Preface

> It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way—in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.
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> *Tale of Two Cities*, Charles Dickens

We are living in a new age of economic inequality; a new age that is reminiscent of past ages, but also a new age that is better than it ever has been before. Over the last 25 years, nearly two billion people across the globe have risen out of poverty, poverty rates in the US and other developed countries have declined, and income levels have risen worldwide (albeit slower than before for most of the rich world). Yet economic dissatisfaction—driven by the persistent fear felt by many that they are "falling behind"—is higher than at any point since the 1930s. This is because of rising inequality. To pick just one fact to illustrate how much inequality has increased, in the US the top 1 percent earn twice the amount of income as the poorest 50 percent of the population. Read that sentence again. It means that those in the top 1 percent have average incomes that are 100 times what the bottom half of the US population earns.

Any history of the twenty-first century would be incomplete without discussing the "99 percent versus the 1 percent". Many political leaders have referred to inequality as the crucial issue of our time, and inequality is now dominating our civic conversations in ways that it has never done before. The proportion of articles in *The New York Times* mentioning economic inequality increased by a factor of ten between 2009 and 2016.[1] Recent elections on both sides of the Atlantic, in both the northern and southern hemispheres, from both the right and the left of the political spectrum, have been driven by the fears and frustrations associated with economic dislocation and the increasing disparity between those racing ahead and those who are running in place but falling further behind. There is growing recognition that increasing disparities in income and wealth pose a serious threat to entrepreneurship, democracy, social mobility, public health, education, and our civil society.

The fact that you are reading this book means that you too have been caught up in these discussions and share the same fears about inequality that most of your fellow Earthlings share—the anxiety associated with economic uncertainty is one rare thing that is more evenly owned by everyone in this time of polarization. The objective of this book is to bring an economist's eye and a mind broadened by insights from philosophy, sociology, psychology, and political science to examine questions related to why economic inequality is growing today and why this is so important for our economics and for our society. Why does inequality matter? How has it changed over time? What is driving it? How does it differ across people and places? What policies can be adopted to moderate it? These are seemingly simple yet extremely complicated questions. The good news is that many of our brightest minds are paying attention: inequality has risen to the forefront of the research agendas of many of the best scholars in sociology, political science, philosophy, and in economics. The last decade has brought with it more groundbreaking research into the causes and consequences of inequality—both theoretical and empirical—than the previous 50 years combined. My focus in this book is to serve as translator and facilitator—organizing and repackaging some of this groundbreaking research into a form that it is accessible to the rest of us who want to understand our world, our society, our politics, our paychecks, and our neighbor's paychecks better.

Let me begin this book on economic inequality by possibly surprising you: until recently, economics has not really had much to say about inequality. Let me explain why this was, and why economists today are finally recognizing the importance of inequality long after the public was paying attention to it.

Economics is primarily the study of who gains and who gains more. In many ways, economics is the most optimistic of the academic disciplines. Its primary focus is on understanding where improvements in quality of life come from and how to get more of them. Economics generally focuses on mutually beneficial trades, not zero-sum outcomes where one person gains only when someone else loses. It tends to be most interested in growth and development, not decay and retreat. In contrast to its well-known moniker as the "dismal science", economics is the study of progress as much as it is the study of scarce resources, incentives, and trade. And the fact that our overall quality of life—by whatever measure you choose to use—has risen so dramatically over time and across the globe is a testament to the fact that while there have been periodic episodes of reversal, the greater arc of history is one of progress.

What drives improvements in people's quality of life? The primary focus of economics has been on advocating for efficiency and increasing productivity (output per worker hour) as the best means of improving the quality of life for everyone. The idea is that if people can become more productive and efficient, they will produce more with whatever resources they have. Greater production will expand the resources available to everyone in society, improving our general quality of life. In other words, by expanding the size of the proverbial pie, most people (although no guarantee that all people) will be left with more to eat than they would if the pie was small, regardless of the fact that everyone's slice may not be the same.

This iron link between productivity and well-being can be traced back to Adam Smith. The impetus for Smith's *The Wealth of Nations* was Smith's curiosity about why the quality of life was so much higher in England than in France in the mid-1700s. Smith placed the focus squarely on productivity. According to Smith's "invisible hand" theory, it is the efficiency gains from specialization amplified by the power of markets to share these gains far and wide that drive increases in productivity over time and that generate higher standards of living for society. Specialization is crucial to growth because it allows each individual to develop particular skills and tools that increase their productivity at specific activities. But markets are also necessary because they allow us to trade the narrow range of goods that we are good at producing for an infinite variety of goods that we are not so good at producing, granting each of us the best of both worlds—variety and volume—that improve our quality of life. While Smith's ideas on specialization and trade are simple, they are also powerful; after 250 years, they remain the most succinct explanation of the fundamental sources of improvements in our material conditions. Because of the predictive power of Smith's theories, and of the many other economists that came after him, efficiency has regularly been treated as synonymous with well-being by many economists.

A few of the founding fathers of economics did think about the role that distribution, not just efficiency, plays in determining our quality of life. Thomas Malthus worried about population growth among the lower classes and how this could depress their incomes below subsistence levels, leading to widespread famine. David Ricardo worried about how economic growth could raise the rental rate on land to levels that were unsustainable over time. The windfall for rentiers would consign tenant farmers to higher and higher levels of debt, eventually exposing everyone to the dangers of default and financial collapse. And there was Karl Marx, who believed that profits entirely flow to the rich owners of capital—profits that are generated only by depressing wages and consigning workers to subsistence levels of income. However, these economic worrywarts have never been the mainstream voices in economics, in part because their discussions of inequality were couched within dour economic models of economic collapse that are incongruous with the overall historical arc of economic progress. The dire predictions of their models have contaminated the study of inequality with the one idea that is abhorred in economics: pessimism.

As a result, until recently, economists have never really given income distribution the attention that it deserves. Inequality has generally been a second-order concern to efficiency, despite the fact that even the most ardent free-market economists recognize that the unequal distribution of resources has costs (as well as possibly benefits) that should be considered when studying economic behavior. The predominant viewpoint in economics is well captured by the Nobel Prize winning economist Robert Lucas, who sees less danger in inequality than he does in people worrying too much about inequality:

> Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on the questions of distribution … The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production.[2]

You might say that Lucas ascribes to the invisible hand theory of pie-making: if you make the pie bigger, the market will figure out a way to make sure that most people will get a larger piece than they had before.

Consider two specific examples of how economists have often purposefully ignored the impact of inequality. The first is the widespread use of representative agent models in economics, where groups of people are assumed to be just the same median person, multiplied. Representative agent models significantly simplify economic analysis, but at the cost of pretending that inequality doesn't matter because everyone is basically the same. Second, economists sometimes evaluate the welfare impacts of policy using the "Pareto efficient" standard, meaning that one policy cannot be superior to another unless every single person is made better off by it. Any policy that redistributes income from one person to another is destined to fail the Pareto standard, even a policy that benefits everyone at a slight expense to a single individual. Using the Pareto efficient standard to evaluate policy places a heavy hand on the scale in favor of policies that emphasize overall efficiency and ignore how any gains from these policies are distributed.

However, the study of economics in the real world recognizes few Pareto efficient outcomes where everyone wins but no one loses. By too often focusing on scenarios where macroeconomic outcomes are emphasized and distributional effects are glossed over, economists have reduced their public standing in the debate over economic inequality and weakened their influence. The impact of this on the study of economics generally—and on the study of inequality specifically—has not been good. By failing to give inequality the consideration that it deserves, economists have ceded much of the study of economic inequality and the notion of what constitutes "fairness" to other disciplines: political science, philosophy, sociology, and psychology chief among them. This is not to say that these disciplines have nothing to say on this topic—in fact, they have a great deal to say, and I will attempt to present some of what we have learned from these disciplines regarding what fairness means and what it looks like in the real world. But by assuming that fairness has more to do with politics and philosophy than economics, economists have allowed muddled thinking and mistaken conclusions about inequality to persist in our public debates. All economists must recognize that fairness can be an important outcome for society in and of itself, and must think more carefully about what economic fairness looks like both in theory and in practice.

There is another, and in my mind more important, reason why inequality must move to the forefront of economics. It is because understanding inequality is key to understanding how economics actually works. In the real world—not the world of most theoretical economists—it is not our *absolute* standing that often determines our behavior, but it is our *relative* status. Inequality is not just the outcome of economic interactions, but it fundamentally influences economic decision-making because of our psychology and the complex social and institutional environments within which we interact with each other.

Traditional economics has assumed that there is a simple tradeoff between efficiency and equity: to have efficiency, we must accept a certain level of inequality. However, if there is one thing I hope to accomplish in this book, it is to convince you that if the only thing you know about the economics of inequality is the efficiency/equity tradeoff, then your knowledge of economics is dangerously simplistic. In fact, efficiency and equity often go hand-in-hand. Belief in a strict efficiency/equity tradeoff is based upon a worldview that ignores many of the major developments in economic thinking over the last three decades. Some of these new developments (which we will talk about in much greater detail later) include: the power of networks in generating new ideas; the importance of psychology and behavioral economics in decision-making; the significance of social norms and status; the crucial roles of social capital and trust; the market failures created by information externalities; the importance of coordination failure and historical path dependence; the impact of financial market failures and macroeconomic instability; the political economy of democratic capitalism; and the primacy of economic institutions.

In this book, I hope to convince you that there is no simple tradeoff between efficiency and equity, but a virtuous/vicious circle can exist between the two where more equality can actually increase efficiency and productivity, while higher levels of inequality can actually reduce productivity. In such a world, inequality is no longer just a matter of second-order importance, but of first-order significance equal to that of efficiency. Studying inequality is not at the periphery of economics, but at its core.

In a counter to Robert Lucas, another Nobel Prize winning economist, Robert Solow, captures this new thinking in the following quote:

> Heterogeneity is the essence of a modern economy. In real life we worry about the relations between managers and shareowners, between venture capitalists and

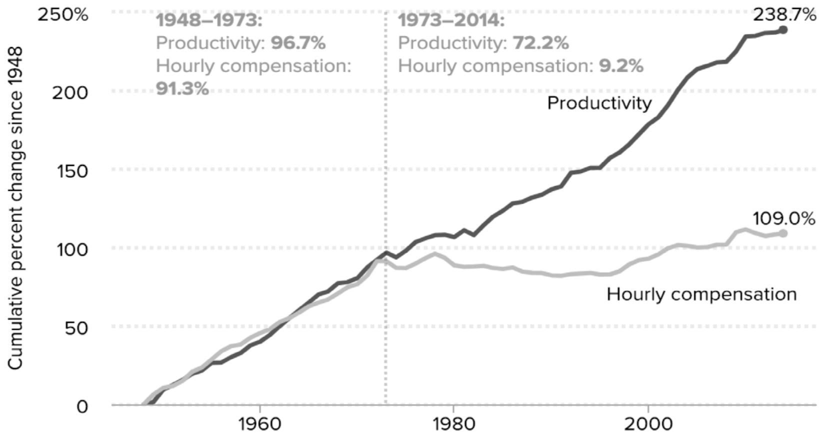
> entrepreneurs, you name it … We know for a fact that heterogeneous agents have different and sometimes conflicting goals, different information, different capacities to process it, different expectations, different beliefs about how the economy works. [Traditional economic] models exclude all this landscape.[3]

To put this another way, modern economics recognizes that there is more than a little truth to the quip by H. L. Mencken that a wealthy person is anyone with an "income that is at least $100 more a year than the income of one's wife's sister's husband".[4]

Let me give you a brief introduction to the ways that the relationship between efficiency and equality is more complicated than it is often portrayed in an introductory economics course. Consider the way that wages are set within an economy. Classical economic models assume that everyone's wages reflect their own marginal productivity, meaning the amount of output that they alone produce. As a result, the Classical assumption is that inequality simply reflects the fact that some workers are more productive than others. But in the real world, how does a firm know a single worker's productivity? Most people work in groups, where the productivity of one worker is dependent upon the productivity of their teammates, of the business strategies they may or may not have a hand in drafting, on the capital and technology that the firm has available to use, and even on social norms within the firm. This is true if you are the lowest level worker in the company hierarchy, and even more true if you are the CEO of a company. As a practical matter, there is no such thing as individual productivity for most jobs, yet many Classical economists act like there is. If wage differences do not reflect large differences in individual productivity, the Classical explanation of income inequality falls apart.

Likewise, even if the productivity of individual workers could be measured, do wages always reflect that productivity? There are good reasons to believe that they often do not. One reason is that there are often market failures that allow some people with more power to reap returns that are higher than their marginal productivity—these excess returns are what economists call *economic rents*. Consider Figure P.1, which presents data on cumulative productivity growth since 1948 and average pay growth for non-supervisory workers who are directly involved in production (in other words, hourly workers that are not salaried managers, and who comprise 80 percent of the workforce).

Before 1973, the iron link between productivity and wages held for these workers, just as assumed in Classical economic models. But since the mid-1700s—roughly when our modern era of growing inequality began—productivity has grown at *eight times* the rate of a typical worker's pay. And since 2000, productivity has been growing at *ten times* the rate of a typical worker's pay. In other words, the benefits of higher productivity are not going to the vast majority of workers, but elsewhere in the form of economic rents.



Source: Bivens and Mishel (2015), used with permission.

Figure P.1 *Growth of productivity and pay of production/non-supervisory workers, 1948–2014*

Another reason why wages may not reflect actual productivity is because most wages are determined within the context of where you work: your wage is a function of your level within a company, your years of service, the evaluations of peers and supervisors, the industry your company operates in, where your job is located, and the profitability of the company in addition to measures of productivity. In other words, wages reflect social norms, aggregate productivity, and complicated professional networks as much or more than individual productivity. If this wasn't true, then why is it that an average immigrant from Mexico can increase their wages by 250 percent simply by migrating to the US, or a Haitian by 1,000 percent, or a Nigerian by 1,500 percent? In this context, when we talk about why wages have become more unequal, we are not only talking about why some individuals are paid more than other individuals, but why some groups of people are paid more for doing similar activities than other groups of people. These are complicated questions for which Classical economic wage theory gives us few satisfactory answers. Thinking carefully about these questions—and others like them—gets us much closer to the big questions we want to address in this book about what causes inequality, its impact on society, and how we deal with it.

This book has eight chapters, each organized around a question. Chapter 1, 'How Do We Measure Unequal? The Who, Where, What, When, and How of Inequality', focuses on how we define and measure economic inequality. Many of our debates about inequality boil down to the fact that there are many different definitions and types of inequality, and many different data sources with which to measure it. Here we introduce the most common sources of inequality data and frame some of the important questions for discussion throughout the rest of the book.

Chapter 2, 'How Unequal Are We? Six Major Facts', summarizes the empirical data on wealth and income inequality across the globe in six major facts, highlighting how inequality in income and wealth within countries is growing, but inequality in income across the globe (ignoring nationality) is falling.

Chapter 3 is entitled 'Why Might Inequality be Necessary? Incentives, Freedom, and Efficiency'. Before I discuss the reasons to be worried about inequality, it is important to understand why some scholars have argued that we shouldn't worry about inequality, or should even be happy about it. This "let the market decide" approach to inequality has a long history, not only in economics but also in philosophy. In this chapter we will examine the arguments that inequality simply reflects efficient differences in productivity that should be rewarded, that inequality incentivizes higher productivity, that providing equality of opportunity should be our focus rather than promoting equality of outcomes, and that economic policy should concentrate on dealing with poverty and not inequality.

Chapter 4, 'Why Does Unequal Matter? The Economic Externalities of Inequality', gets to the heart of the matter: Why exactly should we be worried about economic inequality? Here, we examine why there may not be a tradeoff between equity and efficiency but in fact a virtuous/vicious circle between the two. This chapter will focus on the social nature of productivity and wage determination; the role that inequality plays in degrading social capital, polarizing our political systems, reducing public health, and reducing social mobility; how inequality can lead to financial fragility and macroeconomic instability; and recent research on the ways that our perceptions of fairness and our relative positions in social hierarchies impact productivity.

Chapter 5, 'Why has Domestic Inequality Risen, and Fallen, and Risen?', examines why inequality within countries is rising today in most countries. Over the very long run, inequality has risen and fallen across the globe in long waves. In this chapter, we will examine why there have been these ebbs and flows in inequality, paying particular attention to why domestic inequality fell in the mid-1900s in most countries but has risen dramatically since 1980. Many hypotheses have been offered to explain rising inequality today, such as: globalization, skills-based technological change, rising returns to capital (particularly intangible capital), changes in fiscal policy, rising market power and economic rents, and changes in family structure. We will investigate each of these potential factors.

Chapter 6, 'Why are the Three Most Important Factors in Global Inequality Location, Location, and Location?', changes our viewpoint and examines inequality not from a country-specific perspective, but from a global perspective. Here, the focus is on differences in income and wealth between countries and across the entire world population. The biggest fact in global economic inequality is that the vast majority of inequality across people can be explained by one simple word: where. In other words, *where* is much more important than *who*, which indicates that the social determinants of productivity and the networks we work within are much more important than individual productivity. The focus in this chapter is to understand why location is so important to everyone's potential income, and, in the process, understand why inequality, poverty, and wealth are so persistent across place and time. We will also investigate why global inequality has been falling, but why there remain tremendous incentives for people to migrate from poor countries to rich countries.

Chapter 7, 'Is Inequality a Problem We Can Solve?', examines the efficacy of public policies that could moderate inequality, weighed against their potential costs. This includes examining structural reform policies that change the workings of markets (such as changes in labor laws, creating more market competition, and improving education) and fiscal policies that transfer resources from the richer to the poorer citizens (such as increasing the progressiveness of taxation and providing everyone guaranteed incomes). The goal here is to broadly consider the policy menu that governments have to choose from when they set a goal to reduce inequality.

Finally, Chapter 8 is entitled 'What is the Future of Economic Inequality?' There is always value in looking forward, even when forecasting in economics is murky enough to make any prediction about the future very likely to be wrong. I conclude this book with a discussion of the most likely continuing trends in economic inequality and what factors will be most likely to drive the distribution of income and wealth in the future. Despite the fact that this book is about the seemingly dour topic of economic inequality, I hope to leave you with a sense of optimism by convincing you that rising economic inequality does not have to be the inevitable outcome of capitalism. In fact, we can have a world that is both more productive and more fair, and that there are tools at our disposal that can gain us entry to this world if we can first educate ourselves about the full causes and consequences of economic inequality, and then choose to take appropriate action.

NOTES

1. Pinker (2018).
2. Lucas (2004), p. 20.
3. Solow (2003).
4. Mencken (1916), p. 209.