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**WIDENING INEQUALITY: IMPLICATIONS FOR AMERICANS' ATTITUDES
AND AMERICAN SOCIETY***

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Although increased economic inequality in America has emerged only recently as a front-line issue in public debate, in fact the gaps separating those who have more from those who don't have been widening for several decades. On the most broadly based conventional measure, the incomes of American families were most tightly distributed in 1968.¹ Different segments of the country's income distribution have likewise been systematically gaining or losing ground compared to one another, in directions that take them farther apart, for some decades. Families in the bottom fifth of the distribution, for example, had increased their share of all incomes earned from 4.5 percent in 1950 to 5.7 percent in 1974; by 1991 the bottom fifth were back to a 4.5 percent share, and by 2005 they were down to just 4.0 percent. Families in both the next fifth and the middle fifth reached their peak share of the country's total income in 1957, at 12.7 percent and 18.1 percent, respectively; today these groups' shares of the total are only 9.6 percent

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and 15.3 percent. At the other end of the scale, families in the top fifth have seen their share of America's income rise from 40.5 percent in 1966 to 48.1 percent today. Further, nearly all of this increase has accrued to what amounts to the top of the top. Families in the top one-twentieth of the distribution have jumped from a 14.4 percent share of the total, as recently as 1981, to 21.1 percent today.

This phenomenon has confounded conventional expectations. A half-century ago Simon Kuznets hypothesized that inequality would widen in a country's initial stages of economic development, but that further economic advance would lead to progressively more equal incomes.² Kuznets not only offered cogent theoretical reasons why inequality within any given economy should trace out a widening and then narrowing trajectory over time but also showed that the historical experience of the United Kingdom, the United States, and other by-then advanced industrial economies was consistent with this hypothesis. Subsequent research also found support for Kuznets's claim, especially the idea that after some point inequality tends to narrow with further economic development.³ Hence the recent widening of inequality, not just in the United States but in most other high-income countries too, has come as a surprise.

It also raises troubling questions of broader significance. The specific focus of this paper is the way in which the interaction between economic growth and changing inequality governs the extent to which the majority of a country's citizens either enjoy rising living standards or not. In earlier work I have argued that a rising standard of living, for the broad bulk of a society's citizenry, is a crucial condition determining whether that society also makes progress in a variety of other dimensions that Western thinking has traditionally regarded as positive in explicitly moral terms: tolerance, openness of opportunity, generosity toward the disadvantaged, and

commitment to democracy, among others. When the majority of citizens see that they are getting ahead economically – and share a sense of optimism that they will continue to do so in the future, and even that their children will achieve yet further economic advance after them – their society typically moves forward in these other, moral dimensions as well. But when people see their living standards stagnating or even in decline, in most cases the society makes no further progress on these moral fronts; instead the outcome is retrenchment and rigidification, often with disastrous consequences.

The important question that follows is what measures American public policy can and should take to address this situation. But knowing what to do depends in the first instance on understanding why U.S. inequality has been increasing so rapidly in the first place.

Causes of Widening Inequality

Two key features provide the starting point for any inquiry into why inequality has been widening so dramatically in America in recent decades. First, this is not a uniquely American phenomenon. Virtually all other advanced industrialized countries have, to at least some extent, undergone a similar experience in recent years. Second, while income from asset ownership has always been distributed highly unequally, and may have become more so (from the existing data it is difficult to tell), widening disparities in labor income – which represents some two-thirds of all incomes earned in the United States – has clearly driven the wider inequality in incomes as a whole. The core of any explanation for widening inequality in America must therefore be a story that applies to other advanced economies as well, and that revolves in large part around income earned from work.

The most obvious driving force behind this worldwide process is technological change, and more specifically the ongoing revolution in information processing and transmission. With new technologies replacing old ones, some skills and some forms of experience that people bring to the workplace take on increased value while others become less useful. (To take one very simple example, more than half of all new jobs created in the United States today involve using a computer keyboard.) If the supply of workers who have the newly valued skills fails to keep pace with the increasing demand for them – as almost inevitably happens at first when technological change is unexpected – then employers' efforts to compete for those scarce workers will result in a larger wage premium for whoever qualifies. Conversely, the wages of those who have few skills, or whose skills are no longer useful in the changing workplace, will fall behind.

Indeed, not just in America but elsewhere too, wage differentials have been widening not just randomly but systematically, in line with any observable measure of either skill or experience. Not surprisingly, in light of the driving role of information technology in this process and the skills required to take advantage of that technology, education is particularly important in this respect. In 1950 Americans with a college education enjoyed wage rates that were on average 31 percent above their counterparts with only a high school education. By 1980 the premium on a college education had risen, but only to 38 percent. The demand for college-educated employees was expanding rapidly, but with more and more Americans going to college the supply was almost keeping pace. Since then the demand for college-educated workers has accelerated, driven by new computer-based technologies, while the fraction of Americans who graduate from college has stagnated. By 2005 college graduates had wage rates on average 62

percent above those with only a high school diploma. In the same way, although much less dramatically, the wage advantage of high school graduate over those who do not even complete high school has risen from 23 percent in 1980 to 29 percent today. In the race between the technology-driven demand for more skilled workers and the education-driven supply, the American education system has increasingly been falling behind.⁴

In different ways, reflecting different positions on the technological spectrum, other countries have shared a similar experience. Throughout the industrialized world, wage inequality has been widening along lines of skill and experience. The same is true in developing economies too. Workers with the skills to operate sophisticated machinery have taken most of the higher-paying jobs in China's surging manufacturing centers. In India those with the ability to program computers, or read X-ray images, or even staff call centers, earn wages well above the country's average. But because the United States has made far greater investments in information technology than other countries, even those that also have advanced economies, the impact on wage differentials has naturally been larger here.⁵

Skill-biased technological change is almost certainly the most powerful force accounting for today's widening inequality, but other influences may be at work in this regard as well. In America one important factor that has compounded the effect of changing technology is the skill-biased pattern of immigration. Although the United States in recent years has instituted new categories of temporary visas for high-skilled workers, since the 1960s the criteria for permanent immigration have primarily emphasized family unification and other objectives not related to what immigrants bring to the workplace. As a result, even legal immigration tends to be skewed toward people with lower-than-average skills compared to the American workforce as a whole.

Presumably the same is true (probably more so) among illegal immigrants. Hence immigration patterns have added to the imbalance between high- and low-skilled workers, disproportionately bringing lower-skilled people into the American labor force at the same time that patterns of technological change are requiring higher-skilled labor instead. The result has been to drive skill-based wage inequalities even wider.⁶

Other developments, also specific to America, may have played some role as well. As is well known, the rewards payed out to top-level business executives have increased dramatically in recent years. Between the early 1990s and the early years of this decade, the compensation of the five highest-paid executives at U.S. public companies (which must be disclosed each year) doubled in relation to companies' earnings. Moreover, even the amounts paid to just these five individuals have become sufficiently large to represent a significant share of the typical firm's total compensation budget.⁷ At the other end of the scale, Congressional inaction over the years has allowed the federally mandated minimum wage rate to fall well behind ongoing inflation. At midyear 2007, just before the most recent increase took place, the minimum wage (at \$5.15 per hour) had an inflation-adjusted value less than two-thirds what it had been in the late 1960s. Yet a further contributing factor, probably affecting many workers whose wages are well above the legal minimum, is the declining influence of labor unions; today barely 7 percent of all workers in American business belong to unions.

Finally, the increasing exposure of American jobs and businesses to foreign competition, as advancing technology makes it possible to produce an ever wider range of goods and services in one country for final sale in another, may have influenced American inequality as well. In this case, however, although the overall effect on U.S. wages is clearly downward, the implications

for inequality are not obvious. Some high-wage jobs in America have proved especially vulnerable to shifting abroad – computer programming, routine legal work, and automobile assembly, for example – while many low-wage jobs (mowing lawns, collecting garbage, watching over parking lots) are, by the nature of the work, practically immune.⁸

In all probability, each of these disparate developments has played at least some role in influencing the continuing increase in inequality in America in recent decades. Especially for purposes of public policy, however, distinguishing those that are primarily responsible from those that play only peripheral roles is key. On the evidence, the most significant force at work has been skill-biased technical change, interacting with the far slower response in the skill mix of the American labor force.

The Importance of Rising Incomes and Improving Living Standards

Not surprisingly, widening inequality can – and, on the evidence, often does – have significant consequences. People’s sense of fairness plausibly refers not just to equality of opportunity but equality of outcomes as well. (If it didn’t, those sufficiently poor would be left to starve and go without medical care even in emergencies.) But the two are not unrelated. Because today’s earning power in part reflects skills garnered in the past, not to mention a vast complex of other acquired advantages as well, observed inequality of outcomes, particularly when it is systematic, is also suggestive of underlying inequality of opportunity. For just this reason, people’s attitudes toward inequality often differ depending on whether they believe economic success depends more on individual luck or societal forces.⁹ Similarly, attitudes to inequality often depend on perceptions of how easy economic mobility is. The long-standing

view that the United States offers greater opportunity for mobility than in other countries – in *Democracy in America*, Tocqueville wrote, “To tell the truth, though there are rich men, the class of rich men does not exist ... the rich are constantly becoming poor” – has served this country well in this regard.¹⁰ (Whether mobility here is actually greater than elsewhere is another matter.¹¹)

Widening inequality, in conjunction with a country’s overall pace of economic growth, can also affect people’s attitudes in another important way. The experience of many countries suggests that when a society experiences rising standards of living, broadly distributed across the population at large, it is also likely to make progress along a variety of dimensions that Western thinking, at least since the Enlightenment of the eighteenth century, has held to be not merely positive but positive in explicitly moral terms: openness of opportunity for economic and social advancement; tolerance toward recognizably distinct racial, or religious, or ethnic groups within the society, including immigrants if the country regularly receives in-migration; a sense of fairness in the provision made for those in the society who, whether on account of limited opportunities, or lesser human endowments, or even just poor luck in the labor market, fall too far below the prevailing public standard of material well-being; and a commitment to democracy, meaning not just open, contested elections determining who controls the levers of political power but also political rights and civil liberties more generally. Conversely, experience also demonstrates that when a society is either stagnating economically or, worse yet, suffering a pervasive decline in living standards, it is not only likely to make little if any progress in these social, political and (in the eighteenth century sense) moral dimensions, but rather will undergo a

period of rigidification and retrenchment; in some familiar cases the consequences, both for those societies and for others that they affect, have been catastrophic.¹²

The reason so many societies behave in this way stems from the familiar fact that most people evaluate how well off they are by considering their incomes or living standards not in absolute terms but relative to some benchmark. More specifically, there is substantial evidence for two separate benchmarks by which people judge such matters. Most people take satisfaction from living better than they, or their families, have lived in the past. And they take satisfaction from living better than their friends, neighbors, co-workers, and others with whom they compare themselves.

The pervasive tendency for people to evaluate their economic situation on these relative benchmarks, rather than absolutely, explains a variety of familiar features of economic and psychological behavior that otherwise would be puzzling – for example, the fact that within any one country, at any given time, people with higher incomes are systematically happier than those with lower incomes, but that there is no corresponding increase over time in how happy people are on average even though average incomes may be steadily increasing.¹³ As Adam Smith observed long ago, “all men, sooner or later, accommodate themselves to whatever becomes their permanent situation,” so that “between one permanent situation and another there [is], with regard to real happiness, no essential difference.” Smith went on, “in every permanent situation, where there is no expectation of change, the mind of every man ... returns to its natural state of tranquillity. In prosperity, after a certain time, it falls back to that state; in adversity, after a certain time, it rises up to it.”¹⁴

But this tendency toward a relative rather than an absolute perspective in such matters can also explain why market economies, as long as they deliver rising living standards to most of a society's population, bear positive social, political, and moral consequences. If people derive satisfaction *both* from living better than they have lived in the past *and* from living better than people around them – and, importantly, if these two sources of satisfaction are at least partially substitutes for one another – then people who are in fact living better than they have lived in the past (and have confidence that their living standard will continue to improve in the future) will attach less urgency to their desire also to live better than others around them. Hence the economically self-protective instinct that underlies so much of what emerges as intolerant, anti-democratic and ungenerous behavior – racial and religious discrimination, antipathy toward immigrants, lack of generosity toward the poor – naturally takes a back seat to other priorities when the economy in which people live is delivering sustained economic growth with broadly distributed increases in living standards.

In America's historical experience in particular, eras in which economic expansion has delivered ongoing material improvement to the majority of the country's population have mostly corresponded to eras when opportunities and freedoms have broadened, political institutions have become more democratic, and the treatment of society's unfortunates has become more generous. But when incomes have stagnated or declined, reaction and retreat have been the order of the day. (A major exception was the depression of the 1930s, which instead led to a significant opening of American society and strengthening of American democracy – perhaps because the economic distress was so severe and widespread that the sense of being together in the same

sinking ship overwhelmed the more competitive instincts that usually prevail when people realize they are not getting ahead.)

To take just one example, albeit one very much on the nation's political agenda today, attitudes toward immigrants are a useful case in point: The United States experienced a wave of anti-immigrant violence in the 1850s, but it largely disappeared during the robust industrial expansion that followed the Civil War. The long agricultural depression of the 1880s and 1890s saw a return, not of violence, but of extremely ugly anti-immigrant agitation and prejudice. That movement gave way, after the turn of the twentieth century when economic growth had returned, to a period in which the mood of the country was to welcome – in the language of the time, to “Americanize” – large numbers of immigrants. But the pair of economic downturns that followed World War I then led to the highly restrictive and plainly discriminatory Emergency Quota Act of 1921 and National Origins Act of 1924. (The first half of the 1920s was also when the Ku Klux Klan achieved its greatest influence in American society and politics, and not just in the south, or only in rural areas, but also in states like Michigan and Pennsylvania and in cities like Chicago and Indianapolis.)

Wholesale immigration reform followed only in 1965, in the middle of what was then the longest sustained economic expansion in U.S. history. As incomes stagnated in the late 1980s and early 1990s, however, a backlash developed including such manifestations as Proposition 187 in California and efforts in other high-immigration states like Florida and Texas to deny various public benefits even to legal immigrants. But with the strong economic expansion of the mid and late 1990s, the issue disappeared to such an extent that the one candidate who chose to run for president in 2000 on an explicitly anti-immigrant platform (Patrick Buchanan) attracted

so few votes, even in the Republican primaries, that he had to change parties. Today, following the return of mostly stagnating incomes since then, immigration is again a highly contentious issue, as the current presidential election plainly demonstrates.

It would be foolish to pretend that every twist in this century-and-a-half of American attitudes and policies toward immigrants was narrowly or deterministically driven by the simple difference between improving and stagnating living standards. But it would be absolutely blind to pretend that the underlying ebb and flow of economic prosperity and stagnation had nothing to do with what happened. And on other issues as well – race relations, religious prejudice, generosity to the poor, even such basics as who gets to vote and under what circumstances – the historical record likewise makes clear that America has made progress mostly when living standards for the majority of the nation's citizens are advancing. Leaving aside the depression of the 1930s, the opposite has been true when incomes have stagnated or fallen.

Nor is America the only long-established Western democracy where a connection between rising living standards and moral progress in this sense is evident. In Britain the opening of the universities, the civil service and other areas of society to non-Anglicans in the 1870s; the institution of many forms of basic economic protection in the 1940s, as recommended by the wartime Beveridge Report; and the reform of British race relations in the 1960s (at the same time that American blacks gained protection of their civil rights) all occurred during times of robust economic expansion and widely shared improvement in living standards. In France the same was true for the broad reforms in civil liberties, in electoral institutions and in education during the early years of the Third Republic, and for the parallel set of reforms introduced by de Gaulle after World War II. In Germany the legal and judicial reforms that followed the

unification of the German empire in 1871, the creation of the Federal Republic as a post-war democratic state, and Willy Brandt's dramatic challenge to "dare more democracy" likewise all occurred in the context of robust, sustained, widely shared increases in incomes and living standards.

Conversely, many of the horrifying anti-democratic phenomena that so marred Europe's twentieth-century history ensued in a setting of pervasive economic stagnation or decline. The most obvious example, Hitler's rise to power in the wake of economic and political chaos under the Weimar Republic, is a familiar story. But it is worth recalling that as late as 1928 the Nazi party drew only 2.8 percent of the vote in German national elections. What made the difference, soon thereafter, was the onset of depression, which affected Germany more than any other European country. Similarly, France's Vichy regime, which willingly collaborated with the authorities in German-occupied areas of the country – further, France was one of only two European countries (along with Bulgaria) to turn over to the Nazis Jews from territory that the Germans did not occupy – emerged out of a protracted period of French economic stagnation.¹⁵

In short, the evidence is clear that improving living standards, broadly enjoyed throughout a country's citizenry, have powerful consequences that extend far beyond the realm of purely economic concerns. Unfortunately, those consequences are also at work, but in the opposite direction, when living standards stagnate or decline.

Consequences of Widening Inequality When Economic Growth Is Limited

The importance of widening inequality in this context springs from the basic principle that in a heterogenous society economic growth does not benefit everyone identically, and that

when the fruits of growth accrue disproportionately to some people, growth in the aggregate is not always sufficient for others to get ahead as well. The point is especially apt in America today, where the labor force is highly heterogenous (perhaps becoming more so as a result of trends in education and immigration), the economy's large investments in information technology are leading to ever wider skill-based differentials in what workers are able to earn, and the economy's already-advanced status means that its aggregate growth is likely to be modest even under the best of circumstances.

Income distributions, in all known economies, are positively skewed; in other words, there are more people with incomes far above average than far below average. As a result, the *median* income – that is, the income of the person, or family, just in the middle of the income ranking (so that half of the population has greater incomes, and half lower) – is below the population-wide average, or mean. In the United States, for example, the total income produced in 2007 (the gross domestic product), was \$13.8 trillion. With 302 million residents, the average, or mean, income was therefore \$45,900 per person. No one who lives in America would suppose that the typical income for a family of four, say, was 4 times \$45,900, or nearly \$184,000. In fact, the median income for an American family of four was well below half that. (In 2006 it was \$73,400; median family income data for 2007 are not yet available.) The simple reason is that the income distribution is positively skewed.

As an economy grows, not just in terms of population but also in production per person, per capita income of course increases; in commonplace usage, this is the definition of economic growth. If everyone in the economy shared in that growth in proportion to the incomes already being earned, then the median income would rise in step with the mean, and the respective

percentages of the economy's total income earned by different groups within the population (the bottom fifth of the distribution, the top twentieth, and so on) would remain unchanged. But when the returns to the economy's incremental production are not distributed in proportion to incomes already being earned, then the median income – and therefore the incomes of at least half of the population – will either outpace the economywide per capita growth or fall further behind it. Specifically, when most of the returns to incremental production accrue disproportionately to those at the top of the scale, so that the income distribution as a whole is becoming more unequal, growth of the median income will be less than growth of the simple per capita average. (Conversely, if the returns to growth mostly accrued to those in the middle or at the bottom, incomes as a whole would become more equal and the median income would rise faster than the mean.)

If the economy's aggregate growth is fast enough, the bulk of the population can enjoy rising incomes and living standards even if widening inequality means that the increase in their incomes is less than that of the economywide per capita average. For example, since the beginning of the economic reforms instituted by Deng Xiao-ping, nearly three decades ago, China has maintained the fastest advance in per capita income observed anywhere in the world: on average, roughly seven percent per annum in real terms. The benefits of these economic gains have accrued highly unevenly, especially between the country's urban/commercial minority and its rural/agricultural majority. As a result, income inequality in China has widened rapidly. Thirty years ago China's income distribution was far more equal than America's; today it is slightly more unequal. But it is clear that the great bulk of China's population has enjoyed a significant improvement in living standards over this period. With such a rapid rate of aggregate

growth, there is room for widening income inequality to cause advances in the median income to fall well short of advances in the per capita mean, and yet for the median to rise solidly nonetheless.

The United States, like other countries where the economy is already highly developed, is unlikely to achieve an overall growth rate anything like China's. Living at the frontier of economic advance (America has by some distance the highest per capita income of any of the world's large economies) is different from playing catch-up. Growth in an already-advanced economy requires creating and implementing new technologies, not just imitating what others have already done. Further, unlike in China and other developing economies, approximately five-sixths of Americans already graduate from high school and two-thirds of those go on to receive some college education (although less than one-third graduate with a four-year degree). Hence the rapid gains in productivity of the labor force that follow from providing basic education to wider groups within the population are already in the past. Instead, over the last half-century America's growth of real per capita income has averaged only 2.1 percent per annum.

Growth of only 2 percent per annum in per capita mean income, in contrast to China's 7 percent, allows much less latitude for the fruits of that growth to accrue disproportionately to those at the top while still leaving enough to provide rising incomes to those in the middle of the scale or lower. Hence widening inequality is problematic for an advanced economy like America's in ways that it is not for a country like China. Even with only modestly increasing inequality, growth in the range of 2 percent in the per capita mean can translate into no growth at

all, or even a decline, in the median income – and therefore in the incomes of the majority of the country's citizens. Indeed, this is precisely the situation prevailing in America today.

Since 2000, the median income among American families has consistently lagged behind rising prices, and only those who are already at the very top of the income scale have experienced any improvement. In 2006 the income of the median family was \$58,400. At the beginning of the decade, the median family earned \$59,400 in 2006 dollars. For families in the bottom fifth of the nation's income distribution, the real decline in average income has been worse: from \$16,500 in 2000 to \$15,300 in 2005 (2005 is the latest year for which data on average family income by quintile is available). Even families in the top fifth saw their average income decline, from \$183,700 in 2000 to \$182,100 in 2005.¹⁶

The reason is not that there was no economic growth. Total economic output in the United States expanded on average by 2.4 percent per annum between 2000 and 2006, after allowing for higher prices, while the population grew by not quite 1.0 percent per annum. Hence the mean per capita income rose, in real terms, at an average rate of roughly 1.4 percent. The workforce became more productive at an even faster rate. Output per hour of labor input in the economy's nonfarm business sector rose on average by a healthy 2.7 per annum during these years. But the effect of widening inequality overwhelmed these gains, preventing any increase – actually, resulting in a small decline – at the median, and therefore presumably for the majority of the nation's families.

This situation differs sharply from what America had experienced throughout most of the nation's past. At times when productivity gains were strong, and the economy as a whole moved forward rapidly – the middle of the nineteenth century, for example, or the early decades of the

twentieth, or the quarter-century immediately following World War II, and most recently the mid to latter years of the 1990s – the bulk of the population likewise enjoyed rising incomes and improving living standards. Conversely, when productivity gains slowed, or the economy faltered for other reasons – in the late nineteenth century, during much of the period between the two World Wars, and for roughly two decades running from the early 1970s to the early 1990s – the public at large naturally saw little increase. What is different today is that the link between the U.S. economy’s aggregate productivity gains and output growth (and the corresponding increase in per capita income), and the increase in incomes and living standards that it delivers to the great majority of American citizens, has been severed.

In short, the American economy has been doing reasonably well, but most Americans haven’t. If this situation continues, the social, political, and ultimately moral pathologies that have emerged in prior eras of stagnating incomes and living standards, not just in America but in other societies as well, are very likely to reappear.

More Complex Patterns of Causation

Relationships like those connecting economic growth, inequality, and the broader social consequences of rising versus stagnating living standards need not flow in only one direction. The idea that rising living standards foster tolerance and open opportunity and democratic political institutions need not preclude the parallel notion that these features of society enhance the ability of any economy, but especially one like America’s based primarily on private initiative and decentralized markets, to achieve superior performance over time. At the most basic level, it is straight forward that either formal or informal restrictions barring half of the population from

certain jobs because they are of the “wrong” sex, and one-sixth of the remainder because their skin is the “wrong” color, interfere with a society’s ability to make the most efficient use of its labor resources. Failing to educate and train large numbers of children in a way that adequately equips them for modern post-industrial employment, often simply because their parents have failed to earn middle-class incomes, presents a similar impediment. Economists, who are normally more concerned with explaining economic phenomena than in exploring their consequences, have devoted substantial effort to investigating the role of different social and political institutions, and even different personal attitudes, in accounting for why some countries enjoy more economic success than others. The difference that greater or lesser equality makes for economic growth has long been part of that inquiry.

The traditional view, associated with economists as disparate as Smith, Keynes, and Kuznets, was that greater inequality fostered faster economic growth. Most importantly, because people with higher incomes typically save more than others, greater inequality means more saving and therefore more investment. (Whether that investment takes place at home or abroad matters for some purposes, but mostly not here.) There are also reasons to think greater inequality is likely to increase the median voter’s willingness to support public expenditures for education. In earlier phases of economic development, which are no longer of much relevance for the United States, there are yet other ways in which greater inequality can foster more rapid overall growth.¹⁷

In recent years, however, economists have placed greater emphasis on ways in which inequality may retard economic growth. The evidence is clear that greater inequality results in more social and political instability, thereby undermining the conditions that make either

households or firms willing to invest.¹⁸ Greater inequality also depresses investment by heightening concerns about potentially expropriative increases in taxation.¹⁹ There is also some evidence that inequality erodes personal trust among individuals – a feature of societies that ample other evidence suggests is conducive to better economic performance. For example, the difference in income inequality between Argentina (like most Latin American countries, a highly unequal society) and Austria (like most European countries, a very equal one) accounts for half of the difference between the lower level of personal trust found in Argentina compared to Austria.²⁰ In the context of early economic development, there is also evidence that a more equal distribution of incomes helps to reduce average fertility levels, thereby lowering birth rates and slowing population growth, and that it enables more households to achieve a secondary education.

As a result, societies may find themselves stuck in either a “virtuous” circle in which economic growth and greater equality (not to mention democratic institutions and freedoms more generally) mutually reinforce one another or, less fortunately, a vicious circle in which the stagnation of living standards blunts any movement toward addressing inequality while greater inequality retards economic growth and hence the improvement of living standards for most citizens. During much of the twentieth century, America’s experience overall more nearly resembled the picture of the virtuous circle. In recent decades, and especially in the current decade, the reality has been the opposite.

What Should Be Done?

Most economists agree that the principal force acting to widen income gaps in America in recent decades has been a technological revolution that has sharply increased the demand for some kinds of skills while reducing the demand for others. As a result, workers who have those newly scarce skills (computer programming, for example, or facility with certain forms of organizational management) have been able to command increasing premiums in the labor market, while those whose skills are in lesser demand (more basic industrial disciplines, or even brute-force manpower) have seen their wages decline and jobs become harder to find. The difference from what Kuznets hypothesized years ago is that instead of occurring just once, at the beginning of a country's economic development, this kind of massive shift in the demand for different kinds of skills in the workforce can recur whenever an economy undergoes a new technological revolution. Hence the distribution of incomes need not simply widen once and then contract indefinitely thereafter, but rather can undergo repeated episodes of widening inequality depending on the course of technological innovation. America, like most other advanced economies, is currently undergoing just such a shift.

Further, Kuznets and other economic historians (most prominently Jeffrey Williamson) posited that the subsequent narrowing of inequalities, once the technological basis of production has stabilized, is also the result of systematic economic forces. On the demand side, larger wage premiums for workers with certain skills lead business to innovate in yet further ways, so as to economize on the use of what has now become high-wage labor. At the same time, the larger wage premiums give workers an increased incentive to acquire the skills that are scarce, thereby introducing a supply response as well. Over time, therefore, the widening of inequality brought on by technological revolutions in countries that are far along the path of economic development

is also likely to turn around. But this process may be a lengthy one, as America's recent experience as well as in the latter half of the nineteenth century suggests, and along the way the wider inequality remains a fact with which the society must deal.

Importantly, however, public policy is also a significant part of this dynamic response to skill-biased technical change. In America, as in most other countries, the education of young people who are yet to enter the labor force is primarily the responsibility of the public sector. Hence a key part of the incentive to impart those skills that the labor market now values more highly must operate not privately but at the level of public policy. Numerous public education programs – ranging from improving the basic education that nearly everyone receives, to making college more affordable, to providing vocational training or even retraining – are potentially part of the warranted policy response. The evidence suggests that programs focused on the very young, such as Project Headstart for preschool children judged to be at risk of underperforming in the early grades of elementary school, offer the greatest prospect of success.²¹ Moreover, such programs simultaneously serve the objectives of rendering the distribution of skills and therefore wages more equal, and of improving the average productivity of the labor force as a whole and thereby increasing aggregate economic growth.²²

Skill-biased technical change is almost surely the primary force at work in widening the inequalities among Americans' income, but there is evidence that other influences are at work too. To the extent that they are, there is a case for public policy action on other grounds as well. For example, the skill mix among new immigrants to the United States (particularly legal immigrants) is in part the consequence of immigration policies, adopted in the 1960s, that give priority to immigrants seeking permanent admission to this country for purposes such as family

unification or political asylum. From time to time, supplementary policies, like the H1-B temporary visa program, have sought to redress this imbalance in a limited way. A larger-scale and more comprehensive shift in U.S. policies on permanent immigration would blunt at least some of the effect of skill-biased immigration in compounding the effect on wage differentials due to skill-biased technical change. Presumably Congress had reasons for setting the priorities that it did in the 1960s, and so objectives like family unification and political asylum are not to be dismissed lightly. But the economic condition of the United States is different today – specifically, economic growth on average is slower and incomes are becoming more unequal, so that the majority of families are no longer enjoying an increase in their standard of living – and so a reasoned assessment may plausibly lead to different choices now than what seemed appropriate then.

Similarly, the increase in rewards paid to top executives that has absorbed a sizeable share of American corporations' total compensation budgets during the last decade or two may be in part due to market forces (greater demands placed on top executives, perhaps, or fewer people willing to assume those roles). But it is also at least in part the consequence of corporate governance practices affecting how pay is set, and those rules are, in turn, partly set by public policy. Congress has recently acted to require greater disclosure of executive compensation, as well as to cut back on some of the patent abuses that contributed to higher compensation in some instances in the past (for example, backdating of options granted to purchase company shares, or falsifying the reported earnings on which incentive pay is often based). Other steps, such as requiring "plain English" shareholder approval of certain forms of executive compensation, or under certain specified circumstances, are also possible. Here too, redressing widening

inequality is hardly the only concern in shaping such policies. But here again there is no reason to assume that the specific rules of corporate governance inherited from the past are the best ones under today's circumstances.

Other changes in public policy, directed not at income distribution but at improving the economy's aggregate growth prospects, are important in this context as well. On this front, many of the answers are already familiar. The U.S. Government's again-chronic budget deficits (after a brief respite at the end of the last decade) are sapping the economy's ability to invest in new factories and up-to-date machinery. America's failing schools are not equipping the nation's young people with the skills they need. The country's tax policies are increasingly designed to preserve the position of whoever has already done well (or whose parents did well), rather than create new opportunities for those willing to work and able to contribute. While there is much to debate in the details, the warranted directions in which to move are well known. The faster is the economy's aggregate growth, the more room there is for increase in incomes and living standards more broadly even if widening inequality means that they continue to lag behind the rising per capita mean.

Whatever actions public policy might take to address the situation, the implications of today's ongoing increase in inequality in America are sobering. If part of what matters for tolerance and fairness and opportunity, not to mention the strength of a society's democratic political institutions, is that the broad cross-section of the population have a confident sense of getting ahead economically, then no society – no matter how rich it becomes or how well-formed its institutions may be – is immune from seeing its basic democratic values at risk whenever the majority of its citizens lose their sense of forward economic progress. Since the widening of the

American income distribution began in the late 1960s (or, on some measures, the 1970s), and especially since the onset of the economic pressures that first emerged when the OPEC cartel quadrupled oil prices in 1973, overall economic growth in the United States has mostly failed to offset the effect of ever wider inequalities in retarding the economic advance of most Americans. Between 1973 and 1993 the median family income rose in real terms by only 7 percent (not per annum, but in total over the twenty years). With faster overall growth, and some slowing in the widening of the income distribution, the median American family income rose by 17 percent (again, overall) during the remainder of the 1990s. Since then, however, the pattern of the prior two decades has again been dominant, and even more so. The median family income is lower today than it was in 2000.

Experience suggests that if these trends persist, many of the social and political pathologies that have emerged in the past, both here and elsewhere, are likely to reappear. If so, they will be not just pathologies but predictable pathologies – predictable on the basis of the protracted stagnation of living standards for the bulk of America's citizenry.

Notes

1. The Gini coefficient for family incomes was .348 in 1968. In 2005 it was .440. Here and below, data are from the U.S. Census Bureau unless otherwise noted.
2. Simon Kuznets, "Economic Growth and Income Inequality," *American Economic Review*, 45 (March, 1955), 1-28.
3. See, for example, Jeffrey G. Williamson, *Inequality, Poverty and History* (Cambridge: Basil Blackwell, 1991), and Peter H. Lindert, "Three Centuries of Inequality in Britain and America," in Atkinson and Bourguignon (eds.), *Handbook of Income Distribution* (Amsterdam: Elsevier, 2000), vol. 1. The evidence was not unambiguous, however. For an opposing view, see Charles H. Feinstein, "Pessimism Perpetuated: Real Wages and the Standard of Living in Britain During and After the Industrial Revolution," *Journal of Economic History*, 58 (September, 1998), 625-658.
4. Data are from Claudia Goldin and Lawrence F. Katz, "Long-Run Changes in the U.S. Wage Structure: Narrowing, Widening, Polarizing," *Brookings Papers on Economic Activity* (No. 2, 2007), 135-165. The concept of a "race" between technology and education is theirs as well.
5. For comparisons of the importance of investment in information technology in the United States and elsewhere, see Dale W. Jorgenson, "Information Technology and the G7 Economies," *World Economics*, 4 (October-December, 2003), 139-169.
6. George Borjas has estimated that immigration has depressed the wages of lower-skilled workers in the United States by 7 to 9 percent. See, for example, George J Borjas, Richard B. Freeman and Lawrence F. Katz, "How Much Do Immigration and Trade Affect Labor Market Outcomes?" *Brookings Papers on Economic Activity* (No. 1, 1997), 1-90.
7. See Lucien Bebchuk and Yaniv Greenstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy*, 21 (Summer, 2005), 283-303.
8. For a discussion of the role of "offshoring" in this context, see Jagdish Bhagwati and Alan S. Blinder, *Offshoring of American Jobs: What Response from U.S. Economic Policy?* (Cambridge: MIT Press, forthcoming).
9. See Alberto Alesina and Edward L. Glaeser, *Fighting Poverty in the US and Europe: A World of Difference* (Oxford: Oxford University Press, 2004).
10. Alexis de Tocqueville, *Democracy in America*, trans. Henry Reeve (New York: Vintage: 1990), vol. 2, p. 160.
11. The question is an old one; see Seymour Martin Lipset and Reinhard Bendix, *Social Mobility in Industrial Society* (Berkeley: University of California Press, 1959). For more recent evidence, see, for example, Daniel Aaronson and Bhashkar Mazumdar, "Intergenerational Economic

Mobility in the U.S., 1940 to 2000,” Federal Reserve Bank of Chicago, Working Paper 2005-12.

12. This is the central argument in Benjamin M. Friedman, *The Moral Consequences of Economic Growth* (New York: Alfred A Knopf, 2005).

13. See Richard A. Easterlin, “Does Economic Growth Improve the Human Lot? Some Empirical Evidence,” in David and Reader (eds.), *Nations and Households in Economic Growth: Essays in Honor of Moses Abramowitz* (New York: Academic Press, 1974). A large literature on this issue has followed in the wake of Easterlin’s original observation.

14. Adam Smith, *The Theory of Moral Sentiments* (Oxford, 1976), p. 149.

15. In these other countries as well, one can easily point to significant historical events that contradict the tendency for social and political progress to follow economic progress (though probably none so obvious, or so important, as the 1930s in America). Bismarck’s pioneering introduction of social insurance in Germany in the 1880s, the Asquith reforms in Britain before World War I, and the ambitious agenda of the Matignon Accords in France in the 1930s, are all noticeable counterexamples for this purpose. But the predominant tendency is clear nonetheless.

16. Data on median income and mean income within each quintile are from the Census Bureau. The figures given here for 2000 and 2005 are also in 2006 dollars.

17. See Williamson, *Inequality, Poverty and History*, Ch. 3, for a review of this historical debate.

18. See, for example, Alberto Alesina and Dani Rodrik, “Distributive Politics and Economic Growth,” *Quarterly Journal of Economics*, 109 (May, 1994), 465-490.

19. See Torsten Persson and Guido Tabellini, “Is Inequality Harmful for Growth?” *American Economic Review*, 84 (June, 1994), 600-621.

20. See Giovanni Reggiani, “The Moral Consequences of the Shadow Economy,” unpublished paper, Harvard University, 2007. Reggiani’s regression equation also controls for country average income; education; ethnic, linguistic and religious diversity; and differences among continents.

21. For an assessment of the effectiveness (and the cost) of such policies, see James H. Heckman and Alan B. Krueger, *Inequality in America: What Role for Human Capital Policies?* (Cambridge: MIT Press, 2003).

22. See Friedman, *The Moral Consequences of Economic Growth*, Ch. 16, for an elaboration of this argument.