internet Explorer, but the product couldn't compete in the open market. The company decided to use its monopoly power in PC operating systems to make sure that the playing field was not level. It deployed a strategy known as FUD (fear, uncertainty, and doubt), creating anxiety about compatibility among users by programming error messages that would randomly appear if Netscape was installed on a Windows computer. The company also did not provide the disclosures necessary for full compatibility as new versions of Windows were developed. And most cleverly, it offered Internet Explorer at a zero price—free, bundled in as part of its operating system. It's hard to compete with a zero price. Netscape was doomed.[36]

It was obvious that selling something at a zero price was not a profit-maximizing strategy—in the short run. But Microsoft had a vision for the long run: the maintenance of its monopoly. For that, it was willing to make short-run sacrifices. It succeeded, but so blatant were its methods that courts and tribunals throughout the world charged it with engaging in anticompetitive practices. And yet, in the end, Microsoft won—for it realized that in a network economy, a monopoly position, once attained, is hard to break. Given Microsoft's dominance of the operating system market, it had the incentives and capabilities to dominate in a host of other applications.[37]

No wonder, then, that Microsoft's profits have been so enormous—an average of $7 billion per year over the last quarter century, $14 billion over the past ten years, increasing in 2011 to $23 billion[38]—and reaping wealth for those who bought shares early enough. The conventional wisdom has it that in spite of its dominant position and huge resources, Microsoft has not been a real innovator. It did not develop the first widely used word processor, the first spreadsheet, the first browser, the first media player, or the first dominant search engine. Innovation lay elsewhere. This is consistent with theory and historical evidence: monopolists are not good innovators.[39]

Looking at the U.S. economy, we see in many sectors large numbers of firms, and therefore infer that there must be competition. But that's not always the case. Take the example of banks. While there are hundreds of banks, the big four share between them almost half of the country's banking assets,[40] a marked increase from the degree of concentration fifteen years ago. In most smaller communities, there are at most one or two. When competition is so limited, prices are likely to be far in excess of competitive levels.[41] That's why the sector enjoys profits estimated to be more than $115 billion a year, much of which is passed along to its top officials and other bankers—helping create one of the major sources of inequality at the top.[42] In some products, such as over-the-counter credit default swaps (CDSes), four or five very large banks totally dominate, and such market concentration always gives rise to the worry that they collude, albeit tacitly. (But sometimes the collusion is not even tacit—it is explicit. The banks set a critical rate, called the London Interbank Offered Rate, or Libor. Mortgages and many financial products are linked to Libor. It appears that the banks worked to rig the rate, enabling them to make still more money from others who were unaware of these shenanigans.)

Of course, even when laws that prohibit monopolistic practices are on the books, these have to be enforced. Particularly given the narrative created by the Chicago school of economics, there is a tendency not to interfere with the "free" workings of the market, even when the outcome is anticompetitive. And there are good political reasons not to take too strong a position: after all, it's antibusiness—and not good for campaign contributions—to be too tough on, say, Microsoft.[43]

Politics: getting to set the rules and pick the referee

It's one thing to win in a "fair" game. It's quite another to be able to write the rules of the game—and to write them in ways that enhance one's prospects of winning. And it's even worse if you can choose your own referees. In many areas today, regulatory agencies are responsible for oversight of a sector (writing and enforcing rules and regulations)—the Federal Communications Commission (FCC) in telecom; the Securities and Exchange Commission (SEC) in securities; and the Federal Reserve in many areas of banking. The problem is that leaders in these sectors use their political influence to get people appointed to the regulatory agencies who are sympathetic to their perspectives.

Economists refer to this as "regulatory capture."[44] Sometimes the capture is associated with pecuniary incentives: those on the regulatory commission come from and return to the sector that they are supposed to regulate. Their incentives and those of the industry are well aligned, even if their incentives are not well aligned with those of the rest of society. If those on the regulatory commission serve the sector well, they get well rewarded in their post-government career.

Sometimes, however, the capture is not just motivated by money. Instead, the mindset of regulators is captured by those whom they regulate. This is called "cognitive capture," and it is more of a sociological phenomenon. While neither Alan Greenspan nor Tim Geithner actually worked for a big bank before coming to the Federal Reserve, there was a natural affinity, and they may have come to share the same mindset. In the bankers' mindset—despite the mess that the bankers had made—there was no need to impose stringent conditions on the banks in the bailout.

The bankers have unleashed enormous numbers of lobbyists to persuade any and all who play a role in regulation that they should not be regulated—an estimated 2.5 for every U.S. representative.[45] But persuasion is easier if the target of your efforts begins from a sympathetic position. That is why banks and their lobbyists work so strenuously to ensure that the government appoints regulators who have already been "captured" in one way or another. The bankers try to veto anyone who does not share their belief. I saw this firsthand during the Clinton administration, when potential names for the Fed were floated, some even from the banking community. If any of the potential nominees deviated from the party line that markets are self-regulating and that the banks could manage their own risk—there arose a hue and cry so great that the name wouldn't be put forward or, if it was put forward, that it wouldn't be approved.[46]

Government munificence

We've seen how monopolies—whether government granted or government "sanctioned," through inadequate enforcement of competition laws—have built the fortunes of many of the world's wealthiest people. But there is another way to get rich. You can simply arrange for the government to hand you cash. This can happen in myriad ways. A little-noticed change in legislation, for example, can reap billions of dollars. This was the case when the government extended a much-needed Medicare drug benefit in 2003.[47] A provision in the law that prohibited government from bargaining for prices on drugs was, in effect, a gift of some $50 billion or more per year to the pharmaceutical companies.[48] More generally, government procurement—paying prices well above costs—is a standard form of government munificence.

Sometimes gifts are hidden in obscure provisions of legislation. A provision of one of the key bills deregulating the financial derivative market—ensuring that no regulator could touch it, no matter how great the peril to which it exposed the economy—also gave derivatives claims "seniority" in the event of bankruptcy. If a bank went under, the claims on the derivatives would be paid off before workers, suppliers, or other creditors saw any money—even if the derivatives had pushed the firm into bankruptcy in the first place.[49] (The derivatives market played a central role in the 2008–09 crisis and was responsible for the $150 billion bailout of AIG.)

There are other ways that the banking sector has benefited from government munificence, evident most clearly in the aftermath of the Great Recession. When the Federal Reserve (which can be thought of as one branch of the government) lends unlimited amounts of money to banks at near-zero interest rates, and allows them to lend the money back to the government (or to foreign governments) at much higher interest rates, it is simply giving them a hidden gift worth billions and billions of dollars.

These are not the only ways that governments spur the creation of enormous personal wealth. Many countries, including the United States, control vast amounts of natural resources like oil, gas, and mining concessions. If the government grants you the right to extract these resources for free, it doesn't take a genius to make a fortune. That is, of course, what the U.S. government did in the nineteenth century, when anyone could stake a claim to natural resources. Today, the government doesn't typically give away its resources; more often it requires a payment, but a payment that is far less than it should be. This is just a less transparent way of giving away money. If the value of the oil under a particular piece of land is $100 million after paying the extraction costs, and the government requires a payment of only $50 million, the government has, in effect, given away $50 million.

It doesn't have to be this way, but powerful interests ensure that it is. In the Clinton administration, we tried to make the mining companies pay more for the resources they take out of public lands than the nominal amounts that they do. Not surprisingly, the mining companies—and the congressmen to whom they make generous contributions—opposed these measures, and successfully so. They argued that the policy would impede growth. But the fact of the matter is that, with an auction, companies will bid to get the mining rights so long as the value of the resources is greater than the cost of extraction, and if they win the bid, they will extract the resources. Auctions don't impede growth; they just make sure that the public gets paid appropriately for what is theirs. Modern auction theory has shown how changing the design of the auction can generate much more revenue for the government. These theories were tested out in the auction of the spectrum used for telecommunications beginning in the 1990s, and they worked remarkably well, generating billions for the government.

Sometimes government munificence, instead of handing over resources for pennies on the dollar, takes the form of rewriting the rules to boost profits. An easy way to do this is to protect firms from foreign competition. Tariffs, taxes paid by companies abroad but not by domestic firms, are in effect a gift to domestic producers. The firms demanding protection from foreign competition always provide a rationale, suggesting that society as a whole is the beneficiary and that any benefits that accrue to the companies themselves are incidental. This is self-serving, of course, and while there are instances in which such pleas contain some truth, the widespread abuse of the argument makes it hard to take seriously. Because tariffs put foreign producers at a disadvantage, they enable domestic firms to raise their prices and increase their profits. In some cases, there may be some incidental benefits such as higher domestic employment and the opportunity for companies to invest in R&D that will increase productivity and competeviness. But just as often, tariffs protect old and tired industries that have lost their competitiveness and are not likely to regain it, or occasionally those that have made bad bets on new technologies and would like to postpone facing competition.

The ethanol subsidy offers an example of this phenomenon. A plan to reduce our dependence on oil by replacing it with the energy of the sun embedded in one of America's great products, its corn, seemed irresistible. But converting plant energy into a form that can provide energy for cars instead of people is hugely expensive. It is also easier to do with some plants than others. So successful has Brazil's research on sugar-based ethanol been that in order for America to compete, for years it had to tax Brazilian sugar-based ethanol 54 cents a gallon.[50] Forty years after the introduction of the subsidy, it was still in place to support an infant technology that seemingly would not grow up. When oil prices fell after the 2008 recession, many ethanol plants went bankrupt, even with massive subsidies.[51] It wasn't until the end of 2011 that the subsidy and tariff were allowed to expire.

The persistence of such distortionary subsidies stems from a single source: politics. The main—and for a long while, effectively the only—*direct* beneficiary of these subsidies were the corn-ethanol producers, dominated by the megafirm Archer Daniels Midland (ADM). Like so many other executives, those at ADM seemed to be better at managing politics than at innovation. They contributed generously to both parties, so that as much as those in Congress might rail against such corporate largesse, lawmakers were slow to touch the ethanol subsidies.[52] As we've noted, firms almost always argue that the true beneficiaries of any largesse they receive lie elsewhere. In this case, ethanol advocates argued that the real beneficiaries were America's corn farmers. But that was, for the most part, not the case, especially in the early days of the subsidy.[53]

Of course, why American corn farmers, who were already the recipients of massive government handouts, receiving almost half of their income from Washington rather than from the "soil," should receive still further assistance is hard to understand, and hard to reconcile with principles of a free-market economy. (In fact, the vast preponderance of government money subsidizing agriculture does not go, as many believe, to poor farmers or even family farms. The design of the program reveals its true objective: to redistribute money from the rest of us to the rich and corporate farms.)[54]

Sadly, government munificence toward corporations does not end with the few examples we have given, but to describe each and every instance of government approved rent seeking would require another book.[55]

CHAPTER THREE

MARKETS AND INEQUALITY

THE PRECEDING CHAPTER EMPHASIZED THE ROLE OF rent seeking in creating America's high level of inequality. Another approach to explaining inequality emphasizes abstract market forces. In this view, it's just the bad luck of those in the middle and at the bottom that market forces have played out the way they have—with ordinary workers seeing their wages decline, and skilled bankers seeing their incomes soar. Implicit in this perspective is the notion that one interferes with the wonders of the market at one's peril: be cautious in any attempt to "correct" the market.

The view I take is somewhat different. I begin with the observation made in chapters 1 and 2: other advanced industrial countries with similar technology and per capita income differ greatly from the United States in inequality of pretax income (before transfers), in inequality of after tax and transfer income, in inequality of wealth, and in economic mobility. These countries also differ greatly from the United States in the *trends* in these four variables over time. If markets were the principal driving force, why do seemingly similar advanced industrial countries differ so much? Our hypothesis is that market forces are real, but that they are shaped by political processes. Markets are shaped by laws, regulations, and institutions. Every law, every regulation, every institutional arrangement has distributive consequences—and the way we have been shaping America's market economy works to the advantage of those at the top and to the disadvantage of the rest.

There is another factor determining societal inequality, one that we discuss in this chapter. Government, as we have seen, shapes market forces. But so do societal norms and social institutions. Indeed, politics, to a large extent, reflects and amplifies societal norms. In many societies, those at the bottom consist disproportionately of groups that suffer, in one way or another, from discrimination. The extent of such discrimination is a matter of societal norms. We'll see how changes in social norms—concerning, for instance, what is fair compensation—and in institutions, like unions, have helped shape America's distribution of income and wealth. But these social norms and institutions, like markets, don't exist in a vacuum: they too are shaped, in part, by the 1 percent.

THE LAWS OF SUPPLY AND DEMAND

Standard economic analysis looks to demand and supply to explain wages and wage differences and to shifts in demand and supply curves to explain changing patterns of wages and income inequality. In standard economic theory, wages of unskilled workers, for example, are determined so as to equate demand and supply. If demand increases more slowly than supply,[1] then wages fall. The analysis of changes in inequality then focuses on two questions: (a) What determines shifts in demand and supply curves? and (b) What determines individuals' endowments, that is, the fraction of the population with high skills or large amounts of wealth?

Immigration, legal and illegal alike, can increase the supply. Increasing the availability of education may reduce the supply of unskilled labor and increase the supply of skilled labor. Changes in technology can lead to reduced demands for labor in some sectors, or reduced demands for some types of labor, and increases in the demand for labor of other types.

In the background of the global financial crisis were major structural changes in the economy. One was a shift in the U.S. job market structures over some twenty years, especially the destruction of millions of jobs in manufacturing,[2] the very sector that had helped create a broad middle class in the years after World War II. This was partly a result of technological change, advances in productivity that outpaced increases in demand. Shifting comparative advantages compounded the problem, as the emerging markets, especially China, gained competencies and invested heavily in education, technology, and infrastructure. The U.S. share of global manufacturing shrank in response. Of course, in a dynamic economy jobs are always being destroyed and created. But this time it was different: the new jobs typically were often not as well-paying or as long-lasting as the old. Skills that made workers valuable—and highly paid—in manufacturing were of little value in their new jobs (if they could get new jobs), and, not surprisingly, their wages reflected the changed status, as they went from being a skilled manufacturing worker to being an unskilled worker in some other sector of the economy. American workers were, in a sense, victims of their own success: their increased productivity did them in. As the displaced manufacturing workers fought for jobs elsewhere, wages in other sectors suffered.

The stock market boom and the housing bubble of the early twenty-first century helped to hide the structural dislocation that America was going through. The real estate bubble offered work for some of those who lost their jobs, but it was a temporary palliative. The bubble fueled a consumption boom that allowed Americans to live beyond their means: without this bubble, the weakening of incomes of so many in the middle class would have been readily apparent.

This sectoral shift was one of the key factors in the increase in inequality in the United States. It helps explain why ordinary workers are doing so badly. With their wages so low, it's not a surprise that those at the top, who get the lion's share of the profits, are doing so well.

A second structural shift stemmed from changes in technology that increased the demand for skilled workers, and replaced many unskilled workers with machines. This was called skill-biased technological change. It should be obvious that innovations or investments that reduce the need for unskilled labor (for example, investments in robots) weaken the demand for unskilled labor and lead to lower unskilled wages.

Those who attribute the decline of wages at the bottom and in the middle to market forces then see it as the normal working of the balance of these forces. And, unfortunately, if technological change continues as it has, these trends may persist.

Market forces haven't always played out this way, and there is no theory that says that they necessarily should. Over the past sixty years, supply and demand for skilled and unskilled labor have shifted in ways that at first decreased, and then increased, wage disparities.[3] In the aftermath of World War II, large numbers of Americans received a higher education thanks to the GI Bill. (College graduates formed only 6.4 percent of the labor force in 1940, but the percentage had doubled, to 13.8 percent, by 1970.)[4] But the growth of the economy and the demand for high-skill jobs kept pace with the increase in supply, so the return to education remained strong. Workers with a college education still received 1.59 times what a high school graduate received, almost unchanged from the ratio in 1940 (1.65). The diminished *relative* supply of unskilled workers meant that even these workers benefited, so wages across the board increased. America enjoyed broadly shared prosperity, and in fact at times incomes at the bottom increased faster than those at the top.

But then U.S. educational attainment stopped improving, especially relative to the rest of the world. The fraction of the U.S. population graduating from college increased much more slowly, which meant the relative supply of skilled workers, which had increased at an average annual rate of almost 4 percent from 1960 to 1980, instead increased at the much smaller rate of 2.25 percent over the next quarter century.[5] By 2008 the U.S. high school graduation rate was 76 percent, compared with 85 percent for the EU.[6] Among the advanced industrial countries, the United States is only average in college completion; thirteen other countries surpass it.[7] And average scores of American high school students, especially in science and mathematics, were at best mediocre.[8]

In the past quarter century, technological advances, particularly in computerization, enabled machines to replace jobs that could be routinized. This increased the demand for those who mastered the technology and reduced the demand for those who did not, leading to higher relative wages for those who had mastered the skills required by the new technologies.[9] Globalization compounded the effects of technology's advances: jobs that could be routinized were sent abroad, where labor that could handle the work cost a fraction of what it cost in the United States.[10]

At first, the balance of supply and demand kept wages in the middle rising, but those at the bottom stagnated or even fell. Eventually, the deskilling and outsourcing effects dominated. Over the past fifteen years, wages in the middle have not fared well.[11]

The result has been what we described in chapter 1 as the “polarization” of America’s labor force. Low-paying jobs that cannot be easily computerized have continued to grow—including “care” and other service sectors jobs—and so have high-skilled jobs at the top.

This skill-biased technological change has obviously played a role in shaping the labor market—increasing the premium on workers with skills, deskilling other jobs, eliminating still others. However, skill-biased technological change has little to do with the enormous increase in wealth at the very top. Its *relative* importance remains a subject of debate, upon which we will comment later in this chapter.

There is one more important market force at play. Earlier in the chapter, we described how increases in productivity in manufacturing—outpacing the increase in demand for manufactured goods—led to higher unemployment in that sector. Normally, when markets work well, the workers displaced easily move to another sector. The economy as a whole benefits from the productivity increase, even if the displaced worker doesn’t. But moving to other sectors may not be so easy. The new jobs may be in another location or require different skills. At the bottom, some workers may be “trapped” in sectors with declining employment, unable to find alternative employment.

A phenomenon akin to what happened in agriculture in the Great Depression may be happening in large swaths of today’s job market. Then increases in agricultural productivity raised the supply of agricultural products, driving down prices and farm incomes relentlessly, year after year, with an occasional exception from a bad harvest. At points, and especially at the beginning of the Depression, the fall was precipitous—a decline of half or more in farmers’ income in three years. When incomes were declining more gradually, workers migrated to new jobs in the cities, and the economy went through an orderly, if difficult, transition. But when prices fell precipitously—and the value of housing and other assets that the farmers owned fell concomitantly—people were suddenly trapped on their farms. They couldn’t afford to move, and their decreased demand for goods made in urban factories caused unemployment in the cities as well.

Today America’s manufacturing workers have been experiencing something similar.[12] I recently visited a steel mill near where I was born, in Gary, Indiana, and although it produces the same amount of steel that it did several decades ago, it does so with one-sixth the labor. And once again there is neither the push nor the pull to move people to new sectors: higher costs of education make it difficult for people to obtain the skills they need for jobs that would pay a wage comparable to their old wage; and among the sectors where there might have been growth, low demand from the recession creates few vacancies. The result is stagnant, or even declining, real wages. As recently as 2007, the base wage of an autoworker was around $28 an hour. Now, under a two-tier wage system agreed upon with the United Automobile Workers union, new hires can expect to earn only about $15 an hour.[13]

Back to the role of government

This broad narrative of what has happened to the market and the contribution of market forces to increasing inequality ignores the role that government plays in shaping the market. Many of the jobs that have not been mechanized, and are not likely to be soon, are public-sector jobs in teaching, public hospitals, and so on. If we had decided to pay our teachers more, we might have attracted and retained better teachers, and that might have improved overall long-term economic performance. It was a public decision to allow public-sector wages to sink below those of comparable private-sector workers.[14]

The most important role of government, however, is setting the basic rules of the game, through laws such as those that encourage or discourage unionization, corporate governance laws that determine the discretion of management, and competition laws that *should* limit the extent of monopoly rents. As we have already noted, almost every law has *distributive* consequences, with some groups benefiting, typically at the expense of others.[15] And these distributive consequences are often the most important effects of the policy or program.[16]

Bankruptcy laws provide an example. Later, in chapter 7, I describe how "reforms" in our bankruptcy laws are creating partially indentured servants. That reform, together with the law prohibiting the discharge of student debt in bankruptcy,[17] is causing immiseration for large parts of America. Like the effects on distribution, the effects on efficiency have been adverse. The bankruptcy "reform" reduced the incentives of creditors to assess creditworthiness, or to ascertain whether the individual is likely to get a return from the education commensurate with its costs. It increased the incentives for predatory lending, since lenders could be more certain of recovering the loans, no matter how onerous the terms and how unproductive the uses to which the money was put.[18]

In later chapters, we'll also see other examples of how government helps shape market forces—in ways that help some, at the expense of others. And too often, the ones who are helped are those at the top.

It is, of course, not just laws that have large distributive effects, but also policies. We've considered several policies in the previous chapter—for example, on the enforcement of laws against anticompetitive practices. In chapter 9 we'll look at monetary policies, which affect the level of employment and the stability of the economy. We'll see how they have been set in ways that weakened the income of workers and enhanced that of capital.

Finally, public policy affects the direction of innovation. It is not inevitable that innovation be skill biased. Innovation could, for instance, be biased toward the saving of natural resources. Later in this book, we'll describe alternative policies that might succeed in redirecting innovation.

Globalization

One aspect of the "market forces" theory has been the center of attention now for more than a decade: globalization, or the closer integration of the economies of the world. Nowhere do politics shape market forces more than in the globalization arena. Much as the lowering of transportation and communication costs has promoted globalization, changes in the rules of the game have been equally important: these include reducing impediments to the flow of capital across borders and trade barriers (for instance, reducing tariffs on imported Chinese goods that allow them to compete with American ones on an almost even playing field).

Both trade globalization (the movement of goods and services) and capital markets globalization (international financial market integration) have contributed to growing inequality, but in different ways.

Financial liberalization

Over the past three decades, U.S. financial institutions have argued strongly for the free mobility of capital. Indeed, they have become the champions of the rights of capital—over the rights of workers or even political rights.[19] Rights simply specify what various economic players are entitled to: the rights workers have sought include, for instance, the right to band together, to unionize, to engage in collective bargaining, and to strike. Many nondemocratic governments severely restrict these rights, but even democratic governments circumscribe them. So too, the owners of capital may have rights. The most fundamental right of the owners of capital is that they not be deprived of their property. But again, even in a democratic society, these rights are restricted; under the right of eminent domain, the state can take away somebody's property for public purpose, but there must be "due process" and appropriate compensation. In recent years, the owners of capital have demanded more rights, like the right to move freely into or out of countries. Simultaneously, they've argued *against* laws that might make them more accountable for human rights abuses in other countries, such as the Alien Torts Statute, which enables victims of those abuses to bring suit in the United States.

As a matter of simple economics, the efficiency gains for world output from the free mobility of labor are much, much larger than the efficiency gains from the free mobility of capital. The differences in the return to capital are minuscule compared with those on the return to labor.[20] But the financial markets have been driving globalization, and while those who work in financial markets constantly talk about efficiency gains, what they really have in mind is something else—a set of rules that benefits them and increases their advantage over workers. The threat of capital outflow, should workers get too demanding about rights and wages, keeps workers' wages low.[21] Competition across countries for investment takes on many forms—not just lowering wages and weakening worker protections. There is a broader "race to the bottom," trying to ensure that business regulations are weak and taxes are low. In one arena, finance, this has proven especially costly and especially critical to the growth in inequality. Countries raced to have the least-regulated financial system for fear that financial firms might decamp for other markets. Some in the U.S. Congress worried about the consequences of this deregulation, but they felt helpless: America would lose jobs and a major industry if it didn't comply. In retrospect, however, this was a mistake. The loss to the country from the crisis that resulted from inadequate regulation was orders of magnitude larger than the number of jobs in finance that were saved.

Not surprisingly, whereas a decade ago it was part of conventional wisdom that everyone would benefit from free capital movements, in the aftermath of the Great Recession many observers have their doubts. These concerns are coming not just from those in developing countries but also from some of globalization's strongest advocates. Indeed, even the IMF (the International Monetary Fund, the international agency responsible for ensuring global financial stability) has now recognized the dangers of unencumbered and excessive financial integration:[22] a problem in one country can rapidly spread to another. In fact, fears of contagion have motivated bailouts of banks in the magnitude of tens and hundreds of billions of dollars. The response to contagious diseases is "quarantine," and finally, in the spring of 2011, the IMF recognized the desirability of the analogous response in the financial markets. This takes the form of capital controls, or limiting the volatile movement of capital across borders, especially during a crisis.[23]

The irony is that in the crises that finance brings about, workers and small businesses bear the brunt of the costs. Crises are accompanied by high unemployment that drives down wages, so workers are hurt doubly. In earlier crises, not only did the IMF (typically with the support of the U.S. Treasury) insist on huge budget cuts from troubled nations, converting downturns into recessions and depressions, but it also demanded the fire sales of assets, and the financiers then swooped in to make a killing. In my earlier book *Globalization and Its Discontents,* I described how Goldman Sachs was one of the winners in the 1997 East Asia crisis, as it was in the 2008 crisis. When we wonder how it is that the financiers get so much wealth, part of the answer is simple: they've helped write a set of rules that allows them to do well, even in the crises that they help create.[24]

Trade globalization

The effects of trade globalization have not been as dramatic as those of the crises associated with capital and financial market liberalization, but they have nonetheless been operating slowly and steadily. The basic idea is simple: the movement of goods is a substitute for the movement of people. If the United States imports goods that require unskilled workers, it reduces the demand for unskilled workers to make those goods in the United States, and that drives down unskilled workers' wages. American workers can compete by accepting lower and lower wages—or by getting more and more skilled.[25] This effect would arise no matter how we managed globalization, so long as it led to more trade.

The way globalization has been managed, however, has itself led to still lower wages because workers' bargaining power has been eviscerated. With capital highly mobile—and with tariffs low—firms can simply tell workers that if they don't accept lower wages and worse working conditions, the company will move elsewhere. To see how asymmetric globalization can affect bargaining power, imagine, for a moment, what the world would be like if there was free mobility of labor, but no mobility of capital.[26] Countries would compete to attract workers. They would promise good schools and a good environment, as well as low taxes on workers. This could be financed by high taxes on capital. But that's not the world we live in, and that's partly because the 1 percent doesn't want it to be that way.

Having succeeded in getting governments to set the rules of globalization in ways that enhance their bargaining power vis-à-vis labor, corporations can then work the political levers and demand lower taxation. They threaten the country: unless you lower our taxes, we will go elsewhere, where we are taxed at lower rates. As corporations have pushed a political agenda that shapes market forces to work for them, they have not, of course, revealed their hand. They don't argue for globalization—for free capital mobility and investment protections—saying that doing so will enrich them at the expense of the rest of society. Rather, they make specious arguments about how *all* will benefit.

There are two critical aspects to this contention. The first is that globalization will increase the country's overall output as measured, for instance, by GDP. The second is that if GDP is increased, trickle-down economics will ensure that all will benefit. Neither argument is correct. It is true that when markets work perfectly, free trade allows people to move from protected sectors to more efficient unprotected export sectors. There *can* be, as a result, an increase in GDP. But markets often don't work so nicely. For example, workers displaced by imports often can't find another job. They become unemployed. Moving from a low-productivity job in a protected sector to unemployment lowers national output. This is what has been happening in the United States. It happens when there is bad macroeconomic management, so the economy faces a high unemployment rate, and it happens when financial sectors don't do their jobs, so new businesses aren't created to replace the old businesses that are destroyed.

There is another reason why globalization may lower overall output; it typically increases the risks that countries face.[27] Opening up a country can expose it to all kinds of risks, from the volatility of capital markets to that of commodity markets. Greater volatility will induce firms to move to less risky activities, and these safer activities often have a lower return. In some cases, the risk-avoidance effect can be so large that everyone is made worse-off.[28]

But even if trade liberalization leads to a higher overall output for a given economy, large groups in the population can still be worse off. Consider for a moment what a fully integrated global economy (with both knowledge and capital moving freely around the world) would entail: all workers (of a given skill) would get the same wage everywhere in the world. America's unskilled workers would get the same wage that an unskilled worker gets in China. And that would mean, in turn, that America's workers' wages would fall precipitously. The prevailing wage would be the average of that of America and the rest of the world and, unfortunately, much closer to the lower wage prevailing elsewhere. Not surprisingly, advocates of full liberalization, who typically believe that markets function well, don't advertise this outcome. In fact, unskilled workers in the United States have already taken a beating. As globalization proceeds, there will be further downward pressures on their wages. I don't think markets work so well that wages will be fully equalized, but they will move in that direction, and far enough to be of serious concern.[29] The problem is particularly severe today in the United States and Europe: at the same time that labor-saving technological change has reduced the demand for many of the "good" middle-class blue-collar jobs, globalization has created a global marketplace, putting the same workers in direct competition with comparable workers abroad. Both factors depress wages.

How, then, can globalization's advocates claim that everybody will be better-off? What the theory says is that everybody *could* be better off. That is, the winners could compensate the losers. But it doesn't say that they will—and they usually don't. In fact, globalization's advocates often claim that globalization means that they can't and shouldn't do this. The taxes that would have to be levied to help the losers would, they claim, make the country less competitive, and in our highly competitive globalized world countries simply can't afford that. In effect, globalization hurts those at the bottom not only directly but also indirectly, because of the induced cutbacks in social expenditures and progressive taxation.

The result is that in many countries, including the United States, globalization is almost surely contributing significantly to our growing inequality. I have emphasized that the problems concern *globalization as it has been managed.* Countries in Asia benefited enormously through export-led growth, and some (such as China) took measures to ensure that significant portions of that increased output went to the poor, some went to provide for public education, and much was reinvested in the economy, to provide more jobs. In other countries, there have been big losers as well as winners—poor corn farmers in Mexico have seen their incomes decline as subsidized American corn drives down prices on world markets.

In many countries, poorly functioning macroeconomies have meant that the pace of job destruction has exceeded that of job creation. And that's been the case in the United States and Europe since the financial crisis.

Among the winners from globalization in the United States and some European countries, as it's been managed, are the people at the top. Among the losers are those at the bottom, and increasingly even those in the middle.

Beyond Market Forces: Changes in Our Society

So far, we have discussed the role that market forces, politics, and rent seeking play in creating the high level of inequality in our society. Broader societal changes are also important, changes both in norms and in institutions.[30] These too are shaped by, and help shape, politics.

The most obvious societal change is the decline of unions, from 20.1 percent of wage- and salary-earning U.S. workers in 1980 to 11.9 percent in 2010.[31] This has created an imbalance of economic power and a political vacuum. Without the protection afforded by a union, workers have fared even more poorly than they would have otherwise. Market forces have also limited the effectiveness of the unions that remain. The threat of job loss by the moving of jobs abroad has weakened their power. A bad job without decent pay is better than no job. But just as the passage of the Wagner Act during Franklin Delano Roosevelt's presidency encouraged unionization, Republicans at both the state and the federal levels, in the name of labor flexibility, have worked to weaken them. President Reagan's breaking of the air traffic controllers strike in 1981 represented a critical juncture in the breaking of the strength of unions.[32]

Part of the conventional wisdom in economics of the past three decades is that flexible labor markets contribute to economic strength. I would argue, in contrast, that strong worker protections correct what would otherwise be an imbalance of economic power. Such protection leads to a higher-quality labor force with workers who are more loyal to their firms and more willing to invest in themselves and in their jobs. It also makes for a more cohesive society and better workplaces.[33]

That the American labor market performed so poorly in the Great Recession and that American workers have done so badly for three decades should cast doubt on the mythical virtues of a flexible labor market. But in the United States unions have been seen as a source of rigidity and thus of labor market inefficiency. This has undermined support for unions both inside and outside of politics.[34]

Inequality may be at once cause and consequence of a breakdown in social cohesion over the past four decades. The pattern and magnitude of changes in labor compensation as a share of national income are hard to reconcile with any theory that relies *solely* on conventional economic factors. For instance, in manufacturing, for more than three decades, from 1949 to 1980, productivity and real hourly compensation moved together. Suddenly, in 1980, they began to drift apart, with real hourly compensation stagnating for almost fifteen years, before starting to rise, again almost at the pace of productivity, until the early 2000s, when compensation again began essentially stagnating. One of the interpretations of these data is that in effect, during the periods when wages grew so much slower than productivity, corporate managers seized a larger share of the "rents" associated with corporations.[35]

The extent to which this occurs is affected not just by economics and societal forces (the ability and willingness of CEOs to garner for themselves a larger fraction of the corporate revenues), but also by politics and how they shape the legal framework.

Corporate governance

Politics—and in particular how politics shapes the laws governing corporations—is a major determinant of the fraction of a corporation's revenues that its top executives take for themselves. U.S. laws provide them considerable discretion. This meant that when social mores changed in ways that made large disparities in compensation more acceptable, executives in the United States could enrich themselves at the expense of workers or shareholders more easily than could executives in other countries.

A significant fraction of U.S. output occurs in corporations whose shares are publicly traded. Corporations have numerous advantages—legal protection afforded by limited liability,[36] advantages of scale, often long-established reputations—that allow them to earn excess returns over what they would otherwise have to pay to raise capital. We call these excess returns "corporate rents," and the question is how these rents are divided among the various "stakeholders" in the corporation (in particular, between workers, shareholders, and management). Before the mid-1970s there was a broad social consensus: executives were well paid, but not fabulously so; the rents got divided largely between loyal workers and management. Shareholders never had much say. America's corporate law gives wide deference to management. It's hard for shareholders to challenge what the management does, hard to wage a takeover battle,[37] hard even to wage a proxy battle for control. Over the years, managers learned how to entrench and protect their interests. There were numerous ways for them to do this, including investments shrouded in uncertainty that made the value of the firm less certain and a takeover battle that much riskier; poison pills that decreased the value of the firm in the event of a takeover; and golden parachutes that guaranteed managers a lifetime of comfort should the firm be taken over.[38]

Gradually, beginning in the 1980s and 1990s, management realized that the measures taken to fend off outside attacks, combined with weaker unions, also meant that they could take a larger share of the corporate rents for themselves with impunity. Even some financial leaders recognized that "executive compensation in our deeply flawed system of corporate governance has led to grossly excessive executive compensation."[39]

Norms of what was "fair" changed too: the executives thought little of taking a bigger slice of the corporate pie, awarding themselves large amounts *even as they claimed they had to fire workers and reduce wages to keep the firm alive.* In some circles, so engrained did these schizophrenic attitudes to "fairness" become that early in the Great Recession an Obama administration official could say, with a straight face, that it was necessary to honor AIG bonuses, even for the officials who had led the company to need a $150 billion bailout, because of the sanctity of contracts; minutes later he could admonish autoworkers to accept a revision of their contract that would have lowered their compensation enormously.

Different corporate governance laws (even modest ones, like giving shareholders some say in the pay of their CEO)[40] might have tamed the unbridled zeal of executives, but the 1 percent didn't—and still don't—want such reforms in corporate governance, even if they would make the economy more efficient. And they have used their political muscle to make sure that such reforms don't occur.

The forces we have just described, including weaker unions and weaker social cohesion working with corporate governance laws that give management enormous discretion to run corporations for their own benefit, have led not only to a declining wage share in national income but also to a change in the way our economy responds to an economic downturn. It used to be that when the economy went into recession, employers, wanting to maintain the loyalty of their workers and concerned about their well-being, would keep as many as they could on their payroll. The result was that labor productivity went down, and the share of wages went up. Profits bore the brunt of the downturn. Wage shares would then fall after the end of a recession. But in this and the previous (2001) recession, the pattern changed; the wage share declined in the recession, as well as in the ensuing years. Firms prided themselves on their ruthlessness—cutting out so many workers that productivity actually increased.[41]

Discrimination

One other major societal force affects inequality. There is economic discrimination against major groups in American society—against women, against African Americans, against Hispanics. The existence of large differences in income and wealth across these groups is clear. Wages of women, African Americans, and Hispanics are all markedly lower than those of white males.[42] Differences in education (or other characteristics) account for a portion of the disparity, but only a portion.[43]

Some economists have argued that discrimination was impossible in a market economy.[44] In a competitive economy, so the theory went, as long as there are some individuals who do not have racial (or gender or ethnic) prejudices, they will hire members of the discriminated-against group because their wages will be lower than those of similarly qualified members of the not discriminated-against group. This process will continue until the wage/income discrimination is eliminated. Prejudice might lead to segregated workplaces, but not to income differentials. That such arguments gained currency in the economics profession says a lot about the state of the discipline. To an economist like me who grew up in the midst of a city and country where discrimination was *obvious*, such arguments provided a challenge: something was wrong with a theory that said discrimination couldn't exist. Over the past forty years, a number of theories have been developed to help explain the persistence of discrimination.[45]

Game-theoretic models, for instance, have shown how tacit collusive behavior of a dominant group (whites, men) can be used to suppress the economic interests of another group. Individuals who break with the discriminatory behavior are punished: others will refuse to buy from their store, work for them, supply them inputs; social sanctions, like ostracism, can also be effective. Those who don't punish transgressors are subjected to the same punishment.[46]

Related research has shown how other mechanisms (associated with imperfect information) can lead to discriminatory equilibria even in a competitive economy. If it is difficult to assess the true ability of an individual and the quality of his education, then employers may turn to race, ethnicity, or gender—whether justified or not. If employers believe that those who belong to a particular group (women, Hispanics, African Americans) are less productive, then they will pay them lower wages. The result of discrimination is to reduce incentives for members of the group to make the investments that would lead to higher productivity. The beliefs are self-reinforcing. This is sometimes called statistical discrimination—but of a particular form, where the discrimination actually leads to the differences that are believed to exist between groups.[47]

In the theories of discrimination just described, individuals *consciously* discriminate. Recently, economists have suggested an additional driver of discriminatory behavior: "implicit discrimination," which is unintentional and outside the awareness of those engaging in discrimation and at variance with what they (explicitly) think or favor for their organization.[48] Psychologists have learned to measure implicit attitudes (that is, attitudes of which individuals are not consciously aware). There is preliminary evidence that these attitudes predict discriminatory behavior better than explicit attitudes, especially in the presence of time pressure. That finding sheds new light on studies that have shown systematic racial discrimination.[49] This is because many real-world decisions, such as job offers, are often made under time pressure, with ambiguous information—conditions that give greater scope for implicit discrimination.

A striking example, from a study by the sociologist Devah Pager, is of the stigmatizing effect of a criminal record.[50] In her field study, matched pairs of twenty-three-year-olds applied for real entry-level jobs in order to test the degree to which a criminal record (a nonviolent drug offense) affects subsequent employment opportunities. All the individuals presented roughly identical credentials, including a high school diploma, so that differences experienced among groups can be attributed to the effects of race or criminal status. After an invited interview, the ratio of callbacks for white nonoffenders to white ex-offenders is 2:1, this same ratio for blacks is nearly 3:1. And a white man *with* a criminal record is slightly more likely to be considered for a job than a black man with no criminal past. Thus, on average, being black reduces employment opportunities substantially, and more so for ex-offenders. These effects can represent important barriers to black men trying to become economically self-sufficient, since roughly one in three black men will spend time in prison in his lifetime.

There are strong interactions between poverty, race, and government policies. If certain minorities are disproportionately poor, and if the government provides poor education and health care to the poor, then members of the minority will suffer disproportionately from poor education and health. Health statistics, for instance, are telling: life expectancy at birth for blacks in 2009 was 74.3 compared with 78.6 for whites.[51]

The Great Recession has not been good for members of the groups that have been traditionally discriminated against, as we saw in chapter 1. The banks saw them as easy targets, because they had aspirations of upward mobility; owning a home was a sign that they were making it into America's middle class. Unscrupulous vendors pushed mortgages on households that were beyond their ability to pay, ill-suited for their needs, and carrying high transactions costs. Today large fractions of these populations have lost not only their homes but also their life savings. The data on what has happened to their wealth are truly disturbing: in the aftermath of the crisis, the typical black household had a net worth of only $5,677, a twentieth of that of a typical white household.[52]

Our economic system rewards profits, no matter how they're made, and in a money-centric economy it's not surprising to see moral scruples put to the side. Occasionally, our system holds those who have behaved wrongly accountable, though only after a long and expensive legal battle. Even then, it's not always clear whether the penalties do more than take back a part of the profits that the banks have made by their unscrupulous behavior. In that case, even among those who are punished, crime pays.[53] In December 2011, four to seven years after the subprime lending occurred, Bank of America agreed to a $335 million settlement for its discriminatory practices against African Americans and Hispanics, the largest settlement ever over residential fair lending practices. Wells Fargo and other lenders have been similarly accused of discriminatory practices; Wells, the country's largest home mortgage lender, paid the Fed $85 million to settle charges that it had brought. In short, discrimination in lending was not limited to isolated instances, but was a pervasive practice.

Lending and housing discrimination has thus contributed to lowering standards of living of African Americans and their wealth, compounding the effects of the labor market discrimination discussed earlier.

Role of Government in Redistribution

We have examined how market forces, shaped by politics and societal changes, have played a role in bringing about the level of inequality in *before-tax incomes and transfers*.

The irony is that just as markets started delivering more unequal outcomes, tax policy asked less of the top. The top marginal tax rate was lowered from 70 percent under Carter to 28 percent under Reagan; it went up to 39.6 percent under Clinton and down finally to 35 percent under George W. Bush.[54]

This reduction was supposed to lead to more work and savings, but it didn't.[55] In fact, Reagan had promised that the incentive effects of his tax cuts would be so powerful that tax revenues would *increase*. And yet, the only thing that increased was the deficit. George W. Bush's tax cuts weren't any more successful: savings did not increase; instead the household savings rate fell to a record low (essentially zero).

The most egregious aspect of recent tax policy was the lowering of tax rates on capital gains. This happened first under Clinton and again under Bush, making the long-term capital gains tax rate only 15 percent. In this way we have given the very rich, who receive a large fraction of their income in capital gains, close to a free ride. It doesn't make sense that investors, let alone speculators, should be taxed at a lower rate than someone who works hard for his living, yet that's what our tax system does. And capital gains are not taxed until they are realized (that is, until the asset is sold), so there is an enormous benefit from this deferral of taxes, especially when interest rates are high.[56] Furthermore, if the assets are passed on at death, the capital gains made during the individual's lifetime escape taxation. Indeed, the tax lawyers for rich people like Ronald Lauder, who inherited his fortune from his mother, Estée Lauder, even figured out how to "have your cake and eat it too," that is, in effect, sell your stock and not pay the tax.[57] Their plan, and other similar tax-avoidance schemes, involves complicated transactions including short selling (selling borrowed stock) and derivatives. Though this particular loophole was eventually closed, tax lawyers for the rich are always seeking to outsmart the IRS.

The inequality in dividends is greater than that in wages and salaries, and the inequality in capital gains is greater than that in any other form of income, so giving a tax break to capital gains is, in effect, giving a tax break to the very rich. The bottom 90 percent of the population gets less than 10 percent of all capital gains.[58] Under 7 percent of households earning less than $100,000 receive any capital gains income, and for these households capital gains and dividend income combined make up an average of 1.4 percent of their total income.[59] Salaries and wages accounted for only 8.8 percent of the income of the top 400, capital gains for 57 percent, and interest and dividends for 16 percent—so 73 percent of their income was subject to low rates. Indeed, the top 400 taxpayers garner close to 5 percent of the country's entire dividends.[60] They posted an average of $153.7 million in gains each (a total of $61.5 billion in gains) in 2008, $228.6 million each (for a total of $91.4 billion) in 2007. Lowering the tax on capital gains from the ordinary rate of 35 percent to 15 percent thus gave each of these 400, on average, a gift of $30 million in 2008 and $45 million in 2007, and it lowered overall tax revenues by $12 billion in 2008 and $18 billion in 2007.[61]

The net effect is that the superrich actually pay on average a lower tax rate than those less well-off; and the lower tax rate means that their riches increase faster. The average tax rate in 2007 on the top 400 households was only 16.6 percent, considerably lower than the 20.4 percent for taxpayers in general. (It increased slightly in 2008, the last year for which data are available, to 18.1 percent.) While the average tax rate has decreased little since 1979—going from 22.2 percent to 20.4 percent, that of the top 1 percent has fallen by almost a quarter, from 37 percent to 29.5 percent.[62]

Most countries have adopted estate taxes, not just to raise revenue from those who are more able to afford it but also to prevent the creation of inherited dynasties. The ability of one generation to pass on its wealth to another more easily tilts the playing field of life chances. If the wealthy escape taxation (as they increasingly do) and if estate taxes are lowered (as they were under President Bush—actually abolished in 2010, though only for one year), then the role of inherited wealth will become more important.[63] Under these circumstances, and with more and more of the wealth concentrated in the upper 1 percent (or the upper 0.1 percent), America has the potential of becoming increasingly a land of an inherited oligarchy.

The rich and superrich often use corporations to protect themselves and shelter their income, and they have worked hard to ensure that the corporate income tax rate is low and the tax code is riddled with loopholes. Some corporations make such extensive use of these provisions that they don't pay any taxes.[64] Even though the United States supposedly has a higher corporate tax rate than much of the world, reaching 35 percent according to statute, the real average tax that firms pay is on par with that of many other countries, and corporate tax revenues as a share of GDP are smaller than they are, on average, in other advanced industrial countries. Loopholes and special provisions have eviscerated the tax to such a degree that it has gone from providing 30 percent of federal revenues in the mid-1950s to less than 9 percent today.[65] If an American firm invests abroad through a foreign subsidiary, its profits are not taxed by the United States until the money is brought home. While a great deal for the firm (if it invests in a low-tax jurisdiction like Ireland), it has the perverse effect of encouraging reinvestment abroad—creating jobs outside the United States but not in it. But then the corporations duped President Bush into giving them a tax holiday—money they brought back during the holiday, supposedly for investment, would be taxed at only 5.25 percent; they would bring the money back and reinvest it in America. When Bush put in place a one-year holiday at that rate, they did bring their money back; Microsoft alone brought back more than $32 billion.[66] But the evidence shows that little additional investment was generated. All that happened is that they managed to avoid paying most of the taxes that they should have paid.[67]

At the state level, things are even worse. Many states don't even make a pretense at progressivity, that is, having a tax system that makes the 1 percent, who can afford it, pay a larger fraction of their income than the poor have to pay. Instead, the sales tax offers a major source of revenue, and because the poor spend a larger fraction of their income, such taxes are often regressive.[68]

While tax policies can either let the rich get richer or restrain the growth of inequality, expenditure programs can play an especially important role in preventing the poor from becoming poorer. Social Security has almost eliminated poverty among the elderly. Recent research has shown how large these effects can be: the earned-income tax credit, which supplements the income of poor working families, by itself lowers the poverty rate by 2 percentage points. Housing subsidies, food stamps, and school lunch programs all have big effects in lowering poverty.[69] A program like the provision of health insurance for poor kids can bring benefits to millions and help ensure that these children have a lower risk of being handicapped for life by an illness or other health problem; this stands in marked contrast to some of the corporate subsidies or tax loopholes that cost much more and the benefits of which go to far fewer people. The United States spent far more on its big bank bailout, which helped the banks to maintain their generous bonuses, than it spent to help those who were unemployed as a result of the recession that the big banks brought about. We created for the banks (and other corporations, like AIG) a much stronger safety net than we created for poor Americans.

What is striking about the United States is that while the level of inequality generated by the market—a market shaped and distorted by politics and rent seeking—is higher than in other advanced industrial countries, it does less to temper this inequality through tax and expenditure programs. And as the market-generated inequality has increased, our government has done less and less.[70]

Government and opportunity

Among the more disturbing findings recited in chapter 1 is that the United States has become a society in which there is less equality of opportunity, less than it was in the past, and less than in other countries, including those of old Europe. Market forces described earlier in this chapter play a role: as the returns to education have increased, those with a good education have fared well, those (and especially men) with a high school education or less have done miserably. This is even more true today, in our deep economic downturn. While the unemployment rate among those with a college degree or higher was only 4.2 percent, those with less than a high school diploma faced an unemployment rate three times higher, at 12.9 per cent. The picture for recent high school dropouts and even graduates not enrolled in college is far more dismal: jobless rates of 42.7 percent and 33.4 percent, respectively.[71]

But access to good education depends increasingly on the income, wealth, and education of one's parents, as we saw in chapter 1, and for good reason: a college education is becoming more and more expensive, especially as states cut back on support, and access to the best colleges depends on going to the best high schools, grade schools, and kindergartens. The poor can't afford high-quality private primary and secondary schools, and they can't afford to live in the rich suburbs that provide high-quality public education. Many of the poor have traditionally lived in close proximity to the rich—partly because they provided services to them.

This phenomenon in turn led to public schools with students from diverse social and economic backgrounds. As a recent study by Kendra Bischoff and Sean Reardon of Stanford University shows, that is changing: fewer poor are living in proximity to the rich, and fewer rich are living in proximity to the poor.[72]

U.S. neighborhoods are even segregated between homeowners and renters. This pattern cannot be explained by race or the presence of children in the household, because it occurs within racial groups and among households with children. The segregation in American metropolitan areas into homeowner communities and renter communities can produce communities with starkly different civic environments. Community quality depends on residents' efforts to prevent crime and improve local governance, and the payoff to an individual making that effort is greater for homeowners than for renters, and generally greater for those who live in communities where many other residents make similar efforts to render local government more responsive to community members. Thus there are economic forces that lead from differences in household wealth (and homeownership) to differences in the civic quality of the community in which a household lives.[73] U.S. policy to increase low-income ownership rates reflects the understanding that homeownership rates affect neighborhood quality and that growing up in a violent, crime-ridden neighborhood impairs health, personal development, and school outcomes. But homeownership—a major way in the United States that households access better neighborhoods and also accumulate wealth—is not sustainable for households with no wealth to start with and little income.

We also noted in chapter 1 that even among college graduates, those who are fortunate enough to have wealthier and better-educated parents have better prospects. This may be partly because of networking—making connections—which may become especially important when jobs are scarce, as now. But it is also partly because of the increasing role of internships. In a labor market such as the one we have had since 2008, there are many job seekers for every job, and having experience counts. Firms are exploiting this imbalance by providing unpaid or low paid internships, which adds an important element to a resume. But not only are the rich in a better position to get the internship; they are in a better position to *afford* unpaid work for a year or two.[74]

While government has been doing less to countervail these market forces that lead to greater inequality of opportunity, on the basis of differential access to "human capital" and jobs, it has also, as we have noted, been doing less to level the playing field in financial capital, as a result of less progressive taxation and especially lower inheritance taxes. In short, we have created an economic and social system, and a politics, in which, going forward, current inequalities are not only likely to be perpetuated but to be exacerbated: we can anticipate in the future more inequality both in human capital and in financial capital.

Earlier in this chapter and in chapter 2 we saw how the rules of the game have helped create the riches of those at the top and have contributed to the miseries of those at the bottom. Government today plays a double role in our current inequality: it is partly responsible for the inequality in *before-tax distribution of income*, and it has taken a diminished role in "correcting" this inequality through progressive tax and expenditure policies.

As the wealthy get wealthier, they have more to lose from attempts to restrict rent seeking and redistribute income in order to create a fairer economy, and they have more resources with which to resist such attempts. It might seem strange that as inequality has increased we have been doing less to diminish its impact, but it's what one might have expected. It's certainly what one sees around the world: the more egalitarian societies work harder to preserve their social cohesion; in the more unequal societies, government policies and other institutions tend to foster the persistence of inequality. This pattern has been well documented.[75]

Justifying inequality

We began the chapter by explaining how those at the top have often sought to justify their income and wealth, and how "marginal productivity theory," the notion that those who got more did so because they had made a greater contribution to society, had become the prevailing doctrine, at least in economics. But we noted, too, that the crisis had cast doubt on this theory.[76] Those who perfected the new skills of predatory lending, who helped create derivatives, described by the billionaire Warren Buffett as "financial weapons of mass destruction," or who devised the reckless new mortgages that brought about the subprime mortgage crisis walked away with millions, sometimes hundreds of millions, of dollars.[77]

But even before that, it was clear that the link between pay and societal contribution was, at best, weak. As we noted earlier, the great scientists who have made discoveries that provided the basis of our modern society have typically reaped for themselves no more than a small fraction of what they have contributed, and received a mere pittance compared with the rewards reaped by the financial wizards who brought the world to the brink of ruin.

But there is a deeper philosophical point: one can't really separate out any individual's contributions from those of others. Even in the context of technological change, most inventions entail the synthesis of preexisting elements rather than invention de novo. Today, at least in many critical sectors, a large fraction of all advances depend on basic research funded by the government.

Gar Alperovitz and Lew Daly concluded in 2009 that "if much of what we have comes to us as the free gift of many generations of historical contribution, there is a profound question as to how much can reasonably be said to be 'earned' by any one person, now or in the future."[78]

So too, the success of any businessperson depends not just on this "inherited" technology but on the institutional setting (the rule of law), the existence of a well-educated workforce, and the availability of good infrastructure (transportation and communications).

Is inequality necessary to give people incentives?

Another argument is often proffered by those who defend the status quo: that we need the current high level of inequality to give people incentives to work, save, and invest. This confuses two positions. One is that we should have no inequality. The other is that we would be better-off if we had less inequality than we have today. I and, as far as I know, most progressives—do not argue for full equality. We realize that that would weaken incentives. The question is, How seriously would incentives be weakened if we had a little bit less inequality? In the next chapter, I will explain why, to the contrary, less inequality would actually enhance productivity.

Of course, much of what is called incentive pay isn't really that. It's just a name given it to justify the huge inequality, and to delude the innocent to think that without such inequality our economic system wouldn't work. That was made evident when, in the aftermath of the financial debacle of 2008, the banks were so embarrassed about calling what they paid their executives "performance bonuses" that they felt compelled to change the name to "retention bonus" (even if the only thing being retained was bad performance).

Under incentive compensation schemes, pay is supposed to increase with performance. What the bankers did was common practice: when there was a decline in *measured* performance according to the yardsticks that were supposed to be used to determine compensation, the compensation system changed. The effect was that, in practice, pay was high when performance was good, and pay was high when performance was bad.[79]

Parsing out the sources of inequality

Economists are prone to quibble about the relative importance of various factors leading to America's growing inequality. Increasing inequality in wages and capital income and an increasing share of income going to those forms of income that are more unequally distributed contributed to greater inequality in market income, and, as we saw earlier in the chapter, less progressive tax and expenditure policies contributed to an even larger increase in after-tax and transfer income.

The explanation for the increase in dispersion of wages and salaries has been particularly contentious. Some focus on changes in technology—skill-biased technological change. Others on social factors—the weakening of unions, the breakdown of social norms restraining executive pay. Still others focus on globalization. Some focus on the increasing role of finance. Strong vested interests inform each of these explanations: those fighting to open up markets see globalization as playing a minor role; those arguing for stronger unions see the weakening of unions as central. Some of the debates have to do with the different aspects of inequality that are being focused upon: the increasing role of finance may have little to do with the polarization of wages in the middle, but a great deal to do with the increases of income and wealth at the top. At different times, different forces have played different roles: globalization has probably played a more important role since, say, 2000 than it did in the preceding decade. Still, there is a growing consensus among economists that it is hard to parse out cleanly and precisely the roles of different forces. We can't conduct controlled experiments, to see what inequality would have been if, keeping everything else the same, we had had stronger unions. Moreover, the forces interact: the competitive forces of globalization—the threat of jobs moving elsewhere—has been important in weakening unions.[80]

To me, much of this debate is beside the point. The point is that inequality in America (and some other countries around the world) has grown to where it can no longer be ignored. Technology (skill-biased technological change) may be central to certain aspects of our current inequality problem, especially to the polarization of the labor market. But even if that is the case, we don't have to sit idly by and accept the consequences. Greed may be an inherent part of human nature, but that doesn't mean there is nothing we can do to temper the consequences of unscrupulous bankers who would exploit the poor and engage in anticompetitive practices. We can and should regulate banks, forbid predatory lending, make them accountable for their fraudulent practices, and punish them for abuses of monopoly power. So too, stronger unions and better education might mitigate the consequences of skill-biased technological change. And it's not even inevitable that technological change continues in this direction: making firms pay for the environmental consequences of their production might encourage firms to shift away from skill-biased technological change to resource-saving technological change. Low interest rates may encourage firms to robotize, replacing unskilled jobs that can easily be routinized; so alternative macroeconomic and investment policies could slow the pace of the deskilling of our economy. So too, while economists may disagree about the precise role that globalization has played in the increase in inequality, the *asymmetries* in globalization to which we call attention put workers at a particular disadvantage; and we can manage globalization better, in ways that might lead to less inequality.

We have also noted how the growth in the financial sector as a share of total U.S. income (sometimes referred to as the increased financialization of the economy) has contributed to increased inequality—to both the wealth created at the top and the poverty at the bottom. Jamie Galbraith has shown that countries with larger financial sectors have more inequality, and the link is not an accident.[81] We have seen how deregulation and hidden and open government subsidies distorted the economy, not only leading to a larger financial sector but also enhancing its ability to move money from the bottom to the top. We don't have to know precisely the fraction of inequality that should be attributed to the increased financialization of the economy to understand that a change in policies is needed.

Each of the factors that have contributed to inequality has to be addressed, with especial emphasis on those that simultaneously contribute *directly* to the weakening of our economy, such as the persistence of monopoly power and of distortionary economic policies. Inequality has become ingrained in our economic system, and it will take a comprehensive agenda—described more fully in chapter 10—to uproot it.

Alternative models of inequality

In this chapter, we have explained that there are alternative theories of inequality, in some of which inequality seems more ”justified,” the income of those at the top more deserved, and the costs of checking the inequality and redistribution greater than others. The “achievement” model of income determination focuses on the efforts of each individual; and if inequality were largely the result of differences in effort, it would be hard to fault it, and it would seem unjust, and inefficient, not to reward it. The Horatio Alger stories that we described in chapter 1 belong to this tradition: in the more than a hundred tales of rags to riches, it was by dint of the individual’s own efforts that the hero of each tale pulled himself out of poverty. They may contain a grain of truth, but it is only a grain. We saw in chapter 1 that the major determinant of an individual’s success was his initial conditions—the income and education of his parents. Luck also plays an important role.

The central thesis of this chapter and the preceding one is also that inequality is not just the result of the forces of nature, of abstract market forces. We might like the speed of light to be faster, but there is nothing we can do about it. But inequality is, to a very large extent, the result of government policies that shape and direct the forces of technology and markets and broader societal forces. There is in this a note of both hope and despair: hope because it means that this inequality is not inevitable, and that by changing policies we can achieve a more efficient and a more egalitarian society; despair because the political processes that shape these policies are so hard to change.

There is one source of inequality, especially at the bottom, about which this chapter has had little to say: as this book goes to press, we are still in the worst economic downturn since the Great Depression. Macro-mismanagement, in all of its guises, is a major source of inequality. The unemployed are more likely to join those in poverty, the more so, the longer the economic downturn. The bubble gave a few of the poor an illusion of wealth, but only for a moment; as we have seen, when the bubble burst, it wiped out the wealth of those at the bottom, creating new levels of wealth inequality and heightening the fragility of those at the bottom. Chapter 9 will lay out how the macroeconomic (and especially monetary) policies that the United States and many other countries pursued reflected the interests and ideologies of the top.

Another theme of this book is that of “adverse dynamics,” “vicious circles.” We saw in the last chapter how greater inequality led to less equality of opportunity, leading in turn to more inequality. In the next chapter, we’ll see some further examples of downward spirals—how more inequality undermines support for collective action, the kinds of actions that ensure that everyone lives up to his or her potential, as a result, for instance, of good public schools. We'll explain how inequality fosters instability, which itself gives rise to more inequality.

CHAPTER FOUR

WHY IT MATTERS

WE SAW IN CHAPTER 1 THAT THE AMERICAN ECONOMY has not been delivering for most citizens for years, even though, with the exception of 2009, GDP per capita has been increasing. The reason is simple: growing inequality, an increasing gap between the top and the rest. We saw in chapter 2 that one of the reasons that the top has done so well is *rent seeking*—which entails seizing a larger share of the pie and, in doing so, making the size of the pie smaller than it otherwise would be.

We are paying a high price for our large and growing inequality, and because our inequality is likely to continue to grow—unless we do something—the price we pay is likely to grow too. Those in the middle, and especially those at the bottom, will pay the highest price, but our country as a whole—our society, our democracy—also will pay a very high price.

Widely unequal societies do not function efficiently, and their economies are neither stable nor sustainable in the long term. When one interest group holds too much power, it succeeds in getting policies that benefit itself, rather than policies that would benefit society as a whole. When the wealthiest use their political power to benefit excessively the corporations they control, much-needed revenues are diverted into the pockets of a few instead of benefiting society at large.

But the rich do not exist in a vacuum. They need a functioning society around them to sustain their position and to produce income from their assets. The rich resist taxes, but taxes allow society to make investments that sustain the country's growth. When little money is invested in education, for lack of tax revenues, schools do not produce the bright graduates that companies need to prosper. Taken to its extreme—and this is where we are now—this trend distorts a country and its economy as much as the quick and easy revenues of the extractive industry distort oil- or mineral-rich countries.

We know how these extremes of inequality play out because too many countries have gone down this path before. The experience of Latin America, the region of the world with the highest level of inequality,[1] foreshadows what lies ahead. Many of the countries were mired in civil conflict for decades, suffered high levels of criminality and social instability. Social cohesion simply did not exist.

This chapter explains the reasons why an economy like America's, in which most citizens' wealth has fallen, median incomes have stagnated, and many of the poorest citizens have been doing worse year after year, is not likely to do well over the long haul. We will look first at the effects of inequality on national output and economic stability, then at its impact on economic efficiency and on growth. The effects are multiple and occur through a number of channels. Some are caused by the increase in poverty; others can be attributed to the evisceration of the middle class, still more to the growing disparity between the 1 percent and the rest of us. Some of these effects arise through traditional economic mechanisms, while others are the consequence of inequality's broader impact on our political system and society.

We'll also examine the fallacious ideas that inequality is good for growth, or that doing anything about inequality—like raising taxes on the rich—would harm the economy.

Instability and Output

It is perhaps no accident that this crisis, like the Great Depression, was preceded by large increases in inequality:[2] when money is concentrated at the top of society, the average American's spending is limited, or at least that would be the case in the absence of some artificial prop, which, in the years before the crisis, came in the form of a housing bubble fueled by Fed policies. The housing bubble created a consumption boom that gave the appearance that everything was fine. But as we soon learned, it was only a temporary palliative.

Moving money from the bottom to the top lowers consumption because higher-income individuals consume a smaller proportion of their income than do lower-income individuals (those at the top save 15 to 25 percent of their income, those at the bottom spend all of their income).[3] The result: until and unless something else happens, such as an increase in investment or exports, total demand in the economy will be less than what the economy is capable of supplying—and that means that there will be unemployment. In the 1990s that "something else" was the tech bubble; in the first decade of the twentieth-first century, it was the housing bubble. Now the only recourse is government spending.

Unemployment can be blamed on a deficiency in aggregate demand (the total demand for goods and services in the economy, from consumers, from firms, by government, and by exporters); in some sense, the entire shortfall in aggregate demand—and hence in the U.S. economy—today can be blamed on the extremes of inequality. As we've seen, the top 1 percent of the population earns some 20 percent of U.S. national income. If that top 1 percent saves some 20 percent of its income, a shift of just 5 percentage points to the poor or middle who do not save—so the top 1 percent would still get 15 percent of the nation's income—would increase aggregate demand *directly* by 1 percentage point. But as that money recirculates, output would actually increase by some 1½ to 2 percentage points.[4] In an economic downturn such as the current one, that would imply a decrease in the unemployment rate of a comparable amount. With unemployment in early 2012 standing at 8.3 percent, this kind of a shift in income could have brought the unemployment rate down close to 6.3 percent. A broader redistribution, say, from the top 20 percent to the rest, would have brought down the unemployment further, to a more normal 5 to 6 percent.

There's another way of seeing the role of growing inequality in weakening macroeconomic performance. In the last chapter, we observed the enormous decline in the wage share in this recession; the decline amounted to more than a half trillion dollars a year.[5] That's an amount much greater than the value of the stimulus package passed by Congress. That stimulus package was estimated to reduce unemployment by 2 to 2½ percentage points. Taking money away from workers has, of course, just the opposite effect.

Since the time of the great British economist John Maynard Keynes, governments have understood that when there is a shortfall of demand—when unemployment is high—they need to take action to increase either public or private spending. The 1 percent has worked hard to restrain government spending. Private consumption is encouraged through tax cuts, and that was the strategy undertaken by President Bush, with three large tax cuts in eight years. It didn't work. The burden of countering weak demand has thus been placed on the U.S. Federal Reserve, whose mandate is to maintain low inflation, high growth, and full employment. The Fed does this by lowering interest rates and providing money to banks, which, in normal times, lend it to households and firms. The greater availability of credit at lower interest rates often spurs investment. But things can go wrong. Rather than spurring *real* investments that lead to higher long-term growth, the greater availability of credit can lead to bubbles. A bubble can lead households to consume in an unsustainable way, on the basis of debt. And when a bubble breaks, it can bring on a recession. While it is not inevitable that policy makers will respond to the deficiency in demand brought about by the growth in inequality in ways that lead to instability and a waste of resources, it happens often.

How the government's response to weak demand from inequality led to a bubble and even more inequality

For instance, the Federal Reserve responded to the 1991 recession with low interest rates and the ready availability of credit, helping to create the tech bubble, a phenomenal increase in the price of technology stocks accompanied by heavy investment in the sector. There was, of course, something *real* underlying that bubble—technological change, brought about by the communications and computer revolution. The Internet was rightly judged to be a transformative innovation. But the irrational exuberance on the part of investors went well beyond anything that could be justified.

Inadequate regulation, bad accounting, and dishonest and incompetent banking also contributed to the tech bubble. Banks famously had touted stocks that they knew were "dogs." "Incentive" pay provided CEOs with incentives to distort their accounting, to show profits that were far larger than they actually were. The government could have reined this in by regulating the banks, by restricting incentive pay, by enforcing better accounting standards, and by requiring higher margins (the amount of cash that investors have to put down when they buy stock). But the beneficiaries of the tech bubble—and especially the corporate CEOs and the banks—didn't want the government to intervene: there was a party going on, and it was a party that lasted for several years. They also believed (correctly, as it turned out) that somebody else would clean up the mess.

But the politicians of the era were also beneficiaries of the bubble. This irrational investment demand during the tech boom helped to offset the otherwise weak demand created by the high inequality, making the Bill Clinton era one of *seeming* prosperity. Tax revenues from capital gains and other income generated by the bubble even gave the appearance of fiscal soundness. And, to some extent, the administration could claim "credit" for what was going on: Clinton's policies of financial market deregulation and cuts to capital gains tax rates (increasing the returns to speculating on the tech stocks) added fuel to the fire.[6]

When the tech bubble finally burst, the demand by firms (especially technology firms) for more capital diminished markedly. The economy went into recession. Something else would have to rekindle the economy. George W. Bush succeeded in getting a tax cut targeted at the rich through Congress. Much of the tax cut benefited the very rich: a cut in the rate on dividends, which was reduced from 35 percent to 15 percent, a further cut in capital gains tax rates, from 20 percent to 15 percent, and a gradual elimination of the estate tax.[7] But because, as we have noted, the rich save so much of their income, such a tax cut provided only a limited stimulus to the economy. Indeed, as we discuss next, the tax cuts had even some perverse effects.

Corporations, realizing that the dividend tax rate was unlikely to remain so low, had every incentive to pay out as much as they felt that they could do safely—without jeopardizing too much the future viability of the firm. But that meant smaller cash reserves left on hand for any investment opportunities that came along. Investment, outside of real estate, actually fell,[8] contrary to what some on the right had predicted.[9] (Part of the reason for the weak investment, of course, was that during the tech bubble many firms had *overinvested.*) By the same token, the cut in the estate tax may have discouraged spending; the rich could now safely stow away more money for their children and grandchildren, and they had less incentive to give away money to charities that would have spent the money on good causes.[10]

Strikingly, the Fed and its chairman at the time, Alan Green-span, didn't learn the lessons of the tech bubble. But this was in part because of the politics of "inequality," which didn't allow alternative strategies that could have resuscitated the economy without creating another bubble, such as a tax cut to the poor or increased spending on badly needed infrastructure. This alternative to the reckless path the country took was anathema to those who wanted to see a smaller government—one too weak to engage in progressive taxation or redistributive policies. Franklin Delano Roosevelt had tried these policies in his New Deal, and the establishment pilloried him for it. Instead, low interest rates, lax regulations, and a distorted and dysfunctional financial sector came to the rescue of the economy—for a moment.

The Fed engineered, unintentionally, another bubble, this one temporarily more effective than the last but in the long run more destructive. The Fed's leaders didn't see it as a bubble, because their ideology, their belief that markets were always efficient, meant that there *couldn't* be a bubble. The housing bubble was more effective because it induced spending not just by a few technology companies but by tens of millions of households that thought that they were richer than they were. In one year alone, close to a trillion dollars were taken out in home equity loans and mortgages, much of it spent on consumption.[11] But the bubble was more destructive partly for the same reasons: it left in its wake tens of millions of families on the brink of financial ruin. Before the debacle is over, millions of Americans will lose their homes, and millions more will face a lifetime of financial struggle.

Overleveraged households and excess real estate have already weighed down the economy for years and are likely to do so for more years, contributing to unemployment and a massive waste of resources. At least the tech bubble left something useful in its wake—fiber optics networks and new technology that would provide sources of strength for the economy. The housing bubble left shoddily built houses, located in the wrong places and inappropriate to the needs of a country where most people's economic position was in decline. It's the culmination of a three-decade stretch spent careening from one crisis to another without learning some very obvious lessons along the way.

In a democracy where there are high levels of inequality, politics can be unbalanced, too, and the combination of an unbalanced politics managing an unbalanced economy can be lethal.

Deregulation

There is a second way that unbalanced politics driven by extremes of inequality leads to instability: deregulation. Deregulation has played a central part in the instability that we, and many other countries, have experienced. Giving corporations, and especially the financial sector, free rein was in the *shortsighted* interest of the wealthy; they used their political weight, and their power to shape ideas, to push deregulation, first in airlines and other areas of transportation, then in telecom, and finally, and most dangerously, in finance.[12]

Regulations are the rules of the game that are designed to make our system work better—to ensure competition, to prevent abuses, to protect those who cannot protect themselves. Without restraints, the kinds of market failures described in the last chapter—where markets fail to produce efficient outcomes—are rampant. In the financial sector, for instance, there will be conflicts of interest and excesses, excess credit, excess leverage, excess risk taking, and bubbles. But those in the business sector see things differently: without the restraints, they see increases in profits. They think not of the broad, and often long-term, social and economic consequences, but of their narrower, short-term self-interest, the profits that they might garner now.[13]

In the aftermath of the Great Depression, an event preceded by similar excesses, the country enacted strong financial regulations, including the Glass-Steagall Act in 1933. These laws, effectively enforced, served the country well: in the decades following passage, the economy was spared the kind of financial crisis that had repeatedly plagued this country (and others). With the dismantling of these regulations in 1999, the excesses returned with even greater force: bankers quickly put to use advances in technology, finance, and economics. The innovations offered ways to increase leverage that circumvented the regulations that remained and that the regulators didn't fully understand, new ways of engaging in predatory lending, and new ways to deceive unwary credit card users.

The losses from the underutilization of resources associated with the Great Recession and other economic downturns are enormous. Indeed, the sheer waste of resources brought on by this crisis caused by the private sector—a shortfall of trillions of dollars between what the economy could have produced and what it has produced—is greater than the waste of any democratic government, ever. The financial sector claimed that its innovations had led to a more productive economy—a claim for which there is no evidence—but there is no doubting the instability and inequality for which it is responsible. Even if the financial sector had led to a quarter percent higher growth for three decades—a claim that is beyond that of even the most exaggerated supporters of the sector—it would barely have made up for the losses that its misbehavior precipitated.

We have seen how inequality gives rise to instability, as a result of both the deregulatory policies that are enacted and the policies that are typically adopted in response to the deficiencies in aggregate demand. Neither is a *necessary* consequence of inequality: if our democracy worked better, it might have resisted the political demand for deregulation and might have responded to the weaknesses in aggregate demand in ways that enhanced sustainable growth rather than creating a bubble.[14]

There are further adverse effects of this instability: it increases risk. Firms are risk averse, which means that they demand compensation for bearing the risk. Without compensation, firms will invest less, and so there will be less growth.[15]

The irony is that while inequality gives rise to instability, the instability itself gives rise to more inequality, one of the vicious cycles that we identify in this chapter. In chapter 1, we saw how the Great Recession has been particularly hard on those at the bottom, and even those in the middle, and this is typical: ordinary workers face higher unemployment, lower wages, declining house prices, a loss of much of their wealth. Since the rich are better able to bear risk, they reap the reward that society provides for compensating for the greater risk.[16] As always, they seem to be the winners from the policies that they advocated and that imposed such high costs on others.

In the wake of the 2008 global financial crisis, there is now an increasing global consensus that inequality leads to instability, and that instability contributes to inequality.[17] The International Monetary Fund (IMF), the international agency charged with maintaining global economic stability, which I have strongly criticized for paying insufficient attention to the consequences of its policies for the poor, belatedly acknowledged that it cannot ignore inequality if it is to fulfill its mandate. In a 2011 study, the IMF concluded, "We find that longer growth spells are robustly associated with more equality in the income distribution. . . . Over longer horizons, reduced inequality and sustained growth may thus be two sides of the same coin."[18] In April of that year its former managing director, Dominique Strauss-Kahn, emphasized, "Ultimately, employment and equity are building blocks of economic stability and prosperity, of political stability and peace. This goes to the heart of the IMF's mandate. It must be placed at the heart of the policy agenda."[19]

High Inequality Makes for a Less Efficient and Productive Economy

Beyond the costs of the instability to which it gives rise, there are several other reasons why high inequality—the kind that now characterizes the United States—makes for a less efficient and productive economy. We discuss in turn (a) the reduction in broadly beneficial public investment and support for public education, (b) massive distortions in the economy (especially associated with rent seeking), in law, and in regulations, and (c) effects on workers' morale and on the problem of "keeping up with the Joneses."

Lowering public investment

The current economic mantra stresses the role of the private sector as the engine of economic growth. It's easy to see why: when we think of innovation we think of Apple, Facebook, Google, and a host of other companies that have changed our lives. But behind the scenes lies the public sector: the success of these firms, and indeed the viability of our entire economy, depends heavily on a well-performing public sector. There are creative entrepreneurs all over the world. What makes a difference—whether they are able to bring their ideas to fruition and products to market—is the government.

For one thing, the government sets the basic rules of the game. It enforces the laws. More generally, it provides the soft and hard infrastructure that enables a society, and an economy, to function. If the government doesn't provide roads, ports, education, or basic research—or see to it that someone else does, or at least provides the conditions under which someone else could—then ordinary business cannot flourish. Economists call such investments "public goods," a technical term referring to the fact that everyone can enjoy the benefits of, say, basic knowledge.

A modern society requires collective action, the country acting together to make these investments. The broad societal benefits that flow from them cannot be captured by any private investor, which is why leaving it to the market will result in underinvestment.

The United States and the world have benefited greatly from government-sponsored research. In earlier decades research conducted through our state universities and agricultural extension services contributed to enormous increases in agricultural productivity.[20] Today, government-sponsored research has promoted the information technology revolution and advances in biotechnology.

For several decades America has suffered from underinvestment in infrastructure, basic research, and education at all levels. Further cutbacks in these areas lie ahead, given the commitment by both parties to bringing down the deficit and the refusal of the House of Representatives to raise taxes. The cuts come despite evidence that the boost these investments give to the economy far exceeds the average return in the private sector, and is certainly higher than the cost of funds to the government.[21] Indeed, the boom years of the 1990s were buoyed by innovations made in previous decades that finally took their place in our economy. But the well from which the private sector can draw—for the next generation of transformational investments—is drying up. Applied innovations depend on basic research, and we simply haven't been doing enough of it.[22]

Our failure to make these critical public investments should not come as a surprise. It is the end result of a lopsided wealth distribution in society. The more divided a society becomes in terms of wealth, the more reluctant the wealthy are to spend money on common needs. The rich don't need to rely on government for parks or education or medical care or personal security. They can buy all these things for themselves. In the process, they become more distant from ordinary people.

The wealthy also worry about a strong government—one that could use its power to adjust the imbalances in our society by taking some of their wealth and devoting it to public investments that would contribute to the common good or that would help those at the bottom. While the wealthiest Americans may complain about the kind of government we have in America, in truth many like it just fine: too gridlocked to redistribute, too divided to do anything but lower taxes.

Living up to potential: the end of opportunity

Our underinvestment in the common good, including public education, has contributed to the decline in economic mobility that we noted in chapter 1. This in turn has important consequences for the country's growth and efficiency. Whenever we diminish equality of opportunity, we are not using one of our most valuable assets—our people—in the most productive way possible.

In earlier chapters we saw how the prospects of a good education for the children of poor and middle-income families were far bleaker than those of the children of the rich. Parental income is becoming increasingly important, as college tuition increases far faster than incomes, especially at public colleges, which educate 70 percent of Americans. But, one might ask, don't expanded student loan programs fill the gap? The answer, unfortunately, is no; and again, the financial sector is more than a little at fault. Today, the market is characterized by a set of perverse incentives, which, together with the absence of regulations that prevent abuse, mean that the student loan programs, rather than uplifting the poor, can (and too often do) lead to their further immiseration. The financial sector succeeded in making student loans non-dischargeable in bankruptcy, which meant that the lenders had little incentive to see to it that the schools for which the students were borrowing money were actually providing them with an education that would enhance their income. Meanwhile, private for-profit schools with richly compensated executives have defeated attempts to impose high standards that would make schools that exploit the poor and ill informed—by taking their money and not providing them with an education that enables them to get jobs to repay the loans—ineligible for loans.[23] It is totally understandable that a young person, seeing how the burden of debt is crushing his parents' lives, would be reluctant to take on student loans. It is, in fact, remarkable that so many are willing to do so, to the point that the average college graduate now has a debt of over $25,000.[24]

There may be another factor at play that is decreasing mobility and that, over the long run, will decrease the nation's productivity. Studies of educational attainment stress the importance of what happens in the home. As those in the middle and at the bottom struggle to make a living—as they have to work more to get by—families have less time to spend together. Parents are less able to supervise their children's homework. Families have to make compromises, and among them is less investment in their children (though they wouldn't use those words.)

A distorted economy—rent seeking and financialization—and a less well-regulated economy

A central theme of the preceding chapters was that much of the inequality in our economy was the result of rent seeking. In their simplest form, rents are just redistributions from the rest of us to the rent seekers. That's the case when oil and mining companies succeed in getting rights to oil and minerals at prices well below what they should be. The main waste of resources is only on lobbying: there are more than 3,100 lobbyists working for the health industry (nearly 6 for every congressperson), and 2,100 lobbyists working for the energy and natural resources industries. All told, more than $3.2 billion was spent on lobbying in 2011 alone.[25] The main distortion is to our political system; the main loser, our democracy.

But often rent seeking involves a real waste of resources that lowers the country's productivity and well-being. It distorts resource allocations and makes the economy weaker. A byproduct of efforts directed toward getting a larger share of the pie is shrinkage of the pie. Monopoly power and preferential tax treatment for special interests have exactly this effect.[26]

The magnitude of "rent seeking" and the associated distortions in our economy, while hard to quantify precisely, are clearly enormous. Individuals and corporations that excel at rent seeking are amply rewarded. They may garner immense profits for their firms. But this does not mean that their *social* contribution is even positive. In a rent-seeking economy such as ours is becoming, private and social returns are badly misaligned. The bankers who gained large profits for their companies were amply rewarded, but, as I have repeatedly said, those profits were ephemeral and unconnected to sustainable improvements in the *real* economy. That something was wrong should have been evident: the financial sector is supposed to *serve* the rest of the economy, not the other way around. Yet before the crisis, 40 percent of all corporate profits went to the financial sector.[27] Credit card companies would extract more money from transaction fees than the store would profit from the sale of its goods. For the movement of a few electrons upon the swipe of a card, something that costs at most a few pennies, the finance company received as much money as the store did for managing a complex operation that made a wide variety of food available at a low price.[28]

Rent seeking distorts our economy in many ways—not the least of which is the misallocation of the country's most valuable resource: its talent. It used to be that bright young people were attracted to a variety of professions—some to serving others, as in medicine or teaching or public service; some to expanding the frontiers of knowledge. Some always went into business, but in the years before the crisis an increasingly large fraction of the country's best minds chose finance. And with so many talented young people in finance, it's not surprising that there would be innovation in that sector. But many of these "financial innovations" were designed to circumvent regulations, and actually lowered long-run economic performance. These financial innovations do not compare with real innovations like the transistor or the laser that increased our standard of living.

The financial sector is not the only source of rent seeking in our economy. What is striking is the prevalence of limited competition and rent seeking in so many key sectors of the economy. Earlier chapters referred to the hi-tech sector (Microsoft). Two others that have drawn attention are the health care sector and telecommunications. Drug prices are so much higher than the costs of production that it pays drug companies to spend enormous amounts of money to persuade doctors and patients to use them, so much so that they now spend more on marketing than on research.[29] And much of the so-called research itself is rent seeking—producing a me-too drug that will divide the high profits of a rival firm's blockbuster drug. Imagine how competitive our economy might be—and how many jobs might be created—if all that money was invested in *real* research and *real* investments to increase the nation's productivity.

Whenever rents are generated by monopoly power, a large distortion in the economy occurs. Prices are too high, and that induces a shift from the monopolized product to others. It is remarkable that even though the United States is allegedly a highly competitive economy, certain sectors seem to continue to reap excess profits. Economists marvel at our health care sector and its ability to deliver less for more: health outcomes are worse in the United States than in almost all other advanced industrial countries, and yet the United States spends absolutely more per capita, and more as a percentage of GDP, by a considerable amount. We've been spending more than one-sixth of GDP on health care, while France has been spending less than an eighth. Per capita spending in the United States has been two and a half times higher than the average of the advanced industrial countries.[30] This inefficiency is so large that after it is taken into account, the gap between income per capita in the United States and in France shrinks by about a third.[31] While there are many reasons for this disparity in the efficiency of the health care system, rent seeking, in particular on the part of health insurance companies and drug companies, plays a significant role.

Earlier, we cited the most notorious example: a provision in the 2003 Bush Medicare expansion that led to much higher drug prices in the United States and to a windfall gain (a rent) for the drug companies estimated at $50 billion or more a year. Well, one might say, what is $50 billion among friends? In a $15 trillion economy,[32] it amounts to less than a third of 1 percent. But as Everett Dirksen, the senator from Illinois, is reputed to have said: a billion here, a billion there, and pretty soon you're talking real money.[33] In the case of our rent-seeking corporations, it's more like $50 billion here, $50 billion there, and pretty soon you're talking very big money.

When competition is very restricted, the real effect of competition is often waste, as the competitors fight over who gets to exploit the consumer. Accordingly, high profits are not the only sign of rent seeking. Indeed, distorted, oligopolistic competition among firms can even lead to dissipation of rents, but not economic efficiency; when profits (above a normal return) are driven to or near zero (or to where the return on capital is normal), it is not necessarily evidence of an efficient economy. We see evidence of rent seeking in the high expenditures to recruit credit card or cell phone customers. Here the object becomes to exploit customers as much and as fast as possible, with fees and charges that are neither understandable nor predictable. Companies work hard to make it difficult to compare the costs of using, say, one credit card versus another because to do so would enhance competition, and competition would erode profits.

American businesses, too, have to pay much more to the credit card companies than do businesses in other countries that have managed to curb some of the anticompetitive practices—and the higher costs faced by businesses get passed on to American consumers, lowering standards of living.

The same holds for cell phones: Americans pay higher cell phone rates, and get poorer service, than people in countries that have succeeded in creating a more truly competitive marketplace.

Sometimes the distortions of the rent seekers are subtle, not well captured in the diminution of GDP. This is because GDP doesn't adequately capture costs to the environment. It doesn't assess the sustainability of the growth that is occurring. When GDP arises from taking resources out of the ground, we should make note that the country's wealth is diminished, unless that wealth is reinvested above ground in human or physical capital. But our metrics don't do that. Growth that arises from depleting fish stocks or groundwater is ephemeral, but our metrics don't tell us that. Our price system is flawed, because it doesn't reflect accurately the scarcity of many of these environmental resources. And since GDP is based on market prices, our GDP metrics are also flawed.

Industries like coal and oil want to keep it that way. They don't want the scarcity of natural resources or the damage to our environment to be priced, and they don't want our GDP metrics to be adjusted to reflect sustainability. Not charging them for the costs they impose on the environment is, in effect, a hidden subsidy, little different from the other gifts the industry receives in favorable tax treatment and acquiring resources at below fair market prices.

When I was chair of the Council of Economic Advisers under President Clinton, I tried to have the United States issue a "Green GDP account," which would reflect the depletion of our resources and the degradation of our environment. But the coal industry knew what it would mean—and it used its enormous influence in Congress to threaten to cut off funding for those engaged in this attempt to define Green GDP, and not just for this project.

When the oil industry pushes for more offshore drilling and simultaneously pushes for laws that free companies from the full consequences of an oil spill, it is, in effect, asking for a public subsidy. And such subsidies do more than provide rents; they also distort resource allocations. GDP, and more broadly, societal welfare, is diminished—as was made so evident by the 2010 BP oil spill in the Gulf of Mexico. Because the oil and coal companies that use their money to influence environmental regulation, we live in a world with more air and water pollution, in an environment that is less attractive and less healthy, than would otherwise be the case. The costs show up as lower standards of living for ordinary Americans, the benefits as higher profits for the oil and coal companies. Again, there is a misalignment between social returns (which may in fact be negative, as a result of the lowering of our standard of living in the wake of environmental deterioration) and private rewards (which are often huge).[34]

As we explained in the last two chapters, one objective of rent seekers is to shape laws and regulations to their benefit. To do that, you need lawyers. If it can be said that America has a government of the 1 percent, by the 1 percent, and for the 1 percent, it can be said with even more conviction that America has a government of the lawyers, by the lawyers, and for the lawyers. Twenty-six of America's forty-four presidents have been lawyers, and 36 percent of the legislators in the House have a background in law. Even if they are not narrowly pursuing what is in the financial interests of lawyers, they may be "cognitively captured."

The legal framework is *supposed* to make our economy more efficient by providing incentives for individuals and firms not to behave badly. But we have designed a legal system that is an arms race: the two protagonists work hard to out-lawyer each other, which is to say outspend each other, since good and clever lawyers are expensive. The outcome is often determined less by the merits of the case or issue than by the depth of the pockets. In the process, there is massive distortion of resources, not just in the litigation but in actions taken to affect the outcome of litigation and to prevent litigation in the first place.

The macroeconomic effect of America's litigious society was suggested by some studies that showed that countries with fewer lawyers (relative to their population) grew faster.[35] Other research suggests that the main channel through which a high proportion of lawyers in a society hurts the economy is the diversion of talent away from more innovative activities (like engineering and science), a finding consistent with our earlier discussion of finance.[36]

But I should be clear: given the success of the financial sector and corporations more generally in stripping away the regulations that protect ordinary citizens, the legal system is often the only source of protection that poor and middle-class Americans have. But instead of a system with high social cohesion, high levels of social responsibility, and good regulations protecting our environment, workers, and consumers, we maintain a very expensive system of *ex post accountability*, which to too large an extent relies on penalties for those that do injury (say, to the environment) *after the fact* rather than restricting action *before the damage is done.*[37]

Corporations successfully beat back regulations in their battle with the rest of society, but have met their match with the lawyers. Both groups spend heavily on lobbying to ensure that they can continue their rent-extracting activities. In the course of this arms race, a balance appears to have been struck—there are at least some countervailing powers checking the behavior of corporations. While the balance is better than what would emerge if, say, the corporations wrote their own rules—where the victims of their actions would have no recourse—the current system is still enormously costly to our society.

The 1 percent that shapes our politics not only distorts our economy by not doing what it should, in aligning private and social incentives, but also by encouraging it to do what it shouldn't. The recurrent bank bailouts, which encourage banks to engage in excessive risk taking,[38] offer the most obvious example. But many argue that even more costly are the distortions in foreign policy. More persuasive as an explanation of the Iraq War than Bush's avowed determination to eliminate one dictator was the attraction of Iraqi oil (and perhaps the huge profits that would accrue to Bush devotees, including Vice President Richard Cheney's Halliburton Corporation).[39]

While those at the top may disproportionately be among the beneficiaries of war, they bear disproportionately less of the cost. Members of the top 1 percent rarely serve in the military—the reality is that the all-volunteer army does not pay enough to attract their sons and daughters. The wealthiest class feels no pinch from higher taxes when the nation goes to war: borrowed money pays for it,[40] and if budgets get tight, middle-class tax benefits and social programs are given the ax, not the preferential tax treatment and manifold loopholes for the rich.

Foreign policy is, by definition, about the balancing of national interests and national resources. With the top 1 percent in charge and paying no price for wars, the notion of balance and restraint goes out the window. There is no limit to the adventures we can undertake; corporations and contractors stand only to gain. At the local level around the world, contractors love roads and buildings, from which they can benefit enormously, especially if they make the right political contributions. For U.S. contractors, the military has provided a bonanza beyond imagination.

Efficiency wage theory and alienation

A central theme of this chapter is that much of the inequality in our society arises because private rewards differ from social returns, and that the high level of inequality that now characterizes the United States, and the *widespread acceptance* of that level of inequality (despite the encouraging signs from the Occupy Wall Street movement), makes it difficult in the United States to adopt good policies. Policy failures include those in macroeconomic stabilization, industry deregulation, and underinvestment in infrastructure, public education, social protection, and research.

We now consider an altogether different reason why the high inequality makes for a less efficient and productive economy than we could otherwise achieve. People are not like machines. They have to be motivated to work hard. If they feel that they are being treated unfairly, it can be hard to motivate them. This is one of the central tenets of modern labor economics, encapsulated in the efficiency wage theory, which argues that how firms treat their workers—including how much they pay them—affects productivity. It was, in fact, a theory elaborated nearly a century ago by Alfred Marshall, the great economist who wrote in 1895 that "highly paid labour is generally efficient and therefore not dear labour," though he admitted that "a fact which, though it is more full of hope for the future of the human race than any other that is known to us, will be found to exercise a very complicating influence on the theory of distribution."[41]

The revival of this theory began in development economics, where theorists recognized that malnourished workers are less productive.[42] But the insight applies as well to more advanced industrial countries, as America discovered in World War II when it found that many recruits were sufficiently malnourished that it might impair their effectiveness in the military. Education scholars have shown that hunger and inadequate nutrition impede learning.[43] That's why school lunch programs are so important. With one of seven Americans facing food insecurity, many poor American children also face impaired learning.

In a modern economy, efficiency is affected not so much by malnutrition as by a host of other factors. The immiseration of the bottom and the middle of the population has forced upon them a host of anxieties: Will they lose their home? Will they be able to give their children an education that will allow them to succeed in life? How will the parents survive in retirement? The more energy that is focused on these anxieties, the less energy there is for productivity at the workplace.

The economist Sendhil Mullainathan and psychologist Eldar Shafir have found evidence from experiments that living under scarcity often leads to choices that exacerbate the conditions of scarcity: "The poor borrow at great cost and stay poor. The busy [the time-poor] postpone when they have little time only to become busier."[44] Results of a very simple survey illustrate the cognitive resources that the poor expend for day-to-day survival and that the better-off do not. In the survey, individuals who have just exited a grocery store are asked what they had spent in total at the store and what the price of a few of the items in their shopping bags were. The poor typically could answer these questions precisely, whereas the nonpoor often did not know. An individual's cognitive resources are limited. The stress of not having enough money to meet urgent needs may actually impair the ability to take decisions that would help alleviate the situation. The limited stock of cognitive resources is depleted and this can lead people to make irrational decisions.

Stress and anxiety can also impair the acquisition of new skills and knowledge. If that learning is impaired, productivity increases will be slower, and this bodes ill for the long-run performance of the economy.

Equally important in motivating workers is their sense that they are being fairly treated. While it is not always clear what is fair, and people's judgments of fairness can be biased by their self-interest, there is a growing sense that the present disparity in wages is unfair. When executives argue that wages have to be reduced or that there have to be layoffs in order for corporations to compete, but simultaneously increase their own pay, workers rightly consider that what is going on is unfair. That will affect both their effort today, their loyalty to the firm, their willingness to cooperate with others, and their willingness to invest in its future. As any firm knows, a happier worker is a more productive worker; and a worker who believes that a firm is paying senior employees too much relative to what everyone else receives is not likely to be a happy worker.[45]

A detailed case study by Krueger and Mas of the plants that manufactured Bridgestone/Firestone tires provides a particularly chilling illustration. After a profitable year management demanded moving from an eight-hour to a twelve-hour shift, which would rotate between days and nights, and cutting pay for new hires by 30 percent. The demand created the conditions that led to the production of many defective tires. Defective tires were related to over one thousand fatalities and injuries until the recall of Firestone tires in 2000.[46]

In Russia under communism, the widespread sense by workers that they were not being adequately paid played a major role in the collapse of their economy. As the old Russian adage had it, “They pretended to pay us, and we pretended to work.”

Recent experiments in economics have confirmed the importance of fairness. One experiment showed that raising wages of workers who felt that they were being treated unfairly had a substantial effect on productivity—and no effect on those who felt they were being treated fairly. Or take another situation, involving a group of workers performing a similar job. One might have expected that increasing the wages of some and lowering that of others would increase productivity of the higher-wage worker, and lower that of the lower-wage workers in offsetting ways. But economic theory—confirmed by the experiments—holds that the decrease in productivity of the low-wage worker is greater than the increase in productivity of the high-wage worker, so total productivity diminishes.[47]

Consumerism

We have described how inequality adversely affects the economy’s growth and efficiency—and societal well-being, in both the short and the long run—through a variety of what might be viewed as *economic* mechanisms, reinforced and shaped by politics and public policy. But there are deeper, distorting effects of inequality on our society. Trickle-down economics may be a chimera, but trickle-down behaviorism is very real. People below the top 1 percent increasingly aspire to imitate those above them. Of course, for those at the very bottom, living like the wealthiest 1 percent is unimaginable. But for those in the second percentile, the 1 percent provides an aspiration, for those in the third percentile, the second percentile provides an aspiration, and so on down the line.

Economists talk about the importance of “relative income” and relative deprivation. What matters (for an individual’s sense of well-being, for instance) is not just an individual’s absolute income, but his income relative to that of others.[48] The importance of relative income in developed countries is so great that it is a completely unsettled question among economists whether there is *any* long-run relationship between GDP growth and subjective well-being in those countries.[49] Individuals’ concerns with their consumption relative to that of others—the problem of “keeping up with the Joneses”—helps explain why so many Americans live beyond their means—and why so many work so hard and so long.

Many years ago Keynes posed a question. For thousands of years, most people had to spend most of their time working just to survive—for food, clothing, and shelter. Then, beginning with the Industrial Revolution, unprecedented increases in productivity meant that more and more individuals could be freed from the chains of subsistence living. For increasingly large portions of the population, only a small fraction of their time was required to provide for the necessities of life. The question was, How would people spend the productivity dividend?[50]

The answer was not obvious. They could decide to enjoy more and more leisure, or they could decide to enjoy more and more goods. Economic theory provides no clear prediction, though one might have assumed that reasonable people would have decided to enjoy both more goods and more leisure. That is what happened in Europe. But America took a different turn—less leisure (per household, as women joined the labor force) and more and more goods.

America's high inequality—and individuals' sensitivity to others' consumption—may provide an explanation. It may be that we are working more to maintain our consumption relative to others, and that this is a rat race, which is individually rational but futile in terms of the goal that it sets for itself. Adam Smith pointed out that possibility 250 years ago: in "this general scramble for preeminence, when some get up, others must necessarily fall undermost."[51] While there is no "right" answer to Keynes's question according to standard economic theory, there is something disturbing about America's answer.[52] Individuals say they are working so hard *for the family,* but as they work so hard there is less and less time for the family, and family life deteriorates. Somehow, the means prove inconsistent with the stated end.

The Alleged Inequality Efficiency Trade-Off

In the previous pages, I explained how inequality—in all of its dimensions—has been bad for our economy. As we saw in earlier chapters, there is also a counternarrative, advanced primarily by those on the political right, which focuses on incentives. In this view incentives are essential for making an economy work, and inequality is the inevitable consequence of any incentive system, since some will produce more than others. Any program of redistribution will accordingly necessarily attenuate incentives. Proponents of this view argue, too, that it is wrong to fixate on the inequality of outcomes, particularly in any single year. What matters is lifetime inequality, and what matters even more is opportunity. They then maintain that there is a trade-off between efficiency and equality. While different people may differ in how much efficiency one would be willing to give up to get more equality, in the view of the Right the price we have to pay for any more equality in America is just too great. Indeed, it's so high that even the middle and the bottom, especially those who depend on government programs, would likely suffer; with a weaker economy, incomes for all would be down, tax revenues would be lower, and government programs would have to be cut.

We have argued in this chapter, to the contrary, that we could have a more efficient and productive economy with more equality. In this section, I recap the essential points of divergence: The Right has in mind a perfectly competitive economy with private rewards equal to social returns; we see an economy marked by rent seeking and other distortions. The Right underestimates the need for public (collective) action, to correct pervasive market failures. It overestimates the importance of financial incentives. And, as a result of all of these mistakes, the Right overestimates the costs and underestimates the benefits of progressive taxation.

Rent seeking and the inequality/efficiency trade-off

A central thesis of this book is that rent seeking is pervasive in the American economy, and that it actually impairs overall economic efficiency. The large gaps between private rewards and social returns that characterize a rent-seeking economy mean that incentives that individuals face often misdirect their actions, and that those who receive high rewards are not necessarily those who have made the largest contributions. In those instances where private rewards of those at the top exceed by a considerable amount their marginal social contribution, redistribution could both reduce inequality and increase efficiency.[53]

Making markets work better, by aligning the two and reducing the scope for rent seeking, and by correcting other market failures, whose effects are especially hard felt at the bottom and in the middle, would also simultaneously reduce inequality and increase efficiency—just the opposite of what the Right contends.

Market failures and the inequality/efficiency trade-off

The Right has underestimated the importance of other imperfections in our economy: if capital markets were perfect, then each individual would be able to invest in himself up to the point where additional returns equal the cost of capital. But capital markets are far from perfect. Individuals do not have easy access to capital and cannot divest themselves of risk.

A lack of wealth restricts families' opportunities to be productive in a variety of ways. It reduces their ability to invest in their children, to become homeowners and thereby participate in the financial rewards of improving their neighborhoods, and to offer collateral that can credibly show lenders that the uses to which they will put borrowed funds are sound—which is useful for obtaining bank credit on affordable terms.

Wealth in the form of collateral plays a kind of catalytic role rather than a role of input that gets used up in the process of producing output.[54] The most important consequence of these imperfections is that in a world in which many families have little or no wealth, and in which only limited educational opportunity is provided by the government, there is underinvestment in human capital.

The result is that, especially without a good public education system, parental wealth (education, income) will be a primary determinant of that of their children. It is not a surprise, then, that America, with its high level of wealth and income inequality, is also a society with a lack of equality of opportunity, as we saw in chapter 1. Increasing equality and equality of opportunity, by the same token, would enhance the nation's productivity.

There is still another reason why the alleged inequality/inefficiency trade-off may not exist. Risk markets—giving individuals the ability to buy insurance in the private market against the important risks that individuals face, like unemployment—are imperfect and absent; that imposes a huge burden on those with limited resources. Because risk markets are imperfect, in the absence of social protection, individual welfare is lower—and the willingness to undertake high-return and high-risk ventures is lower. Providing better social protection can help create a more dynamic economy.

The adverse effects of so-called incentive pay

The Right, like many economists, tends to overestimate the benefits and underestimate the costs of incentive pay. There are certainly contexts in which monetary prizes have the potential to focus minds on a thorny problem and deliver a solution. A famous example is detailed in Dava Sobel's *Longitude: The True Story of a Lone Genius Who Solved the Greatest Scientific Problem of His Time.* As she reports, in the Longitude Act of 1714, the British Parliament set "a prize equal to a king's ransom (several million dollars in today's currency) for a 'Practicable and Useful' means of determining longitude." This was critical to the success of transoceanic navigation. John Harrison, a watchmaker with no formal education but a mechanical genius, devoted his life to this quest and ultimately claimed the prize in 1773.[55] However, it is a great leap from the power of monetary incentives to focus minds on a great quest to the idea that monetary incentives are the key to high performance in general.

The absurdity of incentive pay in some contexts is made clear by thinking of how it might apply to medical doctors. Is it conceivable that a doctor performing heart surgery would exert more care or effort if his pay depended on whether the patient survived the surgery or if the heart valve surgery lasts for more than five years? Doctors work to make sure each surgery is their absolute best, for reasons that have little to do with money. Interestingly, in some areas we recognize the dangers of incentive pay: expert witnesses in litigation are not allowed to be paid contingent on the outcome of the case.

Because financial incentive systems can never be perfectly designed, they often lead to distorted behavior, an overemphasis on quantity and an underemphasis on quality.[56] As a result, in most sectors of the economy simplistic (and distorting) incentive schemes like those used in finance and those provided to CEOs are not used. Instead, assessments take into account performance relative to others in a similar position; there is an evaluation of long-term performance and potential. Rewards often take the form of promotions. But it is assumed, especially for higher-level jobs, that employees will do their best and not hold back, even in the absence of "incentive pay."[57]

Incentive pay, especially as it was implemented in the financial sector, illustrates how distorting such compensation can be: the bankers had an incentive to engage in excessive risk taking, shortsighted behavior, and deceptive and nontransparent accounting.[58] In good years the bankers could walk off with a large fraction of the profits; in bad years the shareholders were left with the losses; and in really bad years so were the bondholders and taxpayers. It was a one-sided pay system: heads the bankers won, tails everyone else lost.

Even if the bankers' pay system had made sense before the Great Recession, it didn't afterward, when the banks were put on life-support systems provided by the public. I described earlier how the government essentially gave them blank checks—lending them money at near-zero interest rates that they could "invest" in bonds paying much higher returns. As one banker friend put it to me, anyone, even his twelve-year-old son, could have made a fortune if the government had been willing to lend money to him at those terms. But the bankers treated the resulting profits as if they were a result of their genius, fully deserving of the same compensation to which they had become accustomed.

But while the bankers' compensation schemes demonstrated some of what was wrong with the so-called incentive pay systems, the problems were more pervasive. Stock options were as one-sided as bankers' compensation—executives did well when things went well, but didn't suffer commensurately when stocks went down. But stock options also encouraged dishonest accounting that made it seem that the company was doing well, so the stock price would go up.

Part of the creatively dishonest accounting involved accounting for the stock options themselves, so shareholders wouldn't know how much the value of their shares was being diluted by newly issued options. When the Financial Accounting Standards Board (the nominally independent board that sets accounting standards), supported by the Securities and Exchange Commission and the Council of Economic Advisers, tried to force companies to provide honest accounting of what they were giving their executives, the CEOs replied with a vehemence that demonstrated their commitment to deception. The proposed reforms didn't require firms to do away with stock options, but only to reveal what was being given to their executives in a way that their shareholders could easily grasp. We wanted to make markets work better, by having better information.

It is because accounting standards affect how markets perceive firms' future prospects, and because firms want standards that make them look good—leading to a higher stock price, at least in the short run—that we created an independent board to set these standards. But then corporations used their trump card—their political influence—as senior government officials weighed in, in a process that is *supposed to be independent and nonpolitical*, to maintain the deception.[59] The pressure worked.

Indeed, if one were really interested in incentives—and not in deception—one would have designed a quite different compensation system. Stock option incentive pay rewarded executives when there was a stock market boom for which they could fairly claim no credit. It also gave CEOs a big bonus whenever the price of what they sold soared or the price of a critical input fell—regardless of whether there was anything they had done to bring these price changes about. Fuel costs are critical for airlines, meaning that airline CEOs got a bonus anytime the price of oil fell. A good incentive system might base pay on how the company performs relative to others in the industry, but few firms do this. That's testimony either to their lack of understanding of incentives or to their lack of interest in having a reward structure that is related to performance, or to both.[60]

The lack of well-designed compensation schemes, such as one based on relative performance, compared to a group of comparable peers, reflects *another* market failure, to which we called attention in the last chapter: deficiencies in corporate governance that provide scope for executives to do what is in their interests—including adopting compensation systems that enrich themselves—rather than in the interests of society, or even of shareholders.

The criticisms of incentive pay that I have discussed so far are well within the confines of traditional economic analysis. But incentives are about *motivating* people, for instance, to work hard. Psychologists, labor economists, and other social scientists have studied closely what motivates people, and it appears that, at least in many circumstances, economists have gotten it all wrong.

Individuals can often be better motivated by intrinsic rewards—by the satisfaction of doing a job well—than by extrinsic rewards (money). To take one example, the scientists whose research and ideas have transformed our lives in the past two hundred years have, for the most part, not been motivated by the pursuit of wealth. This is fortunate, for if they had, they would have become bankers and not scientists. It is the pursuit of truth, the pleasure of using their minds, the sense of achievement from discovery—and the recognition of their peers—that matters most.[61] Of course, that doesn't mean that they will turn down money if it's given to them. And, as we noted earlier, an individual preoccupied with where his and his family's next meal will come from will be too distracted to do good research.

In some circumstances, a focus on extrinsic rewards (money) can actually diminish effort. Most (or at least many) teachers enter their profession not because of the money but because of their love for children and their dedication to teaching. The best teachers could have earned far higher incomes if they had gone into banking. It is almost insulting to assume that they are not doing what they can to help their students learn, and that by paying them an extra $500 or $1,500, they would exert greater effort. Indeed, incentive pay can be corrosive: it reminds teachers of how bad their pay is, and those who are led thereby to focus on money may be induced to find a better-paying job, leaving behind only those for whom teaching is the only alternative. (Of course, if teachers perceive themselves to be badly paid, that will undermine morale, and that will have adverse incentive effects.)

An often told story provides another example: a cooperative day center had a problem with certain parents' picking up their children in a timely way. It decided to impose a charge, to provide an incentive for them to do so. But many parents, including those who had occasionally been late, had struggled to pick up their children on time; they did as well as they did because of the social pressure, the desire to do the "right thing," even if they were less than fully successful. But charging a fee converted a social obligation into a monetary transaction. Parents no longer felt a social responsibility, but assessed whether the benefits of being late were greater or less than the fine. Lateness increased.[62]

There is another defect of standard incentive pay compensation schemes. In business school we emphasize the importance of teamwork. Most employers recognize that teamwork is absolutely essential for the success of the company. The problem is that *individual* incentives can undermine this kind of teamwork. There can be destructive as well as constructive competition.[63] By contrast, cooperation can be facilitated by pay that depends on "team performance."[64] Ironically, standard economic theory always disparaged such reward systems, arguing that individuals would have no incentives, because typically the impact of each individual's efforts on team performance (if the team is of even moderate size) is negligible.

The reason that economic theory failed to gauge accurately the effectiveness of team incentives is that it underestimated the importance of personal connectiveness.[65] Individuals work hard to please others in their team—and because they believe it is the right thing to do. Economists overestimate, too, the selfishness of individuals (though there is considerable evidence that economists are more selfish than others, and that economics training does make individuals more selfish over time).[66] It is thus perhaps not surprising that firms owned by their workers—and who therefore share in the profits—have performed better in the crisis and laid off fewer employees.[67]

The blinders in economic theories in this arena are related to a broader deficiency in the field. The prevailing approach to behavior in standard economic theory focuses on rational *individualism*. Each individual assesses everything from a perspective that pays no attention to what others do, how much they get paid, or how they are treated. Human emotions such as envy, jealousy, or a sense of fair play do not exist or, if they do, have no role in *economic* behavior; and if they do appear, they shouldn't. Economic analysis should proceed as if they did not exist. To noneconomists, this approach seems nonsensical—and to me, it does too. I have explained, for instance, how individuals may decrease effort if they feel they are being unfairly treated, and how team spirit can spur them on. But this individual-centered, bottom-line economics, tailor-made for America's short-term financial markets, is undermining trust and loyalty in our economy.

In short, contrary to the assertion of the Right that incentive pay is *necessary* to the country's maintaining its high level of productivity, the kinds of incentive pay schemes employed by many corporations, while they create more inequality, are actually counterproductive.

Overestimating the costs, and underestimating the

benefits, of more-progressive taxation

The Right has not only underestimated the costs of inequality and ignored the benefits that we have described in eliminating the market distortions that give rise to it. It has also overestimated the costs of correcting inequality through progressive taxation, and underestimated the benefits of public spending.

We observed in the last chapter that President Reagan, for instance, claimed that by making the tax system less progressive—lowering taxes at the top—one would actually raise more money, because savings and work would increase. He was wrong: tax revenues fell significantly. President Bush's tax cuts fared no better; they, like those of Reagan, simply increased the deficit. President Clinton raised taxes at the top, and America experienced a period of rapid growth and a slight diminution in inequality. Of course, the Right is right in noting that if marginal tax rates were near 100 percent tax rates, incentives would be significantly weakened, but these examples show that we're nowhere near the point where this should be of concern. Indeed, University of California professor Emmanuel Saez, Thomas Piketty of the Paris School of Economics, and Stefanie Stantcheva of the MIT Department of Economics, carefully taking into account the incentive effects of higher taxation and the societal benefits of reducing inequality, have estimated that the tax rate at the top should be around 70 percent—what it was before President Reagan started his campaign for the rich.[68]

But even these calculations do not fully reflect, I believe, the benefit from more-progressive taxation, for three reasons. First, we noted earlier that increasing fairness (and the perception of fairness) increases productivity, and in keeping with most economic analyses, those calculations ignored this.

Second, the sense that our economic and political system is unfair undermines trust, which is essential for the functioning of our society. In the next chapter, we'll explain in greater detail how inequality and the way in which it has arisen in the United States has undermined trust, and how the weakening of trust weakens our economy and our democracy. A more-progressive tax system might contribute a little to a restoration in confidence that our system is, after all, fair. That could have enormous societal benefits, including to our economy.

Third, as we noted in the last chapter, much of the lack of progressivity—the low rates faced by those at the top, including the presidential candidate Mitt Romney—comes from special provisions of the tax code, like the low rates on capital gains taxation, the broad definition of capital gains,[69] and loopholes in both corporate and individual income taxes. These distort the economy, lowering productivity. As we commented, one of the reasons that so many of our corporations pay so little is that they are not taxed on income of foreign subsidiaries until they bring it home, a provision of the tax code that encourages these firms to invest abroad rather than in the United States. Eliminating these provisions would both increase progressivity and strengthen the U.S. economy.

Moreover, to the extent that incomes at the top arise from rents and to the extent that it is possible to target these rents, again one can have a more-progressive tax system without any adverse effects on incentives.

The fact that tax cuts for the rich have increased the deficit and the national debt substantially has another effect: it has created pressure to reduce government support for investments in education, technology, and infrastructure. The Right has underestimated the importance of these public investments, which not only can yield high returns directly but provide the basis of high-return private-sector investment. Earlier I mentioned the contribution that government investments in research and technology had made (including the first telegraph line that spanned North America in the nineteenth century, and the creation of the Internet and the foundations of the first browser in the twentieth). Recent research has shown that the years before World War II were years of high productivity increase, which set the stage for even more productivity increases in subsequent years. Among the reasons for this is government investment in roads (which interestingly played an important role in increasing productivity in railroads).[70] Such public investments can be financed sustainably only through taxation, and given the level of inequality, what is required is well-designed progressive taxation that can be less distortionary than regressive taxation. A corporate CEO will not exert less effort to make the company work well simply because his take-home pay is $10 million a year rather than $12 million. In any case, the possible loss of effort in socially productive activities from taxing the few in the top 1 percent—which, because of the huge inequality in our society, raises large amounts of money—pales in comparison with the effects on the many more numerous who would have to face higher tax rates to raise the same amount of money.[71]

Concluding comments

Some of the adverse effects of inequality might be smaller if those who are poor today were rich tomorrow, or if there were true equality of opportunity. As the Occupy Wall Street movement drew attention to the growing inequality, the response of the Right was to say, almost proudly, that unlike the Democrats, who believe in equality of outcomes, they were committed to equality of opportunity. According to Paul Ryan, the Wisconsin Republican who heads the House Budget Committee, responsible for making the critical budgetary decisions affecting the country's future, a central difference between the parties is "[w]hether we are a nation that still believes in equality of opportunity, or whether we are moving away from that, and towards an insistence on equality of outcome."[72] He went on to say, "Let's not focus on redistribution; let's focus on upward mobility."

There are two factual problems with this perspective. First, it suggests that while we are failing in equality of outcomes, we are succeeding in equality of opportunity. Chapter 1 showed that that was not true. The quip of Jonathan Chait seems to fit here: "The facts shouldn't get in the way of a pleasant fantasy."[73]

The second factual problem is the claim that the progressive perspective argues for equality of outcome. As Chait expressed it, the reality is that the Democrats are not arguing for equality of outcome, only for policies "that leave in place skyrocketing inequality of income, just ever so slightly ameliorated by government."[74]

Perhaps the most essential point is this: no one succeeds on his own. There are plenty of bright, hardworking, energetic people in developing countries who remain poor—not because they lack abilities or are not making sufficient effort, but because they work in economies that don't function well. Americans all benefit from the physical and institutional infrastructure that has developed from the country's collective efforts over generations. What's worrying is that those in the 1 percent, in attempting to claim for themselves an unjust proportion of the benefits of this system, may be willing to destroy the system itself to hold on to what they have.

This chapter has explained that we are paying a high price for the inequality that is increasingly scarring our economy—lower productivity, lower efficiency, lower growth, more instability—and that the benefits of reducing this inequality, at least from the current high levels, far outweigh any costs that might be imposed. We have identified numerous channels through which the adverse effects of inequality operate. The bottom line, though, that higher inequality is associated with lower growth—controlling for all other relevant factors—has been verified by looking at a range of countries and looking over longer periods of time.[75]

Of all the costs imposed on our society by the top 1 percent, perhaps the greatest is this: the erosion of our sense of identity in which fair play, equality of opportunity, and a sense of community are so important. America has long prided itself on being a fair society, where everyone has an equal chance of getting ahead, but the statistics today, as we've seen, suggest otherwise: the chances that a poor or even a middle-class American will make it to the top in America are smaller than in many countries of Europe. And as inequality itself creates a weaker economy, the chance can only grow slimmer.

There is another cost of America's inequality, beyond this loss of a sense of identity and beyond the way it is weakening our economy: our democracy is being put at peril, a subject to which we turn in the next two chapters.

Chapter Five

A DEMOCRACY IN PERIL

WE HAVE SEEN HOW AMERICA'S CURRENT INEQUALITY, and that of many other countries, did not arise spontaneously from abstract market forces but was shaped and enhanced by politics. Politics is the battleground for fights over how to divide nation's economic pie. It is a battle that the 1 percent have been winning. That isn't how it's supposed to be in a democracy. In a system of one person one vote, 100 percent of the people are supposed to count. Modern political and economic theory predicted that the outcomes of electoral processes with one person having one vote would reflect the views of the average citizen—not that of the elites. More precisely, standard theory, based on individuals with well-defined preferences who are voting in their self-interest, predicts that the outcome of democratic elections would reflect the views of the "median" voter—the person in the middle. In the case of public expenditures, for instance, it says that half would want more spending and half less.[1] But polls consistently show that there are large discrepancies between what most voters want and what the political system delivers.

In the aftermath of the Great Recession there is disillusionment not only with the global economic system but also with how the political systems in many Western democracies have been working. This disillusionment found expression in the Occupy Wall Street and *indignado* movements around the world. That there are major failures in our economic system is obvious; but it is equally evident that the American political system has not even begun to fix them. Most Americans don't think the new financial regulations (Dodd-Frank) went far enough, and they're right. Even before the crisis, there was an awareness of widespread predatory lending practices. It was in the interests of most Americans to curb those as well as the abusive credit card practices. But that didn't happen. The federal government has done little to prosecute banks that violated the law—as we will see in chapter 7, much less than it did in the much less serious Savings and Loan crisis two decades ago. The *New York Times* has described how the Securities and Exchange Commission, which is supposed to protect investors from fraud, "has repeatedly allowed the biggest firms to avoid punishments specifically meant to apply to fraud cases."[2]

Why hasn't the middle had the political influence that standard theory predicts it should have, and why does our current system seem to operate on "one dollar" one vote instead of one person one vote? In earlier chapters, we saw how markets are shaped by politics: politics determines the rules of the economic game, and the playing field is slanted in favor of the 1 percent. At least part of the reason is that the rules of the political game, too, are shaped by the 1 percent.

This story has two critical elements. One, shaping individuals' perceptions—so that the 99 percent adopt the interests of the 1 percent as their own—is the focus of the next chapter. The current chapter focuses on the economics and politics of voting itself.

Undermining Democratic Political Processes

The voting paradox and voter disillusionment

One of the puzzles in modern political economy is why anyone votes at all. Very few elections actually turn on the vote of a single individual. There is a cost to voting—although no American state has an explicit charge for voting today, it takes time and effort to get to the voting booth. Registration can also be a burden, requiring planning well in advance of elections. People who live in sprawling Western cities with poor public transportation may be at a disadvantage for reaching their polling stations. People with limited mobility may find it difficult to get to the polling station even when it is nearby. For voters' troubles, there is little personal benefit. Indeed, it almost never happens that the individual's vote is pivotal, that is, makes any difference to the final outcome. Modern political and economic theories assume rational self-interested actors. On that basis, why anyone votes is a mystery.

The answer, of course, is that we've been indoctrinated with notions of "civic virtue." It is our responsibility to vote. Each individual contemplating not voting worries about what would happen if everyone acted like him: "If I and other like-minded people didn't vote, that would leave the outcome to be determined by others with whom I disagree."

Such civic virtue should not be taken for granted. If the belief takes hold that the political system is stacked, that it's unfair, individuals will feel released from the obligations of civic virtue. When the social contract is abrogated, when trust between a government and its citizens fails, disillusionment, disengagement, or worse follows.[3] In the United States today, and in many other democracies around the world, mistrust is ascendant.[4]

The irony is that the wealthy who seek to manipulate the political system for their own ends welcome such an outcome. Those who turn out to vote are those who see the political system working, or at least working for them. So if the political system works systematically in favor of those at the top, it is they who (disproportionately) are induced to engage in politics, and inevitably the system serves best those whose voices are heard.

Moreover, if voters have to be *induced* to vote because they are disillusioned, it becomes expensive to turn out the vote; the more disillusioned they are, the more it costs. But the more money that is required, the more power that the moneyed interests wield. For those with money, spending it to shape the political process is not a matter of civic virtue; it is an investment, from which they demand (and get) a return. It is only natural that they end up shaping the political process *in their interests*. That, in turn, increases the sense of disillusionment that pervades the rest of the electorate and boosts the power of money further.

Lowering trust

I have emphasized how the country has to act together, cooperatively, if the country's problems are to be solved. Government is the formal institution through which we act together, collectively, to solve the nation's problems. Inevitably, individuals will differ in their views of what should be done. That's one of the reasons that collective action is so difficult. There needs to be compromise, and compromise has to be based on trust: one group gives in today, in the understanding that another does in another year. There must be trust that all will be treated fairly, and if matters turn out differently from how the proponents of a measure claim it will, there will be change to accommodate the unexpected circumstances.

But it's easier to act together if the interests and perspectives of the members of a group are at least loosely aligned; if everyone is, as it were, in the same boat. But it is evident that the 1 percent and the rest are not in the same boat.

Cooperation and trust are important in every sphere of society. We often underestimate the role of trust in making our economy work or the importance of the social contract that binds us together. If every business contract had to be enforced by one party's taking the other to court, our economy, and not just our politics, would be in gridlock. The legal system enforces certain aspects of "good behavior," but most good behavior is voluntary. Our system couldn't function otherwise. If we littered every time we could get away with it, our streets would be filthy, or we would have to spend an inordinate amount on policing to keep them clean. If individuals cheated on every contract—so long as they could get away with it—life would be unpleasant and economic dealings would be fractious.

Throughout history the economies that have flourished are those where a man's word is his honor, where a handshake is a deal.[5] Without trust, business deals based on an understanding that the complex details will be worked out later are no longer feasible. Without trust, each participant in a deal looks around to see how and when those with whom he is dealing will betray him. To protect against these outcomes, individuals spend energy and resources obtaining insurance, making contingency plans, and taking actions to ensure that, should they be "betrayed," the consequences are limited.

Some social scientists try to account for the effect of "trust" on the overall economy by referring to social capital. An economy with more "social capital" is more productive, just like an economy with more human or physical capital. Social capital is a broad concept that includes those factors that contribute to good governance in both the public and the private sectors. But the idea of trust underlies all notions of social capital; people can feel confident that they will be treated well, with dignity, fairly. And they reciprocate.

Social capital is the glue that holds societies together. If individuals believe the economic and political system is unfair, the glue doesn't work and societies don't function well. As I've traveled around the world, partly in my job as chief economist of the World Bank, I've seen instances where social capital has been strong and societies have worked together. I've also seen instances where social cohesion has been destroyed and societies have become dysfunctional.

Bhutan, the remote Himalayan state to the northeast of India, for instance, is protecting its forests as part of a broader commitment to the environment. Each family is allowed to cut down a fixed number of trees for its own use. In this sparsely populated country, I asked, how could one enforce such an edict? The answer was simple and straightforward: in our jargon, social capital. The Bhutanese have internalized what is "right" when it comes to the environment. It would be wrong to cheat, and so they don't.

Communities that rely on irrigation—whether it's in the hills and mountains of Bali or in the Atacama Desert of northern Chile—have to work together to manage their water and to maintain the irrigation canals. These communities, too, seem to develop strong bonds, a strong sense of social capital, with little or no cheating on the "social contract."

At the other extreme, when I visited Uzbekistan after the fall of the Soviet empire, I saw the consequences of the erosion of social capital. Most greenhouses had no glass, making them totally ineffective. I was told that as Uzbek society and economy decayed, each family looked out for itself. The glass was stolen from the greenhouses. Nobody was sure what they would do with the stolen glass, but it provided some limited security, and they were sure that if they didn't steal it, somebody else would.

More generally, in the aftermath of the breakdown of the Soviet Union, Russia experienced a marked decline in output. This puzzled most economists. After all, there was the same physical, human, and natural capital after the breakdown that there had been before the crisis. Eliminating the old distortionary centralized planning system and replacing it with a market economy should have meant that those resources would, at last, be more efficiently used. But what the analysis failed to incorporate was how seventy-four years of Communist Party rule, along with the suppression of civil society institutions, had eroded social capital. The only thing that had held the country together was a central planning system and an oppressive dictatorship. When these institutions crumbled, the social capital required to hold the country and the economy together just wasn't there. Russia became the "Wild East," more lawless than America's Wild West before it was tamed. Russia was "caught up in a systemic vacuum with neither the plan nor the market."[6]

Recent advances in the study of social norms show that many or even a majority of people will abstain from an individually beneficial but socially harmful action if they perceive that most people do too. But the converse is also true. This has an important consequence: desirable behavior can quickly degrade when people are exposed to a sufficient number of "transgressions."[7]

In America there has been an enormous erosion of trust in recent years.[8] Within the economy the banking sector has been at the forefront of the trend. An entire industry that was once based on trust has lost it. Pick up the newspaper on a random day, and there will almost surely be more than one article describing some bank or someone from another part of the financial sector being accused or convicted of engaging in some fraud, aiding and abetting some tax evasion scheme, or participating in some credit card abuse, some insider trading, some mortgage scandal.

The head of Goldman Sachs, Lloyd Blankfein, made it perfectly clear: sophisticated investors don't, or at least shouldn't, rely on trust. Those who bought the products the banks sold were consenting adults who should have known better. They should have known that Goldman Sachs had the means, and the incentives, to design products that would fail, that they had the means and the incentives to create asymmetries of information—where they knew more about the products than the buyers did—and that they had the means and the incentives to take advantage of these asymmetries. Those who fell victim to the investment banks were, for the most part, well-off investors (though they included pension funds managing the money of ordinary citizens). But deceptive credit card practices and predatory lending have made every American understand that the banks are not to be trusted. One has to read the fine print—and even that won't be enough.

Shortsighted financial markets, focusing on quarterly returns, have also been central in undermining trust within the workplace. In *old* economics, most firms held on to their good workers through the ups and downs of the business cycle, and those workers returned the favor with loyalty and investment of human capital in the firm, to increase the firm's productivity. This was called "labor hoarding," and it made good economic sense.[9] But as markets became more shortsighted, such humane polices no longer seemed profitable. The extra profitability—from investments in human capital, from lower turnover costs, and from greater loyalty among workers—wouldn't be felt for years to come, especially if the downturn went on for some time. Sloughing off workers was relatively easy in America's flexible labor market, and that rendered them another disposable input. That helps explain one of the unusual aspects of the 2008 recession (and other recent downturns) that I discussed in the beginning of chapter 2. Under the old model, in an economic downturn, productivity would go down because so many workers were retained. Instead of going down at the bottom of the cycle, productivity now went up: all those good workers about whom the firm worried, wondering whether they should or should not be terminated, were given the ax. The task of restoring team spirit, loyalty, and human capital would be left to a future manager.[10]

More broadly, not only are workers happier in workplaces that treat them well—including during downturns—but productivity is enhanced.[11] The importance of a sense of well-being in the workplace should not be underestimated: most people spend a substantial fraction of their lifetime at the workplace, and what happens there spills over strongly into the rest of their lives.[12]

The breaking of the social bonds and trust—seen in our politics, in our financial sector, and in the workplace—will, inevitably, have broader societal consequences. Trust and reciprocal goodwill are necessary not only for the functioning of markets but also for every other aspect of societal cooperation. We have explained how the long-term success of any country requires social cohesion—a kind of social contract that binds members of society together. Experiences elsewhere have shown, however, the fragility of social cohesion. When the social contract gets broken, social cohesion quickly erodes.

Governments and societies make decisions—expressed through policies, laws, and budgetary choices—that either strengthen that contract or weaken it. By allowing inequality to metastasize unchecked, America is choosing a path of the destruction of social capital, if not social conflict.

As we have emphasized, the arena in which social cooperation is absolutely essential is politics, for it is here that collective decisions affecting all are taken. Of course, there are other ways of organizing life: police states provide rules and punishments for disobeying. It is a system of compliance based on “incentives”—the incentives of threats. But such societies typically do not function well. The enforcers cannot be everywhere to make good on the threats, and if there is a sense that the rules and regulations are unfair, there will be attempts at circumvention. It will be expensive to achieve compliance, and even then it will be only partial. Productivity will be low, and life will be unpleasant.

The democratic alternative entails trust and a social compact, an understanding of the responsibilities and rights of different individuals. We tell the truth because it is the *right* or *moral* thing to do—knowing the costs imposed on others of the breakdown of the system of trust. We’ve seen how the erosion of trust hurts the economy. But what is happening in the sphere of politics may be even worse: the breaking of the social contract may have even more invidious effects on the functioning of our democracy.

Fairness and disillusionment

To most Americans it is *obvious* that fairness is important. Indeed, one of the aspects of our society that Americans were most proud of was that our economic system was fair—it gave opportunity to everybody.

Recent research has illuminated just how important fairness is to most individuals (though economists continue to focus almost exclusively on efficiency). In a series of experiments initially conducted by three German economists, Werner Güth, Rolf Schmittberger, and Bernd Schwarze, a subject was given a certain amount of money, say $100, and was told to divide it between himself and the other player in the game.[13] In the first version, called the dictator game, the second player has to accept what he is given. Standard economic theory provides a clear prediction: the first player keeps all of the $100 for himself. Yet in practice, the first player gives the second *something*, though usually less than half.[14]

A related experiment gives even stronger evidence of the importance that individuals attach to fairness: most individuals would rather accept an inefficient outcome—even hurting themselves—than an unfair one. In what is known as the ultimatum game, the second player has the right to veto the division proposed by the first player. If the second player exercises his veto, neither party gets anything. Standard economic theory suggests a clear strategy: the first player keeps 99 dollars for himself, giving 1 dollar to the other player, who accepts it, because 1 dollar is better than zero. In fact, offers typically average about 30 to 40 dollars (or 30–40 percent of the total sum in a game with different quantities), and the second player tends to veto the allocation if he is offered less than 20 dollars.[15] He is willing to accept some inequity—he realizes he is in the less powerful position—but there is a limit to how much inequity he will stand for. He would rather have zero than, say, $20—a 4-to-1 split is too unfair.[16]

Perceptions of unfairness affect behavior. If individuals believe that their employer is treating them unfairly, they are more likely to shirk on the job.[17] In the last chapter, we described experimental results confirming the importance of perceptions of fairness to productivity.

But, as chapter 1 pointed out, America's economic system is, in a fundamental sense, no longer fair. Equality of opportunity is just a myth; and Americans are gradually realizing this. One poll showed that 61 percent of Americans now believe that our economic system favors the wealthy; only 36 percent—a little over one out of three Americans—think our system is generally fair.[18] (And, perhaps not surprisingly, by similar numbers, they think unfairness in the economic system that favors the wealthy is a more serious problem than overregulation.)[19]

Other research, comparing individuals' views about what a good distribution of income might look like with their *perceptions* of inequality in the United States confirms that most think there is too much inequality. And these views were held broadly across very different demographic groups, men and women, Democrats and Republicans, and those at the top and those with lower incomes. Indeed, in most people's ideal distribution, the top 40 percent had less wealth than the top 20 percent currently holds. Equally striking, when asked to choose between two distributions (shown on a pie chart), participants overwhelmingly chose one that reflected the distribution in Sweden over that in the United States (92 percent to 8 percent).[20]

Views that our political system is rigged are even stronger than those that our economic system is unfair. The poor, especially, believe that their voice is not being heard. The widespread support expressed for the Occupy Wall Street movement (discussed in the preface) bears testimony to these concerns. The belief (and the reality) that our political and economic system is unfair weakens both.

While the most immediate symptom is disillusionment leading to a lack of participation in the political process, there is always a worry that voters will be attracted to populists and extremists who attack the establishment that has created this unfair system[21] and who make unrealistic promises of change.

Distrust, the media, and disillusionment

Among economists, no one doubts the importance of a competitive marketplace for goods and services. Even more important for our society and our politics is a competitive marketplace of ideas. And unfortunately, that marketplace is—and is perceived to be—distorted.[22] Citizens can't make informed decisions as voters if they don't have access to the requisite information. But if the media are biased, they won't get information that is balanced. And even if the media were balanced, citizens know that the information that the government discloses to the media may not be.

John Kenneth Galbraith some sixty years ago, recognizing that few markets were anywhere close to the economists idea of "perfect competition," wrote about the importance of "countervailing powers."[23] We'll never have truly competitive media in the United States, with a plethora of newspapers and TV stations representing a diversity of views, but we could do better. We could have more forceful policing of antitrust laws, recognizing that what is at stake is more than just control over, say, the market for advertising, but also control over the market for ideas. We could be especially vigilant about attempts by media firms to control newspapers, TV, and radio. And we could provide public support for the media that would help diversify it. After all, the public good is a public good—that is, all benefit from ensuring that our government performs well. A basic insight of economics is that private markets, on their own, spend too little on public goods, since the societywide benefits are far greater than the benefits the individual himself enjoys. Ensuring that we have a well-informed public citizenry is important for a well-functioning democracy, and that in turn requires an active *and diverse* media. Other countries have attempted to ensure this diversity—with some success—by providing broad public support for media, ranging from national public broadcasting stations to community radio stations to support for second newspapers, even in smaller communities.[24]

We could also have more balanced media. As it is, the media are a realm where those in the 1 percent have the upper hand. They have the resources to buy and control critical media outlets, and some of them are willing to do so at a loss: it's an investment in maintaining their economic position.[25] Like the political investments of the banks, these investments may yield far higher *private* returns than ordinary investments—if one includes impacts on the political process.[26]

This is another element in the creation of distrust and disillusionment: not only isn't there trust in the fairness of our political and economic system; there isn't even trust in the information that is provided about our political and economic system.[27]

Disenfranchisement

The political battle is not just fought over getting supporters and getting them to vote. It's also fought over *not allowing those who disagree with you to vote*—a return to the mindset of two centuries ago, when the voting franchise was severely restricted.

The reluctance of the elites to extend the voting franchise, however objectionable from current perspectives, is understandable. In the UK, until the Reform Act of 1832, only large property owners or people of considerable wealth could vote. The elites didn't trust what might happen if voting rights were extended. In the Jim Crow South at the end of the nineteenth century, white politicians devised poll taxes that were designed to disenfranchise the former slaves and their descendants, who wouldn't have the wherewithal to pay.[28] Those taxes, combined with literacy tests and sometimes violence and terror, succeeded both in substantially lowering electoral turnouts and in increasing the Democratic vote share.[29]

In Ecuador, before 1979, only the literate could vote, and the ruling elite made sure that the indigenous people didn't have sufficient education to qualify. In each case elites feared they would lose their position of power and privilege, and even their wealth, if they extended the voting franchise.

Many of the efforts at disenfranchisement, now and in the past, have been directed at disenfranchising the poor; in the 1930s, pauper exclusion laws disenfranchised jobless men and women who were receiving relief.[30] The political science scholar Walter Dean Burnham has detailed the long history of what he calls efforts at voter "demobilization" targeted at various groups: against urban workers, by upstate agrarians and small towners; against leftist parties, by the major parties; against populists, by the urban corporate elites; against the poor, by the middle- and upper-income groups.[31] Many of these measures may be thought of as *disenfranchisement by stealth.*

Of course, those trying to disenfranchise the poor don't describe it that way. Economists and statisticians distinguish two kinds of errors: someone who is qualified to vote not being allowed to vote, and someone who is not qualified to vote being allowed to vote. Republicans tend to claim that the latter is the more important problem, Democrats that it's the former. But the Republican claim is disingenuous: the barriers that they seek to create to catch the latter mistake are really *economic* barriers, not barriers based on the likelihood of being qualified to vote. Requiring a government-issued photo ID—typically a driver's license or an identification card issued by the Department of Motor Vehicles—discriminates between those who have sufficient means, time, and access to information to get to the DMV, and those who do not.[32] Obtaining voter identification may also necessitate having a birth certificate or other documentation, which requires even more time, money, and knowledge of bureaucracy.

While the days of outright exclusion from the voting process are mostly behind us in the United States, there remains a steady stream of initiatives to limit participation, invariably targeting the poor and less well connected. Authorities can use even more subtle methods to discourage certain groups' political participation, whether it is conducting inadequate voter outreach to poor or immigrant neighborhoods, poorly staffing polling places, or preventing some felons from voting. In some cases, it is difficult to distinguish neglect from willful disenfranchisement, but the effects are the same: depressing voter turnout, often of a targeted group. These measures will chip away at voter participation, even when they do not present absolute barriers to registering or voting—especially among the least privileged parts of the population, where enthusiasm for voting is already low and mistrust of the official system runs high. The result is that one in four of those eligible to vote—51 million Americans or more—are not registered.[33]

On the other hand, certain measures can make it easier to register and will make it more likely that those who are qualified to vote do so. Allowing individuals to register to vote at the same time that they apply for a driver's license lowers transactions cost, and thus facilitates voter registration. More flexible schedules at polling centers and more voting booths facilitate the act of voting itself.

These attempts at disenfranchisement have a double effect. To the extent that they succeed, they ensure that the voices of some citizens are not heard; and the perception that there is such a struggle to reverse a long-accepted principle that all citizens have effective access to the vote reinforces disillusionment in the political system and increases political alienation.

Disempowerment

We saw earlier how the rules of the economic game, set by the political process, stack the cards in favor of the 1 percent. So too for the rules of the political game. The perception that they are set in ways that are unfair—that they give disproportionate power to economic elites, in a way that further strengthens the economic power of those at the top—reinforces political alienation and a sense of disempowerment and disillusionment. The sense of disempowerment occurs at myriad levels of engagement with government.

The 2010 decision in the case of *Citizens United v. Federal Election Commission*, in which the Supreme Court essentially approved unbridled corporate campaign spending, represented a milestone in the disempowerment of ordinary Americans.[34] The decision allows corporations and unions to exercise "free speech" in supporting candidates and causes in elections to the same degree as individual human beings. Since corporations have many millions of times the resources of the vast majority of individual Americans, the decision has the potential to create a class of super-wealthy political campaigners with a one-dimensional political interest: enhancing their profits.

It was hard to justify the Court's decision on philosophical terms. Corporations are legal entities, created for a specific purpose and endowed by man-made laws with specific rights and obligations. They have the advantage, for instance, of limited liability, but in certain instances the corporate veil can be pierced. There can still be individual culpability for criminal acts. But corporations aren't people, and they don't have any *inalienable* rights. The Supreme Court, in giving them carte blanche to shape power and our political system, seemed to think otherwise.

The Court's decision in balancing the interests of free speech with the interests of a balanced democracy, gave short shrift to the latter. It is generally recognized that providing money (support) conditional on a candidate's providing a favor (supporting a bill) is corruption. Corruption undermines faith in our democracy. But there is little difference between that and what actually occurs—candidates who, say, support a bill that an oil company wants to have immunity from liability from an oil spill are given money, and the candidate, and everyone else, knows that that money will be withdrawn if he votes differently. There is no *formal* quid pro quo; but the effect is the same. And most importantly, the perception by ordinary citizens is the same, so it weakens faith in our democracy little less than blatant corruption does.[35]

The Court's action was, in a sense, just another reflection of the success of the moneyed interests in creating a system of "one dollar one vote": they had succeeded in electing politicians who in turn appointed judges who would enshrine a corporation's right to unbridled spending in the political arena.[36]

The rules of the political game can also make individuals feel, rightly, that they are disenfranchised. Gerrymandering can make it more likely that an individual's vote *doesn't* count: the outlines of voting districts are drawn so that the outcome of the election is almost preordained. The filibuster gives inordinate power to a minority of senators. In the past, it was used with discretion. There was an understanding that it would be used only on issues that were of intense concern: ironically, it was used most frequently to stop the passage of civil rights laws that would ensure everyone the right to vote. But those days are gone. Now the filibuster is used as a matter of course to obstruct legislation.[37]

Later we'll discuss one more example of disempowerment, the role of the Federal Reserve Bank in setting macroeconomic policy. Government has entrusted the responsibility for a matter of vital concern to ordinary citizens—monetary policy, which affects the level of unemployment and economic activity—to a group that consists in significant measure of those elected by banks and the business community themselves, with insufficient democratic accountability.

The pattern of growing inequality in the United States may be particularly bad for our democracy. There is a widespread understanding that the middle class is the backbone of our democracy. The poor are often so alienated that getting them to vote proves especially hard. The rich don't need a rule of law; they can and do shape the economic and political processes to work for themselves. The middle class is most likely to understand why voting is so important in a democracy and why a *fair* rule of law is necessary for our economy and society. In the middle of the last century, its members believed that the economic and political system was basically fair, and their belief in "civic engagement" was seemingly rewarded by a burst of growth that benefited them—and everyone else. But now all that is changing. As we saw in chapter 3, the polarization of our labor market has been hollowing out the middle class, and the dwindling middle class is itself becoming disillusioned with a political process that is obviously not serving its members well.

Why we should care

In this chapter we have described the construction of a political system that, though nominally based on the principle of one person one vote, has turned out to serve the interests of those at the top. Another vicious circle has been set in play: political rules of the game have not only *directly* benefited those at the top, ensuring that they have a disproportionate voice, but have also created a political process that *indirectly* gives them even more power. We have identified a whole series of forces contributing to the disillusionment with politics and distrust of the political system. The yawning divide in our society has made it difficult to reach compromise, contributing to our political gridlock.

This, in turn, has contributed to undermining trust in our institutions, both their effectiveness and their fairness. Attempts at disenfranchisement, a recognition that our political and economic systems are unfair, the knowledge that the flow of information is controlled by a media that itself is controlled by those at the top, and the apparent role of money in politics, reflected in unbridled campaign contributions, have only enhanced disillusionment with our political system. Disillusionment has decreased political participation, especially at the bottom, every bit as effectively as the outright attempts at disenfranchisement in tilting the electorate toward the top. This has provided more scope for influence of those in the 1 percent and their money—reinforcing the lack of trust, and the disillusionment. With such disillusionment, it costs money to get out the vote—and efforts to get out the vote can be targeted at those whose interests coincide with the top.

The effect can be seen in the United States, where voter turnout looks dismal in comparison with that of other advanced societies. Average voter turnout for the presidential elections has been 57 percent in recent years,[38] but voting for the House of Representatives in nonpresidential years has averaged only 37.5 percent.[39] Given the extent of youth disillusionment—especially after the 2008 elections, when expectations were so high—it is no wonder that in the 2010 election youth turnout was even more dismal, at around 20 percent.[40]

Turnouts in primary elections are even poorer—and biased[41]—with the result that the electoral choices voters face in the general elections seem disappointing, contributing in turn to low voter turnout in those elections.

Disillusionment with our political system—and the belief that it is unfair—can give rise to agitation outside the political system, evidenced in the Occupy Wall Street movement. When this then leads to a reform of the political system, the effects can be positive. When the political system rebuffs these reforms, it reinforces alienation.

Earlier in the chapter, I discussed the importance of trust, cooperation, social capital, and a sense of fairness to the functioning of the economy and society more generally. These failures in our political system have important spillovers. It is another channel through which our society and our economy will pay a great price for the high and growing inequality.

Reforming our political process

Most Americans now realize how essential it is that our political process be reformed in ways that make it more responsive to the wishes of the majority and that diminish the power of money. We have described how the political rules of the game give those at the top outsize influence. Changing the rules of the game can create a more democratic democracy.

We can, and should, for instance, change the rules to make sure the electorate reflects our citizenry—stopping the efforts at disenfranchisement, making it easier, even for the poor, to vote. Practices like gerrymandering, designed to reduce the responsiveness of the political system, need to be circumscribed. So must practices like revolving doors (which allow someone from the banking sector to move smoothly between Wall Street and Washington and back to Wall Street). Rules like mandatory voting (as in Australia) lead, not surprisingly, to higher voter participation, and a greater likelihood that the outcomes of elections reflect the views of society more generally.[42] Most importantly, there is a need for campaign finance reform. Even if *Citizens United* is not reversed, corporations should be allowed to make campaign contributions only if their owners—the shareholders—vote to do so. It shouldn't be just left to the top managers, who have used their power not merely to pay themselves outsize rewards but then also to use their power to maintain a system that allows them to do so. And the government should use its financial resources to make sure that there is a level playing field in the "marketplace of ideas," or at least a more level playing field than exists today.[43]

We know what to do—and even if the reforms would not fully create the one-person-one-vote democracy that we would like, they could move us in that direction. But efforts to do so have been stymied, for the obvious reason: moneyed interests have the incentives and resources to ensure that the system continues to serve those interests. When I was chair of the Council of Economic Advisers, the Clinton administration made a valiant effort to curb the need for campaign finance. The public owns the airwaves that the TV stations use. Rather than giving these away to the TV stations without restriction—a blatant form of corporate welfare—we should sell access to them; and we could sell it with the condition that a certain amount of airtime be made available for campaign advertising. With free advertising politicians would need less money, and we could constrain those accepting the free advertising in the amount and nature of campaign contributions that they accepted. But the TV stations that make such money from campaign advertising—and from their free gifts of spectrum—vehemently and successfully opposed the reform.

The evisceration of our democracy

Democracy—at least as most of us conceive of it—is based on the principle of one person one vote. Much of the political rhetoric focuses on the "middle" "independent" voter, as standard political theory suggests should be the case. But no one would suggest that the outcome of America's politics really reflects the median voter's interests. The median voter has no interest in corporate welfare. The median voter didn't prevail in the battle over financial regulatory reform, where the vast majority (some two-thirds according to some opinion polls)[44] wanted tighter regulation, but the big banks didn't. In the end, we got regulatory reform that was like Swiss cheese—full of holes, exceptions, and exemptions that couldn't be justified by any set of principles. There was no good reason for tighter consumer protection on all loans *except* auto loans; it was just that those lenders succeeded in making the necessary political investments.

It was no wonder that the House Financial Services Committee, charged with writing the new regulations, had sixty-one members, almost 15 percent of all the representatives. The Dodd-Frank bill passed in 2010 represented a carefully balanced compromise between the ten biggest banks and the 200 million Americans who wanted tighter regulation. (History, I am afraid, will prove that the vast majority of Americans were right.)

Paul Krugman put it forcefully when he wrote, "[E]xtreme concentration of income is incompatible with real democracy. Can anyone seriously deny that our political system is being warped by the influence of big money, and that the warping is getting worse as the wealth of a few grows ever larger?"[45]

In the Gettysburg Address, President Abraham Lincoln said that America was fighting a Great Civil War so that "Government of the people, by the people, and for the people shall not perish from this earth." But if what has been happening continues, that dream is in peril.[46]

We began this chapter with a discussion of the puzzle of the median voter—why our democracy seems not to reflect the views of those in the middle as much as the views of those at the top. This chapter has provided a partial explanation: the median voter (the voter such that half the voters have an income higher than his, half lower) is richer than the median American. We have a *biased* electorate, tilted toward the top.

But this doesn't fully explain what's been going on in American politics. The bias in the outcomes—the extent to which the political system favors those at the top—is greater than can be explained by the bias in the electorate. Another part of this puzzle is explained by the bias in perceptions and beliefs—that the top has persuaded those in the middle to see the world in a distorted way, leading them to perceive policies that advance the interests of those at the top as consonant with their own interests. How the top does this is the subject of the next chapter.[47] But first I want to discuss globalization, how it has been mismanaged by our elites in ways that have benefited them at the expense of most Americans, but, even more importantly, how the way it has been managed in the United States, and even more so elsewhere, has undermined democracy. Moreover, the weakening and distortion of our democracy that I've just described is undermining our role in global leadership, and thus our ability to create a world that is more in accord with our values and our interests, more broadly understood.

Globalization, Inequality, and Democracy

These outcomes should not be surprising: globalization, if managed for the 1 percent, provides a mechanism that simultaneously facilitates tax avoidance and imposes pressures that give the 1 percent the upper hand not just in bargaining within a firm (as we saw in chapter 3) but also in politics. Increasingly, not only have jobs been offshored but so, in a sense, has politics. This trend is not limited to the United States; it is a global phenomenon, and in some countries matters are far worse than in the United States.

The most vivid examples have arisen in countries that have become overindebted.[48] The loss of "control" by debtor countries of their own destiny—turning over power to creditors—dates back to the earlier days of globalization. In the nineteenth century, poor countries that owed money to banks in the rich nations were confronted with a military takeover, or bombardment: Mexico, Egypt, and Venezuela were all victims. This continued through the twentieth century: in the 1930s Newfoundland gave up its democracy as it went into receivership and became administered by its creditors.[49] In the post–World War II era, the IMF was the instrument of choice: countries turned over, in effect, their economic sovereignty to an agency that represented the international creditors.

It was one thing for these events to occur in poor developing countries; it's another for them to occur in advanced industrial economies. That's what has been happening lately in Europe, as first Greece and then Italy allowed the IMF, together with the European Central Bank and the European Commission (all unelected), to dictate parameters of policy and then appoint technocratic governments to oversee the implementation of the program.[50] When Greece proposed to submit the tough austerity program that had been prepared to a popular referendum, there arose a shout of horror from European officials and the bankers:[51] Greek citizens might reject the proposal, and that might mean that the creditors would not be repaid.

The surrender to the dictates of financial markets is broader and more subtle. It applies not only to those countries on the brink of disaster but also to any country that has to raise money from capital markets. If the country doesn't do what the financial markets like, they threaten to downgrade the ratings, to pull out their money, to raise interest rates; the threats are usually effective. The financial markets get what they want. There may be free elections, but, as presented to the voters, there are no real choices in the matters that they care most about—

the issues of economics.

Twice in the 1990s Luiz Inácio Lula da Silva was on the verge of being elected president of Brazil, and twice Wall Street objected, exercising what amounted to a veto. It signaled that if he were elected, it would pull money out of the country, the interest rates that the country would have to pay would soar, the country would be shunned by investors, and its growth would collapse. The third time, in 2002, the Brazilians said, in effect, that they would not be dictated to by international financiers.[52] And President Lula made an excellent president, maintaining economic stability, promoting growth, and attacking his country's extreme inequality. He was one of the few presidents around the world who, after eight years, still enjoyed the popular support that he had in the beginning.

This is just one of many instances in which the judgments of the financial markets were badly flawed. Proponents of financial markets like to claim that one of the virtues of open capital markets is that they provide "discipline." But the markets are a fickle disciplinarian, giving an A rating one moment and turning around with an F rating the next. Even worse, the financial markets' interests frequently do not coincide with those of the country. The markets are shortsighted and have a political and economic agenda that seeks the advancement of the well-being of financiers rather than that of the country as a whole.

It doesn't have to be this way. Financial markets can threaten to pull money out of a country overnight largely because of their total openness, especially to short-term capital flows. But in spite of the financial market's ideological commitment to what is called capital market liberalization (allowing capital to move freely in and out of a country)—an ideology consistent with the markets' self-interest—in fact such liberalization doesn't promote economic growth; it does, however, lead to increased instability and inequality.[53]

The problems that I've outlined run deeper and are in fact more widespread. As one of the world's experts on globalization, the Harvard University professor Dani Rodrik has pointed out, one cannot simultaneously have democracy, national self-determination, and full and unfettered globalization.[54]

Often, international companies have attempted to obtain in the international arena what they cannot get at home. The Financial Services Agreement of the World Trade Organization (WTO) has tried to force financial market liberalization, requiring governments to allow foreign banks into their countries and restraining the ability to impose regulations that would ensure that the financial system is stable and actually serves the economy and society in the way it should. The Uruguay Round Trade Agreement has successfully forced upon countries around the world a version of intellectual property rights that is bad for American science, bad for global science, bad for developing countries, and bad for access to health. Designed by corporate interests to prevent the free flow of knowledge, the agreement strengthens monopoly power—helping create rents, and, as we saw in chapter 2, rents are the source of so much of today's inequality.[55] Whether one agrees or not with this assessment of this particular international agreement, it is clear that it has imposed severe—unnecessarily severe—strictures on the design of each country's intellectual property regime. It has undermined the countries' self-determination and the power of their democracies. They cannot choose an intellectual property regime that reflects their view of what will best promote the advance of knowledge in their country, balancing concerns about access to knowledge and to life-saving medicines with the necessity of providing incentives for research and innovation; they have to choose a regime that conforms with the dictates of the WTO.[56]

Other examples abound. The United States, in its bilateral trade agreement with Singapore, attempted to restrict that country's regulations concerning chewing gum: it was worried that they might discourage U.S. exports of one of our "major" export commodities, chewing gum. In its bilateral agreement with Chile, the United States attempted to prevent the imposition of capital controls, rules that the country had used successfully to stabilize its economy. Other agreements have tried to prevent countries from discouraging the purchase of gasoline-guzzling vehicles, because those are the kinds of cars in which America specializes. Chapter 11 of the North American Free Trade Agreement and other bilateral investment agreements (and other economic agreements that the United States and Europe have signed with developing countries) arguably provides compensation to firms for loss of profits incurred as a result of a regulatory change, something that both Congress and the U.S. courts have refused to do. It is a provision designed to discourage environmental regulations by making the imposition of such regulations costly to the government's budget.[57]

For many developing countries—and, more recently, even for European countries—that are indebted and have to turn to the IMF, the consequences of their loss of economic sovereignty have been serious. At least within the United States and most European countries, the 1 percent normally doesn't get its way without a fight. But finance ministries often use the IMF to enforce their perspectives, to adopt the institutional arrangements and the regulatory and macroeconomic frameworks that are in the interests of the 1 percent. Even Greece, to secure its 2011 bailout by the European Union, was forced to pass laws affecting not only the budget but also the health sector, the rights of unions in collective bargaining, and the minimum wage.

Even when globalization doesn't circumscribe democracy through global agreements or as part of an international "rescue," it circumscribes democracy through competition. One of the reasons, we were told, that we *had* to have weak financial regulations was that if we didn't, financial firms would move overseas. In response to a proposal to tax bank bonuses, London firms threatened to leave the country. In these cases, one might argue: good riddance. The cost to society—the bailouts, the economic disruption, the inequality—of the financial sector's excesses far outweighs the few jobs that companies in the sector create. The speculators will leave; but those engaged in the kind of finance that really matters—lending to local firms—will stay. These *have* to be here.

The arena in which democracy is most circumscribed is in taxation, especially in the design of tax systems that reduce inequality. What is called tax competition—the race between different polities to have the lowest taxes around—limits the scope for progressive taxation. Firms threaten to leave if taxes are too high. So do wealthy individuals. Here the United States has at least one advantage over other countries: we are taxed on our worldwide income. A Greek citizen, having benefited from that country's public schools and universities, and having enjoyed the benefit of its hospitals and health care system, can take up residence in Luxembourg, do business in all of Europe freely, and avoid any responsibility of paying taxes—even to repay the costs of her education.

We are often told that this is the way it has to be, that globalization gives us no choice. This fatalism, which serves those benefiting from the current system, obscures reality: the predicament is a choice. The governments of our democracies have chosen an economic framework for globalization that has actually tied the hands of those democracies. The 1 percent was always worried that democracies would be tempted to enact "excessively" progressive taxation under the influence, say, of a populist leader. Now citizens are told they can't do so, not if they want to partake of globalization.

In short, globalization, as it's been managed, is narrowing the choices facing our democracies, making it more difficult for them to undertake the tax and expenditure policies that are necessary if we are to create societies with more equality and more opportunity. But tying the hands of our democracies is exactly what those at the top wanted: we can have a democracy with one person one vote, and still get outcomes that are more in accord with what we might expect in a system with one dollar one vote.[58]

Diminishing America's influence

America's global strength is its soft power, the power of its ideas, an educational system that educates leaders from all over the world, the model that it provides for others to follow. Iraq and Afghanistan have shown the limits of military power; not even a large country spending as much on the military as all of the rest of the world combined can truly pacify or conquer a country with one-tenth its population and 0.1 percent of its GDP. The country has long exerted its influence by the strength of its economy and the attractiveness of its democracy.

But the American model is losing some of its luster. It's not just that the American model of capitalism didn't provide sustained growth. It's more that others are beginning to realize that most citizens have not benefited from that growth, and such a model is not very politically attractive. And they are sensing, too, the corruption (American style) of our political system, rife with the influence of special interests.

Of course, there's more than a little schadenfreude here. We lectured countries all around the world about how to run their economy, about good institutions, about democracy, about fiscal rectitude and balanced budgets. We even lectured them about their excessive inequality and rent seeking. Now our creditability is gone: we are seen to have a political system in which one party tries to disenfranchise the poor, in which money buys politicians and policies that reinforce the inequalities.

We should be concerned about the risk of this diminished influence. Even if things had been going better in the United States, the growth of the emerging markets would necessitate a new global order. There was just a short period, between the fall of the Berlin Wall and the collapse of Lehman Brothers, when the United States dominated in virtually every realm. Now the emerging markets are demanding a larger voice in international forums. We moved from the G-8, where the richest industrial countries tried to determine global economic policy, to the G-20, because we had to: the global recession provided the impetus, but one could not deal with global issues, like global warming or global trade, without bringing others in. China is already the second-largest global economy, the second-largest trading economy, the largest manufacturing economy, the largest saver, and the largest contributor to greenhouse gas emissions.

America has been extraordinarily influential in spreading ideas—of equality, of human rights, of democracy, of the market. Having a world that shares these values has been part of the country's mission. But it is also in our self-interest. I observed earlier that our real source of power is our soft power; but that power arises only because others see things through lenses that are not too dissimilar from ours. We may try to enforce a pax Americana, but we have seen how difficult and costly that is. Far better for others to see their interests as coincident with ours, in creating democratic and prosperous societies. The management of globalization requires global agreements, in trade, finance, investment, the environment, health, and the management of knowledge. In the past the United States had enormous influence in shaping these agreements. We have not always used that influence well; we have often used it to advance some of our special interests, aiding and abetting the rent-seeking activities that play such a large role in the creation of inequalities. Although in the early days of modern globalization, that was not fully grasped, today it is. There is a demand for a change in the governance of the global economic institutions and arrangements, and, combined with the new balance of global economic power, changes are inevitable. Even then, our influence is likely to remain large, almost surely disproportionate to our population or our economy. But the extent to which the global economy and polity can be shaped in accord with our values and interests will depend, to a large extent, on how well our economic and political system is performing *for most citizens.* As democracies grow in many other parts of the world, an economic and political system that leaves most citizens behind—as ours has been doing—will not be seen as a system to be emulated, and the rules of the game that such a country advocates will be approached with jaundiced eyes.

Concluding Comments

The United States played a central role in creating the current rules of the game and the United States, still the world's largest economy, can use its economic power and influence to shape new rules that create a fairer global economy. It may or may not be in the interests of the 1 percent to do so,[59] but it is in our broader national interests. As we saw earlier, current rules of globalization are contributing to our growing inequality. Someday, perhaps soon, we too will see how globalization *as currently managed* promotes neither global efficiency nor equity; even more importantly, it puts our democracy in peril. *Another world is possible*: there are alternative ways of managing globalization that are better for both our economy and our democracy; but they do not entail *unfettered* globalization. We have learned the risks of unfettered markets for our economy and how to temper capitalism so that it serves *the majority* of citizens, not a tiny, powerful fraction. So too, we can temper globalization; indeed, we must if we want to preserve our democracy, prevent our rampant inequality from growing worse, and maintain our influence around the world.

CHAPTER SEVEN

JUSTICE FOR ALL? HOW INEQUALITY IS ERODING THE RULE OF LAW

EVERY MORNING, STUDENTS THROUGHOUT AMERICA pledge their allegiance to the flag of the United States and "to the Republic for which it stands, one nation, under God, with liberty and justice for all." That implicit promise, liberty and justice for all, captures one of the essential values that help define America's sense of identity. At our best, we are a country where the rule of law prevails, where an individual is innocent until proven guilty, and where all people stand equal before the law. These values also are central to our understanding of America's place in the world. We have championed them to other countries. Yet what the pledge really means is seldom taken up. Nor is a still larger question broached: whether America has really delivered on its promises.

This chapter explores one of three crucial battlefields upon which the fight to create a more equal, or more unequal, society is fought—the battle over the laws and regulations that govern our economy and how they are enforced. The next chapter considers the battle of the budget, and chapter 9 examines the conduct of monetary policy and macroeconomics.

The chapter begins by asking a rather abstract, but key, set of questions: What is the purpose of the laws and regulations that are central to the functioning of our economy? Why do we need a rule of law? Is there more than one possible "rule of law," and, if so, what differences do the choices make? The central message echoes that of earlier chapters: There are alternative legal frameworks. Each has consequences for efficiency and distribution. The *wrong* kind of rule of law can help preserve and extend inequities.

While a good "rule of law" is supposed to protect the weak against the powerful, we'll see how these legal frameworks have sometimes done just the opposite, and the effect has been a large transfer of wealth from the bottom and middle to the top.[1] Ironically, while the advocates of these legal frameworks argued for them as promoting an efficient economy, they have actually led to a distorted economy.

WHY WE NEED A RULE OF LAW

As the old poem goes, "No man is an island." In any society what one person does may hurt, or benefit, others. Economists refer to these effects as externalities. When those who injure others don't have to bear the full consequences of their actions, they will have inadequate incentives not to injure them, and to take precautions to avoid risks of injury. We have laws to provide incentives for each of us to avoid injuries to others—to their property, their heath, and the public goods (such as nature) that they enjoy.

Economists have focused on how best to provide incentives so that individuals and firms take into account their externalities: steel producers should be forced to pay for their pollution, and those who cause accidents should pay for the consequences. We embody these ideas, for instance, in the "polluter pays principle," which says that polluters should pay for the full consequences of their actions. Not paying the full consequences of one's action—for instance, for the pollution caused by production—is a subsidy. It is equivalent to not paying the full cost of labor or capital. Some corporations that resist paying for the pollution that they create talk about the possible loss of jobs. No economist would suggest that distortionary subsidies to labor or capital should be preserved to save jobs. Not paying the costs imposed on the environment is a form of subsidy that should be no more acceptable. The responsibility for maintaining the economy at full employment lies elsewhere—with monetary and fiscal policy.

The success corporations often have had in avoiding the full consequences of their actions is an example of how they shape the rules of the economic game in their favor. As a result of laws that limit the extent of their liabilities, nuclear power plants and offshore oil rigs are shielded from bearing the full costs should they explode.[2] The consequence is that we have more nuclear power plants and offshore rigs than we would otherwise—in fact, it's questionable whether, without a whole set of government subsidies, there would be any nuclear power plants at all.[3]

Sometimes, the costs that firms impose on others aren't apparent right away. Corporations often take big risks, and nothing may go wrong for years and years. But when something does go wrong (as with the TEPCO nuclear power plant in Japan or with the Union Carbide plant in Bhopal, India), thousands can suffer. Forcing corporations to compensate those injured doesn't really undo the harm. Even if the family of someone who dies because of unsafe work conditions is compensated, the person isn't brought back to life. That's why we can't rely just on incentives. Some people are risk takers—especially when others bear most of the risk. The explosion aboard the Deepwater Horizon in April 2010 began a spill that spewed millions of barrels of British Petroleum oil into the Gulf of Mexico. BP executives had gambled: skimping on safety increased immediate profits. In this case, they gambled and lost—but the environment and residents of Louisiana and the other Gulf states lost even more.

In the resulting litigation, corporations that do cause damage may have a stronger hand than the people who are hurt. They may be in a position to nickel-and-dime those who suffer damage, since many people cannot hold out for adequate compensation, nor can they afford lawyers to match those of the company. One role of government is to rebalance the scales of justice—and in the case of the BP disaster, it did, but very gently, and in the end, it became clear that many of the victims were likely to receive compensation that was but a fraction of what they suffered.[4]

Ronald Coase, a Chicago Nobel Prize–winning economist, explained how different ways of assigning property rights were equally efficient for addressing externalities, or at least would be in a hypothetical world with no transactions costs.[5] In a room with smokers and nonsmokers, one could assign the "air rights" to the smokers, and if the nonsmokers valued clean air more than the smokers valued smoking, they could bribe the smokers not to smoke. But one could alternatively assign the air rights to the nonsmokers. In that case, smokers could bribe the nonsmokers to allow them to smoke so long as they valued the right to smoke more than the nonsmokers valued clean air. In a world of transactions costs—the real world, where, for instance, it costs money to collect money from one group to pay another—one assignment can be much more efficient than the other.[6] But more to the point, there can be large distributive consequences of alternative assignments. Giving nonsmokers the air rights benefits them at the expense of the smokers.

Try as one might, one cannot escape issues of distribution, even when it comes to the simplest problems in organizing an economy.[7] The flip side of the intertwining of these "property rights"/externalities issues and distribution is that notions of "liberty" and "justice" cannot be separated. Each individual's liberties have to be curtailed when they impose harms on others. One person's liberty to pollute deprives another of her health. One person's liberty to drive fast deprives another of his right not to be injured.[8] But whose liberties are paramount? To answer this fundamental question, societies develop rules and regulations. These rules and regulations both affect the efficiency of the system and distribution: some gain at the expense of others.

That's why "power"—political power—matters so much. If economic power in a country becomes too unevenly distributed, political consequences will follow. While we typically think of the rule of law as being designed to protect the weak against the strong, and ordinary citizens against the privileged, those with wealth will use their political power to shape the rule of law to provide a framework within which they can exploit others.[9] They will use their political power, too, to ensure the preservation of inequalities rather than the attainment of a more egalitarian and more just economy and society. If certain groups control the political process, they will use it to design an economic system that favors them: through laws and regulations that apply specifically to an industry, through those that govern bankruptcy, competition, intellectual property or taxation, or, indirectly, through costs of accessing the court system. Corporations will argue, in effect, that they have the right to pollute—and they will ask for subsidies not to pollute; or that they have the right to impose the risk of nuclear contamination on others—and they will ask for, in effect, hidden subsidies, limitations in liability to protect themselves against being sued if their plant explodes.

My experience in government suggests that those who hold positions of power want to believe that they are doing the right thing—that they are pursuing the public interest. But their beliefs are at least malleable enough for them to be convinced by "special interests" that what they want is in the public interest, when it is in fact in *their own* interests to so believe. In the rest of this chapter, we examine this theme in three contexts where rules and regulations play a central role in determining how America's market economy has been working in recent years: predatory lending, bankruptcy law, and the foreclosure process.

Predatory Lending

Early on in the housing bubble, it became clear that the banks were engaged not only in reckless lending—so reckless that it would endanger the entire economic system—but also in predatory lending, taking advantage of the least educated and financially unsophisticated in our society by selling them costly mortgages and hiding details of the fees in fine print incomprehensible to most people. Some states tried to do something about it. For instance, in October 2002 the Georgia legislature, after observing that mortgage lending in the state was riddled with fraud and predation, tried to call a halt to it with a consumer protection law. The response from the financial markets was quick and furious.

The ratings agencies, today best known for their role in calling pools of F-rated mortgages A-rated securities, also had a hand in sustaining fraudulent lending practices. They should have welcomed the actions of states like Georgia: the law meant that the agencies would not need to assess whether mortgages in a given pool were fraudulent or inappropriate. Instead, Standard & Poor's, one of the leading rating agencies, threatened not to rate any of Georgia's mortgages. Without these ratings, the mortgages would have been hard to securitize and without securitization (in the business model of the day) mortgage lending in the state might dry up. Evidently, the rating agencies were worried that if the practice spread to other states, the flow of bad mortgages from which they made so much money "rating" would be greatly diminished. S&P's threat was effective: the state quickly reversed the law.[10]

In some other states, too, there were attempts to stop predatory lending, and in each of these instances banks used all their political muscle to stop states from enacting laws aimed at curtailing predatory lending.[11] The result, as we know now, was not only massive fraud but also bad lending: too much indebtedness, with financial products that could explode with a change in interest rates or in the broader economic conditions, and indeed many did explode.[12]

In a simpler world, the adage caveat emptor ("let the buyer beware") might have been appropriate; but not in today's complex world. A regulatory agency for financial products is needed to prevent not just fraud but also abusive, deceptive, and inappropriate products.[13]

Even many financial institutions recognized that *some* regulation was needed: without bank and insurance regulations ensuring the soundness of these institutions, individuals would be reluctant to turn over their money to banks and insurance companies, lest they never get it back. Individuals on their own would never be able to assess the financial conditions of these large and complex institutions; it has proven hard enough for experienced government regulators to do so.[14]

But the U.S. banking sector resisted the suggestion that regulation be extended to protect consumers, in spite of its terrible record of bad lending and poor credit practices before the crisis, which had led to widespread public support for an agency to do so. And when a provision creating such an agency was included in the Dodd-Frank bill, financial institutions campaigned to make sure that Elizabeth Warren, a Harvard law professor with all the credentials necessary to run such an agency, including the expertise and commitment to protect consumers, was not chosen to head it. The banks won. (She was in, in fact, widely cited as the originator of the idea of such an agency, and a tireless campaigner for it, a sin for which the financial community could not forgive her. Even worse, she served as chair of the Congressional Oversight Panel, overseeing the government's bailout program. The panel revealed that the administration was giving the banks a great deal—getting back from the banks preferred shares worth about half of what the government was giving them.)[15]

Bankruptcy Law

A host of other laws and regulations shape the market and thereby affect the distribution of income and well-being. Bankruptcy law (which specifies what happens when an individual or a corporation can't pay back what is owed) has particular relevance to two parts of our society—those at the top (the bankers) and those at the bottom, who struggle to make ends meet.

Bankruptcy law is designed to give individuals a fresh start. The notion that under certain conditions debts should be forgiven has a long tradition that goes back at least as far as the Book of Leviticus, where debts were forgiven in the Jubilee year. Virtually every modern economy has a bankruptcy law. These laws can be either more debtor or more creditor friendly, making it easier or more difficult to discharge debts. How they are shaped obviously has strong distributional consequences, but the incentive effects can be equally powerful. If debts can't be discharged, or can't be discharged easily, lenders have less of an incentive to be careful in lending—and more of an incentive to engage in predatory lending.

In 2005, just as subprime mortgages were starting to boom, Congress passed a new creditor-friendly bankruptcy law that gave the banks even more of an upper hand, making it more difficult for distressed borrowers to discharge their debts. The change in the law introduced a system of "partial indentured servitude." An individual with, say, debts equal to 100 percent of his income could be forced to hand over to the bank 25 percent of his gross, pretax income for the rest of his life. This is because the bank could add on, say, 30 percent interest each year to what a person owed. In the end, a mortgage holder would owe far more than the bank ever lent. The debtor would end up working, in effect, one-quarter time for the bank.[16]

Every loan has a willing lender and a willing borrower; the banks are supposed to be financially sophisticated, to know how much debt individuals can manage. But a distorted financial system put more emphasis on the up-front fees that showed up quickly in the banks' bottom line than on the losses that might be incurred further down the line. Emboldened by the new bankruptcy law, they felt they could somehow squeeze money out of their hapless borrowers, whatever happened to the housing market and unemployment. This reckless lending, combined with deceptive practices and sometimes usurious interest rates, has put many households on the brink of financial ruin. In spite of so-called reforms, banks still sometimes charge rates nearing 30 percent a year (which means that a $100 debt can grow to $1,000 in a short span of nine years). On top of this, they can impose crippling fees. While some of the worst abuses have been curbed, such as those associated with overdrafts (which generated literally billions of dollars a year in profits[17]—money taken out of the pockets of ordinary citizens), many continue.

When the new bankruptcy law was passed, property rights were changed, but in a way that favored the banks. At the time the borrowers had incurred their debt, a more humane bankruptcy law gave them a chance for a fresh start if the burden of debt repayment became too onerous. The banks didn't complain about this change in property rights; after all, they had pushed for it vociferously. When things go the other way, of course, the owners of property complain that the rules of the game are being changed midcourse and demand compensation.[18]

Student loan programs

We saw earlier that inequality in the United States has been rising steeply and is likely to continue to increase. One of the reasons is the growing inequality of opportunity, related in part to educational opportunity. Young people and their parents know the importance of education, but we have created a system where the striving for education may actually be leading to more inequality. One reason for this is that over the past twenty-five years, the states have been withdrawing support from higher education.[19] This problem grew in the recession.

Another reason is that aspiring students are becoming increasingly indebted.[20] The 2005 bankruptcy law made it impossible for students to discharge their student debts even in bankruptcy.[21] This eviscerates any incentives for banks, and the for-profit schools that they work with, to provide an education that will yield a return.[22] Even if the education is worthless, the borrower is still on the hook. And for many students, the education is frequently almost worthless. Some 80 percent of the students do not graduate,[23] and the real financial rewards of education come only upon completion of the programs—and even then they may not materialize. But in this conspiracy between the for-profit schools (many owned partly or largely by Wall Street firms) and the for-profit banks, the students are never warned. Rather than "Satisfaction guaranteed or your money back," the reality is "Dissatisfaction is almost guaranteed, but you will be saddled with these debts for the rest of your life." Neither the schools nor the lenders say, "You are almost certain *not* to get a good job, of the kind you dream of. We exploit your dreams; we don't deliver on our promise." When the government proposed standards—schools would qualify for government backed loans only if there was an adequate completion rate and enough student satisfaction, with at least a minimal number of students getting the jobs that were promised—the schools and the banks fought back, largely successfully.

It wasn't as if the government was trying to regulate a private industry that was seemingly doing well on its own (though partly by exploiting the poor and less informed). The for-profit schools existed largely because of the federal government. Schools in the $30 billion a year for-profit education industry receive as much as 90 percent of their revenue from federal student loan programs and federal aid. They were enjoying the more than $26 billion they were getting from the federal government; it was enough money to make it worthwhile to invest heavily in lobbying and campaign contributions, to make sure that they were not held accountable.[24]

In the case of student loans, the banks managed for years to get rewards with almost no risk: in many instances, the government guaranteed the loans; in others, the fact that the loans can never be discharged—they are bankruptcy proof—makes them safer than other loans to similar individuals. And yet the interest rate charged to students was incommensurate with these risks: the banks have used the student loan programs (especially those with government guarantees) as an easy source of money—so much so that when the government finally scaled down the program in 2010, the government and the students could, between them, pocket tens of billions of dollars that previously had gone to the banks.[25]

America sets the pattern

Usury (charging exorbitant interest rates),[26] of course, is not limited to the United States. In fact, around the world the poor are sinking in debt as a result of the spread of the same rogue capitalism. India had its own version of a subprime mortgage crisis: the hugely successful microcredit schemes that have provided credit to poor farmers and transformed their lives turned ugly once the profit motive was introduced. Initially developed by Muhammad Yunus of the Grameen Bank and Sir Fazle Hasan Abed of BRAC in Bangladesh, microcredit schemes transformed millions of lives by giving the poorest, who had never banked, access to small loans. Women were the main beneficiaries. Allowed to raise chickens and engage in other productive activities, they were able to improve living standards in their families and their communities. But then for-profit banks discovered that there "was money at the bottom of the pyramid."[27] Those on the bottom rung had little, but they were so numerous that taking a small amount from each of them was worth it. Banks all over the world enthusiastically embraced microfinance for the poor. In India the banks seized upon the new opportunities, realizing that poor Indian families would pay high interest rates for loans not just to improve livelihoods but to pay for medicines for sick parents or to finance a wedding for a daughter.[28] They could cloak these loans in a mantle of civic virtue, describing them as "microcredit," as if they were the same thing that Grameen and BRAC were doing in neighboring Bangladesh—until a wave of suicides from farmers overburdened with debt called attention to the fact that they were *not* the same.

THE MORTGAGE CRISIS AND THE ADMINISTRATION OF THE RULE OF LAW

When the subprime mortgage crisis finally broke wide open, precipitating the Great Recession of 2008, the country's response to the ensuing flood of foreclosures provided a test of America"s "rule of law." At the core of property rights and consumer protection are strong procedural safeguards (such as record keeping) to protect those who enter into contracts. Such safeguards were in place to protect homeowners as well as lenders. If the bank claimed that a person owed it money, then by law it had to provide proof before it could just throw someone out into the streets. When a mortgage (an IOU from a homeowner to a lender) is transferred from one lender to another, then by law a clear record of what the borrower has repaid, and what he owes, must accompany the mortgage.

The banks had issued so many mortgages, so rapidly, that they had given short shrift to basic procedural safeguards. And as the banks and other lenders rushed to lend more and more money, not surprisingly fraudulent practices became endemic. FBI investigations spiked.[29] The combination of frequent fraudulent practices and a disregard of procedural safeguards was lethal.

The banks wanted a speedier and less costly way of transferring claims, so they created their own system, called MERS (Mortgage Electronic Registry System), but, like so much of what the banks had done in the gold rush days, it proved to be a deficient system, without safeguards, and amounted to an end run around a legal system intended to protect debtors. As one legal expert put it, "MERS and its members believed that they could rewrite property law without a democratic mandate."[30]

When the housing bubble finally burst, the dangers of banks' recklessness in lending and record keeping became apparent. By law, banks were supposed to be able to prove the amounts owed. It turned out that in many cases, they simply could not.

All of this has complicated the process of cleaning up the ensuing mess. The sheer numbers of mortgages in default, running in the millions, made the task even worse. The immensity of the task led the banks to invent "robo-signing." Instead of hiring people to examine records, to verify that the individual did owe the amount claimed, signing an affidavit at the end that they had done so, many banks arranged for a single person to sign hundreds of these affidavits without even looking at the records. Checking records to comply with legal procedure would hurt the bank's bottom line. The banks adopted a policy of *lying to the court*. Bank officers knew this—the system was set up in a way that made it impossible for them to examine the records, as they claimed to have done.

This brought a new twist to the old doctrine of too-big-to-fail. The big banks knew that they were so big that if they lost on their gambles of risky lending they would have to be bailed out. They also knew that they were so big that if they got caught lying, they were too big and powerful to be held accountable. What was the government to do? Reverse the millions of foreclosures that had already occurred? Fine the banks billions of dollars—as the authorities should have done? But this would have put the banks again in a precarious position, requiring another government bailout, for which it had neither the money nor the political will. Lying to a court is normally a very serious matter. Lying to the court routinely, hundreds of times, should have been an even greater offense. There was a true pattern of crime. If corporations had been people[31] in a state that enforced a "three strikes" rule (three instances of shoplifting, and one faces a mandatory life sentence), these repeat offenders would have been sentenced to multiple life sentences, without parole. In fact, no bank officer has gone to jail for these offenses. Indeed, as this book goes to press, neither Attorney General Eric Holder nor any of the other U.S. district attorneys have brought suits for foreclosure fraud. By contrast, following the savings and loan crisis, by 1990, the Department of Justice had been sent 7,000 criminal referrals, resulting in 1,100 charges by 1992, and 839 convictions (of which around 650 led to a prison sentence).[32] Today the banks are simply negotiating what their fines should be—and in some cases the fines may be less than the profits that they have garnered from their illicit activity.[33]

What the banks did was not just a matter of failing to comply with a few technicalities. This was not a victimless crime. To many bankers, the perjury committed as they signed affidavits to rush the foreclosures was just a detail that could be overlooked. But a basic principle of the rule of law and property rights is that you shouldn't throw someone out of his home when you can't prove he owes you money. But so assiduously did the banks pursue their foreclosures that some people were thrown out of their homes who did not owe any money. To some lenders this is just collateral damage as the banks tell millions of Americans they must give up their homes—some eight million since the crisis began, and an estimated three to four million still to go.[34] The pace of foreclosures would have been even higher had it not been for government intervention to stop the robo-signing.

The banks' defense—that most of the people thrown out of their homes did owe money—was evidence that America had strayed from the rule of law and from a basic understanding of it. One is supposed to be innocent until proven guilty. But in the banks' logic, the homeowner had to prove that he was not guilty, that he didn't owe money. In our system of justice it is unconscionable to convict an innocent person, and it should be equally unconscionable to evict anyone who doesn't owe money on her home. We are supposed to have a system that protects the innocent. The U.S. justice system requires a burden of proof and establishes procedural safeguards to help meet that requirement. But the banks short-circuited these safeguards.

In fact, the system we had in place made it easy for them to get away with these shortcuts—at least until there was a popular uproar. In most states, homeowners could be thrown out of their homes without a court hearing. Without a hearing, an individual cannot easily (or at all) forestall an unjust foreclosure. To some observers, this situation resembles what happened in Russia in the days of the "Wild East" after the collapse of communism, where the rule of law—bankruptcy legislation in particular—was used as a legal mechanism to replace one group of owners with another. Courts were bought, documents forged, and the process went smoothly. In America, the venality operates at a higher level. It is not particular judges who are bought but the laws themselves, through campaign contributions and lobbying, in what has come to be called "corruption, American-style." In some states judges are elected, and in those states there's an even closer connection between money and "justice." Monied interests use campaign contributions to get judges who are sympathetic to their causes.[35]

The administration's response to the massive violations of the rule of law by the banks reflects our new style of corruption: the Obama administration actually fought *against* attempts by states to hold the banks accountable. Indeed, one of the federal-government controlled banks[36] threatened to cease doing business in Massachusetts when that state's attorney general brought suit against the banks.

Massachusetts attorney general Martha Coakley had tried to reach a settlement with the banks for over a year, but they had proved intransigent and uncooperative. To them the crimes they had committed were just a matter for negotiation. The banks (she charged) had acted both deceptively and fraudulently; they had not only improperly foreclosed on troubled borrowers (citing fourteen instances), relying to do so on fraudulent legal documentation, but they had also, in many cases, promised to modify loans for homeowners and then reneged on the promise. The problems were not accidental but systematic, with the MERS recording system "corrupting" the framework put into place by the state for recording ownership. The Massachusetts attorney general was explicit in rejecting the "too big to be accountable" argument: "The banks may think that they are too big to fail or too big to care about the impact of their actions, but we believe they are not too big to have to obey the law."[37]

In late February 2012, the *Wall Street Journal* uncovered another unsavory aspect of America's foreclosure crisis. Just as we noted in chapter 3 that there had been discrimination in the issuance of mortgages, so too in the foreclosure process—this time not on the basis of race but on the basis of income. On average, it took banks two years and two months to foreclose on mortgages over $1 million, six months longer than on those under $100,000. There were many reasons for this, including banks' exerting greater efforts to accommodate these big debtors and borrowers' being better armed with lawyers to defend themselves.[38]

The discussion of this chapter, along with that of chapter 6, has shown how the financial sector made sure that the "rule of law" works in its favor *almost always*, and against ordinary Americans. It has the resources, the organization, and the incentives to do so; and it accomplished what it set out to do, through a multifaceted attack that included reforming bankruptcy laws to increase their power over borrowers, ensuring that private, for-profit schools could get access to student loans, almost regardless of standards, abolishing usury laws, preventing legislation to curtail predatory lending, and circumventing the procedural safeguards, weak as they were, to make sure that only individuals who really owed money would lose their homes. But in lending and in foreclosures they targeted the weak, the poorly educated, the poor. Moral scruples were set aside in the grand quest to move money from the bottom to the top.

In chapter 6 we explained how the foreclosure crisis could itself have been largely avoided, if we had only not let the banks have so much influence, by allowing an orderly restructuring of debt, just as we do for large corporations. At each step of the way, from the initial making of loans to the final foreclosure, there were alternatives and regulations that would have curtailed the reckless and predatory lending and enhanced economic stability—perhaps even avoiding the Great Recession itself—but with a political system where money matters, these alternatives had no chance.

The mortgage debacle and the persistence of predatory lending and bankruptcy "reform" have raised deep questions about "the rule of law," which is the universally accepted hallmark of an advanced, civilized society. The rule of law is supposed to protect the weak against the strong and ensure fair treatment for all. In the wake of the subprime mortgage crisis, it has done neither. Instead of a rule of law that protected the weak, we had laws and regulations and a system of enforcement that further empowered the already powerful banks. In moving money from the bottom to the top, they worsened the problems of inequality in both tails of the income and wealth distribution.

De Facto vs. De Jure

Running a judicial system is costly, and the rules of the game determine how large those costs are and who bears them. If one designs a costly system in which the parties themselves bear the cost, then one is designing an unfair system, even if in principle it seems otherwise. If one designs a slow judicial system, that too can be unfair. It's not just that "justice delayed is justice denied," but that the poor can't bear the costs of delay as well as the rich. Corporations know this. In their negotiations with less wealthy opponents a standard tactic is to make a small up-front offer and threaten to impose a long and costly process with an uncertain outcome if the offer is not accepted.[39]

Even access to the legal system is expensive, and that gives an advantage to large corporations and the wealthy. We talk about the importance of intellectual property, but we have designed an expensive and unfair intellectual property regime that works more to the advantage of patent lawyers and large corporations than to the advancement of science and small innovators.[40] Large firms can trespass on the intellectual property rights of smaller ones almost with impunity, knowing that in the ensuing legal fight they can outgun them. Rogue patent trolls (law firms) can buy sleeping patents (patents that have not yet been used to bring products to the market) at a low price, and then when a firm is successful in the same field, claim trespass, and threaten to shut it down as a form of extortion.

That's what happened to Research in Motion, the producer of the popular BlackBerry, which became the target of a patent suit from "patent-holding company" NTP, Inc. That company is currently also in litigation involving Apple, Google, Microsoft, Verizon Wireless, AT&T, Yahoo! and T-Mobile USA.[41] It wasn't even clear whether the patents that were supposedly infringed were valid. But until their claims are reviewed and declared invalid—which may take years and years, the "owners" of the patent can shut down any firm that might trespass, unless it pays *whatever* fee and accept *whatever* conditions are imposed upon it, including the condition that the patent not be challenged. In this case, BlackBerry gave in to the demands and paid more than $600 million to NTP.[42]

More recently, the cell phone industry has engaged in a tangle of patent disputes (involving Apple, Samsung, Ericsson, Google, Microsoft, Motorola, Nokia, RIM, LG, HP, and a patent holder, Acacia Research Corporation), in a variety of legal forums in different countries. While the outcome is uncertain—if certain parties win, the range of choices consumers face may be dramatically reduced and prices increased—what is certain is that the big winners in these battles will be the lawyers.

The legal system itself extracts large rents, as we noted in chapter 2. The big legal battles to enforce the laws that exist—say, over whether Microsoft violated the laws designed to maintain a competitive marketplace or whether the banks committed fraud—entail battalions of lawyers. There has been an arms race; and it's an arms race in which the banks that engage in fraud or the firms that engage in anticompetitive practices have the big advantage, especially since private firms do what they can to circumscribe government's ability to spend. The consequence is illustrated by how the Securities and Exchange Commission has pursued repeated occurrences of fraud by America's banks.

The SEC and securities fraud

I have described how the banks tried to take advantage of ordinary homeowners in the mortgage market. The banks tried to take advantage of the more financially sophisticated as well. The SEC (the U.S. Securities and Exchange Commission, which is in charge of enforcing the federal securities laws) has repeatedly brought civil enforcement actions against Citibank and other major banks for violations of the fraud laws.

What happens after that has generally followed this path: The banks threaten a never-ending legal battle. Compromise follows: the banks pay a large fine, neither admitting nor denying guilt. They also promise never to do such a thing again. But soon after their promise, they engage in similar behavior again. Then they incur another scolding and a fine they can afford.

It's a convenient solution: the government has limited resources to prosecute legal cases, and there are many instances of fraud. Having reached a settlement on one, the government can then go on to attack another. The system also suits the banks: the cost is low relative to the profits they reap from their fraudulent behavior, and, had they admitted guilt, the evidence could have been used against them in private litigation brought by those the fraud injured in their attempt to recover their losses. The banks know that most of their victims don't have the legal resources to challenge them without the government's help. No one can claim that justice is really being done in this system. An economic system in which there is a pattern of such abuses can't work well: fraud distorts the economy and undermines trust.

A court has to approve the SEC settlements, and the courts typically approve them pro forma. But for one judge the level of fraud finally proved too much. In late November 2011, Judge Rakoff of the U.S. District Court in Manhattan rejected a proposed $285 million settlement from Citigoup on a fraud charge. He noted that the bank had been a repeated offender, a "recidivist." It was clear that the SEC enforcement actions were having little effect on its behavior, partly because the SEC didn't bring contempt charges against repeated offenders like Citibank for violating their promises.

In this case, Citibank (like many of the other banks, including Goldman Sachs) had constructed securities consisting of mortgages that it believed would fail, partly so that it (or, in the case of some other banks, favored customers) could bet against the securities. When the values declined, the bank (or its favored customers) made huge profts at the expense of the bank's clients who purchased the securities. Many of the banks didn't disclose what they were doing. One variant of their defense was caveat emptor: "No one *should* trust us, and anyone who does is a fool." But in the case whose settlement Judge Rakoff rejected, Citibank and some of the other banks had gone beyond keeping silent on the risks: they had falsely told investors that an independent party was choosing the portfolio's investments. While investors lost $700 million in the deal, Citibank made $160 million.

If this were an isolated instance, it could be blamed on a few individuals. But the *New York Times*, in an analysis of SEC fraud settlements, "found 51 instances, involving 19 companies, in which the agency claimed that a company had broken fraud laws that they previously had agreed never to breach."[43]

It would seem we have an economic and legal system that provides incentives for bad behavior: the executives' pay goes up when profits go up, even if the profits are based on fraud; but the company's shareholders pay the fines. In many cases the executives who were responsible for the fraudulent behavior have been long gone. There is something to be said here for criminal prosecutions against executives. If the shareholders pay the fines, and management pays itself compensation based on short-term performance and hiding risks in the tails of the return distribution (the events that occur with small likelihood, like getting caught, prosecuted, *and* fined), we shouldn't be surprised at these persistent patterns of fraud. In such circumstances, we have to go beyond fining the company: it is people who make decisions and take actions, and they should bear responsibility for their actions. Those who commit these crimes can't just shift their accountability to an abstract entity called the "corporation."

Concluding Comments

The need for a strong rule of law is widely accepted, but it also matters what kind of rules there are and how they are administered. In designing the system of laws and regulations that govern an economy and a society, there are trade-offs: some laws and regulations favor one group, others another.

We have examined several examples where what has happened was perhaps predictable: the laws and regulations, and how they are implemented and enforced, reflect the interests of the top layer of society more than those of the people in the middle and at the bottom.

Growing inequality, combined with a flawed system of campaign finance, risks turning America's legal system into a travesty of justice. Some may still call it the "rule of law," but in today's America the proud claim of "justice for all" is being replaced by the more modest claim of "justice for those who can afford it." And the number of people who can afford it is rapidly diminishing.