THE GREAT DIVIDE

UNEQUAL SOCIETIES AND WHAT WE CAN DO ABOUT THEM
How has America become the most unequal advanced country in the world, and what can we do about it? In The Great Divide, Joseph E. Stiglitz expands on the diagnosis he offered in his best-selling book The Price of Inequality and suggests ways to counter America’s growing problem. With his signature blend of clarity and passion, Stiglitz argues that inequality is a choice—the cumulative result of unjust policies and misguided priorities. Gathering his writings for popular outlets including Vanity Fair and the New York Times, Stiglitz exposes in full America’s inequality: its dimensions, its causes, and its consequences for the nation and for the world. From Reagan-era to the Great Recession and its long aftermath, Stiglitz delves into the irresponsible policies—deregulation, tax cuts, and tax breaks for the 1 percent—that are leaving many Americans farther and farther beyond and turning the American dream into an ever more unachievable myth. With formidable yet accessible economic insight, he urges us to embrace real solutions: increasing taxes on corporations and the wealthy; offering more help to the children of the poor; investing in education, science, and infrastructure; helping out homeowners instead of banks; and, most importantly, doing more to restore the economy to full employment. Stiglitz also draws lessons from Scandinavia, Singapore, and Japan, and he argues against the tide of unnecessary, destructive austerity that is sweeping across Europe. Ultimately, Stiglitz believes our choice is not between growth and fairness; with the right policies, we can choose both. His complaint is not so much about capitalism as such, but how twenty-first-century capitalism has been perverted. His is a call to confront America’s economic inequality as the political and moral issue that it is. If we reinvest in people and pursue the other policies that he describes, America can live up to the shared dream of a more prosperous, more equal society.
THE GREAT DIVIDE

Unequal Societies and What We Can Do About Them

JOSEPH E. STIGLITZ
To my many readers, who have responded with such enthusiasm to my writings on inequality and opportunity.

To my children, Siobhan, Michael, Jed, and Julia, and my wife, Anya, all of whom, in their own way, are striving to create a fairer and better world.

And to the scholars and activists everywhere who work with such dedication for social justice.

Thank you for the inspiration and encouragement you have provided.
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INTRODUCTION

No one today can deny that there is a great divide in America, separating the very richest—sometimes described as the 1 percent—and the rest. Their lives are different: they have different worries, different aspirations, and different lifestyles.

Ordinary Americans worry about how they will pay for the college education of their children, about what happens if someone in the family has a serious illness, about how they are to manage their retirement. In the depths of the Great Recession, tens of millions worried whether they would be able to keep their house. Millions weren’t able to do so.

Those in the 1 percent—and even more the upper .1 percent—debate other issues: what kind of jet airplane to buy, the best way to shelter their income from taxes (What happens if the United States forces the end to bank secrecy in Switzerland—will the Cayman Islands be next? Is Andorra safe?). On the beaches of Southampton they complain about the noise their neighbors make as they helicopter in from New York City. They worry, too, about what would happen if they fell off their perch—there is so far to fall, and on rare occasions it does happen.

Not long ago I found myself at a dinner party hosted by a bright and concerned member of the 1 percent. Aware of the great divide, our host had brought together leading billionaires, academics, and others who were worried about inequality. As the evening’s early chitchat burbled on, I overheard one billionaire—who had gotten his start in life by inheriting a fortune—discuss with another the problem of lazy Americans who were trying to free ride on the rest. Soon thereafter, they seamlessly transitioned into a discussion of tax shelters, apparently unaware of the irony. Several times in the evening, Marie Antoinette and the guillotine were invoked as the gathered plutocrats reminded each other of the risks of allowing inequality to grow to excess: “Remember the guillotine” set the tone for the evening. And in that refrain they confessed a central message of this book: the level of inequality in America is not inevitable; it is not the result of inexorable laws of economics. It is a matter of policies and politics. It was, they seemed to be saying, possible for these powerful men to do something about inequality.

This is but one of the reasons why concern about inequality has become urgent even among the 1 percent: increasing numbers of them realize that sustained economic growth, upon which their prosperity depends, can’t happen when the vast majority of citizens have stagnant incomes.

Oxfam brought home forcefully the extent of the world’s growing inequality to the annual gathering of the world’s elite in Davos in 2014, pointing out that a bus with some
85 of the world’s billionaires had as much wealth as the bottom half of its population, some three billion people. By a year later the bus had shrunk—it required only 80 seats. Just as dramatic, Oxfam found that the top 1 percent of the world now owned nearly half the world’s wealth—and are on track to own as much of the rest of the 99 percent combined by 2016.

The great divide has been a long time in coming. In the decades after World War II the country grew at its fastest pace, and the country grew together. While all segments saw an increase in their incomes, it was shared prosperity. Incomes of those at the bottom grew faster than the incomes of those at the top.

It was a golden age in America, but to my young eyes there appeared darker edges. Growing up on the southern shore of Lake Michigan, in one of the country’s iconic industrial towns, Gary, Indiana, I saw poverty, inequality, racial discrimination, and episodic unemployment as one recession after another battered the country. Labor strife was common as workers struggled to get a fair share of America’s deservedly lauded prosperity. I heard rhetoric about America being a middle-class society, but for the most part, the people I saw occupied the lower rungs of that supposed middle-class society, and their voices were not among those that were shaping the country.

We were not rich, but my parents had adjusted their lifestyle to their incomes—and in the end that is a big part of the battle. I wore hand-me-down clothes from my brother that my mother had always bought on sale, with an eye toward durability rather than saving money in the short run: penny wise but pound foolish, she would say. When I was growing up, my mother, who had graduated from the University of Chicago in the midst of the Great Depression, helped my father in his insurance business. When she was working, we were left in the care of our “help,” Minnie Fae Ellis, a loving, hardworking, and bright woman. Even as a 10-year-old, I was disturbed: I wondered, Why did she have only a sixth-grade education, in a country that was supposedly so rich and that supposedly offered opportunities for all? Why was she taking care of me rather than her own children?

After I graduated from high school, my mother pursued her life’s ambition—going back to school to get teacher certification and teach elementary school. She taught in the Gary public schools; as white flight set in, she became one of the few white teachers in what had turned into a de facto segregated school. After she was forced to retire at the age of 67, she started teaching on the northwest Indiana campus of Purdue University, working to make sure that there was access for as many as possible. In her 80s, she eventually retired.

Like so many of my contemporaries, I was impatient for change. We were told that changing society was difficult, that it took time. Even though I had not suffered the kinds of hardships that my peers faced in Gary (apart from a small amount of discrimination), I identified with those who had. It would be decades before I studied in
detail the statistics concerning income, but I sensed that America was not the land of opportunity that it claimed to be: there was remarkable opportunity for some, but little for others. Horatio Alger, at least in part, was a myth: many hardworking Americans would never make it. I was one of the lucky ones for whom America did offer opportunity: a National Merit Scholarship to Amherst College. More than anything else, that opportunity opened up a world of other opportunities over time.

As I explain in “The Myth of America’s Golden Age,” in my junior year at Amherst, I switched my major from physics to economics. I was driven to find out why our society worked the way it did. I became an economist not just to understand inequality, discrimination, and unemployment but also, I hoped, to do something about these problems plaguing the country. The most important chapter of my Ph.D. thesis at MIT, written under the supervision of Robert Solow and Paul Samuelson (both of whom were later to receive Nobel Prizes), focused on the determinants of the distribution of income and wealth. Presented in a meeting of the Econometric Society (the international association of economists focusing on mathematics and statistical applications to economics) in 1966 and published in its journal, *Econometrica*, in 1969, it still often serves half a century later as a framework for thinking about the subject.

Readership for an analysis of inequality was limited, both among the general public and even among economists. People were not interested in the subject. Within the economics profession, there sometimes was outright hostility. This remained true even as the country’s inequality began to increase markedly, beginning around the time Reagan became president. One noted economist, a University of Chicago Nobel Prize winner, Robert Lucas, put it forcefully: “Of the tendencies that are harmful to sound economics, the most seductive and … poisonous is to focus on questions of distribution.”

Like so many conservative economists, he argued that the best way to help the poor was to increase the size of the nation’s economic pie, and he believed that focusing attention on the small slice of the pie given to the poor would detract attention from the more fundamental issue of how to enlarge the pie. There is in fact a long tradition in economics that holds that the two issues (of efficiency and distribution, of the size of the pie and how it is divided) can be separated, and that the job of the economist was narrow, important, but hard: it was only to figure out how to maximize the size of the pie. The division of the pie was a matter of politics, something that economists should stay well clear of.

With stances like Lucas’s so fashionable in the economics profession, it was little wonder that economists paid almost no attention to growing inequality in the country. They didn’t pay much attention to the fact that while GDP was growing, the incomes of most Americans were stagnating. This neglect meant that ultimately they couldn’t provide a good explanation of what was going on in the economy, they couldn’t grasp
the implications of growing inequality, and they couldn’t devise policies that might put the country on a different course.

That was why I so welcomed in 2011 the offer of *Vanity Fair* to bring the issues to a wider audience. The resulting article, “Of the 1 Percent, by the 1 Percent, for the 1 Percent,” did have a far wider readership than my *Econometrica* article decades earlier. The new social order that my *Vanity Fair* article discussed—the 99 percent of Americans who were in the same stagnating boat—became the slogan of the Occupy Wall Street movement: “We are the 99 percent.” It presented the thesis that reverberates through the articles here and my subsequent writing: almost all of us, including many in the 1 percent, would actually be better off if there were less inequality. It was in the enlightened self-interest of the 1 percent to help construct a less divided society. I was not seeking to wage a new class war, but rather to establish a new sense of national cohesion, one that had waned as a great divide had opened up in our society.

The article zeroed in on the question of why we should care about the large increase in inequality: it was a matter not only of values and morality but also of economics, the nature of our society, and our sense of national identity. There were even broader strategic interests. Though we remain the largest military power—spending almost half of what is spent around the world—our long wars in Iraq and Afghanistan revealed the limits of that power: we were unable to win clear control of even small swaths of land in countries far, far weaker than the United States. The strength of the United States has always been its “soft power” and, most notably, its moral and economic influence, the example it gives for others and the influence of its ideas, including those concerning its form of economics and politics.

Unfortunately, because of growing inequality, the American economic model has not been delivering for large fractions of the population—the typical American family is worse off than it was a quarter-century ago, adjusted for inflation. Even the fraction in poverty has increased. While a rising China is marked by high levels of inequality and a democratic deficit, its economy has delivered more for most of its citizens—it moved some 500 million out of poverty over the same period that stagnation seized America’s middle class. An economic model that doesn’t serve a majority of its citizens is unlikely to become a role model for other countries to emulate.

The *Vanity Fair* article led to my book *The Price of Inequality*, in which I expanded on many of the themes that I had raised, and this in turn led to the invitation from the *New York Times* in 2013 to curate a series of articles on inequality that we called The Great Divide. It was my hope that, through this series, I could further awaken the country to the problem confronting us: We were not the land of opportunity that we believed we were—and that so many others believed as well. We had become the advanced country with the highest level of inequality, and we had among the lowest levels of equality of opportunity. Our inequalities manifested themselves in numerous
ways. But they were not inevitable, the inexorable workings out of the laws of economics: rather, they were the result of our policies and politics. Different policies could lead to different outcomes: better economic performance (however measured) and lower levels of inequality.

The original *Vanity Fair* article and the series of articles I wrote for The Great Divide constitute the core of this book. For some fifteen years, I have also written a monthly syndicated column for *Project Syndicate*. Originally dedicated to bringing modern economic thinking to countries in transition to a market economy after the fall of the Iron Curtain, *Project Syndicate* in time became so successful that its articles are now published in papers all over the world, including in most of the advanced countries. Not surprisingly, many of the articles I wrote for *Project Syndicate* were concerned with one aspect of inequality or another, and a selection of these—as well as articles published in various other newspapers and periodicals—is included here.

While the focus of these essays is on inequality, I have decided to include several on the Great Recession—articles written in the run-up to the financial crisis of 2007–08 and in the aftermath, as the country and the world entered the great malaise. Those articles deserve a place in this volume because the financial crisis and inequality are intricately intertwined: inequality helped lead to the crisis, the crisis exacerbated already extant inequalities, and the worsening of these inequalities has created a significant downdraft in the economy, making a *robust* recovery all the more difficult. Like inequality itself, there was nothing inevitable about either the depth or the duration of the crisis. Indeed, the crisis was not an act of God, like a once-in-a-hundred-years flood or earthquake. It was something that we did to ourselves; as with outsized inequality, it was the result of our policies and politics.

*This book is* mostly about the *economics* of inequality. But as I have just suggested, one cannot neatly separate out politics and economics. In various essays in this volume, and in my earlier book *The Price of Inequality*, I describe the nexus between politics and economics: the vicious circle by which more economic inequality gets translated into political inequality, especially in America’s political system, which gives such unbridled power to money. Political inequality in turn increases economic inequality. But this process has been reinforced as many ordinary Americans have become disillusioned with the political process: in the aftermath of the 2008 crisis, hundreds of billions went to save the banks, and little went to help homeowners. Under the influence of Treasury Secretary Timothy Geithner and the National Economic Council chairman Larry Summers—who were among the architects of deregulation policies that helped to foment the crisis—the Obama administration initially did not support, or even opposed, efforts to restructure home mortgages, to relieve millions of Americans who had suffered from predatory and discriminatory lending by the banks. No wonder, then, that so many people cast a pox on both houses.
I have resisted the temptation to revise or expand the articles gathered here, or even to update them. Nor have I restored the many “cuttings” of the original pieces, important ideas that had to be left out as I struggled to meet assigned word limits. The journalistic format has much to commend itself: its pieces are short and punchy, responding to the issues of the moment, without all the qualifications and caveats that surround so much academic writing. As I wrote these articles, engaging in the often heated debates at the time, I kept in mind the deeper messages that I wanted to convey. I hope this book succeeds in conveying these broad themes.

As chairman of the Council of Economic Advisers and as chief economist of the World Bank, I had occasionally written op-eds, but it was not until Project Syndicate invited me to write a monthly column in 2000 that I did so on a regular basis. The challenge increased enormously my respect for those who have to write a column once or twice a week. By contrast, one of the main challenges in writing a column once a month is selectivity: Of the myriad economic issues that arise around the world each month, which one would be of greatest interest and provide the context of delivering a message of broader import?

During the past decade, four of the central issues facing our society have been the great divide—the huge inequality that is emerging in the United States and many other advanced countries—economic mismanagement, globalization, and the role of the state and the market. As this book shows, those four themes are interrelated. The growing inequality has been both cause and consequence of our macroeconomic travails, the 2008 crisis and the long malaise that followed. Globalization, whatever its virtues in spurring growth, has almost surely increased inequality—and especially so, given the way we have been mismanaging globalization. The mismanagement of our economy and the mismanagement of globalization are, in turn, related to the role of special interests in our politics—a politics that increasingly represents the interests of the 1 percent. But while politics has been part of the cause of our current troubles, it will only be through politics that we will find solutions: the market by itself won’t do it. Unfettered markets will lead to more monopoly power, more abuses of the financial sector, more unbalanced trade relations. It will only be through reform of our democracy—making our government more accountable to all of the people, more reflective of their interests—that we will be able to heal the great divide and restore the country to shared prosperity.

The essays in this book are grouped into eight parts, each preceded by a short introductory essay, which attempts to explain the context in which the articles were written or touch upon a few of the topics that I was unable to address in the short confines of the articles reprinted here.

I begin with “Prelude: Showing Cracks.” In the years before the crisis our economic
leaders, including the Federal Reserve chairman Alan Greenspan, could boast of a new economy in which economic fluctuations that had been the scourge of the past would be put behind us; the so-called great moderation was bringing a new era of low inflation and seemingly high growth. But those who looked even a little bit more closely saw all of this as merely a thin veneer, masking economic mismanagement and political corruption on a massive scale (some of which had come to light in the Enron scandal); even worse, the growth that was occurring was not being shared by most Americans. The great divide was growing larger. The chapters describe the making of the crisis and its consequences.

After presenting in Part I an overview of some of the key issues in inequality (including my “Of the 1 Percent, by the 1 Percent, for the 1 Percent” Vanity Fair article, and my inaugural article for The Great Divide series in the New York Times), I turn in Part II to two articles providing personal reminiscences on the early awakening of my interest in the subject. Parts III, IV, and V deal with the dimensions, causes, and consequences of inequality; Part VI presents some discussions of key policy ideas. Part VII looks at inequality and policies designed to address it in other countries. Finally, in Part VIII I turn to one of the core causes of inequality in America today—the prolonged weakness in our labor market. I ask how we can best put America back to work, at decent jobs paying livable wages. An afterword contains a short interview with Vanity Fair’s editor Cullen Murphy that touches on some of the questions that have been raised repeatedly during discussions of inequality: When did America make the wrong turn? Aren’t the 1 percent the job creators, so won’t making a more equal society wind up hurting the 99 percent?

Acknowledgments

This is not a standard academic book, but a collection of articles and essays written for an assortment of periodicals and newspapers over the last few years on the subject of inequality—the yawning divide that has opened up especially in America, but to a lesser extent in many other countries around the world. But the articles are based on a long history of academic research, begun when I was a graduate student at M.I.T. and a Fulbright scholar at Cambridge, UK, in the mid-1960s. Back then—and until recently—there was little interest among the American economics profession in the subject. And so, I owe a great deal to my thesis supervisors, two of the great economists of the twentieth century, Robert Solow (whose own dissertation was on the subject) and Paul Samuelson, for encouraging me in this line of research, as well as for their great insights. And an especial thanks to my first co-author, George Akerlof, who shared the 2001 Nobel Prize with me.

At Cambridge, we often discussed the determinants of the distribution of income, and I benefited enormously from conversations with Frank Hahn, James Meade, Nicholas Kaldor, James Mirrlees, Partha Dasgupta, David Champernowne, and Michael Farrell. It
was there that I tutored and then began my collaboration with Anthony Atkinson, the leading scholar on inequality in the past half century. Ravi Kanbur, Arjun Jayadev, Karla Hoff, and Rob Johnson are other former students and colleagues who taught me much about the subjects discussed in this book.

Rob Johnson currently heads the Institute for New Economic Thinking (INET), founded in the aftermath of the Great Recession. Amidst the wreckage of the economy, it was increasingly recognized that standard economic models had not served the country or the world well; new economic thinking—including a greater focus on inequality and the limitations of markets—was needed. I wish to acknowledge the support of INET for some of the research that underlies the essays here.5

While the link between inequality and macroeconomic performance has long been a concern in my theoretical research and policy work, there is, at last, a growing recognition of the importance of this connection (including by the International Monetary Fund). Here, I want to acknowledge the collaboration with my Columbia colleagues Bruce Greenwald and Jose Antonio Ocampo, and the work of the Commission of Experts on Reforms of the International Monetary and Financial System appointed by the President of the United Nations General Assembly, which I chaired.6

Anyone working in the area of inequality today also owes a great debt to Emmanuel Saez and Thomas Piketty, whose painstaking work has produced so much of the data that reveals the extent of inequality at the top in the U.S. and many other advanced countries. Other leading scholars whose influence will be seen here include Francois Bourgignon, Branko Milanovic, Paul Krugman, and James Galbraith.7

When Cullen Murphy, then an editor at The Atlantic Monthly, persuaded me to write an article on some of my experiences at the White House (in an article, “The Roaring Nineties,” which eventually led to my second book for a more popular audience),8 it provided not only an opportunity to articulate ideas I had been pondering for some years but also a new challenge: Could I address complex ideas in a succinct way that would make them widely accessible? I had written many of my academic papers with a co-author; the close relationship between an editor and a writer is similar in some ways, but different in others. We each had distinct roles. He knew the audience, in a way I could barely fathom. I came to appreciate the role that a great editor plays in shaping an article. Great editors allow the voice of the author to come through, even as they improve the exposition—and in some cases, make the topic more tantalizing.

After “The Roaring Nineties” I wrote several other pieces for The Atlantic Monthly, and when Cullen Murphy moved to Vanity Fair, he continued to solicit articles from me. One of these, “Capitalist Fools” (included in this volume), written in the lead-up to and the aftermath of the Great Recession, won a prestigious Gerald Loeb Award for outstanding journalism. Evidently, under the tutelage of Cullen, I had made strides in my writing.
He has worked closely with me on all of the articles I have written for *Vanity Fair*, of which four are included here. Most importantly for this volume, he solicited and worked diligently with me in writing the article “Of the 1 Percent, by the 1 Percent, for the 1 Percent,” which, in turn, gave rise to my book *The Price of Inequality* and this book. Graydon Carter suggested the title for that article. “We are the 99%” became the slogan of the Occupy Wall Street movement, symbolizing America’s Great Divide.

The arrangements I made with *Project Syndicate*, *Vanity Fair*, *The New York Times*, and a host of other media, reflected in the articles collected here, gave me the opportunity to express my views on what was happening in the world—to be a pundit, perhaps more thoughtful than those who are forced to offer their opinions on a huge range of topics on the Sunday morning shows, because I could both choose my topics and mull over the answers.

The editors of each of these articles made invaluable contributions to the essays collected here. In particular, I want to thank Sewell Chan and Aaron Retica, who edited the *New York Times Great Divide* series (which provides the title of this volume). Even before we had strategized together in late 2012 on how to bring the issues of America’s growing inequality, in all of its dimensions and with all of its consequences, before the American people, Sewell had worked with me in editing the essay published here (with Mark Zandi), “The One Housing Solution Left: Mass Mortgage Refinancing.” Aaron and Sewell did an amazing job editing the sixteen articles from *The New York Times* included here. I have a proclivity for writing too long, and it is always sad to see so much of one’s writing end up on the cutting floor; but getting across a set of ideas in 750 words, or even 1,500 words, is one of the real challenges in journalism. Aaron and Sewell always added great insights as they cut away excess verbiage.

Among the many other editors to whom I am greatly indebted are Andrzej Rapaczynski, Kevin Murphy, and the other staff at *Project Syndicate*, Allison Silver (now at Thomson Reuters), Michael Hirsh at *Politico*, Rana Foroohar at *Time*, Philip Oltermann at *The Guardian*, Christopher Beha at *Harper’s*, Joshua Greenman at the *New York Daily News*, Glen Nishimura at *USA Today*, Fred Hiatt at the *Washington Post*, and Ed Paisley at the *Washington Monthly*. I should also acknowledge the encouragement and support of Aaron Edlin at the *Economists’ Voice*, Roman Frydman at *Project Syndicate*, and Felicia Wong, Cathy Harding, Mike Konczal, and Nell Abernathy at the Roosevelt Institute, for which I wrote a policy brief that I partly describe in my essay “Phony Capitalism.”

The Roosevelt Institute and Columbia University have provided unparalleled institutional backing. The Roosevelt Institute, which grew out of the Roosevelt Presidential Library, has developed into one of the country’s leading think-tanks, advancing the ideals of social and economic justice for which the Roosevelts stood. The Ford and MacArthur Foundations and Bernard Schwartz have provided generous
support for the Roosevelt/Columbia research program on inequality.

For the past fifteen years, Columbia University has been my intellectual home. It has given me the freedom to pursue my research, gifted me with bright students enthusiastic about engaging in debates about ideas, and brilliant colleagues from whom I have learned so much. Columbia has provided an environment that has enabled me to flourish, to do what I love to do: research, teach, and advocate ideas and principles that I hope will make the world a better place.

Once again, I am indebted to Drake McFeely, president of W. W. Norton, and my long time friend and editor Brendan Curry, who once again did a superb job in editing this book and benefitted in turn from the help of Sophie Duvernoy. I am indebted too, as usual, to Elizabeth Kerr and Rachel Salzman at Norton—for this book and for their support over the years. I have also benefitted enormously over the years from the close editing of Stuart Proffitt, my editor from Penguin/Allen.

I could not have completed this book without a smooth-running office, headed by Hannah Assadi and Julia Cunico, with the support of Sarah Thomas and Jiaming Ju.

Eamon Kircher-Allen not only managed the whole process of producing the book, but served as an editor as well. I owe him a double thanks: he also edited each of the articles in the book at the time they were originally published.

As always, my biggest debt is to my wife, Anya, who strongly believes in the subjects that I discuss here and in the importance of bringing them to a wider public, who provided such encouragement and help in my doing so, who has repeatedly discussed the ideas behind all of my books and has helped shape and reshape them.

Notes


2. Robert Lucas, “The Industrial Revolution: Past and Present,” 2003 Annual Report Essay, Federal Reserve Bank of Minneapolis, May 1, 2014. He went on to say, “Of the vast increase in the well-being of hundreds of millions of people that has occurred in the 200-year course of the industrial revolution to date, virtually none of it can be attributed to the direct redistribution of resources from rich to poor. 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.”

3. In a few cases, where inadvertently the headline writers choose leads that were too similar, I changed the title of the article. This decision also meant that there is inevitably some overlap in the themes discussed in the different essays. Some small edits have been made to avoid duplication.


Measurement of Economic Performance and Social Progress, emphasizing the many dimensions of well-being that are not well captured in GDP. Many of the ideas of the Commission are reflected in the essays contained in this book. The work of the Commission is now being carried on at the OECD. The report of the Commission is available as J. E. Stiglitz, J. Fitoussi, and A. Sen, *Mismeasuring Our Lives: Why GDP Doesn’t Add Up* (New York: The New Press, 2010).

7. A fuller list of acknowledgments is contained in the paperback edition of *The Price of Inequality*.

PRELUDE:

SHOWING CRACKS
The book begins with the onset of the Great Recession, several years before the start of the Times’s Great Divide series. The first selection was published in Vanity Fair in December 2007, the very month the U.S. economy slipped into a downturn that would prove to be the worst since the Great Depression.

For the preceding three years, I, together with a small band of other economists, had been warning of the impending implosion. Warning signs were, in fact, there for anyone to see—but too many people were making too much money: it was more convenient to close their eyes. There was a party going on—only a few at the top were invited, but the rest of us would be asked to pay the bill. Unfortunately, however, those who were supposed to make sure that the economy was kept on an even keel were too closely connected to those who were throwing the party and who were having all the fun (and making all the money). And that’s why these chapters are included here, as a prelude. The making of the Great Recession is intimately connected with the making of America’s great divide.

First, let’s set the scene: there was a major economic boom during the 90s, fueled by a tech bubble in which technology stocks soared in price, but after that bubble broke, the economy slid into recession in 2001. The George W. Bush administration’s all-purpose remedy for any problem was a tax cut—and especially a tax cut aimed at the wealthy.

For those in the Clinton administration who had worked hard to reduce the fiscal deficit, this was troubling for many reasons. It brought back the deficits—undoing all the work that had been done over the preceding eight years. The Clinton administration had put off investments in infrastructure and education and programs to help the poor, all in the name of deficit reduction. I had not agreed with some of these actions—I thought borrowing to make investments in the country’s future made economic sense, and I was worried that a later administration might squander these hard-fought gains for less noble purposes.

As the economy sank into the 2001 recession, there was consensus among policymakers that the economy needed a stimulus. A far better way of providing that stimulus than Bush’s tax cuts for the rich would have involved making the investments we had postponed. I was already concerned about the country’s growing inequality, and these inequitable tax cuts only made matters worse. I began my New York Review of Books article, “Bush’s Tax Plan—The Dangers” (March 13, 2003) as follows: “Seldom have so few gotten so much from so many.”

Worse still, I thought the tax cuts would be relatively ineffective. And that proved correct. This is a theme I return to frequently in this book. Inequality weakens aggregate demand and the economy. America’s growing inequality was moving money from the bottom of the pyramid to the top, and since those at the top spent less of their
money than those at the bottom, this weakened overall demand. During the 90s we masked the deficiency by creating the tech bubble—a boom in investment. But with the breaking of the tech bubble, the economy fell into recession. Bush responded with a tax cut aimed at the rich. With consumers worried about their future, the hoped-for stimulus to the economy from Bush’s tax cuts was weak. Piling on a further capital-gains tax cut—on top of one that had been given a few years before by President Clinton—only encouraged more speculation. Since its benefits went overwhelmingly to the very top, this tax cut was particularly ineffective and also strongly increased inequality.

The most effective tools for strengthening demand and improving equality are fiscal policies—tax and expenditure policies decided by Congress and the administration. Inadequate fiscal policies put an undue burden on monetary policies, which are the responsibility of the Federal Reserve. The Fed can (sometimes) stimulate the economy by lowering interest rates and making regulations more lax. But these monetary policies are dangerous. Their prescriptions should come with a big label: Use only with caution, and under the close supervision of adults who understand the full risks. Unfortunately, those in charge of monetary policy had not read any such label; and they were naïve market fundamentalists—believing that markets are always efficient and stable. While they underestimated the risks that their policies posed to the economy—and even to the government’s budget—they didn’t seem to care about the inequality that was growing day by day. The result is now well known: they unleashed a bubble, and their policies led to an unprecedented growth in inequality.

The Fed kept the economy churning with a policy of low interest rates and lax regulations. But it worked only by creating a housing bubble. It should have been apparent to all that the housing bubble and the consumption boom to which it led could only be a temporary palliative. Bubbles always break. Our consumption binge meant that the bottom 80 percent of Americans were on average spending 110 percent of their income. By 2005 as a country we were borrowing more than $2 billion a day from abroad. It was not sustainable, and, quoting one of my predecessors as chairman of the Council of Economic Advisers, in my speeches and writings I repeatedly warned that that which is not sustainable wouldn’t be sustained.

When the Fed started to raise interest rates in 2004 and 2005, I anticipated that the housing bubble would break. It did not, in part because we were given a kind of reprieve: long-term interest rates failed to rise in tandem. By January 1, 2006, I predicted that this could not continue.\(^2\) The bubble did break not long thereafter, but it would take a year and a half to two years for the full effects to be realized. As I wrote soon afterward, “Just as the collapse of the real estate bubble was predictable, so are its consequences …”\(^3\) With “by some reckonings, more than two-thirds of the increase in output and employment over the [preceding] six years … [being] real estate–related, reflecting both new housing and households borrowing against their homes to support a
consumption binge,” it should have been no surprise that the subsequent downturn would be deep and long.4

The articles included in this first section describe the policies that laid the groundwork for the Great Recession: What did we do wrong? Who is to blame? While those in the financial market, at the Fed, and at Treasury would like to pretend it was just something that happened—an unpreventable, once-in-a-hundred-years flood—I believed then, and believe even more strongly now, that the crisis was man-made. It was something that the 1 percent (indeed, a sliver of that 1 percent) did to the rest of us. The fact that it could happen was itself a manifestation of the great divide.

**The Making of a Crisis**

That the Great Recession had created victims is clear. But who were the perpetrators of this “crime”? If we were to believe the Justice Department, which brought charges against none of the leaders of the big banks that played a central role in this drama, this was a crime without any perpetrator. I don’t believe that, nor do most Americans. In three of the articles reprinted here, I attempt to find out who killed America’s economy, to trace out the historical arc that led us to this juncture.5 I wanted to dig deeper and go back further: there was more to the story than the stock response “The bankers lent too much and homeowners borrowed too much.”

What, I asked, had brought us to this juncture? There was incompetence and bad judgment. The ill-conceived and poorly executed war in Iraq, whose eventual costs would amount to trillions,6 was the most telling example. But the main blame I assign to a combination of ideology and special-interest pressure—the same combination that has led to the country’s growing inequality. I point a finger particularly at the belief that unfettered markets are necessarily efficient and stable. We should know otherwise: major economic fluctuations have marked capitalism from the start. Some have suggested that all that needs to be done is for the government to ensure macrostability—as if market failures occur only in big macrodoses. I suggest otherwise: the macrocrises are only the tip of the iceberg; less noticeable are myriad inefficiencies. The crisis itself provides ample evidence: the market collapse was a result of a host of failures in the management of risk and the allocation of capital, mistakes made by mortgage originators, investment banks, credit-rating agencies—indeed by millions throughout the financial sector and elsewhere in the economy.7

But I suggest also that there was more than a small dose of hypocrisy on the part of those who advocated free markets, again evidenced in the Great Recession: the seeming advocates of free-market economics were more than willing to accept government assistance—including massive bailouts. Such policies distort the economy, of course, and lead to poorer economic performance; but reflecting the theme of this book, they also have distributive consequences—with more money going to those at the top, with
everyone else picking up the tab.

As I thought about *who killed the economy*, No. 1 on the list of suspects was the president at the time. “The Economic Consequences of Mr. Bush” details *some* of the *economic* consequences of the president. Though conservatives rail against deficits, they seem to have a particular knack for creating them. Large deficits first began to characterize the American economy with President Reagan, and it was not until President Clinton that the deficits turned into surpluses. But in short order Bush reversed this—the largest turnaround (in the wrong direction) in the nation’s history—partly as a result of paying for two wars on the credit card, partly as a result of tax cuts for the rich, partly as a result of his largesse to drug companies and the expansion of other forms of corporate welfare—the increased “dole-out” to the rich corporations across a wide range of sectors, some hidden in the tax system or through guarantees, some brazenly open. And all this even as we cut back on the safety net for the poor, on the grounds that we couldn’t afford it.

As I have written repeatedly,8 deficits are not necessarily a problem: not if the money is spent to make investments, and especially not if this spending occurs when the economy is weak. But the Bush deficits were especially problematic: they occurred during a time of seeming prosperity, even if that prosperity reached only a few. The money was spent not to strengthen the economy but to strengthen the coffers of a few corporations and the pocketbooks of the 1 percent. Most troublesome was that I saw storms ahead—Would we have the wherewithal to weather the storms? Would the conservatives at that point again demand fiscal prudence, imposing austerity at the moment the economy desperately needed the opposite medicine?

Most importantly for this book, the Bush years were marked by growing inequality, which he neither recognized nor did anything about—except to make it worse. This was a short article, and I could not provide a full litany of what had gone wrong. I didn’t note that while inequality had mildly improved during the Clinton years, the income of a *typical* American (median income) adjusted for inflation actually fell under Bush—and this was true even before the recession made things so much worse. More Americans lacked health coverage. And they faced more insecurity—a greater risk of losing their jobs.9

But perhaps his most grievous failure was setting up the conditions for the Great Recession, topics that I delve into at greater length in the next two chapters. Bush’s tax cuts for the rich, which I discussed above, play prominent roles in the drama—while they did not provide much stimulus, they exacerbated the country’s already large inequality. They illustrate a second theme to which I will return later in the book, and which has now been taken up by the International Monetary Fund (IMF), an organization not known for taking “radical” positions: inequality is associated with instability.10 The making of the 2008 crisis exemplifies how this happens: central banks
create bubbles in response to a weakened economy born of growing inequality. The bubble eventually breaks and wreaks havoc on the economy. (Of course, the Fed should have been aware of this risk. But its leadership evinced an almost blind faith in markets and, like Bush, who had reappointed the Fed chair Alan Greenspan and later appointed the Fed chair Ben Bernanke—he had been his chief economic adviser—the institution appeared to pay little attention to the inequality that was growing day by day in the country.)

At the same time, this illustrates a third theme: the role of politics. It is policies and politics that matter. The United States could have responded to the weakened economy by investing in America, or by undertaking policies that reduce inequality. Both of these would have led to a stronger economy and a fairer society. But economic inequality inevitably leads to political inequality. What happened in America is what one comes to expect of a polity with a divided society. Rather than more investment, we got tax cuts and corporate welfare for the rich. Rather than regulations that would stabilize the economy and protect ordinary citizens, we got deregulation that led to instability and left Americans prey to the bankers.

**Deregulation**

To understand the makings of the Great Recession, one has to go back in time, to the deregulatory movement that was given such a boost by President Reagan. In “Capitalist Fools” I identify five critical “mistakes,” which both reflected broader trends in our society and reinforced each other—culminating in the worst economic downturn in three-quarters of a century. Several of them illustrate the new power of finance—the appointment of Greenspan because he supported deregulation, the deregulation itself, begun under Reagan, but continuing under Clinton, including the destruction of regulatory walls between investment and commercial banks.11

The regulators didn’t do what they should have done, but the crimes themselves were committed by the financial sector. At the time I wrote these articles, we had only a partial glimpse of how bad things had become. We knew that the banks had mismanaged risk and misallocated capital—all the time offering huge bonuses to their leaders for the wonderful job that they were doing. We knew that the bonus system itself had created incentives for excessive risk-taking and shortsighted behavior. We knew that the credit-rating agencies had failed miserably in their job of assessing risk. We knew that securitization, long vaunted for its ability to manage risk, had provided incentives for mortgage originators to weaken standards (what was called the moral hazard problem). We knew that the banks had engaged in predatory lending.

But we didn’t know the full extent of the moral depravity of the banks, of their willingness to engage in exploitive practices, or their recklessness. We didn’t know, for
instance, just how widely they engaged in discriminatory lending. We didn’t know of their manipulation of the foreign exchange and other markets. We didn’t know of the sloppiness in their record keeping, in their race to write an ever larger number of bad mortgages. And we didn’t know the full extent of fraudulent behavior, on the part not just of the banks but of the credit-rating agencies and other market participants. Competition among rating agencies to provide a high rating (they were paid only if the investment banks “used” their ratings, and they used only the ratings that were most favorable) had led them to deliberately ignore relevant information that might have yielded a less favorable rating.

The chapters published here do provide, however, a good description of where the financial sector went wrong.

Financial Markets and the Growth of Inequality

In these articles and elsewhere in this volume, I dwell extensively on the financial sector, and for good reason. As Jamie Galbraith of the University of Texas has so persuasively shown, there is a clear link between the increasing financialization of the world’s economies and the growth of inequality. The financial sector is emblematic of what has gone wrong in our economy—a major contributor to the growth of inequality, the major source of instability in our economy, and an important cause of the economy’s poor performance over the last three decades.

This isn’t, of course, the way it was supposed to be. Liberalization of financial markets (“deregulation”) was supposed to allow financial experts to allocate scarce capital and manage risk better; the result was supposed to be faster and more stable growth. The proponents of a strong financial sector were right about one thing: it is hard to have a well-performing economy without a well-performing financial sector. But, as we have seen repeatedly, the financial sector doesn’t perform well on its own; it requires strong regulations, effectively enforced, both to prevent it from imposing harm on the rest of the society and to make sure that it actually performs the functions it is supposed to perform. Sadly, recent discussions on financial sector reform have focused only on the first half of this task—how to prevent the banks and other financial institutions from harming the rest of society, by exposing it to excessive risk-taking or some other form of exploitation—and given little attention to the second.

The crisis confronting the United States and the world in 2008 was, as noted earlier, a man-made disaster. I had seen this movie before: how a combination of powerful (if wrong) ideas and powerful interests can combine to produce calamitous results. As chief economist of the World Bank, I had observed how, after the end of colonialism, the West managed to push ideas of free-market fundamentalism—many of which reflected the perspectives and interests of Wall Street—on developing countries. Of
course, the developing countries didn’t have much choice: colonial powers had ravaged these countries, exploiting them ruthlessly, extracting their resources, but doing little to develop their economies. They needed assistance from the advanced countries, and as a condition of that assistance, officials at the IMF and elsewhere imposed conditions—that the developing countries liberalize their financial markets and open up their domestic markets to a flood of goods from the advanced countries, even as the advanced countries refused to open their markets to the agricultural goods of the South.

The policies failed: Africa saw its per capita income fall; Latin America saw stagnation, with the benefits of the limited growth going to a small sliver at the top. Meanwhile, East Asia took a different course; with governments leading the development effort (“the developmental state,” as it was called), incomes per capita rapidly doubled, tripled—eventually increasing eightfold. In the third of a century that Americans saw their incomes stagnate, China went from being an impoverished country, with a per capita income less than 1 percent that of the United States and a GDP that was less than 5 percent that of the United States, to being the largest economy in the world (measured in what economists called purchasing power parities). By the end of the next quarter-century, it was slated to be twice the size of the U.S. economy.

But ideologies are often more influential than evidence. Free-market economists seldom looked at the success of the managed-market economies of East Asia. They preferred to talk about the failures of the Soviet Union, which eschewed the use of the market altogether. With the fall of the Berlin Wall and the collapse of Communism, it seemed that free markets had triumphed. Though this was the wrong lesson to be drawn, the United States used its sway as the sole remaining superpower to advance its economic interests—or, more accurately, to advance the interests of its large and powerful corporations. And among these, perhaps the most influential was the financial sector. The United States pushed countries to liberalize their financial markets. The result: country after country faced crises—including some of the very countries that had been doing so well before they liberalized their markets.

In a sense, though, we were no worse to these other countries than we were to ourselves. Under both Clinton and Bush we pursued policies at home and abroad that were demanded by the financial sector. In “The Anatomy of a Murder” I touch on how these policies led to a crisis. (In my book *Freefall* I discuss these issues more extensively.)

Here my concern is how the financial sector contributes to growing inequality. There are several channels by which financialization has had these effects. The financial sector excels in rent seeking, in wealth appropriation. There are two ways of getting wealthy: increasing the size of the national pie, and attempting to get a larger size of a preexisting pie—and in the process, the size of the pie may actually be diminished. Incomes at the top of the financial sector are more related to the latter than to the former. While some
of the wealth of those in the financial sector comes at the expense of other wealthy people, including much of what they acquire through market manipulation, much of it comes from siphoning money from the bottom of the economic pyramid. This is true of the billions generated through abusive credit card practices and predatory and discriminatory lending. But it is even true of their abuses of monopoly power in credit and debit cards: the excessive charges they impose on merchants act like a tax on every transaction—a tax that enriches the coffers of the bankers rather than the well-being of society; in competitive markets, the charges inevitably get passed on in the form of higher prices paid by ordinary citizens.

At least before the crisis, those in the financial sector boasted that they were the engine of economic growth, that their “innovativeness” had led to the country’s outstanding economic performance.

The real measure of the performance of an economy is how well the typical family does, and in those terms there has been zero growth over the past quarter-century. But even if one uses GDP as the yardstick, performance has been anemic—far worse than in the decades before financial liberalization and the financialization of the economy—and it’s hard to attribute what growth there has been to the financial sector. But though it’s hard to show any positive effect on growth, it’s easy to establish the connection between the financial sector’s shenanigans and the economy’s instability, evidenced most strongly by the 2008 crisis.

Data on GDP and profits tell us a great deal about how the financial sector helped lead the economy astray. In the years before the crisis, the financial sector absorbed an increasing share of the economy—8 percent of GDP, 40 percent of all corporate profits—with little to show for it. There was, of course, a credit bubble, but rather than leading to higher levels of real investment, which would have led to higher wages and sustained growth, it went toward speculation and to higher real estate prices. A higher price for real estate on the French Riviera, or for Manhattan apartments for billionaires, doesn’t translate into a more productive economy. And that helps explain why, in spite of the enormous increase in the wealth-to-income ratio, average wages stagnated and real returns on capital did not decline. (The standard law of economics—the law of diminishing returns—should have meant that the return to capital should have fallen, and wages should have risen. Improvements in technology would have reinforced the conclusion that average wages should have increased, even if wages for some types of labor would have decreased.)

The excessive risk-taking in the financial sector, combined with its success in curbing regulation, led, in a way that was predictable and predicted, to the most severe crisis in three-quarters of a century. As always, it is the poor who suffer the most from such crises, as they lose their jobs and face protracted unemployment. In this case, the effects on ordinary Americans were particularly grave, given that more than 14 million homes
were foreclosed from 2007 to 2013, and given the magnitude of the cutbacks in government spending, including for education. Aggressive monetary policy (so-called quantitative easing) focused more on restoring prices in the stock market than on restoring lending to small and medium-size enterprises, and as a result was much more effective in restoring wealth to the rich than in benefiting average Americans or in creating jobs for them. That’s why in the first three years of the so-called recovery, some 95 percent of the increases in income went to the top 1 percent, and why six years after the start of the crisis, median wealth was down 40 percent relative to precrisis levels.

There is a final role that the financial sector has played in the creation of America’s, and the world’s, growing inequality (and poor economic performance): I noted earlier that the country’s outsize inequality is a result of the policies it has pursued. The financial sector pushed inequality-increasing policies and developed an ideology to support them. Of course, some participants in financial markets have been important voices of opposition; there are many who embrace “enlightened self-interest.” But, by and large, the financial sector has pushed the idea that markets on their own lead to efficient and stable outcomes, and on that assumption governments should liberalize and privatize; it has argued that progressive taxation should be limited because of its adverse effects on incentives; it has contended that monetary policy should focus on inflation and not job creation. And after these policies brought about the Great Recession, a single-minded focus on fiscal deficits led to cutbacks in government spending that hurt ordinary citizens. These policies in turn prolonged the economic downturn.

Transparency

There is a broad understanding that market economies work best with transparency—it is only with good information that resources can be well allocated. But while markets—especially financial markets—may preach transparency for others, they do what they can to limit it for themselves; after all, with transparent and competitive markets, profits are driven to zero. Ask any businessperson: it’s no fun to be in such markets. One has to struggle to survive. There’s little upside potential. That’s why they make such a big deal over business secrets and confidentiality. All of this is natural and well understood. But government is supposed to weigh in on the other side, to countervail these tendencies, to make markets more competitive and transparent. But this won’t happen if government is captured by businesses, and especially by financial markets. And that’s where I felt special disappointment with what happened in the Clinton administration. One somehow expects this of administrations on the right, but not of one that claimed to be “putting people first.” In “Capitalist Fools” I explain how the Clinton and Bush administrations had put in place incentives to “fake the numbers.” Unfortunately, the
Obama administration failed to use the 2008 crisis to force more transparency—allowing trade in nontransparent over-the-counter derivatives, the source of so much havoc in the crisis—to go on, though with some restrictions.

**The Role of the Economist**

In its list of who is to be blamed, the chapter on the anatomy of a murder adds one more category: economists—the many economists who claimed that markets were self-regulating, who provided the so-called intellectual underpinnings to the deregulatory movement, in spite of the long history of the failure of unregulated and underregulated financial markets, and in spite of important advances in economic theory, which had explained why financial markets need to be and should be regulated. These advances focused on the importance of information imperfections and imperfections of competition, important in all sectors of the economy, but especially in the financial system. Moreover, when an ordinary business fails, there are consequences for its owners and their families, but not typically for the entire economy. As our political leaders and the banks themselves said, we cannot allow any of the big banks to fail. But if that is the case, then they must be regulated. For if they are too big to fail, and they know it, excessive risk-taking is a one-sided bet: if they win, they keep the profits; if they lose, taxpayers pick up the tab.

Dodd-Frank, the financial sector reform bill, did nothing to address the too-big-to-fail problem. Indeed, the way we addressed the crisis made it worse: we encouraged, in some cases forced, banks to merge, so that today concentration of market power is even greater than it was before the crisis. This concentration has one further consequence: it leads to a concentration of political power, so evident in the ongoing struggle to pass effective bank regulation. One area where progress was made in Dodd-Frank was to circumscribe the ability of federally insured financial institutions from writing derivatives—those risky products that had led to the collapse of AIG and the largest bailout in the history of the planet. While there is disagreement about whether these financial products are gambling instruments or insurance, there is no justifiable reason that they should be provided by lending institutions, and especially those insured by the government. But Congress, with language written by Citibank itself, repealed even this provision in 2014, without even any hearings!

The influential documentary *Inside Job* threw light on what may have been going on within the economics profession. Economists are wont to say that incentives matter: indeed, that is the one thing that economists seemingly agree on. The financial sector provides ample rewards for those who agree with them: lucrative consultancies, research grants, and the like. The documentary raises a question: Could this have influenced some economists’ judgments?
RESPONSES TO THE CRISIS

Just as the “making of the crisis” illustrates several of the themes of this book, so do the articles I wrote in 2008 and 2009 on the responses, of which one, “How to Get Out of the Financial Crisis,” published in Time magazine a month after the collapse of Lehman Brothers, is included here. The disparity between what was needed and what was done illustrates the great divide.

Even though the crisis had long been in the making, and even though there had been ample warnings, those in charge, both at the Fed and in the administration, seemed surprised, and I believe genuinely were—a remarkable testament to the ability to close one’s senses to information that one finds unpleasant and contradicts one’s preconceptions. After all, the housing bubble had broken in 2006, the economy had plunged into recession in 2007, the Fed had been supplying unprecedented funds to banks in 2007 and 2008, and there had been a very expensive rescue of Bear Stearns in March 2008. Virtually any economist who did not blindly believe in the virtues of the free and unregulated markets, their efficiency and stability, saw the writing on the wall. Yet the Fed chair Ben Bernanke would blithely claim that the risks were “contained.”

The precipitating event that plunged the country from the recession that began in December 2007 (which Bush’s policies—another tax cut for the rich in February 2008—had done little to end) into a deep recession, the worst since the Great Depression, was the collapse of Lehman Brothers on September 15, 2008. After confidently asserting that letting it collapse would have only a limited effect on the economy—and would teach banks an important lesson—the Fed and Treasury took a 180-degree turn and bailed out AIG, the most expensive bailout in human history, an amount of corporate welfare to one firm that exceeded that given to the millions of poor Americans over years and years. Later we were to learn why—and why they did everything they could to hide what they were doing from the American people: the money passed quickly from AIG to Goldman Sachs and other banks. It was when these banks were in jeopardy that the Fed and Treasury came to the rescue.

In my Time article, I put forward a simple agenda. Regrettably, what was done reflected more the interests and perspectives of the banks and the 1 percent than it did the agenda I laid forth, as I feared at the time. And so too, the recovery has been anemic. The Obama administration may claim that it stopped the economy from falling into another Great Depression. Whether or not that is true, it is clear that it didn’t engineer a robust recovery. As this book goes to press, seven years later, most Americans’ incomes are still below what they were before the crisis. Wealth in the middle is almost back to the level of 1992, some two decades ago. The recovery was designed by the 1 percent, for the 1 percent. President Obama may have claimed in his State of the Union address on January 20, 2015, that the crisis is over. But not even he would suggest that all is well. GDP is some 15 percent below what it would have been.
had there not been the crisis, and the gap between where we are and where we would have been is barely closing. Trillions have been unnecessarily lost by following the 1 percent’s agenda.

There were five items on my agenda. The first was a recapitalization of the banks—in a way that ensured that they return to lending and that gave American taxpayers a fair deal for bearing the risks that they bore. We did recapitalize the banks. Bailing out the banks, however, didn’t mean bailing out the shareholders, the bondholders, and the bankers. But that’s what we did.

When the IMF, the World Bank, or the U.S. government lends money to other countries, we impose conditions—we want to make sure that the money is spent in the way intended. The irony is that the U.S. Treasury is among those most insistent on such conditionality. But when it came to imposing conditions on U.S. banks, Treasury demurred.

Here the intent was clear: to save the banks so that they could continue to provide funds to make our economy function. But because we imposed no conditions, the money went instead to pay mega-bonuses—clearly undeserved—to the bankers. Years after the crisis, lending to small and medium-size businesses was still far below what it had been before the crisis.

The administration claims that the government was repaid, but it was largely a shell game, repaid from one pocket with money the government put into another. The Fed lent money to the banks at a zero interest rate, which they then lent out to the government and big businesses at far higher interest rates. (Even a 12-year-old could make money this way; one didn’t need to be a financial wizard—though the bankers received bonuses as if they were.) The government stealthily arranged for the bad mortgages to move off the banks’ books and onto the government balance sheet. Even then, what the government got was but a fraction of that received by private investors, like Warren Buffett, who had put money into the banks at the time of the crisis.

Put baldly, ordinary Americans were cheated. A huge gift was given to the banks by providing them money at much more favorable terms than those given to others—and at rates much lower than others were willing to extend to the banks. Doing so redistributed money from ordinary citizens to the wealthy bankers. Had the banks been charged what they should have been, our national debt would be lower and we would have more money to invest in education, technology, infrastructure—investments that would have led to a stronger economy with more shared prosperity.

Like so many of the economic policies designed by the 1 percent and for the 1 percent, it relied on trickle-down economics: throw enough money at the banks, and everyone will benefit. It didn’t work out that way, and predictably so. I had argued, by contrast, that we should have tried a bit of trickle-up economics—help those in the middle and the bottom, and the entire economy will benefit.
The crisis had begun in housing, and so it was natural to suggest that a robust recovery would require stemming the tide of foreclosures. Even before he became president, I warned Obama that bailing out the banks would not be enough. He had to help America’s homeowners. But his secretary of treasury Tim Geithner, who had been the head of the New York Fed as the banks engaged in their reckless behavior, thought mostly about the banks. The result was that literally millions and millions of Americans lost their homes. While hundreds of billions went to the banks, a fraction of this was allocated to help homeowners, and even then only something like $10 billion was actually spent—Treasury’s report to Congress didn’t bother to give the amount of support provided—as the administration struggled with one poorly designed program after another. Wasting money on banks might be necessary to save the economy, and any fine-tuning of the bank rescue programs apparently was viewed as a luxury we could not afford. But exactly the opposite attitude was taken in regard to homeowners and ordinary citizens: we had to proceed carefully, so as not to make any mistakes. Terms like “moral hazard” were thrown around glibly—the risk that a bailout to homeowners would encourage reckless borrowing—even though the real moral hazard issue was that of the banks, which had been rescued time after time.

Standard economics—taught in virtually every textbook—calls for a fiscal stimulus when the economy is weak. But we had learned from the Bush 2008 tax cut for the rich that a poorly designed stimulus would be relatively ineffective. Those in the Obama administration, however, including several who bore considerable responsibility for the creation of the crisis, both in their active support of deregulation and in their failure to engage in responsible supervision of the banks, believed that essentially all that was needed was a modest measure: the banks were sick, they required an admittedly massive (money) transfusion, but after a short period in the infirmary, they and the economy would recover. What was needed was a temporary stimulus, while the banks were still sick; and because the recovery was anticipated to be quick, the size, design, and duration of the plan didn’t matter much.

I argued, to the contrary, that the economy had been sick before the crisis—sustained only by an artificial bubble; that the crisis was likely to be long and deep, especially if the right policies weren’t followed (which they weren’t). Moreover, the politics was ugly: one had but a single bite of the apple. If the economy didn’t recover, conservatives would claim that the stimulus didn’t work, and it would be hard to get a second stimulus package. So I argued we needed a large stimulus—far larger than that asked for by the administration and passed by Congress; it needed to be well designed—not the kind of tax cuts for the rich that marked Bush’s so-called stimulus. As it was, about a third of the stimulus consisted of tax cuts. To make matters worse, the administration, not understanding the depth of the downturn, forecast that with the stimulus unemployment would peak at 7 to 8 percent; when it peaked at 10 percent, this claim provided easy fodder for critics. What they should have said was that the stimulus

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would reduce unemployment by some 2 to 3 percent from what it otherwise would have been—and that, the stimulus succeeded in doing.

The last items on the *Time* agenda were domestic regulatory reform and the creation of a multilateral agency to coordinate regulation across national jurisdictions. By the time I wrote the article, it was already clear that this was going to be a global crisis, and that bad banking practices (not just in the United States, but in several countries in Europe as well) had large repercussions elsewhere. Our own toxic mortgages (those mortgages that eventually exploded, bringing on the global crisis) had polluted international financial markets.

These last two items have occasioned the greatest disappointment. Even when it passed in 2010, two years after the crisis, the regulatory reform bill (Dodd-Frank) was recognized to be at most a cup half full. But no sooner was it passed than the banks began efforts to water it down. They resisted attempts to implement regulations. They initiated efforts in Congress to repeal key provisions—and finally, in December 2014, they were successful in rolling back a key provision regulating derivatives, restricting government-insured banks from creating these risky financial products.

Globally, no international agency has been created. An international Financial Stability Board was established (replacing the Financial Stability Forum, which had been established in the aftermath of the East Asian crisis at the end of the 1990s and proven itself ineffective). As with Dodd-Frank, what has emerged is a halfway house: things are, in some ways, better than they were before the crisis, but few outside the financial sector believe that we have really eliminated a significant risk of another meltdown.

What is so striking, though, is that all of the discussions have centered on how to prevent the banks from doing harm to the rest of society; almost no attention has focused on how to make banks actually perform the critical functions that they need to perform if our economy is to function well. For purposes of this book, that is important for at least two reasons. When there is a crisis, it is always ordinary citizens who bear the brunt—workers who lose their jobs, homeowners who lose their homes, ordinary citizens who see their retirement accounts vanish, who are unable to send their children to college, and who cannot live out their dreams. Small businesses go into bankruptcy in droves.

By contrast, big businesses not only survive; some even prosper as wages are forced down and they maintain sales abroad. The bankers who caused the crisis also manage to do quite well, thank you. They might not be quite as well off as they would have been if the unsustainable bubbles that they helped create had been sustained. They might have to scale down from a ski chalet in the Swiss Alps to one in Colorado, from a home on the Riviera to one in the Hamptons.17

The need for regulation should have been particularly clear because the banks and
others in the financial sector have a long-established proclivity for exploitation—for taking advantage of others, whether it’s in the form of market manipulation, insider trading, abusive credit card practices, monopolistic anticompetitive practices, discriminatory and predatory lending, … the list is endless. It seems easier to make money in these ways than by more honest activity, say, by lending to small businesses, which would create new jobs. When banks focus on exploitation, they increase inequality; when they focus on job creation, they promote equality, both by reducing unemployment and by leading to higher wages, which naturally follow from lowered unemployment.

Thus, bank regulations that restrict their bad behavior can help doubly: they inhibit their ability to exploit, and encourage them to do what they should be doing—simply by reducing the profits to be made in alternative ways.

The Failures of the Obama and Bush Responses

In short, just as the crisis itself was the predictable and predicted consequence of our economic policies in the preceding decades, what happened in the years after the crisis was the predictable and predicted consequence of the policies taken in response.

What can we say almost eight years after the beginning of the recession, nine years after the breaking of the bubble? Who has been proven right? The administration and the Fed like to claim that they saved us from another Great Depression. That may be the case, but they failed utterly in restoring the economy to prosperity.

The banking system has largely healed. The recession officially ended, and fairly quickly. But the economy has clearly not been restored to health. Even as growth is restored, it will be years and years, if ever, before the damage of the Great Recession is repaired, years and years, if ever, before the incomes of most Americans are back to where they would have been without the crisis. Indeed, the damage appears to be long-lasting.

Notes

1. President Bush enacted two sets of tax cuts for the rich—the first, in 2001, as the economy slipped into recession. When that didn’t do the trick, he decided to double down and offer even more tax cuts for the rich, in 2003.


4. I elaborated on this theme in “America’s Houses of Cards,” Project Syndicate, October 9, 2007.


6. See Joseph E. Stiglitz and Linda J. Bilmes, The Three Trillion Dollar War: The True Cost of the Iraq Conflict (New York: W. W. Norton, 2008). Though some challenged our numbers at the time, we were deliberately conservative in our estimates, and history has proved us right. The numbers have turned out worse. Indeed, the cost of disability payments and health care through the middle of the century is now estimated by itself to be as much as a trillion dollars, in part because almost 50 percent of troops returning file disability claims, often with multiple disabilities. (See the Web site of Costs of War at http://www.costsofwar.org/article/caring-us-veterans.)


These failings, clear already at the end of his first term, had become even clearer by the end of the second. I noted, for instance, in “Bush’s Four Years of Failure,” *Project Syndicate*, October 4, 2004, “Median real income has fallen by over $1,500 in real terms.” The growth that occurred “benefited only those at the top of the income distribution, the same group that had done so well over the previous thirty years and that benefited most from Bush’s tax cut.”

Andrew G. Berg and Jonathan D. Ostry, “Inequality and Unsustainable Growth: Two Sides of the Same Coin?,” IMF Staff Discussion Note 11/08, April 8, 2011.

For a discussion of the role of the Clinton administration and how what was done then helped “seed” the problems that were to emerge, see Joseph E. Stiglitz, *The Roaring Nineties: A New History of the World’s Most Prosperous Decade* (New York: W. W. Norton, 2003).


Median household wealth was $81,400 in 2013, almost back to the $80,800 figure of 1992. Poor Americans—defined as those with a size-adjusted household income less than 67% of the median—have fared much worse: their median wealth declined from $11,400 in 1983 to $9,300 in 2013. See “America’s Wealth Gap between Middle-Income and Upper-Income Families Is Widest on Record,” Pew Research Center, available at http://www.pewresearch.org/fact-tank/2014/12/17/wealth-gap-upper-middle-income/.


I wrote about this in the context of the East Asian crisis in my *Globalization and Its Discontents* (New York: W. W. Norton, 2002); Jason Furman (later one of my successors as chairman of the Council of Economic Advisers) and I showed that there was a regular pattern to this, in our 1998 paper “Economic Consequences of Income Inequality,” in *Income Inequality: Issues and Policy Options* (Proceedings of a Symposium at Jackson Hole, Wyoming) (Kansas City, MO: Federal Reserve Bank of Kansas City, 1998), pp. 221–63.
WHEN WE LOOK BACK SOMEDAY AT THE CATASTROPHE that was the Bush administration, we will think of many things: the tragedy of the Iraq war, the shame of Guantánamo and Abu Ghraib, the erosion of civil liberties. The damage done to the American economy does not make front-page headlines every day, but the repercussions will be felt beyond the lifetime of anyone reading this page.

I can hear an irritated counterthrust already. The president has not driven the United States into a recession during his almost seven years in office. Unemployment stands at a respectable 4.6 percent. Well, fine. But the other side of the ledger groans with distress: a tax code that has become hideously biased in favor of the rich; a national debt that will probably have grown 70 percent by the time this president leaves Washington; a swelling cascade of mortgage defaults; a record near-$850 billion trade deficit; oil prices that are higher than they have ever been; and a dollar so weak that for an American to buy a cup of coffee in London or Paris—or even the Yukon—becomes a venture in high finance.

And it gets worse. After almost seven years of this president, the United States is less prepared than ever to face the future. We have not been educating enough engineers and scientists, people with the skills we will need to compete with China and India. We have not been investing in the kinds of basic research that made us the technological powerhouse of the late 20th century. And although the president now understands—or so he says—that we must begin to wean ourselves from oil and coal, we have on his watch become more deeply dependent on both.

Up to now, the conventional wisdom has been that Herbert Hoover, whose policies aggravated the Great Depression, is the odds-on claimant for the mantle “worst president” when it comes to stewardship of the American economy. Once Franklin Roosevelt assumed office and reversed Hoover’s policies, the country began to recover. The economic effects of Bush’s presidency are more insidious than those of Hoover, harder to reverse, and likely to be longer-lasting. There is no threat of America’s being displaced from its position as the world’s richest economy. But our grandchildren will still be living with, and struggling with, the economic consequences of Mr. Bush.

REMEMBER THE SURPLUS?

The world was a very different place, economically speaking, when George W. Bush took office, in January 2001. During the Roaring 90s, many had believed that the Internet would transform everything. Productivity gains, which had averaged about 1.5 percent a year from the early 1970s through the early 90s, now approached 3 percent. During Bill Clinton’s second term, gains in manufacturing productivity sometimes even surpassed 6 percent. The Federal Reserve chairman, Alan Greenspan, spoke of a New
Economy marked by continued productivity gains as the Internet buried the old ways of doing business. Others went so far as to predict an end to the business cycle. Greenspan worried aloud about how he’d ever be able to manage monetary policy once the nation’s debt was fully paid off.

This tremendous confidence took the Dow Jones index higher and higher. The rich did well, but so did the not-so-rich and even the downright poor. The Clinton years were not an economic Nirvana; as chairman of the president’s Council of Economic Advisers during part of this time, I’m all too aware of mistakes and lost opportunities. The global-trade agreements we pushed through were often unfair to developing countries. We should have invested more in infrastructure, tightened regulation of the securities markets, and taken additional steps to promote energy conservation. We fell short because of politics and lack of money—and also, frankly, because special interests sometimes shaped the agenda more than they should have. But these boom years were the first time since Jimmy Carter that the deficit was under control. And they were the first time since the 1970s that incomes at the bottom grew faster than those at the top—a benchmark worth celebrating.

By the time George W. Bush was sworn in, parts of this bright picture had begun to dim. The tech boom was over. The NASDAQ fell 15 percent in the single month of April 2000, and no one knew for sure what effect the collapse of the Internet bubble would have on the real economy. It was a moment ripe for Keynesian economics, a time to prime the pump by spending more money on education, technology, and infrastructure—all of which America desperately needed, and still does, but which the Clinton administration had postponed in its relentless drive to eliminate the deficit. Bill Clinton had left President Bush in an ideal position to pursue such policies. Remember the presidential debates in 2000 between Al Gore and George Bush, and how the two men argued over how to spend America’s anticipated $2.2 trillion budget surplus? The country could well have afforded to ramp up domestic investment in key areas. In fact, doing so would have staved off recession in the short run while spurring growth in the long run.

But the Bush administration had its own ideas. The first major economic initiative pursued by the president was a massive tax cut for the rich, enacted in June of 2001. Those with incomes over a million got a tax cut of $18,000—more than 30 times larger than the cut received by the average American. The inequities were compounded by a second tax cut, in 2003, this one skewed even more heavily toward the rich. Together these tax cuts, when fully implemented and if made permanent, mean that in 2012 the average reduction for an American in the bottom 20 percent will be a scant $45, while those with incomes of more than $1 million will see their tax bills reduced by an average of $162,000.

The administration crows that the economy grew—by some 16 percent—during its
first six years, but the growth helped mainly people who had no need of any help, and failed to help those who need plenty. A rising tide lifted all yachts. Inequality is now widening in America, and at a rate not seen in three-quarters of a century. A young male in his 30s today has an income, adjusted for inflation, that is 12 percent less than what his father was making 30 years ago. Some 5.3 million more Americans are living in poverty now than were living in poverty when Bush became president. America’s class structure may not have arrived there yet, but it’s heading in the direction of Brazil’s and Mexico’s.

**The Bankruptcy Boom**

In breathtaking disregard for the most basic rules of fiscal propriety, the administration continued to cut taxes even as it undertook expensive new spending programs and embarked on a financially ruinous “war of choice” in Iraq. A budget surplus of 2.4 percent of gross domestic product (GDP), which greeted Bush as he took office, turned into a deficit of 3.6 percent in the space of four years. The United States had not experienced a turnaround of this magnitude since the global crisis of World War II.

Agricultural subsidies were doubled between 2002 and 2005. Tax expenditures—the vast system of subsidies and preferences hidden in the tax code—increased more than a quarter. Tax breaks for the president’s friends in the oil-and-gas industry increased by billions and billions of dollars. Yes, in the five years after 9/11, defense expenditures did increase (by some 70 percent), though much of the growth wasn’t helping to fight the War on Terror at all, but was being lost or outsourced in failed missions in Iraq. Meanwhile, other funds continued to be spent on the usual high-tech gimcrackery—weapons that don’t work, for enemies we don’t have. In a nutshell, money was being spent everywhere except where it was needed. During these past seven years the percentage of GDP spent on research and development outside defense and health has fallen. Little has been done about our decaying infrastructure—be it levees in New Orleans or bridges in Minneapolis. Coping with most of the damage will fall to the next occupant of the White House.

Although it railed against entitlement programs for the needy, the administration enacted the largest increase in entitlements in four decades—the poorly designed Medicare prescription-drug benefit, intended as both an election-season bribe and a sop to the pharmaceutical industry. As internal documents later revealed, the true cost of the measure was hidden from Congress. Meanwhile, the pharmaceutical companies received special favors. To access the new benefits, elderly patients couldn’t opt to buy cheaper medications from Canada or other countries. The law also prohibited the U.S. government, the largest single buyer of prescription drugs, from negotiating with drug manufacturers to keep costs down. As a result, American consumers pay far more for medications than people elsewhere in the developed world.

You’ll still hear some—and, loudly, the president himself—argue that the
administration’s tax cuts were meant to stimulate the economy, but this was never true. The bang for the buck—the amount of stimulus per dollar of deficit—was astonishingly low. Therefore, the job of economic stimulation fell to the Federal Reserve Board, which stepped on the accelerator in a historically unprecedented way, driving interest rates down to 1 percent. In real terms, taking inflation into account, interest rates actually dropped to negative 2 percent. The predictable result was a consumer spending spree. Looked at another way, Bush’s own fiscal irresponsibility fostered irresponsibility in everyone else. Credit was shoveled out the door, and subprime mortgages were made available to anyone this side of life support. Credit card debt mounted to a whopping $900 billion by the summer of 2007. “Qualified at birth” became the drunken slogan of the Bush era. American households took advantage of the low interest rates, signed up for new mortgages with “teaser” initial rates, and went to town on the proceeds.

All of this spending made the economy look better for a while; the president could (and did) boast about the economic statistics. But the consequences for many families would become apparent within a few years, when interest rates rose and mortgages proved impossible to repay. The president undoubtedly hoped the reckoning would come sometime after 2008. It arrived 18 months early. As many as 1.7 million Americans are expected to lose their homes in the months ahead. For many, this will mean the beginning of a downward spiral into poverty.

Between March 2006 and March 2007 personal-bankruptcy rates soared more than 60 percent. As families went into bankruptcy, more and more of them came to understand who had won and who had lost as a result of the president’s 2005 bankruptcy bill, which made it harder for individuals to discharge their debts in a reasonable way. The lenders that had pressed for “reform” had been the clear winners, gaining added leverage and protections for themselves; people facing financial distress got the shaft.

**And Then There’s Iraq**

The war in Iraq (along with, to a lesser extent, the war in Afghanistan) has cost the country dearly in blood and treasure. The loss in lives can never be quantified. As for the treasure, it’s worth calling to mind that the administration, in the run-up to the invasion of Iraq, was reluctant to venture an estimate of what the war would cost (and publicly humiliated a White House aide who suggested that it might run as much as $200 billion). When pressed to give a number, the administration suggested $50 billion—what the United States is actually spending every few months. Today, government figures officially acknowledge that more than half a trillion dollars total has been spent by the U.S. “in theater.” But in fact the overall cost of the conflict could be quadruple that amount—as a study I did with Linda Bilmes of Harvard has pointed out—even as the Congressional Budget Office now concedes that total expenditures are likely to be more than double the spending on operations. The official numbers do not include, for
instance, other relevant expenditures hidden in the defense budget, such as the soaring
costs of recruitment, with reenlistment bonuses of as much as $100,000. They do not
include the lifetime of disability and health care benefits that will be required by tens of
thousands of wounded veterans, as many as 20 percent of whom have suffered
devastating brain and spinal injuries. Astonishingly, they do not include much of the
cost of the equipment that has been used in the war, and that will have to be replaced. If
you also take into account the costs to the economy from higher oil prices and the
knock-on effects of the war—for instance, the depressing domino effect that war-fueled
uncertainty has on investment, and the difficulties U.S. firms face overseas because
America is the most disliked country in the world—the total costs of the Iraq war
mount, even by a conservative estimate, to at least $2 trillion. To which one needs to
add these words: so far.

It is natural to wonder, What would this money have bought if we had spent it on
other things? U.S. aid to all of Africa has been hovering around $5 billion a year, the
equivalent of less than two weeks of direct Iraq-war expenditures. The president made a
big deal out of the financial problems facing Social Security, but the system could have
been repaired for a century with what we have bled into the sands of Iraq. Had even a
fraction of that $2 trillion been spent on investments in education and technology, or
improving our infrastructure, the country would be in a far better position economically
to meet the challenges it faces in the future, including threats from abroad. For a sliver
of that $2 trillion we could have provided guaranteed access to higher education for all
qualified Americans.

The soaring price of oil is clearly related to the Iraq war. The issue is not whether to
blame the war for this but simply how much to blame it. It seems unbelievable now to
recall that Bush-administration officials before the invasion suggested not only that
Iraq’s oil revenues would pay for the war in its entirety—hadn’t we actually turned a
tidy profit from the 1991 Gulf War?—but also that war was the best way to ensure low
oil prices. In retrospect, the only big winners from the war have been the oil companies,
the defense contractors, and al-Qaeda. Before the war, the oil markets anticipated that
the then price range of $20 to $25 a barrel would continue for the next three years or so.
Market players expected to see more demand from China and India, sure, but they also
anticipated that this greater demand would be met mostly by increased production in the
Middle East. The war upset that calculation, not so much by curtailing oil production in
Iraq, which it did, but rather by heightening the sense of insecurity everywhere in the
region, suppressing future investment.

The continuing reliance on oil, regardless of price, points to one more administration
legacy: the failure to diversify America’s energy resources. Leave aside the
environmental reasons for weaning the world from hydrocarbons—the president has
never convincingly embraced them, anyway. The economic and national-security
arguments ought to have been powerful enough. Instead, the administration has
pursued a policy of “drain America first”—that is, take as much oil out of America as possible, and as quickly as possible, with as little regard for the environment as one can get away with, leaving the country even more dependent on foreign oil in the future, and hope against hope that nuclear fusion or some other miracle will come to the rescue. So many gifts to the oil industry were included in the president’s 2003 energy bill that John McCain referred to it as the “No Lobbyist Left Behind” bill.

**Contempt for the World**

America’s budget and trade deficits have grown to record highs under President Bush. To be sure, deficits don’t have to be crippling in and of themselves. If a business borrows to buy a machine, it’s a good thing, not a bad thing. During the past six years, America—its government, its families, the country as a whole—has been borrowing to sustain its consumption. Meanwhile, investment in fixed assets—the plants and equipment that help increase our wealth—has been declining.

What’s the impact of all this down the road? The growth rate in America’s standard of living will almost certainly slow, and there could even be a decline. The American economy can take a lot of abuse, but no economy is invincible, and our vulnerabilities are plain for all to see. As confidence in the American economy has plummeted, so has the value of the dollar—by 40 percent against the euro since 2001.

The disarray in our economic policies at home has parallels in our economic policies abroad. President Bush blamed the Chinese for our huge trade deficit, but an increase in the value of the yuan, which he has pushed, would simply make us buy more textiles and apparel from Bangladesh and Cambodia instead of China; our deficit would remain unchanged. The president claimed to believe in free trade but instituted measures aimed at protecting the American steel industry. The United States pushed hard for a series of bilateral trade agreements and bullied smaller countries into accepting all sorts of bitter conditions, such as extending patent protection on drugs that were desperately needed to fight AIDS. We pressed for open markets around the world but prevented China from buying Unocal, a small American oil company, most of whose assets lie outside the United States.

Not surprisingly, protests over U.S. trade practices erupted in places such as Thailand and Morocco. But America has refused to compromise—refused, for instance, to take any decisive action to do away with our huge agricultural subsidies, which distort international markets and hurt poor farmers in developing countries. This intransigence led to the collapse of talks designed to open up international markets. As in so many other areas, President Bush worked to undermine multilateralism—the notion that countries around the world need to cooperate—and to replace it with an America-dominated system. In the end, he failed to impose American dominance—but did succeed in weakening cooperation.
The administration’s basic contempt for global institutions was underscored in 2005 when it named Paul Wolfowitz, the former deputy secretary of defense and a chief architect of the Iraq war, as president of the World Bank. Widely distrusted from the outset, and soon caught up in personal controversy, Wolfowitz became an international embarrassment and was forced to resign his position after less than two years on the job.

Globalization means that America’s economy and the rest of the world have become increasingly interwoven. Consider those bad American mortgages. As families default, the owners of the mortgages find themselves holding worthless pieces of paper. The originators of these problem mortgages had already sold them to others, who packaged them, in a nontransparent way, with other assets, and passed them on once again to unidentified others. When the problems became apparent, global financial markets faced real tremors: it was discovered that billions in bad mortgages were hidden in portfolios in Europe, China, and Australia, and even in star American investment banks such as Goldman Sachs and Bear Stearns. Indonesia and other developing countries—innocent bystanders, really—suffered as global risk premiums soared, and investors pulled money out of these emerging markets, looking for safer havens. It will take years to sort out this mess.

Meanwhile, we have become dependent on other nations for the financing of our own debt. Today, China alone holds more than $1 trillion in public and private American IOUs. Cumulative borrowing from abroad during the six years of the Bush administration amounts to some $5 trillion. Most likely these creditors will not call in their loans—if they ever did, there would be a global financial crisis. But there is something bizarre and troubling about the richest country in the world not being able to live even remotely within its means. Just as Guantánamo and Abu Ghraib have eroded America’s moral authority, so the Bush administration’s fiscal housekeeping has eroded our economic authority.

The Way Forward

Whoever moves into the White House in January 2009 will face an unenviable set of economic circumstances. Extricating the country from Iraq will be the bloodier task, but putting America’s economic house in order will be wrenching and take years.

The most immediate challenge will be simply to get the economy’s metabolism back into the normal range. That will mean moving from a savings rate of zero (or less) to a more typical savings rate of, say, 4 percent. While such an increase would be good for the long-term health of America’s economy, the short-term consequences would be painful. Money saved is money not spent. If people don’t spend money, the economic engine stalls. If households curtail their spending quickly—as they may be forced to do as a result of the meltdown in the mortgage market—this could mean a recession; if done in a more measured way, it would still mean a protracted slowdown. The
problems of foreclosure and bankruptcy posed by excessive household debt are likely to get worse before they get better. And the federal government is in a bind: any quick restoration of fiscal sanity will only aggravate both problems.

And in any case there’s more to be done. What is required is in some ways simple to describe: it amounts to ceasing our current behavior and doing exactly the opposite. It means not spending money that we don’t have, increasing taxes on the rich, reducing corporate welfare, strengthening the safety net for the less well off, and making greater investment in education, technology, and infrastructure.

When it comes to taxes, we should be trying to shift the burden away from things we view as good, such as labor and savings, to things we view as bad, such as pollution. With respect to the safety net, we need to remember that the more the government does to help workers improve their skills and get affordable health care the more we free up American businesses to compete in the global economy. Finally, we’ll be a lot better off if we work with other countries to create fair and efficient global trade and financial systems. We’ll have a better chance of getting others to open up their markets if we ourselves act less hypocritically—that is, if we open our own markets to their goods and stop subsidizing American agriculture.

Some portion of the damage done by the Bush administration could be rectified quickly. A large portion will take decades to fix—and that’s assuming the political will to do so exists both in the White House and in Congress. Think of the interest we are paying, year after year, on the almost $4 trillion of increased debt burden—even at 5 percent, that’s an annual payment of $200 billion. Think of the taxes that future governments will have to levy to repay even a fraction of the debt we have accumulated. And think of the widening divide between rich and poor in America, a phenomenon that goes beyond economics and speaks to the very future of the American dream.

In short, there’s a momentum here that will require a generation to reverse. Decades hence we should take stock, and revisit the conventional wisdom. Will Herbert Hoover still deserve his dubious mantle? I’m guessing that George W. Bush will have earned one more grim superlative.

*Vanity Fair*, December 2007, Anya Schiffrin and Izzet Yildiz assisted with research for this article.
CAPITALIST FOOLS*

THERE WILL COME A MOMENT WHEN THE MOST URGENT threats posed by the credit crisis have eased and the larger task before us will be to chart a direction for the economic steps ahead. This will be a dangerous moment. Behind the debates over future policy is a debate over history—a debate over the causes of our current situation. The battle for the past will determine the battle for the present. So it’s crucial to get the history straight.

What were the critical decisions that led to the crisis? Mistakes were made at every fork in the road—we had what engineers call a “system failure,” when not a single decision but a cascade of decisions produce a tragic result. Let’s look at five key moments.

**No. 1: FIRING THE CHAIRMAN**

In 1987 the Reagan administration decided to remove Paul Volcker as chairman of the Federal Reserve Board and appoint Alan Greenspan in his place. Volcker had done what central bankers are supposed to do. On his watch, inflation had been brought down from more than 11 percent to under 4 percent. In the world of central banking, that should have earned him a grade of A+++ and assured his reappointment. But Volcker also understood that financial markets need to be regulated. Reagan wanted someone who did not believe any such thing, and he found him in a devotee of the objectivist philosopher and free market-zealot Ayn Rand.

Greenspan played a double role. The Fed controls the money spigot, and in the early years of this decade, he turned it on full force. But the Fed is also a regulator. If you appoint an anti-regulator as your enforcer, you know what kind of enforcement you’ll get. A flood of liquidity combined with the failed levees of regulation proved disastrous.

Greenspan presided over not one but two financial bubbles. After the high-tech bubble popped, in 2000–2001, he helped inflate the housing bubble. The first responsibility of a central bank should be to maintain the stability of the financial system. If banks lend on the basis of artificially high asset prices, the result can be a meltdown—as we are seeing now, and as Greenspan should have known. He had many of the tools he needed to cope with the situation. To deal with the high-tech bubble, he could have increased margin requirements (the amount of cash people need to put down to buy stock). To deflake the housing bubble, he could have curbed predatory lending to low-income households and prohibited other insidious practices (the no-documentation—or “liar”—loans, the interest-only loans, and so on). This would have gone a long way toward protecting us. If he didn’t have the tools, he could have gone to Congress and asked for them.

Of course, the current problems with our financial system are not solely the result of
bad lending. The banks have made mega-bets with one another through complicated instruments such as derivatives, credit-default swaps, and so forth. With these, one party pays another if certain events happen—for instance, if Bear Stearns goes bankrupt, or if the dollar soars. These instruments were originally created to help manage risk—but they can also be used to gamble. Thus, if you felt confident that the dollar was going to fall, you could make a big bet accordingly, and if the dollar indeed fell, your profits would soar. The problem is that, with this complicated intertwining of bets of great magnitude, no one could be sure of the financial position of anyone else—or even of one’s own position. Not surprisingly, the credit markets froze.

Here too Greenspan played a role. When I was chairman of the Council of Economic Advisors, during the Clinton administration, I served on a committee of all the major federal financial regulators, a group that included Greenspan and Treasury Secretary Robert Rubin. Even then, it was clear that derivatives posed a danger. And yet, for all the risk, the deregulators in charge of the financial system—at the Fed, at the Securities and Exchange Commission, and elsewhere—decided to do nothing, worried that any action might interfere with “innovation” in the financial system. But innovation, like “change,” has no inherent value. It can be bad (the “liar” loans are a good example) as well as good.

**No. 2: TEARING DOWN THE WALLS**

The deregulation philosophy would pay unwelcome dividends for years to come. In November 1999, Congress repealed the Glass-Steagall Act—the culmination of a $300 million lobbying effort by the banking and financial-services industries, and spearheaded in Congress by Senator Phil Gramm. Glass-Steagall had long separated commercial banks (which lend money) and investment banks (which organize the sale of bonds and equities); it had been enacted in the aftermath of the Great Depression and was meant to curb the excesses of that era, including grave conflicts of interest. For instance, without separation, if a company whose shares had been issued by an investment bank, with its strong endorsement, got into trouble, wouldn’t its commercial arm, if it had one, feel pressure to lend it money, perhaps unwisely? An ensuing spiral of bad judgment is not hard to foresee. I had opposed repeal of Glass-Steagall. The proponents said, in effect, Trust us: we will create Chinese walls to make sure that the problems of the past do not recur. As an economist, I certainly possessed a healthy degree of trust, trust in the power of economic incentives to bend human behavior toward self-interest—toward short-term self-interest, at any rate, rather than Tocqueville’s “self interest rightly understood.”

The most important consequence of the repeal of Glass-Steagall was indirect—it lay in the way repeal changed an entire culture. Commercial banks are not supposed to be high-risk ventures; they are supposed to manage other people’s money very conservatively. It is with this understanding that the government agrees to pick up the
tab should they fail. Investment banks, on the other hand, have traditionally managed rich people’s money—people who can take bigger risks in order to get bigger returns. When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risk taking.

There were other important steps down the deregulatory path. One was the decision in April 2004 by the Securities and Exchange Commission, at a meeting attended by virtually no one and largely overlooked at the time, to allow big investment banks to increase their debt-to-capital ratio (from 12:1 to 30:1, or higher) so that they could buy more mortgage-backed securities, inflating the housing bubble in the process. In agreeing to this measure, the SEC argued for the virtues of self-regulation: the peculiar notion that the banks can effectively police themselves. Self-regulation is preposterous, as even Alan Greenspan now concedes, and as a practical matter it can’t, in any case, identify systemic risks—the kinds of risks that arise when, for instance, the models used by each of the banks to manage their portfolios tell all the banks to sell some security all at once.

As we stripped back the old regulations, we did nothing to address the new challenges posed by 21st-century markets. The most important challenge was that posed by derivatives. In 1998 the head of the Commodity Futures Trading Commission, Brooksley Born, had called for such regulation—a concern that took on urgency after the Fed, in that same year, engineered the bailout of Long-Term Capital Management, a hedge fund whose trillion-dollar-plus failure threatened global financial markets. But Secretary of the Treasury Robert Rubin, his deputy Larry Summers, and Greenspan were adamant—and successful—in their opposition. Nothing was done.

**No. 3: Applying the Leeches**

Then along came the Bush tax cuts, enacted first on June 7, 2001, with a follow-on installment two years later. The president and his advisers seemed to believe that tax cuts, especially for upper-income Americans and corporations, were a cure-all for any economic disease—the modern-day equivalent of leeches. The tax cuts played a pivotal role in shaping the background conditions of the current crisis. Because they did very little to stimulate the economy, real stimulation was left to the Fed, which took up the task with unprecedented low-interest rates and liquidity. The war in Iraq made matters worse, because it led to soaring oil prices. With America so dependent on oil imports, we had to spend several hundred billion more to purchase oil—money that otherwise would have been spent on American goods. Normally this would have led to an economic slowdown, as it had in the 1970s. But the Fed met the challenge in the most myopic way imaginable. The flood of liquidity made money readily available in mortgage markets, even to those who would normally not be able to borrow. And, yes, this succeeded in forestalling an economic downturn; America’s household saving rate
plummeted to zero. But it should have been clear that we were living on borrowed money and borrowed time.

The cut in the tax rate on capital gains contributed to the crisis in another way. It was a decision that turned on values: those who speculated (read: gambled) and won were taxed more lightly than wage earners who simply worked hard. But more than that, the decision encouraged leveraging, because interest was tax-deductible. If, for instance, you borrowed a million to buy a home or took a $100,000 home-equity loan to buy stock, the interest would be fully deductible every year. Any capital gains you made were taxed lightly—and at some possibly remote day in the future. The Bush administration was providing an open invitation to excessive borrowing and lending—not that American consumers needed any more encouragement.

**No. 4: Faking the Numbers**

Meanwhile, on July 30, 2002, in the wake of a series of major scandals—notably the collapse of WorldCom and Enron—Congress passed the Sarbanes-Oxley Act. The scandals had involved every major American accounting firm, most of our banks, and some of our premier companies, and made it clear that we had serious problems with our accounting system. Accounting is a sleep-inducing topic for most people, but if you can’t have faith in a company’s numbers, then you can’t have faith in anything about a company at all. Unfortunately, in the negotiations over what became Sarbanes-Oxley a decision was made not to deal with what many, including the respected former head of the SEC Arthur Levitt, believed to be a fundamental underlying problem: stock options. Stock options have been defended as providing healthy incentives toward good management, but in fact they are “incentive pay” in name only. If a company does well, the CEO gets great rewards in the form of stock options; if a company does poorly, the compensation is almost as substantial but is bestowed in other ways. This is bad enough. But a collateral problem with stock options is that they provide incentives for bad accounting: top management has every incentive to provide distorted information in order to pump up share prices.

The incentive structure of the rating agencies also proved perverse. Agencies such as Moody’s and Standard & Poor’s are paid by the very people they are supposed to grade. As a result, they’ve had every reason to give companies high ratings, in a financial version of what college professors know as grade inflation. The rating agencies, like the investment banks that were paying them, believed in financial alchemy—that F-rated toxic mortgages could be converted into products that were safe enough to be held by commercial banks and pension funds. We had seen this same failure of the rating agencies during the East Asia crisis of the 1990s: high ratings facilitated a rush of money into the region, and then a sudden reversal in the ratings brought devastation. But the financial overseers paid no attention.
NO. 5: LETTING IT BLEED

The final turning point came with the passage of a bailout package on October 3, 2008—that is, with the administration’s response to the crisis itself. We will be feeling the consequences for years to come. Both the administration and the Fed had long been driven by wishful thinking, hoping that the bad news was just a blip, and that a return to growth was just around the corner. As America’s banks faced collapse, the administration veered from one course of action to another. Some institutions (Bear Stearns, AIG, Fannie Mae, Freddie Mac) were bailed out. Lehman Brothers was not. Some shareholders got something back. Others did not.

The original proposal by Treasury Secretary Henry Paulson, a three-page document that would have provided $700 billion for the secretary to spend at his sole discretion, without oversight or judicial review, was an act of extraordinary arrogance. He sold the program as necessary to restore confidence. But it didn’t address the underlying reasons for the loss of confidence. The banks had made too many bad loans. There were big holes in their balance sheets. No one knew what was truth and what was fiction. The bailout package was like a massive transfusion to a patient suffering from internal bleeding—and nothing was being done about the source of the problem, namely all those foreclosures. Valuable time was wasted as Paulson pushed his own plan, “cash for trash,” buying up the bad assets and putting the risk onto American taxpayers. When he finally abandoned it, providing banks with money they needed, he did it in a way that not only cheated America’s taxpayers, but failed to ensure that the banks would use the money to restart lending. He even allowed the banks to pour out money to their shareholders as taxpayers were pouring money into the banks.

The other problem not addressed involved the looming weaknesses in the economy. The economy had been sustained by excessive borrowing. That game was up. As consumption contracted, exports kept the economy going, but with the dollar strengthening and Europe and the rest of the world declining, it was hard to see how that could continue. Meanwhile, states faced massive drop-offs in revenues—they would have to cut back on expenditures. Without quick action by government, the economy faced a downturn. And even if banks had lent wisely—which they hadn’t—the downturn was sure to mean an increase in bad debts, further weakening the struggling financial sector.

The administration talked about confidence building, but what it delivered was actually a confidence trick. If the administration had really wanted to restore confidence in the financial system, it would have begun by addressing the underlying problems—the flawed incentive structures and the inadequate regulatory system.

Was there any single decision which, had it been reversed, would have changed the course of history? Every decision—including decisions not to do something, as many of our bad economic decisions have been—is a consequence of prior decisions, an
interlinked web stretching from the distant past into the future. You’ll hear some on the right point to certain actions by the government itself—such as the Community Reinvestment Act, which requires banks to make mortgage money available in low-income neighborhoods. (Defaults on CRA lending were actually much lower than on other lending.) There has been much finger-pointing at Fannie Mae and Freddie Mac, the two huge mortgage lenders, which were originally government-owned. But in fact they came late to the subprime game, and their problem was similar to that of the private sector: their CEOs had the same perverse incentive to indulge in gambling.

The truth is most of the individual mistakes boil down to just one: a belief that markets are self-adjusting and that the role of government should be minimal. Looking back at that belief during hearings this fall on Capitol Hill, Alan Greenspan said out loud, “I have found a flaw.” Congressman Henry Waxman pushed him, responding, “In other words, you found that your view of the world, your ideology, was not right; it wasn’t working.” “Absolutely, precisely,” Greenspan said. The embrace by America—and much of the rest of the world—of this flawed economic philosophy made it inevitable that we would eventually arrive at the place we are today.

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THE ANATOMY OF A MURDER: WHO KILLED AMERICA’S ECONOMY?*

THE SEARCH IS ON FOR WHOM TO BLAME FOR THE GLOBAL ECONOMIC CRISIS. IT IS NOT JUST A MATTER OF VINDICTIVENESS; IT IS IMPORTANT TO KNOW WHO OR WHAT CAUSED THE CRISIS IF ONE IS TO FIGURE OUT HOW TO PREVENT ANOTHER, OR PERHAPS EVEN TO FIX THIS ONE.

THE NOTION OF CAUSATION IS, HOWEVER, COMPLEX. PRESUMABLY, IT MEANS SOMETHING LIKE, “IF ONLY THE GUILTY PARTY HAD TAKEN ANOTHER COURSE OF ACTION, THE CRISIS WOULD NOT HAVE OCCURRED.” BUT THE CONSEQUENCES OF ONE PARTY CHANGING ITS ACTIONS DEPEND ON THE BEHAVIOR OF OTHERS; PRESUMABLY THE ACTIONS OF OTHER PARTIES, TOO, MAY HAVE CHANGED.


THERE ARE MANY PARTIES TO THIS CRIME—BOTH PEOPLE AND INSTITUTIONS. ANY DISCUSSION OF “WHO IS TO BLAME” CONJURES UP NAMES LIKE ROBERT RUBIN, CO-CONSPIRATOR IN Deregulation AND A SENIOR OFFICIAL IN ONE OF THE TWO FINANCIAL INSTITUTIONS INTO WHICH THE AMERICAN GOVERNMENT HAS POURED THE MOST MONEY. THEN THERE WAS ALAN GREENSPAN, WHO ALSO PUSHED THE Deregulatory PHILOSOPHY; WHO FAILED TO USE THE REGULATORY AUTHORITY THAT HE HAD; WHO ENCOURAGED HOMEOWNERS TO TAKE OUT HIGHLY RISKY ADJUSTABLE MORTGAGES; AND WHO SUPPORTED PRESIDENT BUSH’S TAX CUT FOR THE RICH,¹—MAKING LOWER INTEREST RATES, WHICH FED THE BUBBLE, NECESSARY TO STIMULATE THE ECONOMY. BUT IF THESE PEOPLE HADN’T BEEN THERE, OTHERS WOULD HAVE OCCUPIED THEIR SEATS, ARGUABLY DOING SIMILAR THINGS. THERE WERE OTHERS EQUALLY WILLING AND ABLE TO PERPETRATE THE CRIMES. MOREOVER, THE FACT THAT SIMILAR PROBLEMS AROSE IN OTHER COUNTRIES—WITH DIFFERENT PEOPLE PLAYING THE PARTS OF THE PROTAGONISTS—SUGGESTS THAT THERE WERE MORE FUNDAMENTAL ECONOMIC FORCES AT PLAY.

THE LIST OF INSTITUTIONS THAT MUST ASSUME CONSIDERABLE RESPONSIBILITY FOR THE CRISIS INCLUDES THE INVESTMENT BANKS AND THE INVESTORS; THE CREDIT-RATING AGENCIES; THE REGULATORS, INCLUDING THE SEC AND THE FEDERAL RESERVE; THE MORTGAGE BROKERS; AND A STRING OF ADMINISTRATIONS, FROM REAGAN TO BUSH II, THAT PUSHED FINANCIAL-SECTOR Deregulation. SOME OF THESE INSTITUTIONS CONTRIBUTED TO THE CRISIS IN MULTIPLE ROLES—MOST NOTABLY THE FEDERAL RESERVE, WHICH FAILED IN ITS ROLE AS REGULATOR, BUT WHICH ALSO MAY HAVE CONTRIBUTED TO THE CRISIS BY MISHANDLING INTEREST RATES AND CREDIT AVAILABILITY. ALL OF THESE—AND SOME OTHERS DISCUSSED BELOW—SHARE SOME CULPABILITY.
THE MAIN PROTAGONISTS

But I would argue that blame should be centrally placed on the banks (and the financial sector more broadly) and the investors.

The banks were supposed to be the experts in risk management. They not only didn’t manage risk; they created it. They engaged in excessive leverage. At a 30-to-1 leverage ratio, a mere 3 percent change in asset values wipes out one’s net worth. (To put matters in perspective, real estate prices have fallen some 20 percent and, as of March 2009, are expected to fall another 10–15 percent, at least.) The banks adopted incentive structures that were designed to induce shortsighted and excessively risky behavior. The stock options that they used to pay some of their senior executives, moreover, provided incentives for bad accounting, including incentives to engage in extensive off-balance-sheet accounting.

The bankers seemingly didn’t understand the risks that were being created by securitization—including those arising from information asymmetries: The originators of the mortgages did not end up holding on to them, so the originators didn’t bear the consequences of any failure at due diligence. The bankers also misestimated the extent of correlation among default rates in different parts of the country—not realizing that a rise in the interest rate or an increase in unemployment might have adverse effects in many parts of the country—and they underestimated the risk of real estate price declines. Nor did the banks assess with any degree of accuracy the risks associated with some of the new financial products, such as low- or no-documentation loans.

The only defense that the bankers have—and it’s admittedly a weak defense—is that their investors made them do it. Their investors didn’t understand risk. They confused high returns brought on by excessive leverage in an up market with “smart” investment. Banks that didn’t engage in excessive leverage, and so had lower returns, were “punished” by having their stock values beaten down. The reality, however, is that the banks exploited this investor ignorance to push their stock prices up, getting higher short-term returns at the expense of higher risk.

ACCESSORIES TO THE CRIME

If the banks were the main perpetrators of the crime, they had many accomplices.

Rating agencies played a central role. They believed in financial alchemy, and converted F-rated subprime mortgages into A-rated securities that were safe enough to be held by pension funds. This was important, because it allowed a steady flow of cash into the housing market, which in turn provided the fuel for the housing bubble. The rating agencies’ behavior may have been affected by the perverse incentive of being paid by those that they rated, but I suspect that even without these incentive problems, their models would have been badly flawed. Competition, in this case, had a perverse
effect: It caused a race to the bottom—a race to provide ratings that were most favorable to those being rated.

Mortgage brokers played a key role: They were less interested in originating good mortgages—after all, they didn’t hold the mortgages for long—than in originating many mortgages. Some of the mortgage brokers were so enthusiastic that they invented new forms of mortgages: The low- or no-documentation loans to which I referred earlier were an invitation to deception, and came to be called liar loans. This was an “innovation,” but there was a good reason that such innovations hadn’t occurred before.

Other new mortgage products—low- or no-amortization, variable-rate loans—snared unwary borrowers. Home-equity loans, too, encouraged Americans to borrow against the equity in their homes, increasing the (total) loan-to-value ratios and thereby making the mortgages riskier.

The mortgage originators didn’t focus on risk, but rather on transactions costs. But they weren’t trying to minimize transactions costs; they were trying to maximize them—devising ways that they could increase them, and thereby their revenues. Short-term loans that had to be refinanced—and left open the risk of not being able to be refinanced—were particularly useful in this respect.

The transactions costs generated by writing mortgages provided a strong incentive to prey on innocent and inexperienced borrowers—for instance, by encouraging more short-term lending and borrowing, entailing repeated loan restructurings, which helped generate high transactions costs.

The regulators, too, were accomplices in crime. They should have recognized the inherent risks in the new products; they should have done their own risk assessments, rather than relying on self-regulation or on the credit-rating agencies. They should have realized the risks associated with high leverage, with over-the-counter derivatives, and especially the risks that were compounding as these were not netted out.

The regulators deceived themselves into thinking that if only they ensured that each bank managed its own risk (which they had every incentive, presumably, to do), then the system would work. Amazingly, they did not pay any attention to systemic risk, though concerns about systemic risk constitute one of the primary rationales for regulation in the first place. Even if every bank were, “on average,” sound, they could act in a correlated way that generated risks to the economy as a whole.

In some cases, the regulators had a defense: They had no legal basis for acting, even had they discovered something was wrong. They had not been given the power to regulate derivatives. But that defense is disingenuous, because some of the regulators—most notably Greenspan—had worked hard to make sure that appropriate regulations were not adopted.

The repeal of the Glass-Steagall Act played an especial role, not just because of the
conflicts of interest that it opened up (made so evident in the Enron and WorldCom scandals), but also because it transmitted the risk-taking culture of investment banking to commercial banks, which should have acted in a far more prudential manner.

It was not just financial regulation and regulators that were at fault. There should have been tougher enforcement of antitrust laws. Banks were allowed to grow to be too big to fail—or too big to be managed. And such banks have perverse incentives. When it’s heads I win, tails you lose, too-big-to-fail banks have incentives to engage in excessive risk taking.

Corporate governance laws, too, are partly to blame. Regulators and investors should have been aware of the risks that the peculiar incentive structures engendered. These did not even serve shareholder interests well. In the aftermath of the Enron and WorldCom scandals, there was much discussion of the need for reform, and the Sarbanes-Oxley Act represented a beginning. But it didn’t attack perhaps the most fundamental problem: stock options.

Bush’s and Clinton’s capital-gains tax cuts, in conjunction with the deductibility of interest, provided enhanced incentives for leverage—for homeowners to take out, for instance, as large a mortgage as they could.

Credentialed Accomplices

There is one other set of accomplices—the economists who provided the arguments that those in the financial markets found so convenient and self-serving. These economists provided models—based on unrealistic assumptions of perfect information, perfect competition, and perfect markets—in which regulation was unnecessary.

Modern economic theories, particularly those focusing on imperfect and asymmetric information and on systematic irrationalities, especially with respect to risk judgments, had explained how flawed those earlier “neoclassical” models were. They had shown that those models were not robust—even slight deviations from the extreme assumptions destroyed the conclusions. But these insights were simply ignored.

Some important strands in recent economic theory, moreover, encouraged central bankers to focus solely on fighting inflation. They seemed to argue that low inflation was necessary, and almost sufficient, for stable and robust growth. The result was that central bankers (including the Fed) paid little attention to the financial structure.

In short, many of the most popular microeconomic and macroeconomic theories aided and abetted regulators, investors, bankers, and policymakers—they provided the “rationale” for their policies and actions. They made the bankers believe that in pursuing their self-interest, they were, in fact, advancing the well-being of society; they made the regulators believe that in pursuing their policies of benign neglect, they were allowing the private sector to flourish, from which all would benefit.
Rebutting the Defense

Alan Greenspan has tried to shift the blame for low interest rates to China, because of its high savings rate. Clearly, Greenspan’s defense is unpersuasive: The Fed had enough control, at least in the short run, to have raised interest rates in spite of China’s willingness to lend to America at a relatively low interest rate. Indeed, the Fed did just that in the middle of the decade, which contributed—predictably—to the popping of the housing bubble.

Low interest rates did feed the bubble. But that is not the necessary consequence of low interest rates. Many countries yearn for low interest rates to help finance needed investment. The funds could have been channeled into more productive uses. Our financial markets failed to do that. Our regulatory authorities allowed the financial markets (including the banks) to use the abundance of funds in ways that were not socially productive. They allowed the low interest rates to feed a housing bubble. They had the tools to stop this. They didn’t use the tools that they had.

If we are to blame low interest rates for “feeding” the frenzy, then we have to ask what induced the Fed to pursue low interest rates. It did so, in part, to maintain the strength of the economy, which was suffering from inadequate aggregate demand as a result of the collapse of the tech bubble.

In that regard, Bush’s tax cut for the rich was perhaps pivotal. It was not designed to stimulate the economy and did so only to a limited extent. His war in Iraq, too, played an important role. In its aftermath, oil prices rose from $20 a barrel to $140 a barrel. (We don’t have to parse out here what fraction of this increase is due to the war; but there is little doubt that it played a role.) Americans were now spending hundreds of billions of dollars a year more to import oil. This was money not available to be spent at home.

In the 1970s, when oil prices soared, most countries faced recessions because of the transfer of purchasing power abroad to finance the purchase of oil. There was one exception: Latin America, which used debt finance to continue its consumption unabated. But its borrowing was unsustainable. Over the last decade, America took the Latin American route. To offset the negative effect of higher spending on oil, the Fed kept interest rates lower than they otherwise would have been, and this fed the housing bubble more than it otherwise would have. The American economy, like the Latin American economies of the 70s, seemed to be doing well, because the housing bubble fed a consumption boom, as household savings fell all the way down to zero.

Given the war and the consequent soaring oil prices and given Bush’s poorly designed tax cuts, the burden of maintaining economic strength fell to the Fed. The Fed could have exercised its authority as a regulator to do what it could do to direct the resources into more productive uses. Here, the Fed and its chairman have a double
culpability. Not only did they fail in their regulatory role, they became cheerleaders for the bubble that eventually consumed America. When asked about a possible bubble, Greenspan suggested there was none—only a little froth. That was clearly wrong. The Fed argued that you could not tell a bubble until after it broke. That, too, was not fully correct. You can’t be sure there is a bubble until after it breaks, but one can make strong probabilistic statements.

All policy is made in the context of uncertainty. House prices, especially at the lower end, soared, yet the real incomes of most Americans stagnated: There was a clear problem. And it was clear that the problem would get worse once interest rates rose. Greenspan had encouraged people to take out variable-rate mortgages when interest rates were at historically low levels. And he allowed them to borrow up to the hilt—assuming interest rates would remain at the same low level. But because interest rates were so low—real interest rates were negative—it was unreasonable to expect them to remain at that level for long. When they rose, it was clear that many Americans would be in trouble—and so would the lenders who had lent to them.

Apologists for the Fed sometimes try to defend this irresponsible and shortsighted policy by saying they had no choice: Raising interest rates would have killed the bubble, but also would have killed the economy. But the Fed has more tools than just the interest rate. There were, for instance, a number of regulatory actions that would have dampened the bubble. It chose not to employ these tools. It could have reduced maximum loan-to-value ratios as the likelihood of a bubble increased; it could have lowered the maximum house payment-to-income ratios allowed. If it believed it did not have the requisite tools, it could have gone to Congress and requested them.

This doesn’t provide a fully satisfactory counterfactual. True, perhaps the money could have been deployed by financial markets more productively, to support, for instance, more innovation, or important projects in developing countries. But perhaps the financial markets would have found another scam to support irresponsible borrowing—for instance, a new credit card boom.

**Defending the Innocent**

Just as all of the accomplices are not equally culpable, some suspects should be acquitted.

In the long list of possible culprits, there are two that many Republicans often name. They find it difficult to accept that markets fail, that market participants could act in such an irresponsible manner, that the wizards of finance didn’t understand risk, that capitalism has serious flaws. It is government, they are sure, which is to blame.

I have suggested government is indeed to blame, but for doing too little. The conservative critics believe that government is to blame for doing too much. They criticize the Community Reinvestment Act (CRA) requirements imposed on banks,
which required them to lend a certain fraction of their portfolio to underserved minority communities. They also blame Fannie Mae and Freddie Mac, the peculiar government-sponsored enterprises, which, though privatized in 1968, play a very large role in mortgage markets. Fannie and Freddie were, according to conservatives, “under pressure” from Congress and the president to expand homeownership (President Bush often talked about the “ownership society”).

This is clearly just an attempt to shift blame. A recent Fed study showed that the default rate among CRA mortgagors is actually below average. The problems in America’s mortgage markets began with the subprime market, while Fannie Mae and Freddie Mac primarily financed “conforming” (prime) mortgages.

It is America’s fully private financial markets that invented all the bad practices that played a central role in this crisis. When government encouraged homeownership, it meant permanent homeownership. It didn’t intend for people to buy homes beyond their ability to afford them. That would generate ephemeral gains, and contribute to impoverishment: The poor would lose their life savings as they lost their home.

There is always a home that is of an appropriate cost to an individual’s budget. The irony is that because of the bubble, many of the impoverished wound up owning a home no bigger than they would have if more prudent lending policies had been enforced—which would have dampened the bubble. To be sure, Fannie Mae and Freddie Mac did get into the high-risk high-leverage “games” that were the fad in the private sector, though rather late, and rather ineptly. Here, too, there was regulatory failure; the government-sponsored enterprises have a special regulator which should have constrained them, but evidently, amidst the deregulatory philosophy of the Bush administration, did not. Once they entered the game, they had an advantage, because they could borrow somewhat more cheaply because of their (ambiguous at the time) government guarantee. They could arbitrage that guarantee to generate bonuses comparable to those that they saw were being “earned” by their counterparts in the fully private sector.

There is one more important culprit, which, in fact, has played a key behind-the-scenes role in many various parts of this story: America’s political system, and especially its dependence on campaign contributions. This allowed Wall Street to exercise the enormous influence that it has had, to push for the stripping of regulations and to the appointment of regulators who didn’t believe in regulations—with the predictable and predicted consequences that we have seen. Even today, that influence is playing a role in the design of effective means of addressing the financial crisis.

Any economy needs rules and referees. Our rules and referees were shaped by special interests; ironically, it is not even clear whether those rules and referees served those
special interests well. It is clear that they did not serve the national interests well.

In the end, this is a crisis of our economic and political system. Each of the players was, to a large extent, doing what they thought they should do. The bankers were maximizing their incomes, given the rules of the game. The rules of the game said that they should use their political influence to get regulations and regulators that allowed them, and the corporations they headed, to walk away with as much money as they could. The politicians responded to the rules of the game: They had to raise money to get elected, and to do that, they had to please powerful and wealthy constituents. There were economists who provided the politicians, the bankers, and the regulators with a convenient ideology: According to this ideology, the policies and practices that they were pursuing would supposedly benefit all.

There are those who now would like to reconstruct the system as it was prior to 2008. They will push for regulatory reform, but it will be more cosmetic than real. Banks that are too big to fail will be allowed to continue little changed. There will be “oversight,” whatever that means. But the banks will continue to be able to gamble, and they will continue to be too big to fail. Accounting standards will be relaxed, to give them greater leeway. Little will be done about incentive structures or even risky practices. If so, then, another crisis is sure to follow.

Notes

1. Greenspan supported the 2001 tax cut even though he should have known that it would lead to the deficits which previously he has treated as such an anathema. His argument that, unless we acted now, the surpluses that were accumulating as a result of Clinton’s prudent fiscal policies would drain the economy of all its T-bills, which would make the conduct of monetary policy difficult, was one of the worst arguments from a respected government official I have ever heard; presumably, if the contingency he imagined—the wiping out of the national debt—was imminent, Congress had the tools and incentives with which to correct the situation in short order.


* Critical Review, July 2009
HOW TO GET OUT OF THE FINANCIAL CRISIS*

The amount of bad news over the past weeks has been bewildering for many people in the world. Stock markets have plunged, banks have stopped lending to one another, and central bankers and treasury secretaries appear daily on television looking worried. Many economists have warned that we are facing the worst economic crisis the world has seen since 1929. The only good news is that oil prices have finally started to come down.

While these times are scary and strange for many Americans, a number of people in other countries feel a sense of déjà vu. Asia went through a similar crisis in the late 1990s, and various other countries (including Argentina, Turkey, Mexico, Norway, Sweden, Indonesia, and South Korea) have suffered through banking crises, stock market collapses, and credit crunches.

Capitalism may be the best economic system that man has come up with, but no one ever said it would create stability. In fact, over the past 30 years, market economies have faced more than 100 crises. That is why I and many other economists believe that government regulation and oversight are an essential part of a functioning market economy. Without them, there will continue to be frequent severe economic crises in different parts of the world. The market on its own is not enough. Government must play a role.

It’s good news that Treasury Secretary Henry Paulson seems to finally be coming around to the idea that the U.S. government needs to help recapitalize our banks and should receive stakes in the banks that it bails out. But more must be done to prevent the crisis from spreading around the world. Here’s what it will take.

How We Got Here

The troubles we now face were caused largely by the combination of deregulation and low interest rates. After the collapse of the tech bubble, the economy needed a stimulus. But the Bush tax cuts didn’t provide much stimulus to the economy. This put the burden of keeping the economy going on the Fed, and it responded by flooding the economy with liquidity. Under normal circumstances, it’s fine to have money sloshing around in the system, since that helps the economy grow. But the economy had already overinvested, and so the extra money wasn’t put to productive use. Low interest rates and easy access to funds encouraged reckless lending, the infamous interest-only, no-down-payment, no-documentation ("liar") subprime mortgages. It was clear that if the bubble got deflated even a little, many mortgages would end up underwater—with the price of the house less than the value of the mortgage. That has happened—12 million so far, and more every hour. Not only are the poor losing their homes, but they are also losing their life savings.
The climate of deregulation that dominated the Bush-Greenspan years helped the spread of a new banking model. At its core was securitization: mortgage brokers originated mortgages that they sold on to others. Borrowers were told not to worry about paying the ever-mounting debt, because house prices would keep rising and they could refinance, taking out some of the capital gains to buy a car or pay for a vacation. Of course, this violated the first law of economics—that there is no such thing as a free lunch. The assumption that house prices could continue to go up at a rapid pace looked particularly absurd in an economy in which most Americans were seeing their real incomes declining.

The mortgage brokers loved these new products because they ensured an endless stream of fees. They maximized their profits by originating as many mortgages as possible, with frequent refinancing. Their allies in investment banking bought them, sliced and diced the risk, and then passed them on—or at least as much as they could. Our bankers forgot that their job was to prudently manage risk and allocate capital. They became gambling casinos—gambling with other people’s money, knowing that the taxpayer would step in if the losses were too great. They misallocated capital, with massive amounts going into housing that was ultimately unaffordable. Loose money and light regulation were a toxic mixture. It exploded.

**A Global Crisis**

What made America’s recklessness truly dangerous is that we exported it. A few months ago, some talked about decoupling—that Europe would carry on even as the U.S. suffered a downturn. I always thought that decoupling was a myth, and events have proven that right. Thanks to globalization, Wall Street was able to sell off its toxic mortgages around the world. It appears that about half the toxic mortgages were exported. Had they not been, the U.S. would be in even worse shape. Moreover, even as our economy went into a slowdown, exports kept the U.S. going. But the weaknesses in America weakened the dollar and made it more difficult for Europe to sell its goods abroad. Weak exports meant a weak economy, and so the U.S. exported our downturn just as earlier we had exported our toxic mortgages.

But now the problems are ricocheting back. The bad mortgages are contributing to forcing many European banks into bankruptcy. (We exported not only bad loans but also bad lending and regulatory practices; many of Europe’s bad loans are to European borrowers.) And as market participants realized that the fire had spread from America to Europe, there was panic. Part of the concern is psychological. But part of it is because our financial and economic systems are closely intertwined. Banks all over the world lend and borrow from each other; they buy and sell complicated financial instruments—which is why bad regulatory practices in one country, leading to bad loans, can infect the global system.
**How to Fix It**

We are now facing a liquidity problem, a solvency problem, and a macroeconomic problem. We are in the first phase of a downward spiral. It is, of course, part of the inevitable process of adjustment: returning housing prices to equilibrium levels and getting rid of the excessive leverage (debt) that had kept our phantom economy going.

Even with the new capital provided by the government, banks won’t want to, or be able to, lend as much as they did in their reckless past. Homeowners won’t want to borrow so much. Savings, which have been near zero, will go up—good for the economy in the long run but bad for an economy going into recession. While some large firms may be sitting on a bundle of cash, small firms depend on loans not just for investment but even for the working capital to keep going. That’s going to be harder to come by. And the investment in real estate, which played such an important role in our modest growth of the past 6 years, has reached lows not seen in 20 years.

The administration has veered from one half-baked solution to another. Wall Street panicked, but so did the White House, and in that panic, they had a hard time figuring out what to do. The weeks that Paulson and Bush spent pushing Paulson’s original bailout plan—in the face of massive opposition—were weeks that could have been spent actually fixing the problem. At this point, we need a comprehensive approach. Another failed faint attempt could be disastrous. Here’s a five-step, comprehensive approach:

1. **Recapitalize banks.** With all the losses, banks have insufficient equity. Banks will have a hard time raising this equity under current circumstances. The government needs to provide equity. In return, it should have voting stakes in the banks it helps. But equity injections also bail out bondholders. Right now the market is discounting these bonds, saying there is a high probability of default. There needs to be a forced conversion of this debt to equity. If this is done, the amount of government assistance that will be required will be much reduced.

   It’s good news that Treasury Secretary Paulson seems to finally realize that his original proposal of buying what he euphemistically called distressed assets was flawed. That Secretary Paulson took so long to figure this out is worrying. He was so bound by the idea of a free-market solution that he was unable to accept what economists of all stripes were telling him: that he needed to recapitalize the banks and provide new money to make up for the losses they incurred on their bad loans.

   The administration is now doing this, but three questions are raised: Was it a fair deal to the taxpayer? The answer to that seems fairly clear: taxpayers got a raw deal, evident by comparing the terms of Warren Buffet’s injection of $5 billion into Goldman Sachs, and the terms extracted by the administration. Second, is there enough oversight and restrictions to make sure that the bad practices of the past do not recur and that new
lending does occur? Again, comparing the terms demanded by the UK and by the U.S. Treasury, we got the short end of the stick. For instance, banks can continue to pay out money to shareholders, as the government pours money in. Third, is it enough money? The banks are so nontransparent that no one can fully answer the question, but what we do know is that the gaps in the balance sheet are likely to get bigger. That is because too little is being done about the underlying problem.

2. **Stem the tide of foreclosures.** The original Paulson plan is like a massive blood transfusion to a patient with severe internal hemorrhaging. We won’t save the patient if we don’t do something about the foreclosures. Even after congressional revisions, too little is being done. We need to help people stay in their homes, by converting the mortgage-interest and property-tax deductions into cashable tax credits; by reforming bankruptcy laws to allow expedited restructuring, which would bring down the value of the mortgage when the price of the house is below that of the mortgage; and even government lending, taking advantage of the government's lower cost of funds and passing the savings on to poor and middle-income homeowners.

3. **Pass a stimulus that works.** Helping Wall Street and stopping the foreclosures are only part of the solution. The U.S. economy is headed for a serious recession and needs a big stimulus. We need increased unemployment insurance; if states and localities are not helped, they will have to reduce expenditures as their tax revenues plummet, and their reduced spending will lead to a contraction of the economy. But to kick-start the economy, Washington must make investments in the future. Hurricane Katrina and the collapse of the bridge in Minneapolis were grim reminders of how decrepit our infrastructure has become. Investments in infrastructure and technology will stimulate the economy in the short run and enhance growth in the long run.

4. **Restore confidence through regulatory reform.** Underlying the problems are banks’ bad decisions and regulatory failures. These must be addressed if confidence in our financial system is to be restored. Corporate governance structures that lead to flawed incentive structures designed to generously reward CEOs should be changed and so should many of the incentive systems themselves. It is not just the level of compensation; it is also the form—nontransparent stock options that provide incentives for bad accounting to bloat up reported returns.

5. **Create an effective multilateral agency.** As the global economy becomes more interconnected, we need better global oversight. It is unimaginable that America’s financial market could function effectively if we had to rely on 50 separate state regulators. But we are trying to do essentially that at the global level.

The recent crisis provides an example of the dangers: as some foreign governments provided blanket guarantees for their deposits, money started to move to what looked like safe havens. Other countries had to respond. A few European governments have been far more thoughtful than the U.S. in figuring out what needs to be done. Even
before the crisis turned global, French President Nicolas Sarkozy, in his address to the UN last month, called for a world summit to lay the foundations for more state regulation to replace the current laissez-faire approach. We may be at a new “Bretton Woods moment.” As the world emerged from the Great Depression and World War II, it realized there was need for a new global economic order.

It lasted more than 60 years. That it was not well adapted for the new world of globalization has been clear for a long time. Now, as the world emerges from the Cold War and the Great Financial Crisis, it will need to construct a new global economic order for the 21st century, and that will include a new global regulatory agency.

This crisis may have taught us that unfettered markets are risky. It should also have taught us that unilateralism can’t work in a world of economic interdependence.

**GOING FORWARD**

The next U.S. president will have a very hard time of it. Even the most well-thought-out plans may not work as intended. But I am confident that a comprehensive program along the lines I have suggested—stemming foreclosures, recapitalizing banks, stimulating the economy, protecting the unemployed, shoring up state finances, providing guarantees where needed and appropriate, reforming regulations and regulatory structures and replacing regulators and those with responsibility to protect the economy with those focused more on rescuing the economy than on rescuing Wall Street—will not only restore confidence but in due time also enable America to live up to its full potential. Halfway approaches, on the other hand, by continually bringing disappointment, are sure to fail.

In a country where money is respected, Wall Street’s leaders used to have our respect. They had our trust. They were believed to be a font of wisdom, at least on economic matters. Times have changed. Gone is the respect and trust. Too bad, because financial markets are necessary for a well-functioning economy. But most Americans believe that Wall Streeters are more likely to put their interests ahead of those of the rest of the country, dressing it up in as fancy language as necessary. If the next president is seen to have his policies unduly shaped by Wall Street and those policies don’t do the trick, his honeymoon will be short. That will be bad news for him, for the country, and for the world.

* Time, October 17, 2008.
PART I

BIG THINK
OPEN THIS PART OF THE BOOK WITH MY Vanity Fair article “Of the 1 Percent, by the 1 Percent, for the 1 Percent,” evoking the lines of President Lincoln’s famous Gettysburg Address, arguing that the real issue of the Civil War was to ensure “that government of the people, by the people, for the people, shall not perish from the earth.” Democracy, we now know, is more than periodic elections: in some countries, such elections have been used to legitimize essentially authoritarian regimes and deprive large parts of the citizenry of basic rights.

Perhaps the most important aspect of inequality is inequality of political rights—when America’s Declaration of Independence said that “all men are created equal,” it didn’t mean that all were of equal ability; it meant especially that all men should be equal in their political rights. But even the meaning of “political rights” is not obvious, as debates in recent years in the United States have made clear. Though every citizen has the right to vote, the rules of the game affect the ability and likelihood of exercising that right. Making it more difficult to register to vote, or even to vote, for certain groups (e.g., those without a driver’s license, the usual piece of identification in the United States, where there is no national identity card) discourages them from voting. The poll tax (imposing a tax on everyone who votes) affects the “economics” of voting. It creates a de facto disenfranchisement of the poor. This was one of the tried-and-true ways used in America’s South. Some countries try to make it easy for the working poor to vote, by having elections on Sunday. Other countries (like Australia) have actively sought to make sure that the voices of all citizens are heard. Australia’s rule of mandatory voting—charging a penalty on everyone who does not show up at the voting booth—affects the economics of voting in precisely the opposite way that a poll tax does.

Voice is even more important: the ability to influence the political process, either by affecting voting patterns or, more directly, by affecting the actions of key decision makers. If the rich can use their money to control the press or to influence (a gentler, but perhaps less accurate word than “buy”) politicians, then their voice will be heard far more loudly. It is almost inevitable that the rich will be, in this sense, more influential than others; but the rules of the game affect the extent to which this is so. And that’s why America’s laws and regulations governing lobbying, campaign contributions, and revolving doors are so invidious: other Western democracies take the notion of political equality more seriously, and have curbed these abuses; some have gone so far as to enhance equality of voice (e.g., through public support of media or ensuring equal candidate access to all media). And that’s why so many Americans see Citizens United, the Supreme Court decision that paved the way for unbridled spending by corporations, as having such an adverse effect on equality of voice—and contributing to the country’s endemic disease, “process American style.” It is a corruption that occurs not via cash-stuffed envelopes handed to politicians, but via an equally invidious process, using campaign contributions to buy “policies” that bring riches to a few.
Those themes are elaborated in many of the essays to follow: economic inequality (especially of the magnitude found in the United States) leads to political inequality (particularly when the rules of the political game facilitate this—as in the United States). Economic inequality is not just or even so much the result of inexorable laws of economics, as it is of our policies and politics. It is, in this sense, a matter of choice. But here we have a vicious circle, as economic inequality leads to and reinforces political inequality, which simply reinforces our economic inequality.

I argue, too, that inequality—again at least in the extreme form in the United States—is not even in the interests of the 1 percent. “The 1 Percent’s Problem” explains further some of the reasons that inequality is bad for the economy. If those in the 1 percent were pursuing their enlightened self-interest, they would worry about inequality and try to do something about it. As I suggest in “Inequality Is Not Inevitable,” at least in some parts of the world, that is beginning to happen.

The Conservative Response

In the years since these pieces were published, a few critics have said that inequality was not quite as bad as the statistics suggested; changes in tax laws meant that there was now less incentive to engage in tax evasion and avoidance. Of course, if these critics were right, their arguments implied only that the current outrageously high levels of inequality—where the top 1 percent gets between a quarter and a fifth of national income—have prevailed in America for much longer than we had thought. It would also imply that America’s economic performance is even weaker than we thought—for the only people in America who have been doing well are those at the very top. These conservative critics seem to be arguing that even the very top has not seen a real increase in income, only an increase in reported income. But the careful work of Emmanuel Saez and his co-authors actually took into account the effects of the tax changes; in any case, even with subsequent tax changes—which would have restored the incentive for tax avoidance—the share of the top continued to rise.

Others have argued that what mattered was not inequality of outcomes but inequality of opportunity. However, as a later chapter in Part III (“Equal Opportunity: Our National Myth”) points out, America is no longer the land of opportunity that it (and others) like to think it is. To a large extent, the American dream is a myth. Of course, some very talented immigrants do make it to the top. But when social scientists refer to equality of opportunity, they mean the likelihood that someone at the bottom will make it to the top. For a young American today, the chances are far lower than for young persons in other advanced countries.

Enlightened Self-Interest
The essay “The 1 Percent’s Problem” (also originally published in Vanity Fair) was, in a sense, addressed to members of the 1 percent—to explain to them why the level of inequality that characterized the United States was *not* in their enlightened self-interest.

In the space of a few pages, I summarize why it is that inequality is so bad for economic performance. This is perhaps the most profound change in our thinking about inequality in recent decades. It used to be thought that even if one were opposed to inequality, the cost of doing anything about it—in terms of overall economic performance—would be too great. Most discussions focused on *redistribution*, or at least asking those at the top to contribute more to the support of public goods, like national defense, not only absolutely but as a percentage of income. Redistribution was characterized as a leaky bucket: because of the leak, a $100 taken from the top would be worth half as much by the time it was given to the middle or bottom. But in this article I argue that there may not be a trade-off: we can have both more equality and a higher GDP; that there are policies that can increase the equality of before-tax and transfer income, as well as policies that redistribute, and do so in ways that strengthen overall performance. Indeed, some tax policies—taxing the rich on their capital gains on land—could actually lead to more *productive* investments (instead of real estate speculation) and more job creation. Curbing the outsize incomes of the financial sector might divert more of our most talented people into activities that would increase the productivity of the economy. And by increasing overall economic performance, not only would society as a whole benefit, but so would at least many of the 1 percent. They would benefit not just from being part of a more cohesive society but even economically.

**Inequality as a Political Choice**

The next chapter picks up where this chapter leaves off. Observing that our higher inequality has been partially responsible for our slow growth, I argue that slow growth and inequality are political choices and that we can choose otherwise. The article “Phony Capitalism” was written three years into the debate about inequality that my first Vanity Fair article had helped launch. The Washington Monthly organized a special edition to describe the way that America’s inequality plays out at each stage of life. There was an emphasis on education—one of the main ways that the advantaged pass on their privileged position to their children. I discuss briefly America’s health inequities, which result in large disparities—even in life expectancy. These are hardly a surprise, given the magnitude of the country’s income inequality, combined with a reliance on an expensive, private health insurance and medical system. America is unique among the advanced countries in not recognizing access to health care as a basic human right.

I counter a popular conservative argument that we can’t afford to do more, to do a better job in promoting equality and equality of opportunity. Quite the contrary: our
economy pays a high price for our failure to do so. We make political choices about how we spend our money—whether on tax breaks for the rich or on education for ordinary Americans; whether on weapons that don’t work against enemies that don’t exist or on health care for the poor; whether on subsidies for rich cotton farmers or on food stamps to reduce hunger among the poor. We could even raise tax revenues by simply making companies like General Electric and Apple pay the taxes they already should be paying. By taxing pollution, we could have a cleaner environment and more money to spend, both to reduce the inequities in our society and to promote our economy’s growth.

Global Perspectives

While America may have more inequality than any other advanced country, there has been an increase in inequality in most—but not all—countries. Sometimes this inequality has played a central role in the evolution of political events.

I was in Egypt on that fateful day, January 14, 2011, when Ben Ali, the dictator of Tunisia, was overthrown. At a dinner at the American University in Cairo, as news almost instantaneously traveled across North Africa, I remember being told: Egypt is next. In less than two weeks, the predictions I heard that night would come to pass.

During my visit to Egypt, I could see why: though the country had been growing, the benefits had not reached most Egyptians. Socialism under Gamal Abdel Nassar had failed them. Neoliberalism under Hosni Mubarak had also failed them. The desperation to try something else was palpable. Mustapha Nabli, later the central bank governor of Tunisia, helped explain to me what was behind the unrest. It was not just the high level of unemployment. It was the unfairness of the system, the inequities. Those with political connections, those who were willing to be corrupted by the system, were the ones who did well, not those who worked hard, did well in school, and played by the supposed rules.

I returned to Egypt and Tunisia several times in the ensuing years, and I became quite close to some of the young revolutionaries, as well as to some of the older, more established people who welcomed the revolution. I admired the enthusiasm of the former, their idealism, but I worried about their naïveté, their conviction that simply because they had right on their side, they would prevail. Matters have not gone well in Egypt; but as this book goes to press, it appears that at least in one country, Tunisia, the seeds sown in the Arab Spring may actually have taken root.

Growing awareness of the role that inequality had played in the Arab Spring—and growing inequality around the world—moved concerns about inequality front and center. “Inequality Goes Global” was written after I returned from the 2013 meeting at Davos, Switzerland, of the World Economic Forum. This is the annual gathering
world’s elite—entertained and instructed by a few academics and complemented by a few people from civil society and social entrepreneurs. The meeting is a good place to feel the world’s pulse—or at least the pulse of this rarefied group. Before the crisis there was unbridled euphoria about globalization and technology. This optimism sank with the economy. But with the faltering, and unequal, recovery, attention turned to some longstanding problems. What was notable about the 2013 meeting was that inequality had risen to the top of the attendees’ concerns.

“Inequality Is a Choice” was written for the inaugural issue of the international edition of the *New York Times* (really, simply a change in the name, from the *International Herald Tribune*). I chose to focus on a striking aspect of global inequality: though inequality was increasing in most countries around the world, in some countries it was not increasing; in some countries inequality was much, much lower than in the United States. It’s not simply economic laws that determine the degree of inequality in a country, but, as I have repeatedly said, politics and policies.

The effects of globalization on *global inequality* have in fact been complex. India and China, two countries with some 45 percent of the world’s population, whose share of global GDP had shrunk to less than 10 percent, are in resurgence. With growth rates that are so much larger than those of the advanced countries, the gap between them and the advanced countries is narrowing—though there is still a long way to go. China has now become the world’s largest economy—which simply means that because it has roughly five times the population, its income per head is only one-fifth that of the United States (based on standard statistics, called “purchasing power parities,” designed to convert the income in one country into an equivalent income in another). Still, that’s much better than it was even 25 years ago, when purchasing-power-parity income per capita was less than 5 percent that of the United States. But at the same time there has been an enormous growth of inequality in China—more millionaires, more billionaires. Although India’s growth spurt has not been as long or as fast as China’s, it did peak at 9 percent per year. But while fewer people and a smaller percentage of the population moved out of poverty, the increase in millionaires and even billionaires was equally impressive. At the same time, while Africa has finally started to grow, creating an increasing number of middle-class African families, the number of people in poverty has remained very high, with some 415 million people living on less than $1.25 per day. Putting all of this together, one reaches a disappointing result: *overall inequality*, in the way it is conventionally measured (the Gini coefficient, a number ranging from zero, with perfect equality, to one, with perfect *inequality*), has barely budged.

*The Piketty Phenomenon*

The final two articles of this section are, in part, a response to the enormous success of the economist Thomas Piketty’s book *Capitalism in the Twenty-First Century*. The
success of that book echoed the growing concern about inequality, a concern expressed in Davos by the world’s elite, and consistent with the way my own article “Of the 1 percent, by the 1 Percent, for the 1 Percent” had gone viral. President Obama had in 2013 declared that inequality would in fact be the focus of his attention for the remaining three years of his office. There is, he said, “a dangerous and growing inequality and lack of upward mobility that has jeopardized middle-class America’s basic bargain—that if you work hard, you have a chance to get ahead.”

Piketty assembled a wealth of data reinforcing what I and others had pointed out about increasing inequality since around 1980, especially at the top. His great contribution was to put this into historical context, showing that the period in which I had grown up, the period after World War II, was an aberration. This was the one period in which all groups in the United States saw an increase in incomes, but those at the bottom saw their incomes grow more than those at the top. The country grew together, and it grew more rapidly than in any other period. Piketty showed that this was, by and large, true of other countries as well. More importantly, he showed that this was historically unusual. We had come to think of a new middle-class capitalism, but the division of society into “classes” (fashionable at least since Marx)—workers and capitalists—seemed quaint and out-of-date. We were all middle class.

My “1 Percent” article suggested a new classification: almost everyone was in the same boat, but that boat was very different from that on which the 1 percent was traveling. The 99 percent’s boat was sinking, or at least not doing very well. Meanwhile, the other ship was sailing magnificently. Piketty showed that the United States was not alone: similar patterns could be seen elsewhere. Economists had misinterpreted what was happening in the aftermath of World War II. Simon Kuznets, one of the founders of our system of national accounts (by which we measure the size of the economy), who received a Nobel Prize in 1971, had suggested that after an initial period of growth, in which there was an increase in inequality, as economies became richer they became more equal. Experiences since 1980 have showed that this was not true. The conclusion that Piketty reached was thus perhaps a natural one: capitalism was characterized by a high degree of inequality. More disturbing was his argument that as capitalists reinvested most of their wealth, their wealth would grow at the rate of interest—and if the rate of interest was greater than the rate of growth of the economy, that meant that the ratio of their capital to national income would rise forever.

I welcomed Piketty’s work and the attention it received: we were comrades in arms trying to change the global discourse, to recognize the seriousness of the problem posed by inequality. His work was particularly disturbing because its main policy recommendation, a global tax on capital, seemed well beyond anything attainable in the near (or even distant) future. Did that mean we would simply have to accept ever-increasing inequality? I wrote two articles in part to give an emphatic negative answer to that question. Inequality—at least in the extremes that the United States and some other
countries were experiencing it—was not inevitable.

I had, in fact, worried about the question of whether there was a tendency in capitalist economies for ever-increasing inequality in my Ph.D. thesis, completed at MIT in 1966, to which I referred in the introduction. I argued that there was a presumption that the economy would eventually move toward an equilibrium degree of inequality of wealth and income, where inequality was neither increasing nor decreasing. Changes in the economy, in social patterns, and in policies could, of course, move the economy from one equilibrium to another—they could result, for instance, in the economy’s having more inequality.

In that and subsequent work, a number of centrifugal and centripetal forces have been identified—forces leading to greater inequality, on the one hand, or less inequality, on the other. I had argued that there was typically over the long run a balance between these forces. For instance, the fact that the children or grandchildren of very rich people often tend not to do so well, dissipating the family fortune, limits the extent to which inequalities build up. (As the expression goes, from rags to riches and back to rags in three generations.)

The fact that the suburban rich spend more on the education of their children than is spent on the education of the poor is an example of a centrifugal force—the rich transmit their economic advantage to their children. The reality that America is getting more economically segregated means that the strength of this centrifugal force is increasing, and implies that the distribution of wealth and income in the future is likely to be more unequal than it is today (unless something else happens).

Piketty’s book posed a puzzle for standard economic theory. Wealth (or “capital”) was increasing faster than incomes or the labor supply. Normally, one might expect such an increase in wealth to lead to a diminution in the return to capital—one of the most longstanding principles in economics, learned by every student of the subject, is the law of diminishing returns. Piketty seemed to have quietly repealed this law. If the law of diminishing returns worked (as I had assumed in my work), as capital increased (relative to the supply of labor), the interest rate would fall. It would have to fall to the point where capital increased only at the pace of income. There would then not be this ever-increasing inequality of wealth. Piketty is an empiricist. He simply observed that the rate of return on capital was not falling and inferred that there was no reason to believe that it would fall in the future.

As I puzzled over this, it became clear that both of us had not adequately emphasized a key aspect of growing inequality and the seemingly anomalous behavior of the wealth-to-income ratio and the return to capital. Traditionally, wealth had grown as families and firms put aside savings, year after year. But the increase in measured wealth was far greater than could be accounted for by such savings. A careful look at the data showed that much of the increase in wealth was capital gains.
Economists refer to income derived from land as rents; it is income based not on hard work but simply on the ownership of a fixed asset. Larger rents will give rise to a higher price, but a higher price for that asset won’t elicit a greater supply. But economists now apply the term “rents” more generally, not only to land rents but also to the returns, say to a monopolist (“monopoly rents”). If rents—not only land rents or the returns to monopoly power and other forms of market exploitation—increase, there will be corresponding capital gains. Much of the increase in inequality in incomes and wealth is associated with an increase in rents and capital gains, reflecting an increased value of real estate and increased market power (exploitation) in many sectors of the economy. But this means that “wealth” and “capital” (as conventionally understood) are distinct concepts. Indeed, it is even possible that wealth could be increasing, even as capital was decreasing. In Piketty’s home country of France, the value of land in the Riviera was increasing. But that didn’t mean that there was more land. The land in the Riviera is the same today as it was fifty years ago. Only the price of land was increasing.

Loose money (for instance, associated with quantitative easing, where the U.S. Fed tripled its balance sheet by buying large amounts of medium- and long-term debt, increasing it by some two trillion dollars over a short time) had led to a flood of credit. Textbook economics suggested that this should increase the quantity of lending and reduce the cost of lending, and both would have helped the American economy. But in a world of globalization, money created by the Fed doesn’t have to stay in the United States; it can go anywhere in the world it wants; and it naturally went to economies that were booming—and that wasn’t here at home. Money went to where it wasn’t needed or wanted; it didn’t go to where it was intended to go. But even when money stayed here, it did not stimulate the economy much.

Money can be used to purchase two kinds of things: produced objects and fixed objects (like land). When money goes to the former, the demand for those objects increases, and output is likely to increase (unless there is a temporary bottleneck in production). But when money goes to fixed objects, there is only a price effect: the value of the asset increases, not the quantity. Monetary authorities have, in recent years, done a poor job in steering money. Small businesses that desperately needed cash remained starved, as money increased stock market values at home and asset prices globally. As a result, large fractions of supposedly stimulative monetary policies go into asset price bubbles, like an increase in the price of land. An increase in credit then shows up as an increase in wealth, but one shouldn’t confuse what has happened: the country isn’t, as a result, wealthier. The amount of the assets is just the same.

There is a real danger that in the irrational exuberance concerning the growth of the prices in the fixed assets (the real estate bubble), investments in real capital—the plant and equipment that make the economy function and grow—might even diminish. This focus on land offers a resolution of the conundrums discussed earlier: with real capital down or not significantly up (relative to the supply of labor), no wonder that the rate of
return to capital has not diminished and average wages have not increased. Asset price bubbles can go on for a very long time—though eventually such bubbles break, and prices come down. But even when they come down, they may still be too high—and a new asset price bubble can easily form. For years the world has, in fact, been going from one asset price bubble to another, from the tech bubble to the housing bubble.

Of course, even a bubble can have some positive effects for a while—the people who feel wealthy may spend more than they otherwise would, and this may give a boost to the economy. Still, every bubble comes to an end, and it is foolish for policymakers to try to base the recovery from a downturn on the creation of a new bubble—something that the Fed seems to have made into a regular policy since Alan Greenspan assumed office in 1987.5

Here’s how I attempt to square the circle posed by Piketty’s argument: if we can avoid a bubble, returns to capital will eventually diminish enough that there will not be ever-increasing inequality—but the equilibrium inequality the economy arrives at may well be larger than today’s already high and unacceptable level. There are a number of policies—practical policies that can be implemented by individual countries, even without international cooperation—that can lead to a lower level of equilibrium inequality. Many of these policies will actually result not only in lower inequality but in higher growth, because they will result in more real investment.

Moreover, land rents are not the only source of “rents” in our economy. As we observed, much of the wealth of the top is a result of wealth appropriation or other kinds of rent seeking.

When there is an increase in such rent seeking, it can appear as if there is an increase in the wealth of the economy—even though the productivity of the economy decreases as a result. For rents, like monopoly rents, can be bought and sold. They are “capitalized.” They show up in an increase in stock market value. But such increases in wealth do not mean the economy is wealthier; quite the contrary. Monopoly power reflects an underlying inefficiency. There is a redistribution from consumers to those with market power. Indeed, because of the distortion associated with market power, the productivity of the economy is actually lowered, even though measured wealth has increased.

Thus, much of the increase in wealth in our economy is an increase in the value (but not the amount) of fixed assets, like land; some of it is the capitalization of increases in monopoly power. Many changes in our economy have given rise to new opportunities for the exercise of monopoly power. At the end of the 19th century, there was a range of such possibilities, as economies of scale led to a few firms’ dominating key industries, like steel. But much of this dominance, as in oil and tobacco, had little to do with economies of scale or scope; it was just a matter of brute economic power. Teddy Roosevelt led the charge to break up these monopolies, and he worried as much about
the concentration of political power as about the concentration of economic power. It is a lesson that we should today bear more in mind.

In subsequent years we didn’t achieve a perfectly competitive market in many industrial goods, but it was a far cry from the monopoly capitalism that some feared we were headed toward. In the latter part of the 20th century new sources of market power arose, associated with network externalities. It made life easier if everyone used Microsoft’s operating system, and it became the dominant platform for personal computers. It leveraged that market dominance to fend off competitors in other areas and to become dominant in office products like word processing and spread sheets, even though it was not the innovator in any of these areas.

In 1982 the United States broke up the telephone monopoly, AT&T, into seven “Baby Bells.” But the incentive to become a monopolist—or at least large enough to exercise market power—is irresistible in the absence of government curbs; and those weren’t working very well in this era where so many believed in unfettered markets. The result is that today two telephone companies control about two-thirds of the market. If the Comcast merger with Time Warner goes through, a single company will dominate the “information highway.”

As an economist, I understand the drive to get market power. Competitive markets are ruthless; it’s hard to survive. Still, standard theory has it that in competitive markets profits are driven down to zero—and that’s no fun for an entrepreneur—while in less competitive markets, there can be sustained profits.

There are many other instances where measured wealth can go up, but the underlying economy can be worse off. Consider banks. If we weaken regulation (as we did after Reagan took office), the expected value of their profits can increase, taking into account the bailout money that they can be expected to receive. But those gains come, of course, at the expense of taxpayers. Again, it’s a negative-sum game: because of the distortions in the financial sector, our economy is left worse off. Nonetheless, the “market” shows an increase in the value of banks, and no note is made of the losses to taxpayers—the costs that they would have to bear down the line if and when the banks need yet another bailout. Seemingly, wealth has increased as a result of deregulation; in reality, the economy is in worse shape.

We cannot think of wealth as capital. They are distinct concepts. They can change in markedly different ways. If we think, as suggested earlier, that a variety of centrifugal and centripetal forces are pulling the economy and our society apart—making the great divide larger—or pulling it together, either increasing or decreasing inequality, we can attempt to identify forces that we can change—increasing the strength of the centripetal forces and reducing the strength of the centrifugal forces.

The fact that capital gains are taxed at very low rates is one of the reasons that the rich get richer. They can open up corporate accounts in some offshore center, letting money
accumulate there like an unlimited IRA without paying taxes, so long as they don’t bring the money back to the United States. These are easy policies to change—policies that almost surely, over the long run, would reduce the extent of inequality of wealth. So too, since so much of the increase in wealth—and wealth inequality—is associated with an increase in the value of land, high land taxes might contribute to lowering inequality—but because the supply of land is (relatively) fixed, there wouldn’t be any significant effect on the amount of land in the country.

As these essays point out, much of the inequality that we see today is the result not of true market forces but of “ersatz capitalism” or, as I also refer to it there, “phony capitalism.” Making markets act like true markets would increase efficiency and economic performance. I also explain that there are many tax policies that can lead to a more efficient and more equitable economy. Many other social and economic policies would do the same. We know what to do to achieve a more egalitarian society.

Inequality is a matter not so much of capitalism in the 20th century as of democracy in the 20th century. The worry is that our ersatz capitalism—socializing losses while we privatize gains—and our imperfect democracy—closer to a system of one dollar one vote than to one person one vote—will interact to produce disappointment in both the economic and the political spheres.

Notes


2. This is not quite accurate. Convicted felons in some U.S. states lose their voting rights—a provision that is unusual in democracies.


OF THE 1 PERCENT, BY THE 1 PERCENT, FOR THE 1 PERCENT*

It’s no use pretending that what has obviously happened has not in fact happened. The upper 1 percent of Americans are now taking in nearly a quarter of the nation’s income every year. In terms of wealth rather than income, the top 1 percent control 40 percent. Their lot in life has improved considerably. Twenty-five years ago, the corresponding figures were 12 percent and 33 percent. One response might be to celebrate the ingenuity and drive that brought good fortune to these people, and to contend that a rising tide lifts all boats. That response would be misguided. While the top 1 percent have seen their incomes rise 18 percent over the past decade, those in the middle have actually seen their incomes fall. For men with only high-school degrees, the decline has been precipitous—12 percent in the last quarter-century alone. All the growth in recent decades—and more—has gone to those at the top. In terms of income equality, America lags behind any country in the old, ossified Europe that President George W. Bush used to deride. Among our closest counterparts are Russia with its oligarchs and Iran. While many of the old centers of inequality in Latin America, such as Brazil, have been striving in recent years, rather successfully, to improve the plight of the poor and reduce gaps in income, America has allowed inequality to grow.

Economists long ago tried to justify the vast inequalities that seemed so troubling in the mid-19th century—inequalities that are but a pale shadow of what we are seeing in America today. The justification they came up with was called “marginal-productivity theory.” In a nutshell, this theory associated higher incomes with higher productivity and a greater contribution to society. It is a theory that has always been cherished by the rich. Evidence for its validity, however, remains thin. The corporate executives who helped bring on the recession of the past three years—whose contribution to our society, and to their own companies, has been massively negative—went on to receive large bonuses. In some cases, companies were so embarrassed about calling such rewards “performance bonuses” that they felt compelled to change the name to “retention bonuses” (even if the only thing being retained was bad performance). Those who have contributed great positive innovations to our society, from the pioneers of genetic understanding to the pioneers of the Information Age, have received a pittance compared with those responsible for the financial innovations that brought our global economy to the brink of ruin.

Some people look at income inequality and shrug their shoulders. So what if this person gains and that person loses? What matters, they argue, is not how the pie is divided but the size of the pie. That argument is fundamentally wrong. An economy in which most citizens are doing worse year after year—an economy like America’s—is not likely to do well over the long haul. There are several reasons for this.
First, growing inequality is the flip side of something else: shrinking opportunity. Whenever we diminish equality of opportunity, it means that we are not using some of our most valuable assets—our people—in the most productive way possible. Second, many of the distortions that lead to inequality—such as those associated with monopoly power and preferential tax treatment for special interests—undermine the efficiency of the economy. This new inequality goes on to create new distortions, undermining efficiency even further. To give just one example, far too many of our most talented young people, seeing the astronomical rewards, have gone into finance rather than into fields that would lead to a more productive and healthy economy.

Third, and perhaps most important, a modern economy requires “collective action”—it needs government to invest in infrastructure, education, and technology. The United States and the world have benefited greatly from government-sponsored research that led to the Internet, to advances in public health, and so on. But America has long suffered from an underinvestment in infrastructure (look at the condition of our highways and bridges, our railroads and airports), in basic research, and in education at all levels. Further cutbacks in these areas lie ahead.

None of this should come as a surprise—it is simply what happens when a society’s wealth distribution becomes lopsided. The more divided a society becomes in terms of wealth, the more reluctant the wealthy become 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, losing whatever empathy they may once have had. They also worry about strong government—one that could use its powers to adjust the balance, take some of their wealth, and invest it for the common good. The top 1 percent may complain about the kind of government we have in America, but in truth they like it just fine: too gridlocked to redistribute, too divided to do anything but lower taxes.

**Economists are not sure how to fully explain the growing inequality in America.** The ordinary dynamics of supply and demand have certainly played a role: labor-saving technologies have reduced the demand for many “good” middle-class, blue-collar jobs. Globalization has created a worldwide marketplace, pitting expensive unskilled workers in America against cheap unskilled workers overseas. Social changes have also played a role—for instance, the decline of unions, which once represented a third of American workers and now represent about 12 percent.

But one big part of the reason we have so much inequality is that the top 1 percent want it that way. The most obvious example involves tax policy. Lowering tax rates on capital gains, which is how the rich receive a large portion of their income, has given the wealthiest Americans close to a free ride. Monopolies and near monopolies have always been a source of economic power—from John D. Rockefeller at the beginning
of the last century to Bill Gates at the end. Lax enforcement of antitrust laws, especially during Republican administrations, has been a godsend to the top 1 percent. Much of today’s inequality is due to manipulation of the financial system, enabled by changes in the rules that have been bought and paid for by the financial industry itself—one if its best investments ever. The government lent money to financial institutions at close to zero percent interest and provided generous bailouts on favorable terms when all else failed. Regulators turned a blind eye to a lack of transparency and to conflicts of interest.

When you look at the sheer volume of wealth controlled by the top 1 percent in this country, it’s tempting to see our growing inequality as a quintessentially American achievement—we started way behind the pack, but now we’re doing inequality on a world-class level. And it looks as if we’ll be building on this achievement for years to come, because what made it possible is self-reinforcing. Wealth begets power, which begets more wealth. During the savings-and-loan scandal of the 1980s—a scandal whose dimensions, by today’s standards, seem almost quaint—the banker Charles Keating was asked by a congressional committee whether the $1.5 million he had spread among a few key elected officials could actually buy influence. “I certainly hope so,” he replied. The Supreme Court, in its recent *Citizens United* case, has enshrined the right of corporations to buy government, by removing limitations on campaign spending. The personal and the political are today in perfect alignment. Virtually all U.S. senators, and most of the representatives in the House, are members of the top 1 percent when they arrive, are kept in office by money from the top 1 percent, and know that if they serve the top 1 percent well they will be rewarded by the top 1 percent when they leave office. By and large, the key executive-branch policymakers on trade and economic policy also come from the top 1 percent. When pharmaceutical companies receive a trillion-dollar gift—through legislation prohibiting the government, the largest buyer of drugs, from bargaining over price—it should not come as cause for wonder. It should not make jaws drop that a tax bill cannot emerge from Congress unless big tax cuts are put in place for the wealthy. Given the power of the top 1 percent, this is the way you would expect the system to work.

America’s inequality distorts our society in every conceivable way. There is, for one thing, a well-documented lifestyle effect—people outside the top 1 percent increasingly live beyond their means. Trickle-down economics may be a chimera, but trickle-down behaviorism is very real. Inequality massively distorts our foreign policy. 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, and patriotism goes only so far. Plus, the wealthiest class feels no pinch from higher taxes when the nation goes to war: borrowed money will pay for all that. Foreign policy, by definition, is about the balancing of national interests and national resources. With the top 1 percent in charge, and paying no price, 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. The
rules of economic globalization are likewise designed to benefit the rich: they encourage
competition among countries for business, which drives down taxes on corporations,
weakens health and environmental protections, and undermines what used to be viewed
as the “core” labor rights, which include the right to collective bargaining. Imagine what
the world might look like if the rules were designed instead to encourage competition
among countries for workers. Governments would compete in providing economic
security, low taxes on ordinary wage earners, good education, and a clean environment
—things workers care about. But the top 1 percent don’t need to care.

Or, more accurately, they think they don’t. 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 suggest otherwise: the chances of a poor
citizen, or even a middle-class citizen, making it to the top in America are smaller than
in many countries of Europe. The cards are stacked against them. It is this sense of an
unjust system without opportunity that has given rise to the conflagrations in the Middle
East: rising food prices and growing and persistent youth unemployment simply served
as kindling. With youth unemployment in America at around 20 percent (and in some
locations, and among some socio-demographic groups, at twice that); with one out of
six Americans desiring a full-time job not able to get one; with one out of seven
Americans on food stamps (and about the same number suffering from “food
insecurity”)—given all this, there is ample evidence that something has blocked the
vaunted “trickling down” from the top 1 percent to everyone else. All of this is having
the predictable effect of creating alienation—voter turnout among those in their 20s in
the last election stood at 21 percent, comparable to the unemployment rate.

In recent weeks we have watched people taking to the streets by the millions to
protest political, economic, and social conditions in the oppressive societies they
inhabit. Governments have been toppled in Egypt and Tunisia. Protests have erupted in
Libya, Yemen, and Bahrain. The ruling families elsewhere in the region look on
nervously from their air-conditioned penthouses—will they be next? They are right to
worry. These are societies where a minuscule fraction of the population—less than 1
percent—controls the lion’s share of the wealth; where wealth is a main determinant of
power; where entrenched corruption of one sort or another is a way of life; and where
the wealthiest often stand actively in the way of policies that would improve life for
people in general.

As we gaze out at the popular fervor in the streets, one question to ask ourselves is
this: When will it come to America? In important ways, our own country has become
like one of these distant, troubled places.
Alexis de Tocqueville once described what he saw as a chief part of the peculiar genius of American society—something he called “self-interest properly understood.” The last two words were the key. Everyone possesses self-interest in a narrow sense: I want what’s good for me right now! Self-interest “properly understood” is different. It means appreciating that paying attention to everyone else’s self-interest—in other words, the common welfare—is in fact a precondition for one’s own ultimate well-being. Tocqueville was not suggesting that there was anything noble or idealistic about this outlook—in fact, he was suggesting the opposite. It was a mark of American pragmatism. Those canny Americans understood a basic fact: looking out for the other guy isn’t just good for the soul—it’s good for business.

The top 1 percent have the best houses, the best educations, the best doctors, and the best lifestyles, but there is one thing that money doesn’t seem to have bought: an understanding that their fate is bound up with how the other 99 percent live. Throughout history, this is something that the top 1 percent eventually do learn. Too late.

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THE 1 PERCENT’S PROBLEM*

Let’s start by laying down the baseline premise: inequality in America has been widening for decades. We’re all aware of the fact. Yes, there are some on the right who deny this reality, but serious analysts across the political spectrum take it for granted. I won’t run through all the evidence here, except to say that the gap between the 1 percent and the 99 percent is vast when looked at in terms of annual income, and even vaster when looked at in terms of wealth—that is, in terms of accumulated capital and other assets. Consider the Walton family: the six heirs to the Walmart empire possess a combined wealth of some $90 billion, which is equivalent to the wealth of the entire bottom 30 percent of U.S. society. (Many at the bottom have zero or negative net worth, especially after the housing debacle.) Warren Buffett put the matter correctly when he said, “There’s been class warfare going on for the last 20 years and my class has won.”

So, no: there’s little debate over the basic fact of widening inequality. The debate is over its meaning. From the right, you sometimes hear the argument made that inequality is basically a good thing: as the rich increasingly benefit, so does everyone else. This argument is false: while the rich have been growing richer, most Americans (and not just those at the bottom) have been unable to maintain their standard of living, let alone to keep pace. A typical full-time male worker receives the same income today he did a third of a century ago.

From the left, meanwhile, the widening inequality often elicits an appeal for simple justice: why should so few have so much when so many have so little? It’s not hard to see why, in a market-driven age where justice itself is a commodity to be bought and sold, some would dismiss that argument as the stuff of pious sentiment.

Put sentiment aside. There are good reasons why plutocrats should care about inequality anyway—even if they’re thinking only about themselves. The rich do not exist in a vacuum. They need a functioning society around them to sustain their position. Widely unequal societies do not function efficiently and their economies are neither stable nor sustainable. The evidence from history and from around the modern world is unequivocal: there comes a point when inequality spirals into economic dysfunction for the whole society, and when it does, even the rich pay a steep price.

Let me run through a few reasons why.

The Consumption Problem

When one interest group holds too much power, it succeeds in getting policies that help itself in the short term rather than help society as a whole over the long term. This is what has happened in America when it comes to tax policy, regulatory policy, and public investment. The consequence of channeling gains in income and wealth in one direction only is easy to see when it comes to ordinary household spending, which is
one of the engines of the American economy.

It is no accident that the periods in which the broadest cross sections of Americans have reported higher net incomes—when inequality has been reduced, partly as a result of progressive taxation—have been the periods in which the U.S. economy has grown the fastest. It is likewise no accident that the current recession, like the Great Depression, was preceded by large increases in inequality. When too much money is concentrated at the top of society, spending by the average American is necessarily reduced—or at least it will be in the absence of some artificial prop. Moving money from the bottom to the top lowers consumption because higher-income individuals consume, as a fraction of their income, less than lower-income individuals do.

In our imaginations, it doesn’t always seem as if this is the case, because spending by the wealthy is so conspicuous. Just look at the color photographs in the back pages of the weekend Wall Street Journal of houses for sale. But the phenomenon makes sense when you do the math. Consider someone like Mitt Romney, whose income in 2010 was $21.7 million. Even if Romney chose to live a much more indulgent lifestyle, he would spend only a fraction of that sum in a typical year to support himself and his wife in their several homes. But take the same amount of money and divide it among 500 people—say, in the form of jobs paying $43,400 apiece—and you’ll find that almost all of the money gets spent.

The relationship is straightforward and ironclad: as more money becomes concentrated at the top, aggregate demand goes into a decline. Unless something else happens by way of intervention, total demand in the economy will be less than what the economy is capable of supplying—and that means that there will be growing unemployment, which will dampen demand even further. In the 1990s that “something else” was the tech bubble. In the first decade of the 21st century, it was the housing bubble. Today, the only recourse, amid deep recession, is government spending—which is exactly what those at the top are now hoping to curb.

Here I need to resort to a bit of economic jargon. The word “rent” was originally used, and still is, to describe what someone received for the use of a piece of his land—it’s the return obtained by virtue of ownership, and not because of anything one actually does or produces. This stands in contrast to “wages,” for example, which connotes compensation for the labor that workers provide. The term “rent” was eventually extended to include monopoly profits—the income that one receives simply from the control of a monopoly. In time, the meaning was expanded still further to include the returns on other kinds of ownership claims. If the government gave a company the exclusive right to import a certain amount of a certain good, such as sugar, then the extra return was called a “quota rent.” The acquisition of rights to mine or drill produces a form of rent. So does preferential tax treatment for special interests. In a broad sense,
“rent seeking” defines many of the ways by which our current political process helps the rich at the expense of everyone else, including transfers and subsidies from the government, laws that make the marketplace less competitive, laws that allow CEOs to take a disproportionate share of corporate revenue (though Dodd-Frank has made matters better by requiring a nonbinding shareholder vote on compensation at least once every three years), and laws that permit corporations to make profits as they degrade the environment.

The magnitude of rent seeking in our economy, while hard to quantify, is clearly enormous. Individuals and corporations that excel at rent seeking are handsomely rewarded. The financial industry, which now largely functions as a market in speculation rather than a tool for promoting true economic productivity, is the rent-seeking sector par excellence. Rent seeking goes beyond speculation. The financial sector also gets rents out of its domination of the means of payment—the exorbitant credit and debit card fees and also the less well-known fees charged to merchants and passed on, eventually, to consumers. The money it siphons from poor and middle-class Americans through predatory lending practices can be thought of as rents. In recent years, the financial sector has accounted for some 40 percent of all corporate profits. This does not mean that its social contribution sneaks into the plus column, or comes even close. The crisis showed how it could wreak havoc on the economy. In a rent-seeking economy such as ours has become, private returns and social returns are badly out of whack.

In their simplest form, rents are nothing more than redistributions from one part of society to the rent seekers. Much of the inequality in our economy has been the result of rent seeking, because, to a significant degree, rent seeking redistributes money from those at the bottom to those at the top.

But there is a broader economic consequence: the fight to acquire rents is at best a zero-sum activity. Rent seeking makes nothing grow. Efforts are directed toward getting a larger share of the pie rather than increasing the size of the pie. But it’s worse than that: rent seeking distorts resource allocations and makes the economy weaker. It is a centripetal force: the rewards of rent seeking become so outsize that more and more energy is directed toward it, at the expense of everything else. Countries rich in natural resources are infamous for rent-seeking activities. It’s far easier to get rich in these places by getting access to resources at favorable terms than by producing goods or services that benefit people and increase productivity. That’s why these economies have done so badly, in spite of their seeming wealth. It’s easy to scoff and say: We’re not Nigeria, we’re not Congo. But the rent-seeking dynamic is the same.

**The Fairness Problem**

People are not machines. They have to be motivated to work hard. If they feel that they are being treated unfairly, it can be difficult to motivate them. This is one of the central
tenets of modern labor economics, encapsulated in the so-called 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 the great economist Alfred Marshall, who observed that “highly paid labour is generally efficient and therefore not dear labour.” In truth, it’s wrong to think of this proposition as just a theory: it has been borne out by countless economic experiments.

While people will always disagree over the precise meaning of what constitutes “fair,” there is a growing sense in America that the current disparity in income, and the way wealth is allocated in general, is profoundly unfair. There’s no begrudging the wealth accrued by those who have transformed our economy—the inventors of the computer, the pioneers of biotechnology. But, for the most part, these are not the people at the top of our economic pyramid. Rather, to a too large extent, it’s people who have excelled at rent seeking in one form or another. And, to most Americans, that seems unfair.

People were surprised when the financial firm MF Global, headed by Jon Corzine, suddenly collapsed into bankruptcy last year, leaving victims by the thousands as a result of actions that may prove to have been criminal; but given Wall Street’s recent history, I’m not sure people were all that surprised to learn that several MF Global executives would still be getting their bonuses. When corporate CEOs argue that wages have to be reduced or that there must be layoffs in order for companies to compete—and simultaneously increase their own compensation—workers rightly consider what is happening to be unfair. This in turn affects their efforts on the job, their loyalty to the firm, and their willingness to invest in its future. The widespread sense by workers in the Soviet Union that they were being mistreated in exactly this way—exploited by managers who lived high on the hog—played a major role in the hollowing out of the Soviet economy, and in its ultimate collapse. As the old Soviet joke had it, “They pretend to pay us, and we pretend to work.”

In a society in which inequality is widening, fairness is not just about wages and income, or wealth. It’s a far more generalized perception. Do I seem to have a stake in the direction society is going, or not? Do I share in the benefits of collective action, or not? If the answer is a loud “no,” then brace for a decline in motivation whose repercussions will be felt economically and in all aspects of civic life.

For Americans, one key aspect of fairness is opportunity: everyone should have a fair shot at living the American dream. Horatio Alger stories remain the mythic ideal, but the statistics paint a very different picture: in America, the chances of someone’s making it to the top, or even to the middle, from a place near the bottom are lower than in the countries of old Europe or in any other advanced industrial country. Those at the top can take comfort from knowing that their chances of becoming downwardly mobile are lower in America than they are elsewhere.

There are many costs to this lack of opportunity. A large number of Americans are
not living up to their potential; we’re wasting our most valuable asset, our talent. As we slowly grasp what’s been happening, there will be an erosion of our sense of identity, in which America is seen as a fair country. This will have direct economic effects—but also indirect ones, fraying the bonds that hold us together as a nation.

**The Mistrust Problem**

One of the puzzles in modern political economy is why anyone bothers to vote. Very few elections actually turn on the ballot of a single individual. There is a cost to voting —no state has an explicit penalty for staying home, but it takes time and effort to get to the polls—and there is seemingly almost never a benefit. Modern political and economic theory assumes the existence of rational, self-interested actors. On that basis, why anyone would vote is a mystery.

The answer is that we’ve been inculcated with notions of “civic virtue.” It is our responsibility to vote. But civic virtue is fragile. If the belief takes hold that the political and economic systems are stacked, individuals will feel released from their civic obligations. When that social contract is abrogated—when trust between a government and its citizens fails—disillusionment, disengagement, or worse is sure to follow. In the United States today, and in many other democracies around the world, mistrust is on the ascendant.

It’s even built in. 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 his bank sold were consenting adults who should have known better. They should have known that Goldman Sachs had the means, and the incentive, to design products that would fail; that they had the means and the incentive to create asymmetries of information—where they knew more about the products than the buyers did—and the means and the incentive to take advantage of those asymmetries. The people who fell victim to the investment banks were, for the most part, well-off investors. But deceptive credit card practices and predatory lending have left Americans more broadly with a sense that banks are not to be trusted.

Economists often underestimate the role of trust in making our economy work. If every contract had to be enforced by one party taking the other to court, our economy would be in gridlock. Throughout history, the economies that have flourished are those where a handshake is a deal. Without trust, business arrangements based on an understanding that complex details will be worked out later are no longer feasible. Without trust, each participant looks around to see how and when those with whom he is dealing will betray him.

Widening inequality is corrosive of trust: in its economic impact, think of it as the universal solvent. It creates an economic world in which even the winners are wary. But the losers! In every transaction—in every encounter with a boss or business or
bureaucrat—they see the hand of someone out to take advantage of them.

Nowhere is trust more important than in politics and the public sphere. There, we have to act together. It's easier to act together when most individuals are in similar situations—when most of us are, if not in the same boat, at least in boats within a range of like sizes. But growing inequality makes it clear that our fleet looks different—it’s a few mega-yachts surrounded by masses of people in dugout canoes, or clinging to flotsam—which helps explain our vastly differing views of what the government should do.

Today’s widening inequality extends to almost everything—police protection, the condition of local roads and utilities, access to decent health care, access to good public schools. As higher education becomes more important—not just for individuals but for the future of the whole U.S. economy—those at the top push for university budget cuts and tuition hikes, on the one hand, and cutbacks in guaranteed student loans, on the other. To the extent that they advocate student loans at all, it’s as another opportunity for rent seeking: loans to for-profit schools, without standards; loans that are non-dischargeable even in bankruptcy; loans designed as another way for those at the top to exploit those aspiring to get out of the bottom.

THE “BE SELFISH” SOLUTION

Many, if not most, Americans possess a limited understanding of the nature of the inequality in our society. They know that something has gone wrong, but they underestimate the harm that inequality does even as they overestimate the cost of taking action. These mistaken beliefs, which have been reinforced by ideological rhetoric, are having a catastrophic effect on politics and economic policy.

There is no good reason why the 1 percent, with their good educations, their ranks of advisers, and their much-vaunted business acumen, should be so misinformed. The 1 percent in generations past often knew better. They knew that there would be no top of the pyramid if there wasn’t a solid base—that their own position was precarious if society itself was unsound. Henry Ford, not remembered as one of history’s softies, understood that the best thing he could do for himself and his company was to pay his workers a decent wage, because he wanted them to work hard and he wanted them to be able to buy his cars. Franklin D. Roosevelt, a purebred patrician, understood that the only way to save an essentially capitalist America was not only to spread the wealth, through taxation and social programs, but to put restraints on capitalism itself, through regulation. Roosevelt and the economist John Maynard Keynes, while reviled by the capitalists, succeeded in saving capitalism from the capitalists. Richard Nixon, known to this day as a manipulative cynic, concluded that social peace and economic stability could best be secured by investment—and invest he did, heavily, in Medicare, Head Start, Social Security, and efforts to clean up the environment. Nixon even floated the idea of a guaranteed annual income.
So, the advice I’d give to the 1 percent today is: Harden your hearts. When invited to consider proposals to reduce inequality—by raising taxes and investing in education, public works, health care, and science—put any latent notions of altruism aside and reduce the idea to one of unadulterated self-interest. Don’t embrace it because it helps other people. Just do it for yourself.

*Vanity Fair*, May 31, 2012
SLOW GROWTH AND INEQUALITY ARE POLITICAL CHOICES. WE CAN CHOOSE OTHERWISE.*

A rich country with millions of poor people. A country that prides itself on being the land of opportunity, but in which a child’s prospects are more dependent on the income and education of his or her parents than in other advanced countries. A country that believes in fair play, but in which the richest often pay a smaller percentage of their income in taxes than those less well off. A country in which children every day pledge allegiance to the flag, asserting that there is “justice for all,” but in which, increasingly, there is only justice for those who can afford it. These are the contradictions that the United States is gradually and painfully struggling to come to terms with as it begins to comprehend the enormity of the inequalities that mark its society—inequities that are greater than in any other advanced country.

Those who strive not to think about this issue suggest that this is just about the “politics of envy.” Those who discuss the issue are accused of fomenting class warfare. But as we have come to grasp the causes and consequences of these inequities we have come to understand that this is not about envy. The extreme to which inequality has grown in the United States and the manner in which these inequities arise undermine our economy. Too much of the wealth at the top of the ladder arises from exploitation—whether from the exercise of monopoly power, from taking advantage of deficiencies in corporate governance laws to divert large amounts of corporate revenues to pay CEOs’ outsized bonuses unrelated to true performance, or from a financial sector devoted to market manipulation, predatory and discriminatory lending, and abusive credit card practices. Too much of the poverty at the bottom of the income spectrum is due to economic discrimination and the failure to provide adequate education and health care to the nearly one out of five children growing up poor.

The growing debate about inequality in America today is, above all, about the nature of our society, our vision of who we are, and others’ vision of us. We used to think of ourselves as a middle-class society, where each generation was better off than the last. At the foundation of our democracy was the middle class—the modern-day version of the small, property-owning American farmer whom Thomas Jefferson saw as the backbone of the country. It was understood that the best way to grow was to build out from the middle—rather than trickle down from the top. This commonsense perspective has been verified by studies at the International Monetary Fund, which demonstrate that countries with greater equality perform better—higher growth, more stability. It was one of the main messages of my book The Price of Inequality. Because of our tolerance for inequality, even the quintessential American dream has been shown to be a myth: America is less of a land of opportunity than even most countries of “old Europe.”

The articles in this special edition of the Washington Monthly describe the way that
America’s inequality plays out at each stage of one’s life, with several articles focusing in particular on education. We now know that there are huge disparities even as children enter kindergarten. These grow larger over time, as the children of the rich, living in rich enclaves, get a better education than the one received by those attending schools in poorer areas. Economic segregation has become the order of the day, so much so that even those well-off and well-intentioned selective colleges that instituted programs of economic affirmative action—explicitly trying to increase the fraction of their student body from lower socioeconomic groups—have struggled to do so. The children of the poor can afford neither the advanced degrees that are increasingly required for employment nor the unpaid internships that provide the alternative route to “good” jobs.

Similar stories could be told about each of the dimensions of America’s outsized inequality. Take health care. America is unique among the advanced countries in not recognizing access to health care as a basic human right. And that means if you are a poor American, your prospects of getting adequate, let alone good, medical care are worse than in other advanced countries. Even after passage of the Affordable Care Act (ACA), almost two dozen states have rejected expanding vitally needed Medicaid, and more than forty million Americans still lacked health insurance at the beginning of 2014. The dismal statistics concerning America’s health care system are well known: while we spend more—far more—on health care (both per capita and as a percentage of gross domestic product) than other countries, health outcomes are worse. In Australia, for instance, spending on health care per capita is just over two-thirds that in the United States, yet health outcomes are better—including a life expectancy that is a remarkable three years longer.

Two of the reasons for our dismal health statistics are related to inequalities at the top and the bottom of our society—monopoly profits reaped by drug companies, medical device makers, health insurers, and highly concentrated provider networks drive prices, and inequality, up while the lack of access to timely care for the poor, including preventive medicine, makes the population sicker and more costly to treat. The ACA is helping on both accounts. The health insurance exchanges are designed to promote competition. And the whole act is designed to increase access. The numbers suggest it’s working. As for costs, the widespread predictions that Obamacare would cause massive health care inflation have proven false, as the rate of increase in health care prices has remained comparatively moderate over the last several years, showing once again that there is no necessary trade-off between fairness and efficiency. The first year of the ACA showed significant increases in coverage—far more significant in those states that implemented the Medicaid expansion than in those that refused to do so. But the ACA was a compromise, leaving out dental and long-term extended care insurance.

Inequities in health care, then, are still with us, beginning even before birth. The poor are more likely to be exposed to environmental hazards, and mothers have less access to
good prenatal care. The result is infant mortality rates that are comparable to those in some developing countries alongside a higher incidence of low birth weight (systemically correlated with poor lifetime prospects) than in other advanced countries. Lack of access to comprehensive health care for the 20 percent of American children growing up in poverty, combined with lack of access to adequate nutrition, makes success in school even less likely. With the cheapest form of food often being unhealthy carbohydrates, the poor are more likely to face problems of childhood diabetes and obesity. The inequities continue throughout life—culminating in dramatically different statistics on life expectancy.

All well and good, you might say: it would be nice if we could give free health care to all, free college education to all, but these are dreams that have to be tamed by the harsh realities of what we can afford. Already the country has a large deficit. Proposals to create a more equal society would make the large deficit even larger—so the argument goes. America is especially constrained because it has assumed the costly mission of ensuring peace and security for the world.

This is nonsense, on several counts.

The real strength of the United States is derived from its “soft power,” not its military power. But growing inequality is sapping our standing in the world from within. Can an economic system that provides so little opportunity—where real median household income (half above, half below, after adjusting for inflation) is lower today than it was a quarter-century ago—provide a role model that others seek to emulate, even if a few at the very top have done very well?

Moreover, what we can afford is as much a matter of priorities as anything else. Other countries, such as the nations of Scandinavia, have, for instance, managed to provide good health care to all, virtually free college education for all, and good public transportation, and have done just as well, or even better, on standard metrics of economic performance: incomes per head and growth are at least comparable. Even some countries that are far poorer than the United States (such as Mauritius, in the Indian Ocean east of Africa) have managed to provide free college education and better access to health care. A nation must make choices, and these countries have made different ones: they may spend less on their military, they may spend less on prisons, they may tax more.

Besides, many of the distributional issues are related not to how much we spend but whom we spend it on. If we include within our expenditures the “tax expenditures” buried in our tax system, we effectively spend a lot more on the housing of the rich than is generally recognized. Interest deductability on a mega-mansion could easily be worth $25,000 a year. And alone among advanced economies, the United States tends to invest more in schools with richer student bodies than in those with mostly poor students—an effect of U.S. school districts’ dependence on local tax bases for funding. Interestingly,
according to some calculations, the entire deficit can be attributed to our inefficient and inequitable health care system: if we had a better health care system—of the kind that provided more equality at lower cost, such as those in so many European countries—we arguably wouldn’t even have a federal budget deficit today.

Or consider this: if we provided more opportunity to the poor, including better education and an economic system that ensured access to jobs with decent pay, then perhaps we would not spend so much on prisons—in some states spending on prisons has at times exceeded that on universities. The poor instead would be better able to seize new employment opportunities, in turn making our economy more productive. And if we had better public transportation systems that made it easier and more affordable for working-class people to commute to where jobs are available, then a higher percentage of our population would be working and paying taxes. If, like the Scandinavian countries, we provided better child care and had more active labor market policies that assisted workers in moving from one job to another, we would have a higher labor-force participation rate—and the enhanced growth would yield more tax revenues. It pays to invest in people.

This brings me to the final point: we could impose a fair tax system, raising more revenue, improving equity, and boosting economic growth while reducing distortions in our economy and our society. (That was the central finding of my 2014 Roosevelt Institute white paper, “Reforming Taxation to Promote Growth and Equity.”) For instance, if we just imposed the same taxes on the returns to capital that we impose on those who work for a living, we could raise some $2 trillion over ten years. “Loopholes” does not adequately describe the flaws in our tax system; “gaps” might be better. Closing them might end the specter of the very rich almost proudly disclosing that they pay a tax rate on their disclosed income at half the rate of those with less income, and that they keep their money in tax havens like the Cayman Islands. No one can claim that the inhabitants of these small islands know how to manage money better than the wizards of Wall Street; but it seems as though that money grows better in the sunshine of these beach resorts!

One of the few advantages of there being so much money at the top of the income ladder, with close to a quarter of all income going to the top 1 percent, is that slight increases in taxes at the top can now raise large amounts of money. And because so much of the money at the top comes from exploitation (or, as economists prefer to call it, “rent seeking”—that is, seizing a larger share of the national pie rather than increasing its size), higher taxes at the top do not seem to have much of an adverse effect on economic performance.

Then there’s our corporate tax rate. If we actually made corporations pay what they are supposed to pay and eliminated loopholes, we would raise hundreds of billions of dollars. With the right redesign, we could even get more employment and investment in
the United States. True, U.S. corporations face one of the higher official corporate tax rates among the advanced countries; but the reality is otherwise—as a share of corporate income actually paid, our federal corporate taxes are just 13 percent of reported worldwide income. By most accounts, the amount of taxes actually paid (as a percentage of profits) is no higher than the average of other advanced countries. Apple Inc., Google Inc., and General Electric Co. have become the poster children of American ingenuity—making products that are the envy of the rest of the world. But they are using too much of that ingenuity to figure out how to avoid paying their fair share of taxes. Yet they and other U.S. corporations make full use of ideas and innovations produced with the support of the U.S. government, starting with the Internet itself. At the same time they rely on the talent produced by the country’s first-rate universities, all of which receive extensive support from the federal government. They even turn to the U.S. government to demand better treatment from our trading partners.

Corporations argue that they would not engage in so much despicable tax avoidance if tax rates were lower. But there is a far better solution, and one that the individual U.S. states have discovered: have corporations pay taxes based on the economic activity they conduct in the United States, on the basis of a simple formula reflecting their sales, their production, and their research activities here, and tax corporations that invest in the United States at lower rates than those that don’t. In this way we could increase investment and employment here at home—a far cry from the current system, in which we in effect encourage even U.S. corporations to produce elsewhere. (Even if U.S. taxes are no higher than the average, there are some tax havens—like Ireland—that are engaged in a race to the bottom, trying to recruit companies to make their country their tax home.) Such a reform would end the corporate stampede toward “inversions,” changing a corporation’s tax home to avoid taxes. Where they claim their home office is would make little difference; only where they actually do business would.

Other sources of revenue would benefit our economy and our society. Two basic principles of taxation are that it is better to tax bad things than good; and it is better to tax factors in what economists call “inelastic supply”—meaning that the amounts produced and sold won’t change when taxes are imposed on them. Thus, if we taxed pollution in all of its forms—including carbon emissions—we could raise hundreds of billions of dollars every year, and have a better environment. Similarly, appropriately designed taxes on the financial sector would not only raise considerable amounts of money but also discourage banks from imposing costs on others—as when they polluted the global economy with toxic mortgages.

The $700 billion bank bailout pales in comparison to what the bankers’ fecklessness has cost our economy and our society—trillions of dollars in lost GDP, millions of Americans thrown out of their homes and jobs. Yet few in the financial world have been held accountable.
If we required the banks to pay but a fraction of the costs they have imposed on others, we would then have further funds to undo some of the damage that they caused by their discriminatory and predatory lending practices, which moved money from the bottom of the economic pyramid to the top. And by imposing even slight taxes on Wall Street’s speculative activities via a financial transactions tax, we would raise much-needed revenue, decrease speculation (thus increasing economic stability), and encourage more productive use of our scarce resources, including the most valuable one: talented young Americans.

Similarly, by taxing land, oil, and minerals more, and forcing those who extract resources from public land to pay the full values of these resources, which rightly belong to *all* the people, we could then spend those proceeds for public investments—for instance, in education, technology, and infrastructure—without resulting in less land, less oil, fewer minerals. (Even if they are taxed more, these resources won’t go on strike; they won’t leave the country!) The result: increased long-term investments in our economy would pay substantial future dividends in higher economic productivity and growth—and if the money was spent right, we could have more shared prosperity. The question is not whether we can afford to do more about our inequality; it is whether we can afford *not* to do more. The debate in America is not about eliminating inequality. It is simply about moderating it and restoring the American dream.

INEQUALITY GOES GLOBAL*

The World Economic Forum’s annual meeting in Davos has lost some of its precrisis panache. After all, before the meltdown in 2008, the captains of finance and industry could trumpet the virtues of globalization, technology, and financial liberalization, which supposedly heralded a new era of relentless growth. The benefits would be shared by all, if only they would do “the right thing.”

Those days are gone. But Davos remains a good place to get a sense of the global zeitgeist.

It goes without saying that developing and emerging-market countries no longer look at the advanced countries as they once did. But a remark by one mining company executive from a developing country caught the spirit of change. In response to one development expert’s heartfelt despair that unfair trade treaties and unfulfilled promises of aid have cost the developed countries their moral authority, he retorted: “The West never had any moral authority.” Colonialism, slavery, the splintering of Africa into small countries, and a long history of resource exploitation may be matters of the distant past to the perpetrators, but not so to those who suffered as a result.

If there is a single topic that concerned the assembled leaders the most, it is economic inequality. The shift in the debate from just a year ago seems dramatic: no one even mentions the notion of trickle-down economics anymore, and few are willing to argue that there is a close congruence between social contributions and private rewards.

While the realization that America is not the land of opportunity that it has long claimed to be is as disconcerting to others as it is to Americans, inequality of opportunity at the global scale is even greater. One cannot really claim that the world is “flat” when a typical African receives investment in his or her human capital of a few hundred dollars, while rich Americans get a gift from their parents and society in excess of a half-million dollars.

A high point of the meeting was the speech by Christine Lagarde, the International Monetary Fund’s managing director, who stressed the marked change in her institution, at least at the top: deep concern about women’s rights; renewed emphasis on the link between inequality and instability; and recognition that collective bargaining and minimum wages could play an important role in reducing inequality. If only the IMF programs in Greece and elsewhere fully reflected these sentiments!

The Associated Press organized a sobering session on technology and unemployment: Can countries (particularly in the developed world) create new jobs—especially good jobs—in the face of modern technology that has replaced workers with robots and other machines in any task that can be routinized?

Overall, the private sector in Europe and America has been unable to create many
good jobs since the beginning of the current century. Even in China and other parts of
the world with growing manufacturing sectors, productivity improvements—often
related to job-killing automated processes—account for most of the growth in output.
Those suffering the most are the young, whose life prospects will be badly hurt by the
extended periods of unemployment that they face today.

But most of those in Davos put aside these problems to celebrate the euro’s survival.
The dominant note was one of complacency—or even optimism. The “Draghi put”—the
notion that the European Central Bank, with its deep pockets, would and could do
whatever necessary to save the euro and each of the crisis countries—seemed to have
worked, at least for a while. The temporary calm provided some support for those who
claimed that what was required, above all, was a restoration of confidence. The hope
was that Draghi’s promises would be a costless way of providing that confidence,
because they would never have to be fulfilled.

Critics repeatedly pointed out that the fundamental contradictions had not been
resolved, and that if the euro was to survive in the long run, there would have to be a
fiscal and banking union, which would require more political unification than most
Europeans are willing to accept. But much of what was said in and around the meetings
reflected a deep lack of solidarity. One very senior government official of a northern
European country did not even put down his fork when interrupted by an earnest
dinner companion who pointed out that many Spaniards now eat out of garbage cans.
They should have reformed earlier, he replied, as he continued to eat his steak.

IMF growth forecasts released during the Davos meeting highlight the extent to which
the world has become decoupled: GDP growth in the advanced industrial countries is
expected to be 1.4 percent this year, while developing countries continue to grow at a
robust 5.5 percent annual rate.

While Western leaders talked about a new emphasis on growth and employment, they
offered no concrete policies backing these aspirations. In Europe, there was continued
emphasis on austerity, with self-congratulations on the progress made so far, and a
reaffirmation of resolve to continue along a course that has now plunged Europe as a
whole into recession—and the United Kingdom into a triple-dip downturn.

Perhaps the most optimistic note came from the emerging markets: while the risk of
globalization was that it implied a new interdependence, so that flawed economic
policies in the U.S. and Europe could torpedo developing countries’ economies, the
more successful emerging markets have managed globalization well enough to sustain
growth in the face of failures in the West.

With the U.S. politically paralyzed by the Republicans’ infantile political tantrums,
and Europe focused on ensuring the survival of the ill-conceived euro project, the lack
of global leadership was a major complaint at Davos. In the last 25 years, we have
moved from a world dominated by two superpowers to one dominated by one, and
now to a leaderless, multi-polar world. While we may talk about the G-7, or G-8, or G-20, the more apt description is G-0. We will have to learn how to live, and thrive, in this new world.

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INEQUALITY IS A CHOICE*

It’s well known by now that income and wealth inequality in most rich countries, especially the United States, have soared in recent decades and, tragically, worsened even more since the Great Recession. But what about the rest of the world? Is the gap between countries narrowing, as rising economic powers like China and India have lifted hundreds of millions of people from poverty? And within poor and middle-income countries, is inequality getting worse or better? Are we moving toward a more fair world, or a more unjust one?

These are complex questions, and new research by a World Bank economist named Branko Milanovic, along with other scholars, points the way to some answers.

Starting in the 18th century, the industrial revolution produced giant wealth for Europe and North America. Of course, inequality within these countries was appalling—think of the textile mills of Liverpool and Manchester, England, in the 1820s, and the tenements of the Lower East Side of Manhattan and the South Side of Chicago in the 1890s—but the gap between the rich and the rest, as a global phenomenon, widened even more, right up through about World War II. To this day, inequality between countries is far greater than inequality within countries.

But starting around the fall of Communism in the late 1980s, economic globalization accelerated and the gap between nations began to shrink. The period from 1988 to 2008 “might have witnessed the first decline in global inequality between world citizens since the Industrial Revolution,” Mr. Milanovic, who was born in the former Yugoslavia and is the author of The Haves and the Have-Not: A Brief and Idiosyncratic History of Global Inequality, wrote in a paper published last November. While the gap between some regions has markedly narrowed—namely, between Asia and the advanced economies of the West—huge gaps remain. Average global incomes, by country, have moved closer together over the last several decades, particularly on the strength of the growth of China and India. But overall equality across humanity, considered as individuals, has improved very little. (The Gini coefficient, a measurement of inequality, improved by just 1.4 points from 2002 to 2008.)

So while nations in Asia, the Middle East, and Latin America, as a whole, might be catching up with the West, the poor everywhere are left behind, even in places like China where they’ve benefited somewhat from rising living standards.

From 1988 to 2008, Mr. Milanovic found, people in the world’s top 1 percent saw their incomes increase by 60 percent, while those in the bottom 5 percent had no change in their income. And while median incomes have greatly improved in recent decades, there are still enormous imbalances: 8 percent of humanity takes home 50 percent of global income; the top 1 percent alone takes home 15 percent. Income gains have been
greatest among the global elite—financial and corporate executives in rich countries—and the great “emerging middle classes” of China, India, Indonesia, and Brazil. Who lost out? Africans, some Latin Americans, and people in post-Communist Eastern Europe and the former Soviet Union, Mr. Milanovic found.

The United States provides a particularly grim example for the world. And because, in so many ways, America often “leads the world,” if others follow America’s example, it does not portend well for the future.

On the one hand, widening income and wealth inequality in America is part of a trend seen across the Western world. A 2011 study by the Organization for Economic Cooperation and Development found that income inequality first started to rise in the late ’70s and early ’80s in America and Britain (and also in Israel). The trend became more widespread starting in the late ’80s. Within the last decade, income inequality grew even in traditionally egalitarian countries like Germany, Sweden, and Denmark. With a few exceptions—France, Japan, Spain—the top 10 percent of earners in most advanced economies raced ahead, while the bottom 10 percent fell further behind.

But the trend was not universal, or inevitable. Over these same years, countries like Chile, Mexico, Greece, Turkey, and Hungary managed to reduce (in some cases very high) income inequality significantly, suggesting that inequality is a product of political and not merely macroeconomic forces. It is not true that inequality is an inevitable byproduct of globalization, the free movement of labor, capital, goods and services, and technological change that favors better-skilled and better-educated employees.

Of the advanced economies, America has some of the worst disparities in incomes and opportunities, with devastating macroeconomic consequences. The gross domestic product of the United States has more than quadrupled in the last 40 years and nearly doubled in the last 25, but as is now well known, the benefits have gone to the top—and increasingly to the very, very top.

Last year, the top 1 percent of Americans took home 22 percent of the nation’s income; the top 0.1 percent, 11 percent. Ninety-five percent of all income gains since 2009 have gone to the top 1 percent. Recently released census figures show that median income in America hasn’t budged in almost a quarter-century. The typical American man makes less than he did 45 years ago (after adjusting for inflation); men who graduated from high school but don’t have four-year college degrees make almost 40 percent less than they did four decades ago.

American inequality began its upswing 30 years ago, along with tax decreases for the rich and the easing of regulations on the financial sector. That’s no coincidence. It has worsened as we have underinvested in our infrastructure, education and health care systems, and social safety nets. Rising inequality reinforces itself by corroding our political system and our democratic governance.
And Europe seems all too eager to follow America’s bad example. The embrace of austerity, from Britain to Germany, is leading to high unemployment, falling wages, and increasing inequality. Officials like Angela Merkel, the newly reelected German chancellor, and Mario Draghi, president of the European Central Bank, argue that Europe’s problems are a result of a bloated welfare spending. But that line of thinking has only taken Europe into recession (and even depression). That things may have bottomed out—that the recession may be “officially” over—is little comfort to the 27 million out of a job in the EU. On both sides of the Atlantic, the austerity fanatics say, march on: these are the bitter pills that we need to take to achieve prosperity. But prosperity for whom?

Excessive financialization—which helps explain Britain’s dubious status as the second-most-unequal country, after the United States, among the world’s most advanced economies—also helps explain the soaring inequality. In many countries, weak corporate governance and eroding social cohesion have led to increasing gaps between the pay of chief executives and that of ordinary workers—not yet approaching the 500-to-1 level for America’s biggest companies (as estimated by the International Labor Organization) but still greater than prerecession levels. (Japan, which has curbed executive pay, is a notable exception.) American innovations in rent seeking—enriching oneself not by making the size of the economic pie bigger but by manipulating the system to seize a larger slice—have gone global.

Asymmetric globalization has also exerted its toll around the globe. Mobile capital has demanded that workers make wage concessions and governments make tax concessions. The result is a race to the bottom. Wages and working conditions are being threatened. Pioneering firms like Apple, whose work relies on enormous advances in science and technology, many of them financed by government, have also shown great dexterity in avoiding taxes. They are willing to take, but not to give back.

Inequality and poverty among children are a special moral disgrace. They flout right-wing suggestions that poverty is a result of laziness and poor choices; children can’t choose their parents. In America, nearly one in four children lives in poverty; in Spain and Greece, about one in six; in Australia, Britain, and Canada, more than one in ten. None of this is inevitable. Some countries have made the choice to create more equitable economies: South Korea, where a half-century ago just one in ten people attained a college degree, today has one of the world’s highest university completion rates.

For these reasons, I see us entering a world divided not just between the haves and have-nots, but also between those countries that do nothing about it, and those that do. Some countries will be successful in creating shared prosperity—the only kind of prosperity that I believe is truly sustainable. Others will let inequality run amok. In these divided societies, the rich will hunker in gated communities, almost completely
separated from the poor, whose lives will be almost unfathomable to them, and vice versa. I’ve visited societies that seem to have chosen this path. They are not places in which most of us would want to live, whether in their cloistered enclaves or their desperate shantytowns.

The reception in the United States, and in other advanced economies, of Thomas Piketty’s recent book *Capital in the Twenty-First Century* attests to growing concern about rising inequality. His book lends further weight to the already overwhelming body of evidence concerning the soaring share of income and wealth at the very top.

Piketty’s book, moreover, provides a different perspective on the 30 or so years that followed the Great Depression and World War II, viewing this period as a historical anomaly, perhaps caused by the unusual social cohesion that cataclysmic events can stimulate. In that era of rapid economic growth, prosperity was widely shared, with all groups advancing, but with those at the bottom seeing larger percentage gains.

Piketty also sheds new light on the “reforms” sold by Ronald Reagan and Margaret Thatcher in the 1980s as growth enhancers from which all would benefit. Their reforms were followed by slower growth and heightened global instability, and what growth did occur benefited mostly those at the top.

But Piketty’s work raises fundamental issues concerning both economic theory and the future of capitalism. He documents large increases in the wealth/output ratio. In standard theory, such increases would be associated with a fall in the return to capital and an increase in wages. But today the return to capital does not seem to have diminished, and wages have not increased as one could have expected. (In the U.S., for example, average wages have stagnated over the past four decades.)

The most obvious explanation is that the increase in measured wealth does not correspond to an increase in productive capital—and the data seem consistent with this interpretation. Much of the increase in wealth stemmed from an increase in the value of real estate. Before the 2008 financial crisis, a real estate bubble was evident in many countries; even now, there may not have been a full “correction.” The rise in value also can represent competition among the rich for “positional” goods—a house on the beach or an apartment on New York City’s Fifth Avenue.

Sometimes an increase in measured financial wealth corresponds to little more than a shift from “unmeasured” wealth to measured wealth—shifts that can actually reflect deterioration in overall economic performance. If monopoly power increases, or firms (like banks) develop better methods of exploiting ordinary consumers, it will show up as higher profits and, when capitalized, as an increase in financial wealth.

But when this happens, of course, societal well-being and economic efficiency fall, even as officially measured wealth rises. We simply do not take into account the corresponding diminution of the value of human capital—the wealth of workers.

Moreover, if banks succeed in using their political influence to socialize losses and retain more and more of their ill-gotten gains, the measured wealth in the financial
sector increases. We do not measure the corresponding diminution of taxpayers’ wealth. Likewise, if corporations convince the government to overpay for their products (as the major drug companies have succeeded in doing), or are given access to public resources at below-market prices (as mining companies have succeeded in doing), reported financial wealth increases, though the wealth of ordinary citizens does not.

What we have been observing—wage stagnation and rising inequality, even as wealth increases—does not reflect the workings of a normal market economy, but of what I call “ersatz capitalism.” The problem may not be with how markets should work, but with our political system, which has failed to ensure that markets are competitive, and has designed rules that sustain distorted markets in which corporations and the rich can (and unfortunately do) exploit everyone else.

Markets, of course, do not exist in a vacuum. There have to be rules of the game, and these are established through political processes. High levels of economic inequality in countries like the U.S. and, increasingly, in those that have followed its economic model lead to political inequality. In such a system, opportunities for economic advancement become unequal as well, reinforcing low levels of social mobility.

Thus, Piketty’s forecast of still higher levels of inequality does not reflect the inexorable laws of economics. Simple changes—including higher capital-gains and inheritance taxes, greater spending to broaden access to education, rigorous enforcement of anti-trust laws, corporate-governance reforms that circumscribe executive pay, and financial regulations that rein in banks’ ability to exploit the rest of society—would reduce inequality and increase equality of opportunity markedly.

If we get the rules of the game right, we might even be able to restore the rapid and shared economic growth that characterized the middle-class societies of the mid-20th century. The main question confronting us today is not really about capitalism in the 21st century. It is about democracy in the 21st century.

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PHONY CAPITALISM*

A mericans are finally beginning to appreciate the magnitude of the inequalities in income and wealth that mark our society. Lately, this realization has been helped along by an unexpected source: the French economist Thomas Piketty, whose *Capital in the Twenty-First Century* is the surprise bestseller of the year. Piketty has collected the most extensive evidence available of the increases in economic inequality and inherited wealth over the past forty years, which are creating a new plutocracy. But while Piketty is right about the severity of the problem, he is not completely right about its cause—and how to fix it. If Americans take the wrong lessons from his work, we may fail to make the changes that could actually address our inequality problem.

Bluntly put, Piketty argues that inequality is the natural outcome of capitalism. In his view, the long period of shared prosperity that characterized the middle of the 20th century was a historical anomaly, while the disparities of the Gilded Age and our own time are the norm. But what is practiced in the United States today is perhaps best described as an ersatz capitalism designed to create inequalities. This fact was made abundantly clear during the financial crisis, when we socialized losses but allowed the banks to privatize profits, extended largesse to the victimizers but did little to help the victims who were losing their homes and jobs.

Of course, there is no such thing as a “purely” capitalist system. We have always had a mixed economy, relying on the government for investment in education, technology, and infrastructure. The most innovative and successful industries in the U.S. economy (tech and biotech) rest on foundations provided by government research. A well-functioning economy requires a balance between the public and private sectors, with essential public investments and an adequately funded system of social protection. All this requires taxation.

A well-designed tax system can do more than just raise money—it can be used to improve economic efficiency and reduce inequality. Our current system does just the opposite. Piketty’s proposal for addressing inequality through taxation—a global wealth tax—is a political nonstarter, whatever one thinks of its merits. But there are steps the United States—home to the worst inequality among the advanced countries—can take on its own. With a sensible reform of our domestic tax code, we can simultaneously raise money, improve the performance of our economy, and address some of our biggest social problems—not just inequality but joblessness and looming environmental catastrophe.

At the top of the list of concerns in assessing any tax proposal should be its impact on the distribution of income. But three broad principles should also help guide thinking. First, it is better to tax bad things than good things—to tax pollution and speculation, say, than work and savings. Second, it is better to tax things like land, oil, and other
natural resources, which don’t disappear when they are taxed (factors in inelastic supply, as economists put it). These two principles reflect a more general third principle: incentives matter. Taxes should encourage activities that are of widespread benefit and discourage those that are costly to our society. There are a host of reforms that would increase equity while conforming to these principles.

To begin with, corporate taxation should encourage firms to invest and create jobs in America by lowering taxes on those that do so relative to those that do not. Taxing multinational firms on their global income would close what might be called the Apple–Google loophole. Globalization has given these companies new opportunities to dodge taxes by claiming that their immense profits originate not from the ingenuity of their American researchers or the seemingly limitless demand from American consumers for their products but from a few employees scattered across low-tax jurisdictions, such as Ireland. By taxing all corporations on the basis of production and sales here, we can raise significant revenues to create jobs and spur growth.

In addition, there ought to be a special set of taxes on the financial sector. Given the role this sector played in the financial crisis, it is natural that it should pay some of the costs. Well-designed financial-sector taxes would increase the sector’s performance and efficiency and induce it to do better what it’s supposed to do.

While Piketty tells us that market capitalism naturally creates obscene levels of inequality, I believe we have a different problem: our markets don’t act like competitive markets. We learn in the most elementary economics courses that competitive markets, which promote efficiency and innovation, drive profits down. Wealth winds up in the hands of a few multibillionaires because we don’t have a truly competitive economy. The most successful “entrepreneurs” have figured out how to create barriers to competition, behind which they can earn huge profits. It is not a surprise that the world’s richest person, Bill Gates, earned his fortune through a company that has engaged in anticompetitive practices in Europe, America, and Asia. Nor that the world’s second richest, Carlos Slim, made his fortune by taking advantage of a poorly designed privatization process, creating a virtual monopoly in Mexico’s telecom industry, and by charging prices a multiple of what they would be in competitive markets.

To the extent that we fail in our efforts to make markets truly competitive, we should tax monopoly profits, which are a form of what economists call rents. Just as the taxation of land doesn’t lead to less land, so too for a tax on other forms of rent. Other sources of rents include revenues received by the owners of natural resources. In many cases, oil, gas, and mineral companies don’t actually own these resources; they simply extract them from publicly owned land while paying just a fraction of their true value. The best solution to this inequity would be a fair and efficient auction, which would guarantee to the public the full return on these assets. In cases where corporations have already managed to get these resources while paying the public a fraction of their worth,
we need to recoup that value by taxing the resulting profits at a higher rate.

**Moving from corporate** to personal taxes, we must enact a fair income tax so that those who work for a living aren’t forced to pay a larger portion of their income in taxes than those who enjoy the fruits of inherited wealth or manage private equity funds. While most Americans accept the general principle that the rich should pay a larger fraction of their income in taxes, our system departs markedly from this principle in practice. The very richest pay a lower percentage of their reported income than do the merely rich—and their reported income is often a fraction of their actual income.

Many of the commonly discussed proposals for reform of the personal tax code focus on eliminating provisions designed to help the middle class—most notably deductions for mortgage interest and the tax exemption of employer-provided health insurance. Such provisions narrow the tax base and make the economy less efficient, so there is some virtue to eliminating them, if done carefully. In practice, the deduction in mortgage interest provides more assistance to rich homeowners than to the middle class—indeed, by some estimates, the government provides more housing assistance to the rich through the tax system than it does to the poor through public housing. The deduction encourages excessive housing consumption and excessive borrowing (not surprising, given the political clout of our banks). But our real estate sector is still struggling after the housing collapse, when millions of Americans lost a substantial portion of their wealth. Eliminating all subsidies now would make matters worse. A phaseout of the deduction should be gradual, and we should use some of the savings to encourage equity in housing—for instance, through a provision of extended assistance for first-time homebuyers.

Given how hard-pressed the middle class is—incomes, adjusted for inflation, have barely budged in decades—deduction reforms should not be viewed as ways of raising revenue. Instead, the resulting savings should be given back in the form of a reduction of the marginal income-tax rates that hit the middle class. Some would respond that there is no way to achieve significant deficit reduction while raising taxes only on the rich: they don’t have *that* much money. That was once true, but no longer. One upside of growing inequality is that we can raise enormous amounts of money while increasing tax burdens only at the very top of the scale.

Taxing carbon emissions is another way we could raise substantial amounts of money while improving the overall performance of our economy. The most basic principle in economics is that firms should pay the costs that are incurred in their production processes. This is what enables the price system to guide the economy toward efficiency. When production is subsidized, it creates distortions in the market. Our environment is one of our scarcest resources—those who damage it through pollution are imposing serious costs. Forcing firms with high carbon emissions to pay those costs will make the economy more efficient and at the same time raise revenue.
Taken together, these proposals would make real inroads into reducing inequality, returning us to an economy more like that of the postwar years. Those were the years when America was becoming the middle-class society it had long professed to be, with decades of rapid growth and widely shared prosperity, when those at the bottom saw their incomes grow faster than those at the top. They are also the years that Thomas Piketty views as an anomaly in the history of capitalism. But getting back to that time doesn’t require eliminating capitalism; it requires eliminating the market distortions of the ersatz capitalism practiced in this country today. This is less about economics than it is about politics. We don’t have to choose between capitalism and fairness. We must choose both.

PART II

PERSONAL REFLECTIONS
The two chapters in this short part look back at my youth from today’s vantage point. The first was written on the occasion of the fiftieth anniversary of the March on Washington for Jobs and Freedom on August 28, 1963. It was there, at the Washington Mall, that the Reverend Martin Luther King gave his memorable “I have a dream” speech. I was lucky to be there. Of course, it was not just luck: like so many of my classmates, I was engaged in the fight for racial equality. Discrimination was a scar on our body politic. Growing up, I had seen all around me how discrimination was destroying lives. It was against everything I was taught America stood for. And yet the United States had lived with this poison even from before its founding.

Later I would (with other economists) ask whether discrimination could persist in a market economy. It was easy to show that the answer was yes—how could it be otherwise, given that discrimination was a persistent feature of market economies all over the world. Yet some economists had tried to argue the contrary. In “How Dr. King Shaped My Work in Economics” I make a brief allusion to this work—an illustration (like the work on macroeconomics that said that crises couldn’t happen) of how far out of touch with reality some economic models get.\footnote{1}

By contrast, I wrote “The Myth of America’s Golden Age” after reading Thomas Piketty’s book *Capitalism in the Twenty-First Century* and reflecting back on my youth. Piketty had described this period of my youth as the golden age of capitalism—the one period in which capitalism had not been marked by extremes of inequality. My memories were different: Growing up in dirty, industrial America, marked by high levels of discrimination, inequality, labor strife, episodic unemployment, I hardly thought of it as the golden age of capitalism. President Kennedy had said that “a rising tide lifts all boats”; while there may have been a grain of truth in that statement when he uttered those words in the 60s,\footnote{2} it was clearly not true half a century later.

What had upset me most about the Obama administration’s response to the economic crisis was that it, too, seemed wedded to trickle-down economics: throw enough money at the banks, and the economy will recover. I had argued for a greater dose of trickle-up economics—give money to American homeowners, who were losing their homes by the millions, and that will help the economy. It will even help the banks, because of the positive effects on the real estate market, the reduced defaults on home mortgages, and the increased strength of the overall economy.

“The Myth of America’s Golden Age” was also written soon after the publication of former treasury secretary Timothy Geitner’s book, *Stress Test*, where he valiantly, but in my view unsuccessfully, attempt to defend his and the administration’s policies during the crisis period. They worried that helping homeowners who were underwater would be unfair to those homeowners who had managed their funds well and didn’t need assistance. Going forward, it would discourage prudence on the part of homeowners—the “moral hazard problem” well-known to economists.
I never understood how he (like so many in the banking community) could embrace such a double standard. Bailing out bad banks was, in these terms, not only unfair to other banks; it was unfair to the millions of Americans who were suffering because of the misdeeds of the banks. It was going to the assistance of the victimizer, and leaving the victims to take care of themselves. If there was ever need for proof of the relevance of moral hazard, the bankers had provided it: the savings-and-loan bailout, and the Mexican, Korean, Thai, and Indonesian bailouts, which were all really bailouts of Western financial institutions. But here we were, bailing them out one more time. By contrast, for the most part, the homeowners had been misled by those in the financial sector, advised to take large mortgages beyond their capacity to pay. They had learned their lesson and were unlikely to ever repeat such behavior. Besides, among the proposals for dealing with the massive number of foreclosures were those that provided for debt restructuring, but which would have required the homeowners to give up much of the equity in their homes. It wasn’t the virtual free pass that the administration gave the banks.

Notes


2. President Kennedy actually said this on more than one occasion, including in 1960 when praising the building of the St. Lawrence Seaway.
HOW DR. KING SHAPED MY WORK IN ECONOMICS*

I had the good fortune to be in the crowd in Washington when the Rev. Dr. Martin Luther King Jr. gave his thrilling “I Have a Dream” speech on Aug. 28, 1963. I was 20 years old, and had just finished college. It was just a couple of weeks before I began my graduate studies in economics at the Massachusetts Institute of Technology.

The night before the March on Washington for Jobs and Freedom, I had stayed at the home of a college classmate whose father, Arthur J. Goldberg, was an associate justice of the Supreme Court and was committed to bringing about economic justice. Who would have imagined, 50 years later, that this very body, which had once seemed determined to usher in a more fair and inclusive America, would become the instrument for preserving inequalities: allowing nearly unlimited corporate spending to influence political campaigns, pretending that the legacy of voting discrimination no longer exists, and restricting the rights of workers and other plaintiffs to sue employers and companies for misconduct?

Listening to Dr. King speak evoked many emotions for me. Young and sheltered though I was, I was part of a generation that saw the inequities that had been inherited from the past, and was committed to correcting these wrongs. Born during World War II, I came of age as quiet but unmistakable changes were washing over American society.

As president of the student council at Amherst College, I had led a group of classmates down South to help push for racial integration. We couldn’t understand the violence of those who wanted to preserve the old system of segregation. When we visited an all-black college, we felt intensely the disparity in educational opportunities that had been given to the students there, especially when compared with those that we had received in our privileged, cloistered college. It was an unlevel playing field, and it was fundamentally unfair. It was a travesty of the idea of the American dream that we had grown up with and believed in.

It was because I hoped that something could be done about these and the other problems I had seen so vividly growing up in Gary, Indiana—poverty, episodic and persistent unemployment, unending discrimination against African-Americans—that I decided to become an economist, veering away from my earlier intention to go into theoretical physics. I soon discovered I had joined a strange tribe. While there were a few scholars (including several of my teachers) who cared deeply about the issues that had led me to the field, most were unconcerned about inequality; the dominant school worshiped at the feet of (a misunderstood) Adam Smith, at the miracle of the efficiency of the market economy. I thought that if this was the best of all possible worlds, I wanted to construct and live in another world.
In that odd world of economics, unemployment (if it existed) was the fault of workers. One Chicago School economist, the Nobel Prize winner Robert E. Lucas Jr., would later write: “Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution.” Another Nobel laureate of the Chicago School, Gary S. Becker, would attempt to show how in truly competitive labor markets discrimination couldn’t exist. While I and others wrote multiple papers explaining the sophistry in the argument, his was an argument that fell on receptive ears.

Like so many looking back over the past 50 years, I cannot but be struck by the gap between our aspirations then and what we have accomplished.

True, one “glass ceiling” has been shattered: we have an African-American president.

But Dr. King realized that the struggle for social justice had to be conceived broadly: it was a battle not just against racial segregation and discrimination, but for greater economic equality and justice for all Americans. It was not for nothing that the march’s organizers, Bayard Rustin and A. Philip Randolph, had called it the March on Washington for Jobs and Freedom.

In so many respects, progress in race relations has been eroded, and even reversed, by the growing economic divides afflicting the entire country.

The battle against outright discrimination is, regrettably, far from over: 50 years after the march, and 45 years after the passage of the Fair Housing Act, major United States banks, like Wells Fargo, still discriminated on the basis of race, targeting the most vulnerable of our citizens with their predatory lending activities. Discrimination in the job market is pervasive and deep. Research suggests that applicants with names that sound African-American get fewer calls for interviews. Discrimination takes new forms; racial profiling remains rampant in many American cities, including through the stop-and-frisk policies that became standard practice in New York. Our incarceration rate is the world’s highest, although there are signs, finally, that fiscally strapped states are starting to see the folly, if not the inhumanity, of wasting so much human capital through mass incarceration. Almost 40 percent of prisoners are black. This tragedy has been documented powerfully by Michelle Alexander and other legal scholars.

The raw numbers tell much of the story: There has been no significant closing of the gap between the income of African-Americans (or Hispanics) and white Americans the last 30 years. In 2011, the median income of black families was $40,495, just 58 percent of the median income of white families.

Turning from income to wealth, we see gaping inequality, too. By 2009, the median wealth of whites was 20 times that of blacks. The Great Recession of 2007–9 was particularly hard on African-Americans (as it typically is on those at the bottom of the socioeconomic spectrum). They saw their median wealth fall by 53 percent between
2005 and 2009, more than three times that of whites: a record gap. But the so-called recovery has been little more than a chimera—with more than 100 percent of the gains going to the top 1 percent—a group where, needless to say, African-Americans cannot be found in large numbers.

Who knows how Dr. King’s life would have unfolded had it not been cut short by an assassin’s bullet? Just 39 when he was killed, he would be 84 today. While he would have likely embraced President Obama’s efforts to reform our health care system and to defend the social safety net for the elderly, the poor, and the disabled, it is difficult to imagine that someone of such acute moral acumen would look at the America of today with anything short of despair.

Despite rhetoric about the land of opportunity, a young person’s life prospects are in America more dependent on the income and education of his parents than in almost any other advanced country. And thus, the legacy of discrimination and lack of educational and job opportunity is perpetuated, from one generation to the next.

Given this lack of mobility, the fact that even today, 65 percent of African-American children live in low-income families does not bode well for their future, or the nation’s.

Men with just a high school education have seen enormous drops in their real incomes over the past two decades, a decline that has disproportionately affected African-Americans.

While outright race-based segregation in schools was banned, in reality, educational segregation has worsened in recent decades, as Gary Orfield and other scholars have documented.

Part of the reason is that the country has become more economically segregated. Poor black children are more likely to live in communities with concentrated poverty—some 45 percent do so, as opposed to 12 percent for poor white children, as the Economic Policy Institute has pointed out.

I turned 70 earlier this year. Much of my scholarship and public service in recent decades—including my service at the Council of Economic Advisers during the Clinton administration, and then at the World Bank—has been devoted to the reduction of poverty and inequality. I hope I’ve lived up to the call Dr. King issued a half-century ago.

He was right to recognize that these persistent divides are a cancer in our society, undermining our democracy and weakening our economy. His message was that the injustices of the past were not inevitable. But he knew, too, that dreaming was not enough.

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THE MYTH OF AMERICA’S GOLDEN AGE*

I hadn’t realized when I was growing up in Gary, Indiana, an industrial town on the southern shore of Lake Michigan plagued by discrimination, poverty, and bouts of high unemployment, that I was living in the golden era of capitalism. It was a company town, named after the chairman of the board of U.S. Steel. It had the world’s largest integrated steel mill and a progressive school system designed to turn Gary into a melting pot fed by migrants from all over Europe. But by the time I was born, in 1943, cracks in the pot were already appearing. To break strikes—to ensure that workers did not fully share in the productivity gains being driven by modern technology—the big steel companies brought African-American workers up from the South who lived in impoverished, separate neighborhoods.

Smokestacks poured poisons into the air. Periodic layoffs left many families living hand to mouth. Even as a kid, it seemed clear to me that the free market as we knew it was hardly a formula for sustaining a prosperous, happy, and healthy society.

So when I went off to college to study, I was astonished by what I read. The standard economic texts of the time seemed to be unrelated to the reality I had witnessed growing up in Gary. They said that unemployment shouldn’t exist and that the market led to the best of all possible worlds. But if that were the case, I decided, I wanted to live in a different world. While other economists were obsessed with extolling the virtues of the market economy, I focused a lot of my work on why markets fail, and I devoted much of my Ph.D. thesis at MIT to understanding the causes of inequality.

Nearly half a century later, the problem of inequality has reached crisis proportions. John F. Kennedy, in the spirit of optimism that prevailed at the time I was a college student, once declared that a rising tide lifts all boats. It turns out today that almost all of us now are in the same boat—the one that holds the bottom 99 percent. It is a far different boat, one marked by more poverty at the bottom and a hollowing out of the middle class, from the one occupied by the top 1 percent.

Most disturbing is the realization that the American dream—the notion that we are living in the land of opportunity—is a myth. The life chances of a child in America are today more dependent on the income and education of his parents than in many other advanced countries, including “old Europe.”

Now comes Thomas Piketty, who warns us in his justly celebrated new book, Capital in the Twenty-first Century, that matters are only likely to get worse. Above all, he argues that the natural state of capitalism seems to be one of great inequality. When I was a graduate student, we were taught the opposite. The economist Simon Kuznets optimistically wrote that after an initial period of development in which inequality grew, it would begin to decline. Although data at the time were scarce, it might have been true
when he wrote it: The inequalities of the 19th and early 20th centuries seemed to be diminishing. This conclusion appeared to be vindicated during the period from World War II to 1980, when the fortunes of the wealthy and the middle class rose together.

But the evidence of the last third of a century suggests this period was an aberration. It was a time of war-induced solidarity when the government kept the playing field level, and the GI Bill of Rights and subsequent civil rights advances meant that there was something to the American dream. Today, inequality is growing dramatically again, and the past three decades or so have proved conclusively that one of the major culprits is trickle-down economics—the idea that the government can just step back and if the rich get richer and use their talents and resources to create jobs, everyone will benefit. It just doesn’t work; the historical data now prove that.

But it has taken us far too long as a country to understand this danger. Changes in the distribution of income and wealth occur slowly, which is why it requires a grand historical perspective of the kind that Piketty provides to get a feel for what is happening.

Ironically enough, the final proof debunking this very Republican idea of trickle-down economics has come from a Democratic administration. President Barack Obama’s banks-first approach to saving the nation from another Great Depression held that by giving money to the banks (rather than to homeowners who had been preyed upon by the banks), the economy would be saved. The administration poured billions into the banks that had brought the country to the brink of ruin, without setting conditions in return. When the International Monetary Fund and the World Bank engage in a rescue, they virtually always impose requirements to ensure the money is used in the way intended. But here, the government merely expressed the hope that the banks would keep credit, the lifeblood of the economy, flowing. And so the banks shrank lending, and paid their executives mega-bonuses, even though they had almost destroyed their businesses. Even then, we knew that much of the banks’ profits had been earned not by increasing the efficiency of the economy but by exploitation—through predatory lending, abusive credit card practices, and monopolistic pricing. The full extent of their misdeeds—for instance, the illegal manipulation of key interest rates and foreign exchange rates, affecting derivatives and mortgages in the amount of hundreds of trillions of dollars—was only just beginning to be fathomed.

Obama promised to stop these abuses, but so far only a single senior banker has gone to jail (along with a very few mid- and low-level employees). The president’s former Treasury secretary, Timothy Geithner, in his recent book, Stress Test, made a valiant but unsuccessful attempt to defend the administration’s actions, suggesting that there were no alternatives. But Geithner clearly worried excessively about the “moral hazard” of helping underwater homeowners—in other words, encouraging lax borrowing habits—while seeming to care far less about the moral hazard of helping banks, or the
culpability of the banks in encouraging excessive indebtedness and in marketing mortgages that put unbearable risks on the poor and middle classes.

In fact, Geithner’s attempts to justify what the administration did only reinforce my belief that the system is rigged. If those who are in charge of making the critical decisions are so “cognitively captured” by the 1 percent, by the bankers, that they see that the only alternative is to give those who caused the crisis hundreds of billions of dollars while leaving workers and homeowners in the lurch, the system is unfair.

This approach also exacerbated one of the country’s most pressing problems: its growing inequality. Only with a vibrant middle class can the economy fully recover and grow faster. The more inequality, the slower the growth—a conclusion now endorsed even by the IMF. Because the less wealthy consume a greater share of their income than do the rich, they expand demand when they have more income. When demand is expanded, jobs are created: In this sense, it is ordinary Americans who are the real job creators. So inequality commands a high price: a weaker economy, marked by lower growth and more instability. It is not very complicated.

None of this is the outcome of inexorable economic forces, either; it’s the result of policies and politics—what we did and didn’t do. If our politics leads to preferential taxation of those who earn income from capital; to an education system in which the children of the rich have access to the best schools, but the children of the poor go to mediocre ones; to exclusive access by the wealthy to talented tax lawyers and offshore banking centers to avoid paying a fair share of taxes—then it is not surprising that there will be a high level of inequality and a low level of opportunity. And if these policies continue, these conditions will grow even worse.

And now it’s also clear that the high level of economic inequality has translated into gross new forms of political inequality—to the point where we can more aptly be described as having a political system with “one dollar, one vote” than “one person, one vote.” The Supreme Court’s Citizens United decision in January 2010 gave corporations more rights to influence politics than ordinary individuals—without making them, or their officers, really accountable. This year’s follow-on McCutcheon decision eliminated aggregate limits on individual contributions to national candidates and parties. So today, the richer you are, the more you are able to influence the political process and the economic decisions that stem from it, and to rig it all in favor of the 1 percent. Is it any wonder the rich keep getting richer?

Cautionedly and belatedly, some six years after the fact, the Obama administration has now begun to revise its views about the Great Recession. Even Geithner, in his book, agrees that more should have been done. But hey, resources were scarce, and one had to make bets where they would be most effective. That’s the point: Listening to the bankers, it’s not a surprise that he placed his money on the bankers. Even before Obama took office, I urged a greater emphasis on homeowners: that we should
combine at least a little trickle-up economics with trickle-down economics. But those of my persuasion were given short shrift, as the administration sought counsel from the vested interests in the financial sector.

The Obamians seem bewildered that the country is not more thankful to its government for having prevented another Great Depression. They saved the banks, and in doing so, they saved the economy from a once-in-a-hundred-year storm. And they proudly point out that all the money given to the financial sector has been more than repaid. But in making such claims, they ignore some critical realities: It was not something that just happened. It was the result of reckless behavior, the predictable and predicted consequences of deregulation and the inadequate enforcement of the regulations that remained, of buying into the mind-set of the 1 percent and the bankers—for which Geithner and his mentor, former White House economic adviser Larry Summers, had more than a little culpability. It was as if, after an accident caused by drunk driving, in which the last drink was served by the police officer on duty, the drunk driver was put back into the driver’s seat, his car rushed to the repair shop, while the victim was left to languish at the scene of the crime.

The repayment itself is, at least in part, the result of a game that would do any con man proud. The government, under the auspices of the Federal Reserve, lends money to the bank at a near-zero interest rate. The bank then lends it back to the government at 2 or 3 percent, and the “profit” is paid back to the government in repayment of the “investment” the government made. Bank officials, meanwhile, get a bonus for the hefty returns they have “earned” for the bank—something a 12-year-old could have done. This is capitalism? In a true rule-of-law world, a drunk driver would have to pay for not only his own repair costs but also the damage he has inflicted—in this case, the cumulative loss of GDP, which now amounts to more than $8 trillion, and which is mounting at the rate of $2 trillion a year. The banks recover, while the typical American’s income plummets to levels not seen in two decades. It is understandable why there might be some anger in the body politic.

What we have here is not, as administration officials would have it, a failure to communicate. The problem was that Americans saw what they were doing. There was a healthy debate in the country about alternative courses of action—before, during, and after the bailouts. The reason critics like Sheila Bair, Elizabeth Warren, Neil Barofsky, Simon Johnson, Paul Krugman, and others (left, right, and center) won the day—at least the intellectual debate and the war over public perceptions—was not that they were better communicators. It was that they had a more convincing message: There were alternative ways of rescuing the economy that were fairer and that would have resulted in a stronger economy. Instead, our politics and economics are now locked into a vicious circle: Economic inequality leads to political inequality, and this political inequality then leads to rewriting the rules to increase the level of economic inequality even further, and so on. The result? Ever greater disillusionment with our democracy.
Matters may well get worse. Recent research has uncovered a variety of other vicious cycles. Poverty traps mean those in the bottom remain there. The fortunes of a child of poor parents who does well in school are far bleaker than those of a child of rich parents who does much more poorly in school. About a quarter of U.S. college freshmen from the bottom income half finish college by age 24, compared with 90 percent of the upper quartile. And with wages of those who have only a high school diploma at 62 percent of the typical college grad’s earnings—compared with 81 percent in 1965—the prospects are they will be poorer than their parents.

Meanwhile, lower taxes on capital and lower inheritance taxes are allowing the accumulation of inherited wealth—in effect, the creation of a new American plutocracy. It is even possible, as I pointed out long ago in my Ph.D. thesis and as Piketty has emphasized, that wealth will be increasingly concentrated among a select few. The shared prosperity that marked the country in that golden age of my youth—in which every group saw its income growing but those at the bottom saw it rise the fastest—is long gone.

Yet I am, perhaps, naïve enough to believe it is not capitalism alone that is at fault: It is, even more, the paralysis of our politics and the banishing of any progressive thought from a debate that still pretends the No. 1 problem is government. I have spent my career as an economist second-guessing markets, demonstrating their imperfections, and yet markets can be a powerful force for increasing standards of living for all. But we need a balance of the kind we achieved in the middle of the 20th century, when government was afforded a progressive role. Otherwise, I fear, we will permanently scar ourselves with the rigged economic and political system that already has done so much to create today’s inequality.

When I was growing up in Gary during its own smog-choked “golden age,” it was impossible to see where the city was going. We didn’t know, or talk, about the deindustrialization of America, which was about to occur. I didn’t realize, in other words, that the rather grim reality I was leaving behind as I went to college was actually as good as Gary was ever going to get.

I fear America could be at the same place today.

*Politico, July/August 2014.*
PART III

DIMENSIONS OF INEQUALITY
INEQUALITY—IN AMERICA, AS IN OTHER COUNTRIES—has many dimensions. Each has its own story. Some countries are worse in one dimension, better in others. There is inequality at the top—the share of income grabbed by the top 1 percent or .1 percent—and inequality at the bottom—the number of people in poverty, and the depth of their poverty. There are inequalities in health and in access to education, in political voice, and in insecurity. There are gender inequities, and childhood deprivations. And perhaps most important is equality of opportunity.

The inequalities are, of course, related: childhood deprivations, inequality of access to education and health care, essentially ensure that there will not be equality of opportunity. Growing evidence that countries (or areas) where there is more inequality of income are places where there is less equality of opportunity helps us understand why the United States, with the highest level of inequality of outcomes among the advanced countries, has become one of the advanced countries with the least equality of opportunity. A young American’s life prospects are more dependent on the income and education of his parents than are those of young people in other advanced countries.

The articles in this part of the book provide a selective exploration of some key aspects of these inequalities, beginning with “Equal Opportunity, Our National Myth.” Many of the aspects of the issue that are noted there are echoed in later essays. For instance, childhood deprivation seems so morally wrong, simply because children cannot be in any sense responsible for their plight; but we will not be able to do anything about our inequality of opportunity unless we address childhood deprivation. But, as I note in a UNICEF article, written in commemoration of the 25th anniversary of the Convention on the Rights of the Child, one out of five children in America grows up in poverty.

“Student Debt and the Crushing of the American Dream” addresses one of America’s more serious inequities: access to higher education. Inequities in access to education in turn are among the reasons that the United States is no longer the land of opportunity. Whereas it used to have the largest fraction of its population graduating from college, it is now down in the league tables. Even more devastating is how education perpetuates advantages and disadvantages: of Americans born around 1980, only about 9 percent of those from the bottom quarter of the income distribution graduated from college.

One reason for this is the cost of higher education. Other countries provide free education, or subsidize it more heavily. Matters were bad before the 2008 crisis, but that made them worse. As incomes deteriorated, states cut back on support, and colleges were forced to raise tuition. Just as Americans became overleveraged in their purchase of housing, now they are becoming overindebted to finance education—with student debt well over a trillion dollars, and the average student graduating with a debt of nearly $30,000. The macroeconomic consequences of this trend are parsed later—it has implications for young people’s decisions to buy a car or a house, or even to marry. But
the micro consequences are pervasive—stress as young people feel caught between a rock and a hard place, knowing that if they don’t get an advanced education, their prospects are bleak, but that if they do, they will graduate with crushing debt.

In this short essay, I don’t address an obvious question: Is there an alternative, especially in a country facing severe budget restraints? There are two approaches. Countries much poorer than the United States have decided that education for all is a priority, and are providing free (or much more subsidized) university education. President Obama’s 2015 initiative to make community colleges free for qualifying students is an example. This was a major issue in Scotland’s 2014 referendum on independence: while England has been following the American model, raising tuition markedly over the last 15 years, Scotland has been providing free education to its young people. The other approach is that of Australia. There the government lends students money at low interest rates, and then collects from them on the basis of their income. Those with higher income pay back more. This not only avoids the enormous stress put on young people by the U.S. system—and exploitation by private lenders—but also enables young people to choose a profession that corresponds to their interests and abilities. They can go into ministry or teaching without worrying about their loans. Law students can decide to go into public interest law, rather than corporate law. The benefits to society should be obvious.

“Justice for Some” discusses a particularly unsavory aspect of U.S. inequality—the lack of equal access to justice. Young Americans start the day by pledging allegiance to the flag. A key phrase in that pledge is “with justice for all.” Yet increasingly, America is more aptly described as offering “justice for those who can afford it.” Nowhere is this more evident than in our criminal justice system. America sends a larger fraction of its citizens to prison than any other country, including China: with less than 5 percent of the world’s population, it has 25 percent of the world’s prisoners. But it is the poor, and African-Americans, who are most likely to spend their late teens and early twenties in prison, rather than at school.¹

The article takes up the issue in the context of America’s housing crisis, and one aspect of it in particular: the “robo-signing crisis.” In their rush to issue bad mortgages, banks didn’t pay attention to record keeping. When the inevitable housing crisis arrived, and it came time to throw people out of the homes for which banks had gladly lent them money only a few years earlier, the banks’ records of who had repaid what were a mess. Many states have a system in which banks can simply sign an affidavit that they have examined the records and that the individual who is being declared in foreclosure does in fact owe the money alleged. The poor person who is being accused can spend money to try to defend himself—but that’s the problem with being poor in America: obtaining justice is expensive. The banks essentially lied to the courts, not once, but repeatedly. People were thrown out of their homes who didn’t owe money.
The article raises a troubling question: Americans believe that one of their country’s strengths is the rule of law, but is it really? The rule of law is supposed to protect the weak against the strong. And it is supposed to mean that the law is impartially enforced. We have laws against perjury. We have laws that are designed to protect people from unjust takings of their property. But we didn’t enforce the laws against the bankers—not a single one went to jail for this gross miscarriage of justice. We could have prevented the mortgage crisis, if we had only more effectively enforced laws already on the books, regarding predatory and discriminatory lending—and if the Fed had lived up to its responsibilities in enforcing standards of lending in the mortgage market.

“The One Housing Solution Left,” written with Mark Zandi, chief economist of Moody’s, argues that there were alternative ways of handling the housing crisis, after it emerged—borrowing an idea that had worked in the Great Depression and that would have cost the government nothing. Senator Jeff Merkley of Oregon introduced a bill, Rebuilding American Homeownership, which would have accomplished this. And there was even a strategy for doing this within the political constraints of the time. But we couldn’t get the Obama administration on board.

Later the administration recognized its failure to do more for housing as one of its critical mistakes, both economically and politically. Money was being thrown at the banks, while almost nothing was going to ordinary Americans who were losing their homes. There were a few small programs, involving a few billion dollars, announced with great fanfare, each of which in turn would prove to be a disappointment. Few homeowners were rescued. The administration never explained adequately why it didn’t get behind this cost-effective proposal, or alternatives that I and others had advocated. Perhaps it was because they never fathomed the depth of the crisis that was emerging; perhaps because they were so obsessed with rescuing the banks that they thought attention—and money—spent anywhere else would be a mistake; perhaps because they listened too much to the bankers, who were more inclined to blame the borrowers than their own lending practices; perhaps because many of the proposals (but not this one) required the banks to recognize the losses; or perhaps because the bankers hoped to continue to exploit homeowners, and this proposal would have limited their scope for doing so, by giving them an option for refinancing.

The final two articles in this part touch on two of the most disturbing aspects of America’s inequality: poverty among children and inequities in health care. Childhood poverty in America, among the worst within the advanced countries, has lifelong consequences. Because a large fraction of Americans are not living up to their potential, it also has significant consequences for the overall performance of the economy. Children have been particularly hard hit by the country’s growing inequality among adults and the gutting of public programs providing not just a safety net but benefits that ordinary citizens rely upon. Indeed, matters have become so bad that, simply looking at the statistics, if a hypothetical unborn person—not knowing where he would wind up,
whether at the bottom or the top, whether the child of a millionaire, of a plumber, of a schoolteacher—were to be asked in which country his best chances would be, he would not choose the United States. Of course, he would, if he knew that he would be born into a rich and well-educated family, if he could be assured that he entered the fray at the top. But not otherwise.

The last article in this part was written as the Ebola epidemic raged in West Africa, creating fears that it would spread to the United States. There were two key points: the disease took root where poverty was high and health services limited. And we turn to the government—not the private sector—to manage such a crisis; but underfunding of public agencies at the national and global level had undermined their capacity to do so. The article concludes by arguing that we—the United States and the world—are paying a high price for our ideological commitment to privately provided and financed health care and for our failure to do enough to lessen health care inequality in particular.

Before moving on from this section, I should emphasize that I have touched on only some of the many dimensions of America’s great divide. I haven’t written, in particular, about the gender or racial divide; although disparities in gender have been reduced, they remain large, and improvements in racial disparities have been disappointing. Of course, there are iconic successes—a few CEOs and President Obama himself. But income differences between whites and African-Americans have actually worsened, and wealth differentials have increased, particularly in the aftermath of the Great Recession.

Nor have I described how America’s middle class has been eviscerated.

The essays in this part prepare the way to those in the next, where we look at the causes of this growing inequality.

Notes

1. Some have suggested that this is not just an accident but a continuation of policies of discrimination that have long plagued the United States. See, in particular, Michelle Alexander, The New Jim Crow: Mass Incarceration in the Age of Colorblindness, rev. ed. (New York: New Press, 2012).

EQUAL OPPORTUNITY, OUR NATIONAL MYTH*

President Obama’s second Inaugural Address used soaring language to reaffirm America’s commitment to the dream of equality of opportunity: “We are true to our creed when a little girl born into the bleakest poverty knows that she has the same chance to succeed as anybody else, because she is an American; she is free, and she is equal, not just in the eyes of God but also in our own.”

The gap between aspiration and reality could hardly be wider. Today, the United States has less equality of opportunity than almost any other advanced industrial country. Study after study has exposed the myth that America is a land of opportunity. This is especially tragic: While Americans may differ on the desirability of equality of outcomes, there is near-universal consensus that inequality of opportunity is indefensible. The Pew Research Center has found that some 90 percent of Americans believe that the government should do everything it can to ensure equality of opportunity.

Perhaps a hundred years ago, America might have rightly claimed to be the land of opportunity, or at least a land where there was more opportunity than elsewhere. But not for at least a quarter of a century. Horatio Alger–style rags-to-riches stories were not a deliberate hoax, but given how they’ve lulled us into a sense of complacency, they might as well have been.

It’s not that social mobility is impossible, but that the upwardly mobile American is becoming a statistical oddity. According to research from the Brookings Institution, only 58 percent of Americans born into the bottom fifth of income earners move out of that category, and just 6 percent born into the bottom fifth move into the top. Economic mobility is lower in the United States than in most of Europe and lower than in all of Scandinavia.

Another way of looking at equality of opportunity is to ask to what extent the life chances of a child are dependent on the education and income of his parents. Is it just as likely that a child of poor or poorly educated parents gets a good education and rises to the middle class as someone born to middle-class parents with college degrees? Even in a more egalitarian society, the answer would be no. But the life prospects of an American are more dependent on the income and education of his parents than in almost any other advanced country for which there is data.

How do we explain this? Some of it has to do with persistent discrimination. Latinos and African-Americans still get paid less than whites, and women still get paid less than men, even though they recently surpassed men in the number of advanced degrees they obtain. Though gender disparities in the workplace are less than they once were, there is still a glass ceiling: women are sorely underrepresented in top corporate positions and
constitute a minuscule fraction of CEOs.

Discrimination, however, is only a small part of the picture. Probably the most important reason for lack of equality of opportunity is education: both its quantity and quality. After World War II, Europe made a major effort to democratize its education systems. We did, too, with the GI Bill, which extended higher education to Americans across the economic spectrum.

But then we changed, in several ways. While racial segregation decreased, economic segregation increased. After 1980, the poor grew poorer, the middle stagnated, and the top did better and better. Disparities widened between those living in poor localities and those living in rich suburbs—or rich enough to send their kids to private schools. A result was a widening gap in educational performance—the achievement gap between rich and poor kids born in 2001 was 30 to 40 percent larger than it was for those born 25 years earlier, the Stanford sociologist Sean F. Reardon found.

Of course, there are other forces at play, some of which start even before birth. Children in affluent families get more exposure to reading and less exposure to environmental hazards. Their families can afford enriching experiences like music lessons and summer camp. They get better nutrition and health care, which enhance their learning, directly and indirectly.

Unless current trends in education are reversed, the situation is likely to get even worse. In some cases it seems as if policy has actually been designed to reduce opportunity: government support for many state schools has been steadily gutted over the last few decades—and especially in the last few years. Meanwhile, students are crushed by giant student loan debts that are almost impossible to discharge, even in bankruptcy. This is happening at the same time that a college education is more important than ever for getting a good job.

Young people from families of modest means face a Catch-22: without a college education, they are condemned to a life of poor prospects; with a college education, they may be condemned to a lifetime of living at the brink. And increasingly even a college degree isn’t enough; one needs either a graduate degree or a series of (often unpaid) internships. Those at the top have the connections and social capital to get those opportunities. Those in the middle and bottom don’t. The point is that no one makes it on his or her own. And those at the top get more help from their families than do those lower down on the ladder. Government should help to level the playing field.

Americans are coming to realize that their cherished narrative of social and economic mobility is a myth. Grand deceptions of this magnitude are hard to maintain for long—and the country has already been through a couple of decades of self-deception.

Without substantial policy changes, our self-image, and the image we project to the world, will diminish—and so will our economic standing and stability. Inequality of
outcomes and inequality of opportunity reinforce each other—and contribute to economic weakness, as Alan B. Krueger, a Princeton economist and the chairman of the White House Council of Economic Advisers, has emphasized. We have an economic, and not only moral, interest in saving the American dream.

Policies that promote equality of opportunity must target the youngest Americans. First, we have to make sure that mothers are not exposed to environmental hazards and get adequate prenatal health care. Then, we have to reverse the damaging cutbacks to preschool education, a theme Mr. Obama emphasized on Tuesday. We have to make sure that all children have adequate nutrition and health care—not only do we have to provide the resources, but if necessary, we have to incentivize parents, by coaching or training them or even rewarding them for being good caregivers. The right says that money isn’t the solution. They’ve chased reforms like charter schools and private-school vouchers, but most of these efforts have shown ambiguous results at best. Giving more money to poor schools would help. So would summer and extracurricular programs that enrich low-income students’ skills.

Finally, it is unconscionable that a rich country like the United States has made access to higher education so difficult for those at the bottom and middle. There are many alternative ways of providing universal access to higher education, from Australia’s income-contingent loan program to the near-free system of universities in Europe. A more educated population yields greater innovation, a robust economy, and higher incomes—which mean a higher tax base. Those benefits are, of course, why we’ve long been committed to free public education through 12th grade. But while a 12th-grade education might have sufficed a century ago, it doesn’t today. Yet we haven’t adjusted our system to contemporary realities.

The steps I’ve outlined are not just affordable but imperative. Even more important, though, is that we cannot afford to let our country drift farther from ideals that the vast majority of Americans share. We will never fully succeed in achieving Mr. Obama’s vision of a poor girl’s having exactly the same opportunities as a wealthy girl. But we could do much, much better, and must not rest until we do.

A certain drama has become familiar in the United States (and some other advanced industrialized countries): Bankers encourage people to borrow beyond their means, preying especially on those who are financially unsophisticated. They use their political influence to get favorable treatment of one form or another. Debts mount. Journalists record the human toll. Then comes bewilderment: How could we let this happen again? Officials promise to fix things. Something is done about the most egregious abuses. People move on, reassured that the crisis has abated, but suspecting that it will recur soon.

The crisis that is about to break out involves student debt and how we finance higher education. Like the housing crisis that preceded it, this crisis is intimately connected to America’s soaring inequality, and how, as Americans on the bottom rungs of the ladder strive to climb up, they are inevitably pulled down—some to a point even lower than where they began.

This new crisis is emerging even before the last one has been resolved, and the two are becoming intertwined. In the decades after World War II, homeownership and higher education became signs of success in America.

Before the housing bubble burst in 2007, banks persuaded low- and moderate-income homeowners that they could turn their houses and apartments into piggy banks. They seduced them into taking out home equity loans—and in the end, millions lost their homes. In other cases, the banks, mortgage brokers, and real estate agents pushed aspiring homeowners to borrow beyond their means. The wizards of finance, who prided themselves on risk management, sold toxic mortgages that were designed to explode. They bundled the dubious loans into complex financial instruments and sold them to unsuspecting investors.

Everyone recognizes that education is the only way up, but as a college degree becomes increasingly essential to making one’s way in a 21st-century economy, education for those not to the manner born is increasingly unaffordable. Student debt for seniors graduating with loans now exceeds $26,000, about a 40 percent increase (not adjusted for inflation) in just seven years. But an “average” like this masks huge variations.

According to the Federal Reserve Bank of New York, almost 13 percent of student-loan borrowers of all ages owe more than $50,000, and nearly 4 percent owe more than $100,000. These debts are beyond students’ ability to repay (especially in our nearly jobless recovery); this is demonstrated by the fact that delinquency and default rates are soaring. Some 17 percent of student-loan borrowers were 90 days or more behind in
payments at the end of 2012. When only those in repayment were counted—in other words, not including borrowers who were in loan deferment or forbearance—more than 30 percent were 90 days or more behind. For federal loans taken out in the 2009 fiscal year, three-year default rates exceeded 13 percent.

America is distinctive among advanced industrialized countries in the burden it places on students and their parents for financing higher education. America is also exceptional among comparable countries for the high cost of a college degree, including at public universities. Average tuition, and room and board, at four-year colleges is just short of $22,000 a year, up from under $9,000 (adjusted for inflation) in 1980–81.

Compare this more-than-doubling in tuition with the stagnation in median family income, which is now about $50,000, compared to $46,000 in 1980 (adjusted for inflation).

Like much else, the problem of student debt worsened during the Great Recession: tuition costs at public universities increased by 27 percent in the past five years—partly because of cutbacks in government support—while median income shrank. In California, inflation-adjusted tuition more than doubled in public two-year community colleges (which for poorer Americans are often the key to upward mobility), and by more than 70 percent in four-year public schools, from 2007–8 to 2012–13.

With costs soaring, incomes stagnating, and little help from government, it was not surprising that total student debt, around $1 trillion, surpassed total credit card debt last year. Responsible Americans have learned how to curb their credit card debt—many have forsaken them for debit cards, or educated themselves about usurious interest rates, fees, and penalties charged by card issuers—but the challenge of controlling student debt is even more unsettling.

Curbing student debt is tantamount to curbing social and economic opportunity. College graduates earn $12,000 more per year than those without college degrees; the gap has almost tripled just since 1980. Our economy is increasingly reliant on knowledge-related industries. No matter what happens with currency wars and trade balances, the United States is not going to return to making textiles. Unemployment rates among college graduates are much lower than among those with only a high school diploma.

America—home of the land-grant university, the GI Bill, and world-class public universities from California to Michigan to Texas—has fallen from the top in terms of university education. With strangling student debt, we are likely to fall further. What economists call “human capital”—investing in people—is a key to long-term growth. To be competitive in the 21st century is to have a highly educated labor force, one with college and advanced degrees. Instead, we are foreclosing on our future as a nation.

Student debt also is a drag on the slow recovery that began in 2009. By dampening
consumption, it hinders economic growth. It is also holding back recovery in real estate, the sector where the Great Recession started.

It’s true that housing prices seem to be on the upswing, but home construction is far from the levels reached in the years before the bubble burst of 2007.

Those with huge debts are likely to be cautious before undertaking the additional burdens of a family. But even when they do, they will find it more difficult to get a mortgage. And if they do, it will be smaller, and the real estate recovery will consequently be weaker. (One study of recent Rutgers University graduates showed that 40 percent had delayed making a major home purchase, and for a quarter, the high level of debt had an effect on household formation or getting further education. Another recent study showed that homeownership among 30-year-olds with a history of student debt fell by more than 10 percentage points during the Great Recession and in its aftermath.)

It’s a vicious cycle: lack of demand for housing contributes to a lack of jobs, which contributes to weak household formation, which contributes to a lack of demand for housing.

As bad as things are, they may get worse. With budgetary pressures mounting—along with demands for cutbacks in “discretionary domestic programs” (read: K–12 education subsidies, Pell Grants for poor kids to attend college, research money)—students and families are left to fend for themselves. College costs will continue to rise far faster than incomes. As has been repeatedly observed, all of the economic gains since the Great Recession have gone to the top 1 percent.

Consider another dubious distinction: student debt is almost impossible to discharge in bankruptcy proceedings.

We’re a long way from the debtors’ prisons Dickens described. We don’t send debtors to penal colonies or put them in bonded labor. Although personal bankruptcy laws have been tightened, the principle that bankrupt individuals should be allowed a fresh start, and a chance to discharge excessive debt, is an established principle. This helps debt markets work better, and also provides incentives for creditors to assess the creditworthiness of borrowers.

Yet education loans are almost impossible to write off in bankruptcy court—even when for-profit schools didn’t deliver what they promised and didn’t provide an education that would let the borrower get a job that paid enough to pay back the loan.

We should cut off federal support for these for-profit schools when they fail to graduate students, who don’t get jobs and then default on their loans.

To its credit, the Obama administration tried to make it tougher for these predatory schools to lure students with false promises. Under the new rules, schools had to meet
one of three tests, or lose their eligibility for federal student aid: at least 35 percent of graduates had to be repaying their loans; the typical graduate’s estimated annual loan payments could not exceed 12 percent of earnings; or the payments could not exceed 30 percent of discretionary income. But in 2012, a federal judge struck down the rules as arbitrary; the rules remain in legal limbo.

The combination of predatory for-profit schools and predatory lenders is a leech on America’s poor. These schools have even gone after young veterans who served in Iraq and Afghanistan. There are heart-rending stories of parents who co-signed student loans—only to see their child killed in an accident or die of cancer or another disease—and, like students, can’t easily discharge these debts.

Interest rates on federal Stafford loans were set to double in July, to 6.8 percent. Good news came on Friday: it appears that there is a temporary reprieve, as Republicans have come around. But the stay would be temporary and would not address a more fundamental issue: if the Federal Reserve is willing to lend to the banks that caused the crisis at just 0.75 percent, shouldn’t it be willing to lend to students, who will be crucial to our long-term recovery, at an appropriately low rate? The government shouldn’t be profiting from our poorest while subsidizing our richest. A proposal by Senator Elizabeth Warren, Democrat of Massachusetts, for lower student-loan interest rates is a step in the right direction.

Along with tougher regulation of for-profit schools and the banks they connive with, and more humane bankruptcy laws, we must give more support to middle-class families struggling to send their children to college, to ensure that they have a standard of living at least equal to that of their parents.

But a real long-term solution requires rethinking how we finance higher education. Australia has designed a system of publicly provided income-contingent loans that all students must take out. Repayments vary according to individual income after graduation. This aligns the incentives of the providers of education and the receivers. Both have an incentive to see that students do well. It means that if an unfortunate event happens, like an illness or an accident, the loan obligation is automatically reduced. It means that the burden of the debt is always commensurate with an individual’s ability to repay. The repayments are collected through the tax system, minimizing the administrative costs.

Some wonder how the American ideal of equality of opportunity has eroded so much. The way we finance higher education provides part of the answer. Student debt has become an integral part of the story of American inequality. Robust higher education, with healthy public support, was once the linchpin in a system that promised opportunity for dedicated students of any means. We now have a pay-to-play, winner-take-all game where the wealthiest are assured a spot, and the rest are compelled to take a gamble on huge debts, with no guarantee of a payoff.
Even if compassion isn’t a factor—even if we focus just on recovery now and growth and innovation tomorrow—we must do something about student debt. Those concerned about the damage America’s growing divide is doing to our ideals and our moral character should put student debt at the top of any reform agenda.

THE MORTGAGE DEBACLE IN THE UNITED STATES HAS raised deep questions about “the rule of law,” the universally accepted hallmark of an advanced, civilized society. The rule of law is supposed to protect the weak against the strong, and ensure that everyone is treated fairly. In America in the wake of the subprime mortgage crisis, it has done neither.

Part of the rule of law is security of property rights—if you owe money on your house, for example, the bank can’t simply take it away without following the prescribed legal process. But in recent weeks and months, Americans have seen several instances in which individuals have been dispossessed of their houses even when they have no debts.

To some banks, this is just collateral damage: millions of Americans—in addition to the estimated four million in 2008 and 2009—still have to be thrown out of their homes. Indeed, the pace of foreclosures would be set to increase—were it not for government intervention. The procedural shortcuts, incomplete documentation, and rampant fraud that accompanied banks’ rush to generate millions of bad loans during the housing bubble has, however, complicated the process of cleaning up the ensuing mess.

To many bankers, these are just details to be overlooked. Most people evicted from their homes have not been paying their mortgages, and, in most cases, those who are throwing them out have rightful claims. But Americans are not supposed to believe in justice on average. We don’t say that most people imprisoned for life committed a crime worthy of that sentence. The U.S. justice system demands more, and we have imposed procedural safeguards to meet these demands.

But banks want to short-circuit these procedural safeguards. They should not be allowed to do so.

To some, all of this is reminiscent of what happened in Russia, 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 is at a higher level. It is not particular judges that are bought, but the laws themselves, through campaign contributions and lobbying, in what has come to be called “corruption, American-style.”

It was widely known that banks and mortgage companies were engaged in predatory lending practices, taking advantage of the least educated and most financially uninformed to make loans that maximized fees and imposed enormous risks on the borrowers. (To be fair, the banks tried to take advantage of the more financially sophisticated as well, as with securities created by Goldman Sachs that were designed to
fail.) But banks used all their political muscle to stop states from enacting laws to curtail predatory lending.

When it became clear that people could not pay back what was owed, the rules of the game changed. Bankruptcy laws were amended to introduce 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, 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 received, even though the debtor had worked, in effect, one-quarter time for the bank.

When this new bankruptcy law was passed, no one complained that it interfered with the sanctity of contracts: at the time borrowers incurred their debt, a more humane—and economically rational—bankruptcy law gave them a chance for a fresh start if the burden of debt repayment became too onerous.

That knowledge should have given lenders incentives to make loans only to those who could repay. But lenders perhaps knew that, with the Republicans in control of government, they could make bad loans and then change the law to ensure that they could squeeze the poor.

With one out of four mortgages in the U.S. underwater—more owed than the house is worth—there is a growing consensus that the only way to deal with the mess is to write down the value of the principal (what is owed). America has a special procedure for corporate bankruptcy, called Chapter 11, which allows a speedy restructuring by writing down debt, and converting some of it to equity.

It is important to keep enterprises alive as going concerns, in order to preserve jobs and growth. But it is also important to keep families and communities intact. So America needs a “homeowners’ Chapter 11.”

Lenders complain that such a law would violate their property rights. But almost all changes in laws and regulations benefit some at the expense of others. When the 2005 bankruptcy law was passed, lenders were the beneficiaries; they didn’t worry about how the law affected the rights of debtors.

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 it would not be a rule of law that protects the weak against the powerful. Rather, it would enable the powerful to exploit the weak.

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.
* Project Syndicate, November 4, 2010.
THE ONE HOUSING SOLUTION LEFT: MASS MORTGAGE REFINANCING*

More than four million Americans have lost their homes since the housing bubble began bursting six years ago. An additional 3.5 million homeowners are in the foreclosure process or are so delinquent on payments that they will be soon. With 13.5 million homeowners underwater—they owe more than their home is now worth—the odds are high that many millions more will lose their homes.

Housing remains the biggest impediment to economic recovery, yet Washington seems paralyzed. While the Obama administration’s housing policies have fallen short, Mitt Romney hasn’t offered any meaningful new proposals to aid distressed or underwater homeowners.

Late last month, the top regulator overseeing Fannie Mae and Freddie Mac blocked a plan backed by the Obama administration to let the companies forgive some of the mortgage debt owed by stressed homeowners. While half a million homeowners could be helped with a principal writedown, the regulator, Edward J. DeMarco, argued (we believe incorrectly) that helping some homeowners might cause others who are paying on their loans to stop so that they also could get their mortgages reduced.

With principal writedown no longer an option, the government needs to find a new way to facilitate mass mortgage refinancings. With rates at record lows, refinancing would allow homeowners to significantly reduce their monthly payments, freeing up money to spend on other things. A mass refinancing program would work like a potent tax cut.

Refinancing would also significantly reduce the chance of default for underwater homeowners. With fewer losses from past loans burdening their balance sheets, lenders could make more new loans, and communities plagued by mass foreclosures might see relief from blight.

Well over half of all American homeowners with mortgages are paying rates that would appear to make them excellent candidates to refinance. Many of those with stable jobs, good credit scores, and even a modest amount of home equity have already done so, taking out 30-year loans at rates around 3.5 percent, some of the lowest rates since the 1950s. But many others can’t refinance because the collapse in house prices has wiped out their home equity.

Senator Jeff Merkley, an Oregon Democrat, has proposed a remedy. Under his plan, called Rebuilding American Homeownership, underwater homeowners who are current on their payments and meet other requirements would have the option to refinance to either lower their monthly payments or pay down their loans and rebuild equity.
A government-financed trust would be used to buy the mortgages of homeowners who had refinanced at an interest rate that was about 2 percentage points more than the record-low Treasury rates at which the government borrows. This would generate enough interest income to cover the costs of any defaults, administration of the trust, and other expenses. Families would have three years to refinance; after that, the trust would stop buying loans and eventually wind itself down as homeowners repaid their loans.

Homeowners would see lower mortgage payments and rebuild equity more quickly. Taxpayers would get their money back, with interest, and would gain further as a stronger economy lifted tax revenues. Banks and other mortgage investors would get potentially troubled loans off their books. Some banks won’t like losing the large amounts of interest income they are earning on their current mortgages, but if the refinancing market were working properly these loans would have been refinanced long ago.

If the program was very successful, we envisage that two million outstanding loans could be placed in a Rebuilding American Homeownership trust at its peak. If the average mortgage balance was $150,000, then at the peak there would be $300 billion outstanding.

The federal government could finance the plan directly, through the Federal Housing Administration, or indirectly, through the Federal Home Loan Banks, which offer government-backed credit. Or the Federal Reserve could underwrite the plan; the central bank’s chairman, Ben S. Bernanke, recently talked about the Fed’s doing something akin to the Bank of England’s new Funding for Lending program, which offers incentives to banks to increase lending to households and nonfinancial businesses.

Opponents of additional borrowing or Fed lending will say that a program like this is an unacceptable risk, but the greater risk is to do nothing and let the housing market continue to hold back the economy.

Mr. Merkley’s plan resembles the Obama administration’s Home Affordable Refinance Plan, or HARP, which was designed to help underwater homeowners refinance loans backed by Fannie and Freddie. It has made possible 1.4 million refinancings, far fewer than the goal set in 2009 of 3 million to 4 million. The administration has made some improvements to HARP and proposed others. But the Merkley plan has the potential to go further, reaching the 20 million households with mortgages that aren’t backed by Fannie or Freddie.

The Merkley plan has a successful precedent in the Home Owners’ Loan Corporation, established in 1933. It swept more than a million Americans out of foreclosure and into the long-term, stable mortgages that would become the hallmark of the middle class during the 1950s and ’60s. It’s time to revive this idea.
Since the Great Recession began almost five years ago, housing has been at the heart of our economic woes. If we do nothing, the problem will eventually resolve itself, but only with significant pain and a long wait. Mr. Merkley’s plan would speed the healing.

INEQUALITY AND THE AMERICAN CHILD*

Children, it has long been recognized, are a special group. They do not choose their parents, let alone the broader conditions into which they are born. They do not have the same abilities as adults to protect or care for themselves. That is why the League of Nations approved the Geneva Declaration on the Rights of the Child in 1924, and why the international community adopted the Convention on the Rights of the Child in 1989.

Sadly, the United States is not living up to its obligations. In fact, it has not even ratified the Convention on the Rights of the Child. The U.S., with its cherished image as a land of opportunity, should be an inspiring example of just and enlightened treatment of children. Instead, it is a beacon of failure—one that contributes to global sluggishness on children’s rights in the international arena.

Though an average American childhood may not be the worst in the world, the disparity between the country’s wealth and the condition of its children is unparalleled. About 14.5 percent of the American population as a whole is poor, but 19.9 percent of children—some 15 million individuals—live in poverty. Among developed countries, only Romania has a higher rate of child poverty. The U.S. rate is two-thirds higher than that in the United Kingdom, and up to four times the rate in the Nordic countries. For some groups, the situation is much worse: more than 38 percent of black children and 30 percent of Hispanic children, are poor.

None of this is because Americans don’t care about their children. It is because America has embraced a policy agenda in recent decades that has caused its economy to become wildly unequal, leaving the most vulnerable segments of society further and further behind. The growing concentration of wealth—and a significant reduction in taxes on it—has meant less money to spend on investments for the public good, like education and the protection of children.

As a result, America’s children have become worse off. Their fate is a painful example of how inequality not only undermines economic growth and stability—as economists and organizations like the International Monetary Fund are finally acknowledging—but also violates our most cherished notions of what a fair society should look like.

Income inequality is correlated with inequalities in health, access to education, and exposure to environmental hazards, all of which burden children more than other segments of the population. Indeed, nearly one in five poor American children are diagnosed with asthma, a rate that is 60 percent higher than that for nonpoor children. Learning disabilities occur almost twice as frequently among children in households earning less than $35,000 a year than they do in households earning more than $100,000. And some in the U.S. Congress want to cut food stamps—on which some 23
million American households depend, threatening the poorest children with hunger.

These inequalities in outcomes are closely tied to inequalities in opportunities. Inevitably, in countries where children have inadequate nutrition, insufficient access to health care and education, and higher exposure to environmental hazards, the children of the poor will have far different life prospects from those of the rich. And, partly because in America a child’s lifetime prospects are more dependent on his or her parents’ income and education than in other advanced countries, the U.S. now has the least equality of opportunity of any advanced country. At America’s most elite universities, for example, only around 9 percent of students come from the bottom half of the population, while 74 percent come from the top quarter.

Most societies recognize a moral obligation to help ensure that young people can live up to their potential. Some countries even impose a constitutional mandate for equality of educational opportunities.

But in America, more is spent on the education of rich students than on the education of the poor. As a result, the U.S. is wasting some of its most valuable assets, with some young people—bereft of skills—turning to dysfunctional activities. American states like California spend about as much on prisons as on higher education—and sometimes more.

Without compensatory measures—including preschool education, ideally beginning at a very young age—unequal opportunities translate to unequal lifelong outcomes. That should be a spur to policy action.

Indeed, while inequality’s harmful effects are wide-reaching, and impose huge costs on our economies and societies, they are largely avoidable. The extremes of inequality observed in some countries are not the inexorable result of economic forces and laws. The right policies—stronger social safety nets, progressive taxation, and better regulation (especially of the financial sector), to name a few—can reverse these devastating trends.

To generate the political will that such reforms require, we must confront policymakers’ inertia and inaction with the grim facts of inequality and its devastating effects on our children. We can reduce childhood deprivation and increase equality of opportunity, thereby laying the groundwork for a more just and prosperous future—one that reflects our own avowed values. So why don’t we?

Of the harm that inequality inflicts on our economies, politics, and societies, the damage done to children demands special concern. Whatever responsibility poor adults may bear for their lot in life—they may not have worked hard enough, saved enough, or made good decisions—children’s circumstances are thrust upon them without any sort of choice. Children, perhaps more than anyone else, need the protection that rights afford—and the U.S. should be providing the world with a shining example of what
that means.

* Project Syndicate, December 2014.
EBOLA AND INEQUALITY*

THE EBOLA CRISIS REMINDS US, ONCE AGAIN, OF THE downside of globalization. Not only good things—like principles of social justice and gender equality—cross borders more easily than ever before; so do malign influences like environmental problems and disease.

The crisis also reminds us of the importance of government and civil society. We do not turn to the private sector to control the spread of a disease like Ebola. Rather, we turn to institutions—the Centers for Disease Control and Prevention (CDC) in the United States, the World Health Organization (WHO), and Médecins Sans Frontières, the remarkable group of doctors and nurses who risk their lives to save those of others in poor countries around the world.

Even right-wing fanatics who want to dismantle government institutions turn to them when facing a crisis like that caused by Ebola. Governments may not do a perfect job in addressing such crises, but one of the reasons that they have not done as well as we would hope is that we have underfunded the relevant agencies at the national and global level.

The Ebola episode holds further lessons. One reason that the disease spread so rapidly in Liberia and Sierra Leone is that both are war-ravaged countries, where a large proportion of the population is malnourished and the health care system has been devastated.

Moreover, where the private sector does play an essential role—vaccine development—it has little incentive to devote resources to diseases that afflict the poor or poor countries. It is only when advanced countries are threatened that there is sufficient impetus to invest in vaccines to confront diseases like Ebola.

This is not so much a criticism of the private sector; after all, drug companies are not in business out of the goodness of their hearts, and there is no money in preventing or curing the diseases of the poor. Rather, what the Ebola crisis calls into question is our reliance on the private sector to do the things that governments perform best. Indeed, it appears that with more public funding, an Ebola vaccine could have been developed years ago.

America’s failures in this regard have drawn particular attention—so much so that some African countries are treating visitors from the U.S. with special precautions. But this just echoes a more fundamental problem: America’s largely private health care system is failing.

True, at the top end, the U.S. has some of the world’s leading hospitals, research universities, and advanced medical centers. But, though the U.S. spends more per capita and as a percentage of its GDP on medical care than any other country, its health
outcomes are truly disappointing.

American male life expectancy at birth is the worst of 17 high-income countries—almost four years shorter than that in Switzerland, Australia, and Japan. And it is the second worst for women, more than five years below life expectancy in Japan.

Other health metrics are equally disappointing, with data indicating poorer health outcomes for Americans throughout their lives. And, for at least three decades, matters have been getting worse.

Many factors contribute to America’s health lag, with lessons that are relevant for other countries as well. For starters, access to medicine matters. With the U.S. among the few advanced countries that does not recognize access as a basic human right, and more reliant than others on the private sector, it is no surprise that many Americans do not get the medicines they need. Though the Patient Protection and Affordable Care Act (Obamacare) has improved matters, health-insurance coverage remains weak, with almost half of the 50 U.S. states refusing to expand Medicaid, the health care financing program for America’s poor.

Moreover, the U.S. has one of the highest rates of childhood poverty among the advanced countries (which was especially true before austerity policies dramatically increased poverty in several European countries), and lack of nutrition and health care in childhood has lifelong effects. Meanwhile, America’s gun laws contribute to the highest incidence of violent deaths among advanced countries, and its dependence on the automobile underpins a high rate of highway fatalities.

America’s outsize inequality, too, is a critical factor in its health lag, especially combined with the factors mentioned above. With more poverty, more childhood poverty, more people without access to health care, decent housing, and education, and more people facing food insecurity (often consuming cheap foods that contribute to obesity), it is no surprise that U.S. health outcomes are bad.

But health outcomes are also worse in the U.S. than elsewhere for those with higher incomes and insurance coverage. Perhaps this, too, is related to higher inequality than in other advanced countries. Health, we know, is related to stress. Those striving to climb the ladder of success know the consequences of failure. In the U.S., the rungs of the ladder are farther apart than elsewhere, and the distance from the top to the bottom is greater. That means more anxiety, which translates into poorer health.

Good health is a blessing. But how countries structure their health care system—and their society—makes a huge difference in terms of outcomes. America and the world pay a high price for excessive reliance on market forces and an insufficient attention to broader values, including equality and social justice.

* Project Syndicate, November 10, 2014.
PART IV

CAUSES OF AMERICA’S GROWING INEQUALITY
There has always been inequality. There always will be. The question posed by these articles is why inequality—in virtually all of its dimensions—has increased so much in the last 35 years. The Great Recession, of course, contributed greatly to inequality (though, as we comment in the next section, it was also partly a consequence of inequality). The trends were, however, apparent well before then.

Each aspect of inequality—the increasing share of the very top, the growth in poverty, the weakening of the middle—has its own explanations. At the top, the larger share of capital and the high level of capital gains are critical—the rich own a disproportionate share of capital and receive the overwhelming share of capital gains. But that only pushes the question back a little: Why has this occurred? Earlier in the book we explained the concept of rent seeking—there are two ways to get wealthy, making the size of the nation’s economic pie larger and increasing the size of one’s own slice relative to that of others (and in the fight over getting a larger slice, the pie may even get smaller). The increase in the wealth at the top is overwhelmingly associated with an increase in rent seeking. Corporate executives are seizing a larger share of the corporate pie, but not because they have suddenly become more productive. Financialization—the increased importance of the financial sector in the economy—has been central, not only in the increased instability of the economy, evidenced by the Great Recession, but in the increased inequality. Monopoly power has expanded, too, with the growth of firms with global market power (like Apple, Google, and Microsoft) and, in some cases, even the growth of firms with more local market power (like Walmart and Amazon).

In the preceding section we noted a number of aspects of America’s inequality, including inequality in access to health care and education and poverty among children. The result of these inequities is that inequalities get transmitted across generations: the children of the advantaged begin life with a major head start. Inequalities of opportunity are both cause and consequence of inequalities in incomes. It is not surprising that inequality would grow over time, as America is becoming more economically segregated—with the children of the rich going to well-funded schools, the children of the poor going to schools that often hardly function.

The increase in inequality in before-tax and transfer income in the United States, while large, is not that much larger than in some other advanced countries. What distinguishes America’s growing inequality from that of other countries is that we do so little about it: others have made a greater effort to ameliorate the inequalities.

In earlier sections of this book, we emphasized that inequality was a matter of choice: the laws of economics are the same in different countries, but how they play out is markedly different. Every law and regulation, every government expenditure, every policy, can have an effect on inequality. In the next section, we illustrate this with several of the heated policy debates in which America has been engaged. The preceding
section also provided a number of illustrations: we have chosen to finance higher education in a way that is markedly different from that of other countries, and this makes access to higher education more difficult for the poor and even the middle. In *The Price of Inequality* I discuss other examples: how our bankruptcy laws—the laws that specify what happens when a firm or an individual can’t pay all that is owed—favor the financial sector and discriminate against the poor trying to make their way up by borrowing to get an education.

The articles in this part take up only a small part of the story. They don’t discuss how inequality in access to and achievement in education is both a consequence and cause of our ever-increasing income and wealth inequality; how inadequate nutrition and access to health care for the poor (and increasingly even middle America) can also perpetuate inequality; or how poor children’s greater exposure to environmental hazards can do likewise. Nor do they consider how inequality in access to justice can do the same.

Instead, the articles focus on just two issues—corporate welfare and our tax system. The title of the first essay, written soon after America’s bailouts for the banks, says it all: “America’s Socialism for the Rich.” “Socialism” has, of course, become a dirty word in America, just like “welfare.” But how else should one describe the mega-bailouts for America’s banks. We didn’t play by the rules of capitalism, which would have made the bankers, the bank shareholders, and the bondholders pay for their mistakes. Critics of my view say that we *had* to bail out the banks. That’s true. But we didn’t have to bail out the bankers, the shareholders, and the bondholders.

The essay not only illustrates that the tax system is unfair; it also shows how it distorts our economy—and leads to higher levels not only of after-tax inequality but even of before-tax inequality. If speculators are taxed at lower rates than those who work for a living, then speculation is encouraged. In April 2014 I testified to the Senate about America’s growing inequality. One senator asked how he could explain to his constituents why a plumber should pay a higher tax rate than someone with a comparable income reaping the returns from (long-term) speculation. The question was, of course, rhetorical, and none of the panel—either Republican, Democrat, or Independent—could give an answer.

More generally, earlier chapters explained how inequality at the top is associated with exploitation and rent seeking; and here I explain how our tax system encourages these activities, weakening the economy and increasing inequality.

As Americans face the deadline for filing their tax returns every April 15, there is always a rash of articles about our tax system. “A Tax System Stacked against the 99 Percent” shows how our tax system is not just a little unfair—it’s stacked against the 99 percent. Because those at the top don’t pay their fair share of taxes, the burden on the rest is increased; and it means the rich get to keep—and reinvest—their profits, getting richer and richer in the process. Warren Buffett famously pointed out that it was unfair
that he paid a lower tax rate than his secretary. What he didn’t point out is that when he said that, he was presumably referring to the ratio of his taxes to his realized income. Every year, he gets a small salary (relative to his overall income), receives dividends and interest, and realizes some capital gains. But normally he has enormous unrealized capital gains. The assets he owns increase in value, and so long as he doesn’t sell his stock or other ownership claims, no taxes are due. So if the very rich just hold on to their assets, they can increase in value, year after year, without paying any taxes. And then they can pass the assets on to their children; and the children can pass them on to their children. So long as the assets are not sold, no income taxes will ever have to be paid. And if they are sold, the great-grandchild has to pay taxes only on the increase in value since he inherited them; the entire capital gains over the previous generations totally escape taxation. (True, there may be inheritance taxes, though clever estate tax management can often avoid, or at least minimize, these taxes.)

These articles were written before the scandals of tax avoidance on a global scale were exposed. At that time, GE was the shining example of a corporate leader that had managed to avoid paying its fair share of taxes. But then the Apple and Google scandals broke out—these Silicon Valley companies, long noted for their ingenuity in technology, had displayed the same ingenuity in tax avoidance. They took advantage of globalization—the ability to move money around the world. Apple claimed that its profits could really be attributed to a few people working in Ireland! Honesty—let alone a sense of fair play—seems a rarer commodity than ingenuity. These companies were willing to take but not to give back: after all, their success depends on the Internet, which was created by government spending. If we don’t replenish the stock of ideas upon which companies can draw through basic research, the flow of innovations won’t be sustained. But that requires money, tax dollars. Google and Apple have shown that the same shortsighted and selfish behavior that was endemic in America’s financial sector can manifest itself in Silicon Valley.

“Fallacies of Romney’s Logic” was written amid the fury that followed the release of a video of a speech by Mitt Romney, then the Republican candidate for the presidency (he intended the remarks to be private). He claimed that 47 percent of American’s didn’t pay income taxes, and he derided them as free riders. The irony was, of course, that Romney himself had managed to avoid paying his fair share of taxes, taking advantage of a loophole in the tax law that allowed those in the private equity business to pay low taxes—much lower than that of a plumber who earned a comparable income. (There was another issue that I didn’t have time to raise in the article. He admitted that he kept much of his wealth in the Cayman Islands. America has, presumably, the best financial markets in the world—at least for serving the interests of the rich. Surely, he wasn’t keeping his money in the Cayman Islands because they provided unique services—other than a lack of transparency—that Wall Street could not provide. He never deigned to provide Americans with an explanation.) This article explains more narrowly what
the flaw was in Romney’s logic—why his castigating “the 47 percent” was simply wrongheaded.
AMERICA’S SOCIALISM FOR THE RICH*

With all the talk of “green shoots” of economic recovery, America’s banks are pushing back on efforts to regulate them. While politicians talk about their commitment to regulatory reform to prevent a recurrence of the crisis, this is one area where the devil really is in the details—and the banks will muster what muscle they have left to ensure that they have ample room to continue as they did in the past.

The old system worked well for the bankers (if not for their shareholders), so why should they embrace change? Indeed, the efforts to rescue them devoted so little thought to the kind of post-crisis financial system we want that we will end up with a banking system that is less competitive, with the large banks that were too big to fail even larger.

It has long been recognized that America’s banks that are too big to fail are also too big to be managed. That is one reason that the performance of several of them has been so dismal. Because government provides deposit insurance, it plays a large role in restructuring (unlike other sectors). Normally, when a bank fails, the government engineers a financial restructuring; if it has to put in money, it, of course, gains a stake in the future. Officials know that if they wait too long, zombie or near-zombie banks—with little or no net worth, but treated as if they were viable institutions—are likely to “gamble on resurrection.” If they take big bets and win, they walk away with the proceeds; if they fail, the government picks up the tab.

This is not just theory; it is a lesson we learned, at great expense, during the savings-and-loan crisis of the 1980s. When the ATM machine says, “insufficient funds,” the government doesn’t want this to mean that the bank, rather than your account, is out of money, so it intervenes before the till is empty. In a financial restructuring, shareholders typically get wiped out, and bondholders become the new shareholders. Sometimes the government must provide additional funds; sometimes it looks for a new investor to take over the failed bank.

The Obama administration has, however, introduced a new concept: too big to be financially restructured. The administration argues that all hell would break lose if we tried to play by the usual rules with these big banks. Markets would panic. So, not only can’t we touch the bondholders, we can’t even touch the shareholders—even if most of the shares’ existing value merely reflects a bet on a government bailout.

I think this judgment is wrong. I think the Obama administration has succumbed to political pressure and scaremongering by the big banks. As a result, the administration has confused bailing out the bankers and their shareholders with bailing out the banks.

Restructuring gives banks a chance for a new start: new potential investors (whether in equity or debt instruments) will have more confidence, other banks will be more
willing to lend to them, and they will be more willing to lend to others. The bondholders will gain from an orderly restructuring, and if the value of the assets is truly greater than the market (and outside analysts) believe, they will eventually reap the gains.

But what is clear is that the Obama strategy’s current and future costs are very high—and so far, it has not achieved its limited objective of restarting lending. The taxpayer has had to pony up billions, and has provided billions more in guarantees—bills that are likely to come due in the future.

Rewriting the rules of the market economy—in a way that has benefited those that have caused so much pain to the entire global economy—is worse than financially costly. Most Americans view it as grossly unjust, especially after they saw the banks divert the billions intended to enable them to revive lending to payments of outsized bonuses and dividends. Tearing up the social contract is something that should not be done lightly.

But this new form of ersatz capitalism, in which losses are socialized and profits privatized, is doomed to failure. Incentives are distorted. There is no market discipline. The too-big-to-be-restructured banks know that they can gamble with impunity—and, with the Federal Reserve making funds available at near-zero interest rates, there are ample funds to do so.

Some have called this new economic regime “socialism with American characteristics.” But socialism is concerned about ordinary individuals. By contrast, the United States has provided little help for the millions of Americans who are losing their homes. Workers who lose their jobs receive only 39 weeks of limited unemployment benefits, and are then left on their own. And, when they lose their jobs, most lose their health insurance, too.

America has expanded its corporate safety net in unprecedented ways, from commercial banks to investment banks, then to insurance, and now to automobiles, with no end in sight. In truth, this is not socialism, but an extension of long-standing corporate welfarism. The rich and powerful turn to the government to help them whenever they can, while needy individuals get little social protection.

We need to break up the too-big-to-fail banks; there is no evidence that these behemoths deliver societal benefits that are commensurate with the costs they have imposed on others. And, if we don’t break them up, then we have to severely limit what they do. They can’t be allowed to do what they did in the past—gamble at others’ expenses.

This raises another problem with America’s too-big-to-fail, too-big-to-be-restructured banks: they are too politically powerful. Their lobbying efforts worked well, first to deregulate, and then to have taxpayers pay for the cleanup. Their hope is that it will
work once again to keep them free to do as they please, regardless of the risks for taxpayers and the economy. We cannot afford to let that happen.

*Project Syndicate*, June 8, 2009.
A TAX SYSTEM STACKED AGAINST THE 99 PERCENT*

Leona Helmsley, the hotel chain executive who was convicted of federal tax evasion in 1989, was notorious for, among other things, reportedly having said that “only the little people pay taxes.”

As a statement of principle, the quotation may well have earned Mrs. Helmsley, who died in 2007, the title Queen of Mean. But as a prediction about the fairness of American tax policy, Mrs. Helmsley’s remark might actually have been prescient.

Today, the deadline for filing individual income-tax returns, is a day when Americans would do well to pause and reflect on our tax system and the society it creates. No one enjoys paying taxes, and yet all but the extreme libertarians agree, as Oliver Wendell Holmes said, that taxes are the price we pay for civilized society. But in recent decades, the burden for paying that price has been distributed in increasingly unfair ways.

About 6 in 10 of us believe that the tax system is unfair—and they’re right: put simply, the very rich don’t pay their fair share. The richest 400 individual taxpayers, with an average income of more than $200 million, pay less than 20 percent of their income in taxes—far lower than mere millionaires, who pay about 25 percent of their income in taxes, and about the same as those earning a mere $200,000 to $500,000. And in 2009, 116 of the top 400 earners—almost a third—paid less than 15 percent of their income in taxes.

Conservatives like to point out that the richest Americans’ tax payments make up a large portion of total receipts. This is true, as well it should be in any tax system that is progressive—that is, a system that taxes the affluent at higher rates than those of modest means. It’s also true that as the wealthiest Americans’ incomes have skyrocketed in recent years, their total tax payments have grown. This would be so even if we had a single flat income-tax rate across the board.

What should shock and outrage us is that as the top 1 percent has grown extremely rich, the effective tax rates they pay have markedly decreased. Our tax system is much less progressive than it was for much of the 20th century. The top marginal income tax rate peaked at 94 percent during World War II and remained at 70 percent through the 1960s and 1970s; it is now 39.6 percent. Tax fairness has gotten much worse in the 30 years since the Reagan “revolution” of the 1980s.

Citizens for Tax Justice, an organization that advocates for a more progressive tax system, has estimated that, when federal, state, and local taxes are taken into account, the top 1 percent paid only slightly more than 20 percent of all American taxes in 2010—about the same as the share of income they took home, an outcome that is not progressive at all.
With such low effective tax rates—and, importantly, the low tax rate of 20 percent on income from capital gains—it’s not a huge surprise that the share of income going to the top 1 percent has doubled since 1979, and that the share going to the top 0.1 percent has almost tripled, according to the economists Thomas Piketty and Emmanuel Saez. Recall that the wealthiest 1 percent of Americans own about 40 percent of the nation’s wealth, and the picture becomes even more disturbing.

If these numbers still don’t impress you as being unfair, consider them in comparison with other wealthy countries.

The United States stands out among the countries of the Organization for Economic Cooperation and Development, the world’s club of rich nations, for its low top marginal income-tax rate. These low rates are not essential for growth—consider Germany, for instance, which has managed to maintain its status as a center of advanced manufacturing, even though its top income-tax rate exceeds America’s by a considerable margin. And in general, our top tax rate kicks in at much higher incomes. Denmark, for example, has a top tax rate of more than 60 percent, but that applies to anyone making more than $54,900. The top rate in the United States, 39.6 percent, doesn’t kick in until individual income reaches $400,000 (or $450,000 for a couple). Only three OECD countries—South Korea, Canada, and Spain—have higher thresholds.

Most of the Western world has experienced an increase in inequality in recent decades, though not as much as the United States has. But among most economists there is a general understanding that a country with excessive inequality can’t function well; many countries have used their tax codes to help “correct” the market’s distribution of wealth and income. The United States hasn’t—or at least not very much. Indeed, the low rates at the top serve to exacerbate and perpetuate the inequality—so much so that among the advanced industrial countries, America now has the highest income inequality and the least equality of opportunity. This is a gross inversion of America’s traditional meritocratic ideals—ideals that our leaders, across the spectrum, continue to profess.

Over the years, some of the wealthy have been enormously successful in getting special treatment, shifting an ever greater share of the burden of financing the country’s expenditures—defense, education, social programs—onto others. Ironically, this is especially true of some of our multinational corporations, which call on the federal government to negotiate favorable trade treaties that allow them easy entry into foreign markets and to defend their commercial interests around the world, but then use these foreign bases to avoid paying taxes.

General Electric has become the symbol for multinational corporations that have their headquarters in the United States but pay almost no taxes—its effective corporate-tax rate averaged less than 2 percent from 2002 to 2012—just as Mitt Romney, the Republican presidential nominee last year, became the symbol for the wealthy who
don’t pay their fair share when he admitted that he paid only 14 percent of his income in
taxes in 2011, even as he notoriously complained that 47 percent of Americans were
freeloaders. Neither G.E. nor Mr. Romney has, to my knowledge, broken any tax laws,
but the sparse taxes they’ve paid violate most Americans’ basic sense of fairness.

In looking at such statistics, one has to be careful: they typically reflect taxes as a
percentage of reported income. And the tax laws don’t require the reporting of all kinds
of income. For the rich, hiding such assets has become an elite sport. Many avail
themselves of the Cayman Islands or other offshore tax shelters to avoid taxes (and not,
you can safely assume, because of the sunny weather). They don’t have to report
income until it is brought back (“repatriated”) to the United States. So, too, capital gains
have to be reported as income only when they are realized.

And if the assets are passed on to one’s children or grandchildren at death, no taxes
are ever paid, in a peculiar loophole called the “step-up in cost basis at death.” Yes, the
tax privileges of being rich in America extend into the afterlife.

As Americans look at some of the special provisions in the tax code—for vacation
homes, racetracks, beer breweries, oil refineries, hedge funds, and movie studios,
among many other favored assets or industries—it is no wonder that they feel
disillusioned with a tax system that is so riddled with special rewards. Most of these tax-
code loopholes and giveaways did not materialize from thin air, of course—usually,
they were enacted in pursuit of, or at least in response to, campaign contributions from
influential donors. It is estimated that these kinds of special tax provisions amount to
some $123 billion a year, and that the price tag for offshore tax loopholes is not far
behind. Eliminating these provisions alone would go a long way toward meeting deficit-
reduction targets called for by fiscal conservatives who worry about the size of the
public debt.

Yet another source of unfairness is the tax treatment on so-called carried interest.
Some Wall Street financiers are able to pay taxes at lower capital-gains tax rates on
income that comes from managing assets for private equity funds or hedge funds. But
why should managing financial assets be treated any differently from managing people,
or making discoveries? Of course, those in finance say they are essential. But so are
doctors, lawyers, teachers, and everyone else who contributes to making our complex
society work. They say they are necessary for job creation. But in fact, many of the
private equity firms that have excelled in exploiting the carried interest loophole are
actually job destroyers; they excel in restructuring firms to “save” on labor costs, often
by moving jobs abroad.

Economists often eschew the word “fair”—fairness, like beauty, is in the eye of the
beholder. But the unfairness of the American tax system has gotten so great that it’s
dishonest to apply any other label to it.

Traditionally, economists have focused less on issues of equality than on the more
mundane issues of growth and efficiency. But here again, our tax system comes in with low marks. Our growth was higher in the era of high top marginal tax rates than it has been since 1980. Economists—even at traditional, conservative international institutions like the International Monetary Fund—have come to realize that excessive inequality is bad for growth and stability. The tax system can play an important role in moderating the degree of inequality. Ours, however, does remarkably little about it.

One of the reasons for our poor economic performance is the large distortion in our economy caused by the tax system. The one thing economists agree on is that incentives matter—if you lower taxes on speculation, say, you will get more speculation. We’ve drawn our most talented young people into financial shenanigans, rather than into creating real businesses, making real discoveries, providing real services to others. More efforts go into “rent seeking”—getting a larger slice of the country’s economic pie—than into enlarging the size of the pie.

Research in recent years has linked the tax rates, sluggish growth, and rising inequality. Remember, the low tax rates at the top were supposed to spur savings and hard work, and thus economic growth. They didn’t. Indeed, the household savings rate fell to a record level of near zero after President George W. Bush’s two rounds of cuts, in 2001 and 2003, on taxes on dividends and capital gains. What low tax rates at the top did do was increase the return on rent seeking. It flourished, which meant that growth slowed and inequality grew. This is a pattern that has now been observed across countries. Contrary to the warnings of those who want to preserve their privileges, countries that have increased their top tax bracket have not grown more slowly. Another piece of evidence is here at home: if the efforts at the top were resulting in our entire economic engine’s doing better, we would expect everyone to benefit. If they were engaged in rent seeking, as their incomes increased, we’d expect that of others to decrease. And that’s exactly what’s been happening. Incomes in the middle, and even the bottom, have been stagnating or falling.

Aside from the evidence, there is a strong intuitive case to be made for the idea that tax rates have encouraged rent seeking at the expense of wealth creation. There is an intrinsic satisfaction in creating a new business, in expanding the horizons of our knowledge, and in helping others. By contrast, it is unpleasant to spend one’s days fine-tuning dishonest and deceptive practices that siphon money off the poor, as was common in the financial sector before the 2007–8 financial crisis. I believe that a vast majority of Americans would, all things being equal, choose the former over the latter. But our tax system tilts the field. It increases the net returns from engaging in some of these intrinsically distasteful activities, and it has helped us become a rent-seeking society.

It doesn’t have to be this way. We could have a much simpler tax system without all the distortions—a society where those who clip coupons for a living pay the same taxes
as someone with the same income who works in a factory; where someone who earns his income from saving companies pays the same tax as a doctor who makes the income by saving lives; where someone who earns his income from financial innovations pays the same taxes as a someone who does research to create real innovations that transform our economy and society. We could have a tax system that encourages good things like hard work and thrift and discourages bad things, like rent seeking, gambling, financial speculation, and pollution. Such a tax system could raise far more money than the current one—we wouldn’t have to go through all the wrangling we’ve been going through with sequestration, fiscal cliffs, and threats to end Medicare and Social Security as we know it. We would be in sound fiscal position, for at least the next quarter-century.

The consequences of our broken tax system are not just economic. Our tax system relies heavily on voluntary compliance. But if citizens believe that the tax system is unfair, this voluntary compliance will not be forthcoming. More broadly, government plays an important role not just in social protection, but in making investments in infrastructure, technology, education, and health. Without such investments, our economy will be weaker, and our economic growth slower.

Society can’t function well without a minimal sense of national solidarity and cohesion, and that sense of shared purpose also rests on a fair tax system. If Americans believe that government is unfair—that ours is a government of the 1 percent, for the 1 percent, and by the 1 percent—then faith in our democracy will surely perish.

GLOBALIZATION ISN’T JUST ABOUT PROFITS. IT’S ABOUT TAXES TOO.*

The world looked on agog as Tim Cook, the head of Apple, said his company had paid all the taxes owed—seeming to say that it paid all the taxes it should have paid. There is, of course, a big difference between the two. It’s no surprise that a company with the resources and ingenuity of Apple would do what it could to avoid paying as much tax as it could within the law. While the Supreme Court, in its Citizens United case, seems to have said that corporations are people, with all the rights attendant thereto, this legal fiction didn’t endow corporations with a sense of moral responsibility; and they have the Plastic Man capacity to be everywhere and nowhere at the same time—to be everywhere when it comes to selling their products, and nowhere when it comes to reporting the profits derived from those sales.

Apple, like Google, has benefited enormously from what the U.S. and other Western governments provide: highly educated workers trained in universities that are supported both directly by government and indirectly (through generous charitable deductions). The basic research on which their products rest was paid for by taxpayer-supported developments—the Internet, without which they couldn’t exist. Their prosperity depends in part on our legal system—including strong enforcement of intellectual property rights; they asked (and got) government to force countries around the world to adopt our standards, in some cases, at great costs to the lives and development of those in emerging markets and developing countries. Yes, they brought genius and organizational skills, for which they justly receive kudos. But while Newton was at least modest enough to note that he stood on the shoulders of giants, these titans of industry have no compunction about being free riders, taking generously from the benefits afforded by our system, but not willing to contribute commensurately. Without public support, the wellspring from which future innovation and growth will come will dry up—not to say what will happen to our increasingly divided society.

It is not even true that higher corporate tax rates would necessarily significantly decrease investment. As Apple has shown, it can finance anything it wants to with debt—including paying dividends, another ploy to avoid paying their fair share of taxes. But interest payments are tax deductible—which means that to the extent that investment is debt-financed, the cost of capital and returns are both changed commensurately, with no adverse effect on investment. And with the low rate of taxation on capital gains, returns on equity are treated even more favorably. Still more benefits accrue from other details of the tax code, such as accelerated depreciation and the tax treatment of research and development expenditures.

It is time the international community faced the reality: we have an unmanageable, unfair, distortionary global tax regime. It is a tax system that is pivotal in creating the
increasing inequality that marks most advanced countries today—with America standing out in the forefront and the UK not far behind. It is the starving of the public sector which has been pivotal in America no longer being the land of opportunity—with a child’s life prospects more dependent on the income and education of its parents than in other advanced countries.

Globalization has made us increasingly interdependent. These international corporations are the big beneficiaries of globalization—it is not, for instance, the average American worker and those in many other countries, who, partly under the pressure from globalization, has seen his income fully adjusted for inflation, including the lowering of prices that globalization has brought about, fall year after year, to the point where a full-time male worker in the U.S. has an income lower than four decades ago. Our multinationals have learned how to exploit globalization in every sense of the term—including exploiting the tax loopholes that allow them to evade their global social responsibilities.

The U.S. could not have a functioning corporate income tax system within the country if we had elected to have a transfer price system (where firms “make up” the prices of goods and services that one part buys from another, allowing profits to be booked to one state or another). The U.S. has developed a formulaic system, where global profits are allocated on the basis of employment, sales, and capital goods. But there is plenty of room to further fine-tune the system in response to the easier ability to shift profits around when a major source of the real “value added” is intellectual property.

Some have suggested that while the sources of production (value added) are difficult to identify, the destination is less so (though with reshipping, this may not be so clear); they suggest a destination-based system. But such a system would not necessarily be fair—providing no revenues to the countries that have borne the costs of production. But a destination system would clearly be better than the current one.

Even if the U.S. were not rewarded for its global publicly supported scientific contributions and the intellectual property built on them, at least the country would be rewarded for its unbridled consumerism, which provides incentives for such innovation. It would be good if there could be an international agreement on the taxation of corporate profits. In the absence of such an agreement, any country that threatened to impose fair corporate taxes would be punished—production (and jobs) would be taken elsewhere. In some cases, countries can call their bluff. Others may feel the risk is too high. But what cannot be escaped are customers.

The U.S. by itself could go a long way to moving reform along: any firm selling goods there could be obliged to pay a tax on its global profits, at say a rate of 30 percent, based on a consolidated balance sheet, but with a deduction for corporate profits taxes paid in other jurisdictions (up to some limit). In other words, the U.S.
would set itself up as enforcing a global minimum-tax regime. Some might opt out of selling in the U.S., but I doubt that many would.

The problem of multinational corporate tax avoidance is deeper, and requires more profound reform, including dealing with tax havens that shelter money for tax evaders and facilitate money-laundering. Google and Apple hire the most talented lawyers, who know how to avoid taxes staying within the law. But there should be no room in our system for countries that are complicitous in tax avoidance. Why should taxpayers in Germany help bail out citizens in a country whose business model was based on tax avoidance and a race to the bottom—and why should citizens in any country allow their companies to take advantage of these predatory countries?

To say that Apple or Google simply took advantage of the current system is to let them off the hook too easily: the system didn’t just come into being on its own. It was shaped from the start by lobbyists from large multinationals. Companies like General Electric lobbied for, and got, provisions that enabled them to avoid even more taxes. They lobbied for, and got, amnesty provisions that allowed them to bring their money back to the U.S. at a special low rate, on the promise that the money would be invested in the country; and then they figured out how to comply with the letter of the law, while avoiding the spirit and intention. If Apple and Google stand for the opportunities afforded by globalization, their attitudes towards tax avoidance have made them emblematic of what can go, and is going, wrong with that system.

FALLACIES OF ROMNEY’S LOGIC*

Mitt Romney’s acerbic attack against the 47 percent of Americans who allegedly don’t pay income taxes and are dependent on government has rightly given rise to a storm. It suggests that large numbers—Barack Obama’s supporters—are freeloaders.

The irony is that it is people such as Romney who are freelading: The taxes that he has said he is paying (as a percentage of his reported income) are far less than those of people with substantially less income. And contrary to what some of them would like to believe, no one makes it on his own. Even if they don’t inherit their wealth, success in business requires a rule of law, an educated workforce, a public infrastructure, all of which are provided by government.

Even “innovators” such as Google have done what they did only by building on the work of others. Before Google could create the Internet’s most popular search engine, someone had to create the Internet—and it was government that did that.

**Dispelling Myths**

But the fallacies in Romney’s logic run deeper.

First, even those who don’t pay income taxes pay a host of other taxes, including payroll, sales, excise, and property taxes. Many of those receiving “benefits” paid for them—through Social Security and Medicare contributions. They’re not free riders. Government has done a better job providing these benefits than the private sector. Let’s remember why these programs were started: The private sector left most elderly bereft of support, the market for annuities essentially didn’t exist, and the elderly couldn’t get health insurance.

Even today, the private sector doesn’t provide the kind of security that Social Security provides—including protection against market volatility and inflation. And transaction costs of the Social Security Administration are markedly lower than those in the private sector—not a surprise, since their objective is to maximize these costs. Transaction costs are their profits.

Second, many of those receiving benefits are our young—providing them education and healthcare (even if they or their parents don’t pay taxes) are investments in our future. America is the country with the least equality of opportunity of any of the advanced countries for which there is data. While the American dream may have become a myth, it doesn’t have to be that way. Children shouldn’t have to depend on the wealth of their parents to get the education or health care they need to live up to their potential.

Third, an efficient system of social protection is an important part of any modern society—necessary to enable individuals to take risks. Again, the market failed to
provide adequate insurance; for instance, for unemployment or disability. That’s why the government stepped in. Those receiving those benefits typically paid for them, either directly or indirectly, through contributions they or their employer made on their behalf to these insurance funds. But providing social protection against these risks too can make for a more productive society. Individuals can take on more high-return, high-risk activities if they know there is a safety net protecting them if things don’t work out. It’s one of the reasons that some economies with better social protection have been growing much more rapidly than the United States, even during the recent recession.

**Government Failure**

Fourth, many of those at the bottom—who have become so dependent on government—are there partly because government has failed in one way or the other. It has failed to provide them with skills that would make them productive, so they could earn an adequate living. It has failed to stop banks from taking advantage of them through predatory lending and abusive credit card practices. It has failed to stop for-profit schools from taking advantage of their aspirations to move up in the world through education.

Finally, we are a community—and all communities help those who are less fortunate among them. If our economic system results in so many without jobs, dependent on the government for food, then government has to step in. Our economic system has not worked in the way it should: It has not created jobs for all those who would like to work. Many of the jobs that have been created do not pay a livable wage.

We do have a divided society. But it is not divided, as Romney has suggested, between those who are freeloaders and the rest, even if some of those who are paying taxes are not paying their fair share, and are free riding on those who do.

Rather, it is divided between those who see America as a community, and who recognize that the only way to have sustained prosperity is to have shared prosperity, and those who don’t.

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PART V

CONSEQUENCES OF INEQUALITY
The thrust of my book *The Price of Inequality* was that inequality weakens our economy, undermines our democracy, and divides our society. The series The Great Divide elaborated on various aspects. The articles reprinted here again can touch on only a few of the topics. Some of the articles included in the prelude (and the introduction to that section) discuss how inequality undercuts economic performance, lowering demand and increasing instability. In an essay in the last part (“Inequality Is Holding Back the Recovery”), I explain how the country’s ever-increasing inequality was part of the explanation for the extraordinarily slow recovery from the 2008 crisis—a crisis that inequality itself helped create.

Earlier I described America’s high level of inequality of opportunity. A large fraction of Americans—those that weren’t lucky enough to be born of parents of means—have little chance of living up to their potential. This is, of course, a disaster for these individuals, but it is also bad for the economy: we are not using fully our most important resource, our people.

As a government of the 1 percent, for the 1 percent, and by the 1 percent works to enrich the 1 percent, through corporate welfare and tax benefits, fewer resources are available for investments in infrastructure, education, and technology, investments that are needed to keep the economy strong and growing.

But the real cost of inequality is to our democracy and our society. Basic values for which the country has stood—equality of opportunity, equal access to justice, a sense of a system that is fair—have been eroded, as I explain in earlier essays (“Equal Opportunity, Our National Myth” and “Justice for Some”). Bonds of shared sacrifice that hold a country together in times of war are undermined when the rich get a tax cut at the same time that we have a “voluntary” armed forces, disproportionately consisting of poor individuals whose alternative job prospects seem bleak—and then, instead of rewarding them as we did those who served in the armed forces in World War II, with the GI Bill of Rights, we forced them to return time and time again to the battlefield, to the point where nearly half of those returning had one or more disabilities. Making matters still worse, we (or, more accurately, the Bush administration) then underfunded the veterans’ hospitals to which they turn.¹

There are many ways in which our society starts to fray as a sense of fair play diminishes. As I point out in “A Tax System Stacked against the 99 Percent,” a tax system such as ours, based largely on voluntary compliance, works only if there is a belief that the system is fair—but it is now evident to all that ours is not, that those at the top get a far better deal than those in the middle.

The two articles reprinted here take up two consequences of inequality that have been given insufficient attention. The first focuses on what’s happening to our inner cities, in which so many of the country’s poor live. Detroit’s bankruptcy is emblematic. Like so
many American families, it was hurt by following the advice of the exploitive financial sector, buying risky derivatives, which Warren Buffett referred to as financial weapons of mass destruction. In the case of Detroit, they did explode. As in so many other instances, when troubles emerged, the financial sector demanded to be paid back first—putting the welfare of ordinary citizens, including workers with contracts promising them retirement benefits, in the backseat.

The other article in this section, “In No One We Trust,” discusses a further casualty of America’s growing inequality—a loss of trust, without which no society can function. Although economists typically don’t use words like “trust,” in fact, our economy simply can’t function without trust. I explain why this is so, how inequality has eroded this most precious thing, and why, once eroded, it may prove hard to restore.

Note

THE WRONG LESSON FROM DETROIT’S BANKRUPTCY*

When I was growing up in Gary, Indiana, nearly a quarter of American workers were employed in the manufacturing sector. There were plenty of jobs at the time that paid well enough for a single breadwinner, working one job, to fulfill the American dream for his family of four. He could earn a living on the sweat of his brow, afford to send his children to college, and even see them rise to the professional class.

Cities like Detroit and Gary thrived on that industry, not just in terms of the wealth that it produced but also in terms of strong communities, healthy tax bases, and good infrastructure. From the stable foundation of Gary’s excellent public schools, influenced by the ideas of the progressive reformer John Dewey, I went on to Amherst College and then to MIT for graduate school.

Today, fewer than 8 percent of American workers are employed in manufacturing, and many Rust Belt cities are skeletons. The distressing facts about Detroit are by now almost a cliché: 40 percent of streetlights were not working this spring, tens of thousands of buildings are abandoned, schools have closed, and the population declined 25 percent in the last decade alone. The violent crime rate last year was the highest of any big city. In 1950, when Detroit’s population was 1.85 million, there were 296,000 manufacturing jobs in the city; as of 2011, with a population of just over 700,000, there were fewer than 27,000.

So much is packed into the dramatic event of Detroit’s fall—the largest municipal bankruptcy in American history—that it’s worth taking a pause to see what it says about our changing economy and society, and what it portends for our future.

Failures of national and local policy are by now well known: underinvestment in infrastructure and public services, geographic isolation that has marginalized poor and African-American communities in the Rust Belt, intergenerational poverty that has stymied equality of opportunity and the privileging of moneyed interests (like those of corporate executives and financial services companies) over those of workers.

At one level, one might shrug: companies die every day; new ones are born. That is part of the dynamics of capitalism. So, too, for cities. Maybe Detroit and cities like it are just in the wrong location for the goods and services that 21st-century America demands.

But such a diagnosis would be wrong, and it’s extremely important to recognize that Detroit’s demise is not simply an inevitable outcome of the market.

For one, the description is incomplete: Detroit’s most serious problems are confined to the city limits. Elsewhere in the metropolitan area, there is ample economic activity.
In suburbs like Bloomfield Hills, Mich., the median household income is more than $125,000. A 45-minute drive from Detroit is Ann Arbor, home of the University of Michigan, one of the world’s preeminent hubs of research and knowledge production.

Detroit’s travails arise in part from a distinctive aspect of America’s divided economy and society. As the sociologists Sean F. Reardon and Kendra Bischoff have pointed out, our country is becoming vastly more economically segregated, which can be even more pernicious than being racially segregated. Detroit is the example par excellence of the seclusion of affluent (and mostly white) elites in suburban enclaves. There is a rationale for battening down the hatches: the rich thus ensure that they don’t have to pay any share of the local public goods and services of their less well-off neighbors, and that their children don’t have to mix with those of lower socioeconomic status.

The trend toward self-reinforcing inequality is especially apparent in education, an ever shrinking ladder for upward mobility. Schools in poorer districts get worse, parents with means move out to richer districts, and the divisions between the haves and have-nots—not only in this generation, but also in the next—grow ever larger.

Residential segregation along economic lines amplifies inequality for adults, too. The poor have to somehow manage to get from their neighborhoods to part-time, low-paying, and increasingly scarce jobs at distant work sites. Combine this urban sprawl with inadequate public transportation systems and you have a blueprint for transforming working-class communities into depopulated ghettos.

Adding to the problems that would inevitably arise from such poorly designed urban agglomerations is the fact that the Detroit metropolitan area is divided into separate political jurisdictions. The poor are thus not only geographically isolated, but politically ghettoized as well. The result is a separate, poorer inner city with a dearth of resources, made even worse because the industrial plants that had provided the core of the tax base are shut down.

The decision to file for Chapter 9 municipal bankruptcy protection was made by Kevyn D. Orr, the nonelected emergency manager appointed by Gov. Rick Snyder, a Republican, to run the city’s finances. The incumbent mayor, Dave Bing, a Democrat, has decided not to seek a second term, which is hardly surprising given that he and other local officials have been left on the sidelines as their city’s future—and the accumulated debts owed its creditors—is being hashed out in court.

As historians like Thomas J. Sugrue have demonstrated, the disintegration of Detroit precedes the conflicts over social-welfare programs and race relations (including riots in 1967) and reaches back into the postwar decades, a time when the roots of deindustrialization, racial discrimination, and geographic isolation were planted. We’ve reaped what we’ve sown.

Lacking regional political unity, there is no overall structure to improve the
infrastructure and public services between poorer inner cities and affluent suburbs. So the poor fall back on what means they have, which is not good enough. Cars inevitably break down and buses are late, making workers appear to be “unreliable.” But what is really unreliable is the iniquitous design of the city. No wonder America is becoming the advanced industrial country with the least equality of opportunity.

The same skewed priorities that have gutted Detroit at the local level are echoed in a void at the level of national policy. Every country, every society, has regions and industries whose stars are rising, and others that are in decline. Silicon Valley has, for some time, been America’s rising star—just as the upper Midwest was a hundred years ago. With technological change and globalization, though, the Midwest’s comparative advantage as a global manufacturing hub has ebbed, for reasons too well known to list here. Markets, however, often don’t do a good job of self-rejuvenation.

Rather than deal purposefully with this changing economic landscape with useful policies encouraging the growth of other industries, our government spent decades papering over the growing weaknesses by allowing the financial sector to run amok, creating “growth” based on bubbles. We didn’t just let the market run its course. We made an active choice to embrace short-term profits and large-scale inefficiency. There may be something inevitable about the structural changes that have made American manufacturing less central to our economy, but there is nothing inevitable about the waste, pain, and human despair in cities that have accompanied that change. There are policy alternatives that can soften such transitions in ways that preserve wealth and promote equality. Just four hours from Detroit, Pittsburgh, too, grappled with white flight. But it more rapidly shifted its economy from one dependent on steel and coal to one that emphasizes education, health care, and legal and financial services. Manchester, the center of Britain’s textile industry for more than a century, has been transformed into a center of education, culture, and music. America does have an urban renewal program, but it is aimed more at restoring buildings and gentrification than at maintaining and restoring communities, and even at that, it is languishing. American workers were sold “free” trade policies on the promise that the winners could compensate the losers. The losers are still waiting.

Of course, the Great Recession and the policies that created it have made this, like so many other things, much worse. The mortgage bankers marched into large sections of some of our cities and found them good subjects for their predatory and discriminatory lending. Once the bubble burst, those cities were abandoned by all but the debt collectors and foreclosure sheriffs. Rather than saving our communities, our politicians focused more on saving the bankers, their shareholders, and their bondholders.

The situation may be grim, but all is not lost for Detroit and other cities facing similar problems. The question facing Detroit now is how to manage bankruptcy. But here, too, we must be wary of the influence of the “wisdom” of wealthy interests.
In recent years, our financial “wizards” at private banks—whose skill is supposed to be managing risk—sold Detroit some fancy financial products (derivatives) that have worsened its financial plight by hundreds of millions of dollars.

In a conventional bankruptcy, derivatives would get priority as creditors before current and retired municipal workers. Fortunately, the rules governing Chapter 9 of the bankruptcy code put greater emphasis on the public good. When a public body goes into bankruptcy, there is always some ambiguity about its assets and liabilities. Its obligations include an unwritten “social contract,” including social services for its residents. Its ability to increase revenues is limited: higher taxes can accelerate a death spiral, driving out more businesses and homeowners.

The banks, not surprisingly, would like other priorities. With nearly $300 million of outstanding derivatives at stake, they may connive to be first in line for repayment. The Chapter 9 proceeding provides the opportunity to place the banks where they ought to be—at the back of the queue. It was bad enough that these nontransparent financial instruments were used to confuse and deceive investors. It would add insult to injury to reward the banks’ behavior. The priority in the bankruptcy proceedings must be restoring Detroit to vitality as a city, not just getting it out of the red. The basic principle of Chapter 11 of our bankruptcy code (focusing on corporations) is that bankruptcy should provide a fresh start: doing so is vital to preserving jobs and our economy. But when cities go bankrupt, it’s even more important to preserve our communities.

Banks and bondholders will argue that pension payments for city workers are an undue burden, and should be limited or canceled to reduce the banks’ losses. But the high priority that workers are typically given in municipal bankruptcies is entirely justified. After all, they have performed their services on the understanding that they would be paid, and pensions are nothing but “deferred compensation.” Workers are not engaged in the complicated business of risk assessment, as investors are. And unlike investors, they can’t really diversify their portfolios to manage their risk. So it should be unconscionable to tell workers that, sorry, we aren’t paying you what we promised for work you’ve already done. Especially because their pensions, unlike those of corporate chieftains, are far from generous. Most of the retired city employees receiving checks get about $1,600 a month.

This means that much of the burden of bankruptcy will have to fall on those who lent Detroit money, and those who insured those lenders. This is as it should be. They got a return, reflecting their subjective estimate of the risk that they faced. Of course, they would like to get high returns, and somehow not bear the risk. But this is not the way markets work, or should work.

Ensuring that bankruptcy proceeds in a way that is good for Detroit will require vigilance, and is only the first step in recovery. In the longer term, we will need to change the way we run our metropolitan areas. We need to provide better public
transportation, an education system that promotes a modicum of equality of opportunity, and a system of metropolitan “governance” that works not just for the 1 percent, nor even for the top 20 percent, but for all citizens.

And on the national level, we need policies—investment in education, training, and infrastructure—that smooth America’s transition away from a dependency on manufacturing for jobs. If we don’t, post–Great Recession bankruptcies like those in Jefferson County, Ala., Vallejo, Calif., Central Falls., R.I., and now Detroit will become far too common.

Detroit’s bankruptcy is a reminder of how divided our society has become and how much has to be done to heal the wounds. And it provides an important warning to those living in today’s boomtowns: it could happen to you.

IN NO ONE WE TRUST*

IN AMERICA TODAY, WE ARE SOMETIMES MADE TO FEEL that it is naïve to be preoccupied with trust. Our songs advise against it, our TV shows tell stories showing its futility, and incessant reports of financial scandal remind us we’d be fools to give it to our bankers.

That last point may be true, but that doesn’t mean we should stop striving for a bit more trust in our society and our economy. Trust is what makes contracts, plans, and everyday transactions possible; it facilitates the democratic process, from voting to law creation, and is necessary for social stability. It is essential for our lives. It is trust, more than money, that makes the world go round.

We do not measure trust in our national income accounts, but investments in trust are no less important than those in human capital or machines.

Unfortunately, however, trust is becoming yet another casualty of our country’s staggering inequality: As the gap between Americans widens, the bonds that hold society together weaken. So, too, as more and more people lose faith in a system that seems inexorably stacked against them, and the 1 percent ascend to ever more distant heights, this vital element of our institutions and our way of life is eroding.

The undervaluing of trust has its roots in our most popular economic traditions. Adam Smith argued forcefully that we would do better to trust in the pursuit of self-interest than in the good intentions of those who pursue the general interest. If everyone looked out for just himself, we would reach an equilibrium that was not just comfortable but also productive, in which the economy was fully efficient. To the morally uninspired, it’s an appealing idea: selfishness as the ultimate form of selflessness. (Elsewhere, in particular in his Theory of Moral Sentiments, Smith took a much more balanced view, though most of his latter-day adherents have not followed suit.)

But events—and economic research—over the past 30 years have shown not only that we cannot rely on self-interest, but also that no economy, not even a modern, market-based economy like America’s, can function well without a modicum of trust—and that unmitigated selfishness inevitably diminishes trust.

Take banking, the industry that spawned the crisis that has cost us dearly.

That industry in particular had long been based on trust. You put your money into the bank, trusting that when you wanted to take it out in the future, it would be there. This is not to say that bankers never tried to deceive one another or their clients. But a vast majority of their business was conducted on the basis of assumed mutual accountability, sufficient levels of transparency, and a sense of responsibility. At their best, banks were stalwart community institutions that made judicious loans to promising small businesses and prospective homeowners.
In the years leading up to the crisis, though, our traditional bankers changed drastically, aggressively branching out into other activities, including those historically associated with investment banking. Trust went out the window. Commercial lenders hard-sold mortgages to families who couldn’t afford them, using false assurances. They could comfort themselves with the idea that no matter how much they exploited their customers and how much risk they had undertaken, new “insurance” products—derivatives and other chicanery—insulated their banks from the consequences. If any of them thought about the social implications of their activities, whether it was predatory lending, abusive credit card practices, or market manipulation, they might have taken comfort that, in accordance with Adam Smith’s dictum, their swelling bank accounts implied that they must be boosting social welfare.

Of course, we now know this was all a mirage. Things didn’t turn out well for our economy or our society. As millions lost their homes during and after the crisis, median wealth declined nearly 40 percent in three years. Banks would have done badly, too, had it not been for the Bush-Obama mega-bailouts.

This cascade of trust destruction was unrelenting. One of the reasons that the bubble’s bursting in 2007 led to such an enormous crisis was that no bank could trust another. Each bank knew the shenanigans it had been engaged in—the movement of liabilities off its balance sheets, the predatory and reckless lending—and so knew that it could not trust any other bank. Interbank lending froze, and the financial system came to the verge of collapse, saved only by the resolute action of the public, whose trust had been the most abused of all.

There had been earlier episodes when the financial sector showed how fragile trust was. Most notable was the crash of 1929, which prompted new laws to stop the worst abuses, from fraud to market manipulation. We trusted regulators to enforce the law, and we trusted the banks to obey the law: The government couldn’t be everywhere, but banks would at least be kept in line by fearing the consequences of bad behavior.

Decades later, however, bankers used their political influence to eviscerate regulations and install regulators who didn’t believe in them. Officials and academics assured lawmakers and the public that banks could self-regulate.

But it all turned out to be a scam. We had created a system of rewards that encouraged shortsighted behavior and excessive risk-taking. In fact, we had entered an era in which moral values were given short shrift and trust itself was discounted.

The banking industry is only one example of what amounts to a broad agenda, promoted by some politicians and theoreticians on the right, to undermine the role of trust in our economy. This movement promotes policies based on the view that trust should never be relied on as motivation, for any kind of behavior, in any context. Incentives, in this scheme, are all that matter.
So CEOs must be given stock options to induce them to work hard. I find this puzzling: If a firm pays someone $10 million to run a company, he should give his all to ensure its success. He shouldn’t do so only if he is promised a big chunk of any increase in the company’s stock market value, even if the increase is only a result of a bubble created by the Fed’s low interest rates.

Similarly, teachers must be given incentive pay to induce them to exert themselves. But teachers already work hard for low wages because they are dedicated to improving the lives of their students. Do we really believe that giving them $50 more, or even $500 more, as incentive pay will induce them to work harder? What we should do is increase teacher salaries generally because we recognize the value of their contributions and trust in their professionalism. According to the advocates of an incentive-based culture, though, this would be akin to giving something for nothing.

In practice, the right’s narrow focus on incentives has proved inimical to long-term thinking and so rife with opportunities for greed that it was bound to promote distrust, both in society and within companies. Bank managers and corporate executives search out creative accounting devices to make their enterprises look good in the short run, even if their long-run prospects are compromised.

Of course, incentives are an important component of human behavior. But the incentive movement has made them into a sort of religion, blind to all the other factors—social ties, moral impulses, compassion—that influence our conduct.

This is not just a coldhearted vision of human nature. It is also implausible. It is simply impossible to pay for trust every time it is required. Without trust, life would be absurdly expensive; good information would be nearly unobtainable; fraud would be even more rampant than it is; and transaction and litigation costs would soar. Our society would be as frozen as the banks were when their years of dishonesty came to a head and the crisis broke in 2007.

America faces another formidable hurdle if it wants to restore a climate of trust: our out-of-control inequality. Not only did the actions of the bankers and government policies influenced by the right directly undermine trust; both contributed greatly to this inequality.

When 1 percent of the population takes home more than 22 percent of the country’s income—and 95 percent of the increase in income in the post-crisis recovery—some pretty basic things are at stake. Reasonable people, even those ignorant of the maze of unfair policies that created this reality, can look at this absurd distribution and be pretty certain that the game is rigged.

But for our economy and society to function, participants must trust that the system is reasonably fair. Trust between individuals is usually reciprocal. But if I think that you are cheating me, it is more likely that I will retaliate, and try to cheat you. (These notions
have been well developed in a branch of economics called the “theory of repeated games.”) When Americans see a tax system that taxes the wealthiest at a fraction of what they pay, they feel that they are fools to play along. All the more so when the wealthiest are able to move profits offshore. The fact that this can be done without breaking the law simply shows Americans that the financial and legal systems are designed by and for the rich.

As the trust deficit persists, a deeper rot takes hold: Attitudes and norms begin to change. When no one is trustworthy, it will be only fools who trust. The concept of fairness itself is eroded. A study published last year by the National Academy of Sciences suggests that the upper classes are more likely to engage in what has traditionally been considered unethical behavior. Perhaps this is the only way for some to reconcile their worldview with their outlandish financial success, often achieved through actions that reveal a kind of moral deprivation.

It’s hard to know just how far we’ve gone down the path toward complete trust disintegration, but the evidence is not encouraging.

Economic inequality, political inequality, and an inequality-promoting legal system all mutually reinforce one another. We get a legal system that provides privileges to the rich and powerful. Occasionally, individual egregious behavior is punished (Bernard L. Madoff comes to mind); but none of those who headed our mighty banks are held accountable.

As always, it is the poor and the unconnected who suffer most from this, and who are the most repeatedly deceived. Nowhere was this more evident than in the foreclosure crisis. The subprime mortgage hawkers, putting themselves forward as experts in finance, assured unqualified borrowers that repayment would be no problem. Later millions would lose their homes. The banks figured out how to get court affidavits signed by the thousands (in what came to be called robo-signing), certifying that they had examined their records and that these particular individuals owed money—and so should be booted out of their homes. The banks were lying on a grand scale, but they knew that if they didn’t get caught, they would walk off with huge profits, their officials’ pockets stuffed with bonuses. And if they did get caught, their shareholders would be left paying the tab. The ordinary homeowner simply didn’t have the resources to fight them. It was just one example among many in the wake of the crisis where banks were seemingly immune to the rule of law.

I’ve written about many dimensions of inequality in our society—inequality of wealth, of income, of access to education and health, of opportunity. But perhaps even more than opportunity, Americans cherish equality before the law. Here, inequality has infected the heart of our ideals.

I suspect there is only one way to really get trust back. We need to pass strong regulations, embodying norms of good behavior, and appoint bold regulators to enforce
them. We did just that after the Roaring 20s crashed; our efforts since 2007 have been sputtering and incomplete. Firms also need to do better than skirt the edges of regulations. We need higher norms for what constitutes acceptable behavior, like those embodied in the United Nations’ Guiding Principles on Business and Human Rights. But we also need regulations to enforce these norms—a new version of trust but verify. No rules will be strong enough to prevent every abuse, yet good, strong regulations can stop the worst of it.

Strong values enable us to live in harmony with one another. Without trust, there can be no harmony, nor can there be a strong economy. Inequality in America is degrading our trust. For our own sake, and for the sake of future generations, it’s time to start rebuilding it. That this even requires pointing out shows how far we have to go.

PART VI

POLICY
A central message of this book is that inequality is affected by virtually every policy that the government undertakes. Economists are wont to discuss how a policy affects efficiency, how incentives might be distorted. But especially in our divided society, policies that increase that divide should be looked at carefully. I wrote these articles in response to particular policy debates that emerged in the country at various times, debates in which the distributive consequences of the policy were often given short shrift.

“How Policy Has Contributed to the Great Economic Divide” provides an overview of ways in which policies—especially the country’s macroeconomic policies, which determine output and employment—have widened the great divide.

“Why Janet Yellen, Not Larry Summers, Should Lead the Fed” is one of several articles I have written highlighting the relationship between monetary policy and inequality. (I also devoted chapter 9 of The Price of Inequality to the subject.) It was the most pointed. In the summer of 2013, the country became divided over who should lead the Fed after Ben Bernanke’s term came to an end. Bernanke had had a mixed record—the Fed’s policies before the crisis—including the period in which he was chairman, from 2006 on, and an earlier period, 2002 to 2005, when he was an active member of the Federal Reserve Board—were central to its creation; the unprecedented actions the Fed took as the crisis developed are often credited with saving the economy from a Great Depression. But it was clear that the Fed was more interested in saving the big Wall Street banks than in helping the local and regional banks that provide loans to small and medium-size enterprises, more interested in saving the bankers and their shareholders and bondholders than in helping ordinary homeowners save their homes. It was also demonstrably uninterested in democratic transparency, as it, for instance, funneled money to AIG, money that eventually went to Goldman Sachs and other big banks. For obvious reasons, the Fed didn’t want American citizens to know where the money was going.

The battle was more complex and multifaceted than these choices often are. There were two main candidates, Larry Summers and Janet Yellen. I knew both well. I had worked in the White House closely with the former. Janet had been one my earliest Ph.D. students at Yale. Both were smart. Both were experienced. Most of those who had worked closely with both strongly thought Yellen was more suited to the difficult tasks of managing perhaps the most important financial institution in the world. I wrote an early article explaining what was needed in the job, and hinting that Yellen was the right candidate. A large group of senators thought likewise, and in a letter to President Obama urged him to make her his choice. No one wanted to make the battle personal. But, somehow, Obama did not get the hint. He seemingly felt more comfortable with the “old boys club” approach, appointing someone he knew well and who had served him as head of the National Economic Council. A quiet battle became less so, and this article
may have helped turn the tide.² A critical number of senators on the Senate Banking Committee (which has to approve such nominations) made it clear that they would not support his nomination, and so the battle ended.

Part of what was at issue was the glass ceiling—another aspect of America’s inequality, reflected in differences in incomes and opportunities across gender. Yellen had distinguished herself, not only in managing the San Francisco Fed and serving as vice chair of the Fed, but in making forecasts that were more accurate than others. (The administration’s forecasts, in which Summers played a central role, were notoriously off the mark. He was constantly seeing greenshoots: a revival of the economy that would not occur until years later. Earlier, we noted the major political and economic mistake of the administration in underestimating the severity of the downturn.) Yellen’s evenhandedness and her acumen had generated enormous respect on Wall Street.

But the deeper battle was about economic philosophy and values. Summers had become synonymous with financial deregulation. He boasted of his role in passing the legislation that ensured that derivatives—the financial products that had played such a large role in the making of the crisis, and were responsible for the $180 billion AIG bailout—were not regulated. The administration’s strategy for saving the economy focused on saving the banks, with little help for homeowners. Its stimulus had been too small, too poorly designed, and too short.

I thought that Yellen might bring about some real changes in central banking, not only in the United States, but elsewhere as well. Central bank governors have long been generous with opinions about matters going well beyond monetary policy. While Greenspan made a mess of the financial sector, he freely gave advice on fiscal policy (supporting the tax cut for the rich, on the truly remarkable grounds that without such a tax cut, the country risked paying off the entire national debt, and that would make the conduct of monetary policy difficult!). In Europe the head of the European Central Bank similarly mismanaged the eurozone’s financial system, but he freely offered advice on labor market policy, arguing that there was a need for more wage flexibility—code words for saying that wages should be cut, increasing the economic divide in Europe.

Central banks typically focus single-mindedly on inflation. Even though in the United States the central bank is supposed to look also at unemployment and growth (and now, belatedly, at financial stability), de facto it focused on inflation. Yellen helped change that. In recent years, the Fed has announced that it won’t raise interest rates until the labor market improves.

More dramatic was the speech that Yellen gave at a conference at the Boston Fed on October 17, 2014, on inequality and inequality of opportunity. In a debate in the New York Times³ some suggested that this was going beyond the remit of the Fed—no matter that when other central bank governors opined on other aspects of economic policy, no
such criticism was levied. I believe strongly that Yellen was right to talk about inequality because the Fed has such a big impact. If it tightens monetary policy too much—raising interest rates too high or restricting credit availability too severely—unemployment will be higher than it otherwise would be, hurting workers both directly and indirectly, through the resulting downward pressure on wages. If it tightens prematurely—as soon as inflation seems nascent—it is likely that the share of wages will be ratcheted downward, for during the downturn, workers fare badly, and they have to be allowed to make up for what they lost.

While the main thrust of the Fed’s policy has been to restore the economy to full employment—a policy that would be an enormous boon to workers—some of what it has done may have contributed to inequality. One of the main effects of quantitative easing, the policy of buying long-term bonds to lower the long-term interest rate, has been to bolster the stock market—of benefit disproportionately to the rich. Meanwhile, its failure to do what it could and should have done to make the financial market work better for ordinary Americans—to ensure competition, to restrict the excessive fees that credit and debit cards charge to merchants that ultimately get paid by consumers, to restore lending to small and medium-size enterprises, to create a mortgage market that serves Americans rather than the interests of the banks—has hurt those in the middle and bottom at the same time that it has enriched the coffers of the banks.

Yellen is right, too, to point out (as I have done in this book) the limits to monetary policy. It is hard-pressed to restore the economy to full employment on its own. Indeed, it may be contributing to the jobless recovery that we are experiencing (the percentage of the working-age population that is employed, though it has rebounded slightly since the crisis, is still lower than at any time since 1984). Low interest rates encourage firms, when they invest, to invest in very capital intensive technologies—replacing unskilled workers with machines makes no sense in an era in which so many unskilled workers are striving to find jobs.

In some areas of policy the impacts on the poor are almost obvious. “The Insanity of Our Food Policy” discusses one such area—our food programs, upon which close to one out of seven Americans depend. At the time, Congress was debating major cutbacks to this program. But the Republicans in the House of Representatives who argued for such cutbacks were simultaneously supporting the continuation of massive agricultural subsidies for rich farmers. Seldom does one see so starkly the contradictions associated with government of the 1 percent, by the 1 percent, and for the 1 percent. Rhetoric about free markets is uncloaked for what it is: just rhetoric. The Republican-controlled House sustains a safety net for the rich as it renews the corporate welfare largesse for agro-business, even as it hacks away at the safety net for the poor.

Workers have often blamed globalization for their declining fortunes, and in several earlier books I explained how mismanaged globalization can increase inequality in both
developed and developing countries.

Trade agreements have always been sold on the grounds that they create jobs—and if that were true, workers should be among the loudest champions of these agreements. The reality is often otherwise, and the fact that our political leaders (not only Republicans but Clinton and Obama as well) have tried to misrepresent these trade agreements in this way undermines confidence in them, and again reminds citizens of the extent to which our government reflects the interests of those at the top.

There are at least three key flaws in the “logic” that trade agreements create jobs. Administrations across the political spectrum rightly point to the jobs created by the increased exports. But trade balance requires imports to roughly equal exports—and our trading partners would not sign an imbalanced agreement, in which our exports increased but theirs (our imports) did not do so commensurately. But if exports create jobs, imports destroy them. And then there is the careful and complex calculation: Are more jobs created or destroyed? Since our imports tend to be in labor-intensive industries (industries where many workers are required to produce a given value of output) and our exports (like airplanes) are high-technology industries requiring relatively little labor—and what labor is required is highly skilled—on net, it is plausible that balanced trade agreements destroy jobs.

The analysis I have just given assumes that markets are working well. But in recent years the American economy has not been working well: there is a high level of open and disguised unemployment. It is easier to destroy jobs than to create new ones. Competition from imports can destroy jobs overnight. Expanding exports requires expansion of existing firms and the creation of new firms. But when financial markets do not work well—and ours have not been working well—often firms that would like to expand can’t get the capital to do so. Entrepreneurs who would like to start a new business can’t get the funding they need.

Perhaps the most important point is that responsibility for maintaining the economy should lie not with trade but with monetary and fiscal authorities, with the Federal Reserve and the administration. Admittedly, they haven’t done a good job. But it is unlikely that trade will correct for their failures. Indeed, if the Fed were doing its job well, and the economy were at full employment, and the administration were correct that a trade agreement created net new jobs, then the Fed would respond by increasing interest rates, fully offsetting the alleged job creation benefits of the trade agreement.

Dishonesty is never the best policy, and the dishonest selling of trade agreements stands as a low point in public policy.

“On the Wrong Side of Globalization” and “The Free-Trade Charade” were written as President Obama promoted new trade agreements across the Pacific and Atlantic. While trade agreements may not create jobs—and arguably they destroy them—their real effects lie elsewhere. Among those effects is the exacerbation of the country’s already
high level of inequality. That this might be so has long been recognized—but politicians have been loath to mention this, and, ironically, some of the strongest advocates of free trade have been among those least willing to support policies that might mitigate some of these adverse effects.

The reasoning for why trade agreements increase inequality is simple. The effects are seen most clearly in a world of perfect markets—the kind of world imagined as the ideal by many of the advocates of globalization. In such a world, goods, capital, and, yes, even labor would move freely across boundaries. It should be obvious then that unskilled labor (or, for that matter, any factor of production) would have the same price anywhere in the world. And that means that unskilled workers in the United States would get paid the same wage as unskilled workers in China or India. And the level of that wage would almost surely be closer to that of India and China than to that of the United States. The big insight of modern economics was that trade in goods and services was effectively a substitute for the free movement of labor and capital: when China sells labor-intensive goods to the United States, it increases the demand for China’s labor and lowers the demand for that in America, raising wages there and lowering them here. Trade liberalization moves the wages of unskilled labor in the two countries closer together. And the wages of our workers is likely to go down more than theirs is likely to go up.

While economists have long debated the relative importance of this effect—compared with others that increase income inequality—there is a growing consensus that today the impact of trade on wages and inequality can be significant. Places in the country that used to produce goods that are now imported from China have seen a decline in employment and wages.

Unfortunately, our trade agreements are unbalanced in ways that make the inequality-generating effects worse. Advocates of these agreements have worked hard to promote the free flow of not only goods and services but also capital. But that has changed in a fundamental way the bargaining position of workers. If they demand decent wages, the employer can easily threaten to move the factory abroad—knowing that there are no barriers to the movement of his firm and the reverse flow of goods. This too undoubtedly weakens wages.

Ironically, many of the advocates of globalization not only propose to do nothing to help those who are being hurt by it, but say that workers should accept cutbacks in job protections and public services: globalization demands it, if we are to remain competitive, so goes the argument. In effect, they are admitting that workers have to take a hit with globalization. But if globalization does benefit the country as a whole, and if workers as a whole are worse off, what does that mean? It means that all the benefits of globalization—and more—go to the top, to the corporations and their owners.
These two essays argue, however, that the proposed *new* trade agreements are even more pernicious. Presumably, that’s one of the reasons that the negotiations have been conducted with such secrecy. Since tariffs are already very low, the new agreements are really about strengthening intellectual property rights—driving drug prices higher as the agreements try to put generic drugs at more of a competitive disadvantage—and undermining regulations that protect the environment, workers, consumers, and even the economy.

Most disturbing are the provisions that go euphemistically under the label of “investment provisions,” seemingly designed to protect property rights. Who could be against that? But when the United States proposed essentially the same provisions in an agreement across the Atlantic with Europeans, eyebrows were raised. It became clear that something else was going on. For Europe has good property rights—every bit as good as those in the United States. And if there was something wrong with Europe’s system of property rights, why should one want to correct it only for foreign firms and not for Europe’s own firms? Europe, too, has a good regulatory and judicial system. Why would one seek to replace a system for adjudicating disputes (in this case between firms and states) that is well established and well thought through (with good protections for both sides in the dispute, with transparent proceedings based on strong legal precedents) with arbitration proceedings, held in secret, with arbitrators who often have conflicts of interests with positions in other cases, without adequate provisions for appeal and judicial review? If the peculiar form of judicial proceedings called for by these agreements is really superior, why don’t we employ them more widely? And if so, shouldn’t there be a national debate in Congress, with the attorney general and the judiciary committees leading the deliberations—not the U.S. Trade Representative and the congressional committees involving trade?

The articles contend that the new trade agreements are simply an end run by corporate interests, to try to get through a trade agreement the kind of regulatory regime that they could never hope to get through open democratic debate. The agreements attempt to undermine safeguards that have been put into place over 50 years—and even the more recent safeguards meant to restrict the excesses of the financial sector. For these agreements seem to have the power even to restrict our ability and that of our trading partners to regulate the financial sector.

The other noxious set of provisions of these trade agreements are about intellectual property (IP). Intellectual property rights are important, but as I saw so clearly when I first became involved in these issues during the Clinton administration in discussions over the Uruguay Round trade negotiations, the provisions contained in our trade agreements are *not* those designed to advance the progress of science. They are designed to fatten the coffers of corporations, particularly in the pharmaceutical and entertainment industries. Indeed, there is a real concern that current provisions *retard* scientific progress.
The IP provisions of the new trade agreements are particularly aimed against generics. There is a bitter irony in Obama’s having fought so hard for a bill to create a more efficient health care sector—that would lower the cost of health care—now undermining his own efforts with an agreement that would almost surely drive prices of pharmaceuticals up.

In “How Intellectual Property Reinforces Inequality” I continue the discussion of the role that intellectual property plays in worsening the great divide, focusing on the dramatic case in which a private company attempted to patent a set of genes closely related to breast cancer—and then forcing anybody who wished to find out whether she was exposed to this risk to use its tests (which were not as good as those offered by others), paying an exorbitant price. Perhaps the worst inequality of all is the deprivation of life—and that’s what our IP system did. Fortunately, in this case, the Supreme Court ruled the patents invalid. Remarkably, even after the ruling, firms attempting to provide more affordable tests for these genes were sued.

Intellectual property law is not God given. It is man-made. It is a social construction supposedly designed to encourage innovation and the dissemination of knowledge. But there are many details that go into the law, and if one doesn’t get these details right, IP can inhibit innovation. For instance, one is supposed to obtain a patent only for new ideas, and that’s why patent laws embrace a standard of novelty. It has to be sufficiently novel. So too, patents are for a limited period only, 20 years. Drug companies try to extend their monopoly power by coming up with a minor improvement of their drugs. This is called evergreening. India took a tough stance—refusing to grant a patent for an obvious minor variant of a drug that would have simply extended the patent. “India’s Patently Wise Decision” explains why India was right to do so. Since then, the U.S. government has been putting pressure on India to change its policies, hoping that its new, business friendly government, headed by Prime Minister Narendra Modi, will be more receptive to doing a deal.

Bad as inequality in the United States is—and its level in the United States (after taxes and transfers) is the worst among the advanced countries—in some developing countries and emerging markets it is worse. (I talk about many of those countries in the next part of the book.) And just as there are many forms of inequality (inequalities of wealth, income, health, and opportunity), some may have more invidious societal effects than others. “Eliminating Extreme Inequality” was written with my Columbia political science colleague, and former assistant secretary-general of the UN, Michael Doyle, to promote the idea that some measure of reduction in extreme inequality be included in the sustainable development goals that were then under discussion at the UN. At the turn of the century, the UN had formulated a set of millennium development goals, to focus the world’s attention on achievable targets over the succeeding 15 years, including reducing poverty by half by 2015. The goals were more successful than even its most ardent advocates had hoped, not only in centering attention on the importance
of reducing poverty, in all of its manifestations, but even in achieving these goals.

Not surprisingly, as 2015 approached, the consensus was that a new set of goals should be formulated. But there has been extensive debate about the list of objectives to be included. Given my belief that inequality—especially the extremes of inequality being observed in many countries—was so bad for both the economy and society, it was natural that I would advocate including doing something about that in our global goals. I teamed up with Professor Doyle, because I wanted to highlight not just the economic consequences of inequality but also the political and broader societal consequences. One aspect of inequality that we draw attention to is inequality across ethnic groups. In developing countries this kind of inequality is systematically related to civil conflict. America, of course, has enormous inequalities of this form—differences between African-Americans, Hispanics, and other groups are very large. Disturbingly, while there has been progress at the very top, disparities in averages have improved little. Indeed, the Great Recession worsened wealth disparities.

The penultimate article in this section, “The Postcrisis Crises,” was motivated by my concern that, as so much attention was being focused on the Great Recession and its aftermath, we were doing too little about long-festering problems. If we didn’t begin to address them, we would inevitably face a series of other crises, such as climate change. In some cases, the crisis represented a lost opportunity—we could and should have used the crisis to make investments that would have helped us meet the challenges of climate change. If we had done that, our downturn would have been shallower, growth and employment would have been higher, and we would have emerged from the crisis in a stronger position to deal with global warming. In others, the crisis made matters worse. That was the case with inequality, which had been growing markedly over the past third of a century, and especially since the new millennium. Because the Fed and the administration focused on helping the banks and engineering a stock market boom—but did little about housing—wealth inequality continued to expand.\(^5\)

The final article in this section, “Inequality Is Not Inevitable,” was written as the last article for the *New York Times* Great Divide series; it harks back to my earlier article “Inequality Is a Choice” and was intended to recap the central messages and insights of the series that I had curated. Among the most important is that the high level of inequality in the United States is not just or mostly the result of underlying economic forces; rather, it is the result of how we shape those forces, through our *policies*, through our laws and regulations, our monetary, tax, and expenditure policies. Indeed, some other countries have as much, or almost as much, before-tax and transfer inequality; but those countries that have allowed market forces to play out in this way then trim back the inequality through taxes and transfer and the provision of public services. There are many other countries, however, that have managed to have a much lower level of market income inequality—and, as I have noted elsewhere, these countries have just as good overall economic performance as the United States. So not
only is inequality not inevitable, but there are policies that would enable us to have a more shared prosperity; indeed, with more sharing, we could have more prosperity.

Notes


3. The “Room for Debate” published October 28, 2014, to which I contributed, asked, “Should central bank policies attempt to offset inequality in economic outcome? Or should that be left exclusively to the political process?”


5. See the Federal Reserve’s October 2014 Survey of Consumer Finances for a summary of the expansion in wealth inequality since the recession. Median wealth is down 40 percent since the start of the crisis, from $135,400 in 2007 to $81,200 in 2013 (adjusted for inflation).
HOW POLICY HAS CONTRIBUTED TO THE GREAT ECONOMIC DIVIDE*

The United States is in the midst of a vicious cycle of inequality and recession: Inequality prolongs the downturn, and the downturn exacerbates inequality. Unfortunately, the austerity agenda advocated by conservatives will make matters worse on both counts.

The seriousness of America’s growing problem of inequality was highlighted by Federal Reserve data released this month showing the recession’s devastating effect on the wealth and income of those at the bottom and in the middle. The decline in median wealth, down almost 40 percent in just three years, wiped out two decades of wealth accumulation for most Americans. If the average American had actually shared in the country’s seeming prosperity the past two decades, his wealth, instead of stagnating, would have increased by some three-fourths.

In some ways the data confirmed what was already known, but the numbers still shocked. We knew that house prices—the principal source of saving for most Americans—had declined precipitously and that trillions of dollars in home equity had been wiped out. But unless we understand the link between inequality and economic performance, we risk pursuing policies that will worsen both.

America has “excelled” in inequality since at least the beginning of the millennium. Inequality is greater here than in any other advanced country. The data remind us how a combination of monetary, fiscal, and regulatory policies have contributed to these outcomes. Market forces play a role, but they are at play in other countries, too. Politics has much to do with the difference in outcomes.

The Great Recession has made this inequality worse, which is likely to prolong the downturn. Those at the top spend a smaller fraction of their income than do those in the bottom and middle—who have to spend everything today just to get by. Redistribution from the bottom to the top of the kind that has been going on in the United States lowers total demand. And the weakness in the U.S. economy arises out of deficient aggregate demand. The tax cuts passed under President George W. Bush in 2001 and 2003, aimed especially at the rich, were a particularly ineffective way of filling the gap; they put the burden of attaining full employment on the Fed, which filled the gap by creating a bubble, through lax regulations and loose monetary policy. And the bubble induced the bottom 80 percent of Americans to consume beyond their means. The policy worked, but it was a temporary and unsustainable palliative.

The Fed has consistently failed to understand the links between inequality and macroeconomic performance. Before the crisis, the Fed paid too little attention to inequality, focusing more on inflation than on employment. Many of the fashionable
models in macroeconomics said that the distribution of income didn’t matter. Fed officials’ belief in unfettered markets restrained them from doing anything about the abuses of the banks. Even a former Fed governor, Ed Gramlich, argued in a forceful 2007 book that something should be done, but nothing was. The Fed refused to use the authority to regulate the mortgage market that Congress gave it in 1994. After the crisis, as the Fed lowered interest rates—in a predictably futile attempt to stimulate investment—it ignored the devastating effect that these rates would have on those Americans who had behaved prudently and invested in short-term government bonds, as well as the macroeconomic effects from their reduced consumption. Fed officials hoped that low interest rates would lead to high stock prices, which would in turn induce rich stock owners to consume more. Today, persistent low interest rates encourage firms that do invest to use capital-intensive technologies, such as replacing low-skilled checkout clerks with machines. In this way, the Fed may still be contributing to a jobless recovery, when we finally do recover.

Matters may get worse. The austerity advocated by some Republicans will lead to higher unemployment, which will lead to lower wages as workers compete for jobs. Less growth will mean lower state and local tax revenue, leading to cutbacks in services important to most Americans (including the jobs of teachers, police officers, and firefighters). It will force further increases in tuition—data published this month show that the average tuition for a four-year public university climbed 15 percent between 2008 and 2010, while most Americans’ incomes and wealth were falling. This will lead to more student debt, more profits for bankers—but more pain at the bottom and middle. Some, seeing the consequences of their parents’ debts, won’t be willing to take on the levels of debt necessary to get a college education, condemning them to a life of lower wages. Even in the middle, incomes have been doing miserably; for male workers, inflation-adjusted median incomes are lower today than they were in 1968. Opportunity in America—already the country with the least equality of opportunity among the world’s advanced nations, where a child’s prospects depend more on the income and education of his parents than even in ossified Europe—will decline still further.

If we want recovery, there is no choice but to rely on fiscal policy. Fortunately, well-designed spending can lead simultaneously to more employment, growth, and equality. Further investments in education, especially aimed at the poor and middle class, from preschool to Pell Grants, would stimulate the economy, improve opportunity, and increase growth. Spending a fraction of the money the federal government gave to the banks to help underwater homeowners—or extending unemployment benefits for those who have long searched but failed to find a job—would simultaneously ease the burden of those suffering from the recession and help bring the recession to an end. This higher growth would, in turn, lead to higher tax revenue, improving our fiscal position. Plenty of investments would pay for themselves.
By contrast, if we go down the path of austerity, we risk entering a double-dip recession, especially if the European crisis worsens. At the very least, our downturn would be likely to last years longer than it otherwise would. Our growth in the future will be weaker. But perhaps most important, our country will increasingly become divided, and we will pay a high economic price for our growing inequality and declining opportunity. The consequences will be even harder on our democracy, our identity as a nation of opportunity and fair play, and our society.

WHY JANET YELLEN, NOT LARRY SUMMERS, SHOULD LEAD THE FED*

The controversy over the choice of the next head of the Federal Reserve has become unusually heated. The country is fortunate to have an enormously qualified candidate: the Fed’s current vice chairwoman, Janet L. Yellen. There is concern that the president might turn to another candidate, Lawrence H. Summers. Since I have worked closely with both of these individuals for more than three decades, both inside and outside of government, I have perhaps a distinct perspective.

But why, one might ask, is this a matter for a column usually devoted to understanding the growing divide between rich and poor in the United States and around the world? The reason is simple: What the Fed does has as much to do with the growth of inequality as virtually anything else. The good news is that both of the leading candidates talk as if they care about inequality. The bad news is that the policies that have been pushed by one of the candidates, Mr. Summers, have much to do with the woes faced by the middle and the bottom.

The Fed has responsibilities both in regulation and in macroeconomic management. Regulatory failures were at the core of America’s crisis. As a Treasury Department official during the Clinton administration, Mr. Summers supported banking deregulation, including the repeal of the Glass-Steagall Act, which was pivotal in America’s financial crisis. His great “achievement” as secretary of the Treasury, from 1999 to 2001, was passage of the law that ensured that derivatives would not be regulated—a decision that helped blow up the financial markets. (Warren E. Buffett was right to call these derivatives “financial weapons of mass financial destruction.” Some of those who were responsible for these key policy mistakes have admitted the fundamental “flaws” in their analyses. Mr. Summers, to my knowledge, has not.)

Regulatory failures have been at the center of previous crises as well. At Treasury in the 1990s, Mr. Summers encouraged countries to quickly liberalize their capital markets, to allow capital to flow in and out without restrictions—indeed insisted that they do so—against the advice of the White House Council of Economic Advisers (which I led from 1995 to 1997), and this more than anything else led to the Asian financial crisis. Few policies or actions have greater culpability for that Asian crisis and the global financial crisis of 2008 than the deregulatory policies that Mr. Summers advocated.

Supporters of Mr. Summers argue that he is exceptionally qualified to manage crises—and that, while we hope that there won’t be a crisis in the next four years, prudence requires someone who excels at those critical moments. To be fair, Mr. Summers has been involved in several crises. What matters, however, is not just “being there” during a crisis, but showing good judgment in its management. Even more important is a
commitment to taking actions to make another crisis less likely—in sharp contrast to measures that almost ensure the inevitability of another one.

Mr. Summers’s conduct and judgment in the crises was as flawed as his lack of commitment in that regard. In both Asia and the United States, he seemed to me to underestimate the severity of the downturns, and with forecasts that were so off, it was not a surprise that the policies were inappropriate. The performance of those in the Treasury who were responsible for managing the Asian crisis was, to say the least, disappointing—converting downturns into recessions and recessions into depressions. So, too, while the banking system was saved, and the United States avoided another depression, those responsible for managing the 2008 crisis cannot be credited with creating a robust, inclusive recovery. Botched efforts at mortgage restructuring, a failure to restore the flow of credit to small and medium-size enterprises, and the mishandling of the bailouts have all been well documented—as was the failure to foresee the severity of the economic collapse.

These issues are important to anyone concerned with inequality for four reasons. First, crises and how they are managed are real creators of poverty and inequality. Just look at what havoc this crisis wrought: median wealth fell by 40 percent, those in the middle still have not seen their incomes recover to precrisis levels, and those in the upper 1 percent enjoyed all the fruits of the recovery (and then some). It is ordinary workers who have suffered most: they are the ones who face high unemployment, who see their wages cut, and who bear the brunt of cutbacks in public services as a result of the budget austerity. They are the ones who lost their homes in the millions. The Obama administration could have done more, far more, to help homeowners, and to help localities maintain public services (for instance, through the kind of revenue sharing with states and localities that I urged at the beginning of the crisis).

Second, deregulation contributed to the financialization of the economy. It distorted our economy. It provided greater scope for those who manipulate the rules of the game for their benefit. As James K. Galbraith has forcefully argued, as we look around the world, bloated and underregulated financial sectors are closely linked with greater inequality. Those, like Britain, that emulated America’s deregulation have seen inequality soar, too.

Third, the most invidious aspect of this deregulation-induced inequality is that associated with the abusive practices of the financial sector—which prospers at the expense of ordinary Americans, through predatory lending, market manipulation, abusive credit card practices, or taking advantage of its monopoly power in the payments system. The Fed has enormous powers to prevent these abuses, and even more since the passage of the Dodd-Frank Act of 2010. Yet the central bank has repeatedly failed at this, systematically focusing on strengthening the banks’ balance sheets, at the expense of ordinary Americans.
Fourth, it is not only the case that America’s financial sector did what it shouldn’t have done, but it also didn’t do what it was supposed to do. Even today, there is a dearth of loans to small and medium-size enterprises. Good regulation would shift banks away from speculation and market manipulation, back to what should be their core business: making loans.

Whoever succeeds Ben S. Bernanke as the Fed’s leader will have to make repeated judgment calls about when to raise or lower interest rates, the levers of monetary policy.

Two elements enter into these judgments. The first is forecasting. Wrong forecasts lead to wrong policies. Without a good sense of direction of where the economy is going, one can’t take appropriate policies. Ms. Yellen has a superb record in forecasting where the economy is going—the best, according to the *Wall Street Journal*, of anyone at the Fed. As I noted earlier, Mr. Summers’s leaves something to be desired.

Ms. Yellen’s superlative performance should not come as a surprise. Janet Yellen, whom I taught at Yale, was one of the best students I have had, in 47 years of teaching at Columbia, Princeton, Stanford, Yale, MIT, and Oxford. She is an economist of great intellect, with a strong ability to forge consensus, and she has proved her mettle as chairwoman of the president’s Council of Economic Advisers (she succeeded me in that role), as president of the Federal Reserve Bank of San Francisco, from 2004 to 2010, and in her current role, as the Fed’s No. 2.

Ms. Yellen brings to bear an understanding not just of financial markets and monetary policy, but also of labor markets—which is essential at a time when unemployment and wage stagnation are primary concerns.

The second element of Fed policy making is risk assessment: if one steps on the brakes too hard, one risks excessively high unemployment; too gently, one risks inflation. Ms. Yellen has shown herself to be not only excellent in forecasting, but balanced. Legitimate questions have been raised: Would Mr. Summers, with his close connections with Wall Street, reflect financiers’ single-minded focus on inflation, and be more worried about the effects on bond prices than on ordinary Americans? In the past, central banks have focused excessively on inflation. Indeed, this single-minded focus, with little regard to financial stability, not only has contributed to the crisis, but, as I argued in my book *Freefall*, it has also contributed to the declining share of total income that is earned by ordinary workers.

Though the willingness to take actions to prevent crises, and good judgments in a crisis, are undoubtedly critical in the choice of the next Fed chair, there are other important considerations. The Fed is a large organization that has to be managed—and Ms. Yellen demonstrated her management skills at the San Francisco Fed. One has to obtain consensus among a diverse group of strong-minded individuals, some more worried about inflation, some more worried about unemployment. We need someone who knows how to build consensus, not someone who excels in bullying, who knows...
how to listen to and respect the views of others. When I was chairman of Economic Policy Committee of the Organization for Economic Cooperation and Development, I saw how effectively Ms. Yellen represented the United States, and the respect in which she was held. In the ensuing years, she has gained in stature, and today has the enormous respect of central bank governors around the world. She has the judgment, wisdom, and gravitas one should expect of the leader of the Fed.

Finally, the Fed is an enormously important institution, but regrettably, its conduct in the years before Ms. Yellen took up her role in Washington—both its failures in dealing with the bubble and certain aspects of its conduct in the immediate aftermath of the crisis (like the lack of transparency)—has undermined confidence in it. It is important that President Obama’s nominee not be—or even be seen to be—acting at the behest of financial markets. That person cannot be someone who can be tainted even by an accusation of conflict of interest, which is inevitable with the “revolving door” that has too often been associated with the regulation of this sector. Nor should it be someone who suffers from “cognitive capture” by Wall Street. At the same time, the person has to have the confidence of the financial markets, and a deep understanding of those markets. Ms. Yellen has managed to do this—an impressive achievement in its own right.

One might say that the country is fortunate to have two candidates who, as the Harvard economist Kenneth S. Rogoff, a former chief economist at the International Monetary Fund, writes, are “brilliant scholars with extensive experience in public service.” But brilliance is not the only determinant of performance. Values, judgment, and personality matter, too.

The choices have seldom been so stark, the stakes so large. No wonder that the choice of the Fed leader has stirred such emotion. Ms. Yellen has a truly impressive record in each of the jobs she has undertaken. The country has before it one candidate who played a pivotal role in creating the economic problems that we confront today, and another candidate of enormous stature, experience, and judgment.

American food policy has long been rife with headscratching illogic. We spend billions every year on farm subsidies, many of which help wealthy commercial operations to plant more crops than we need. The glut depresses world crop prices, harming farmers in developing countries. Meanwhile, millions of Americans live tenuously close to hunger, which is barely kept at bay by a food stamp program that gives most beneficiaries just a little more than $4 a day.

So it’s almost too absurd to believe that House Republicans are asking for a farm bill that would make all of these problems worse. For the putative purpose of balancing the country’s books, the measures that the House Republican caucus is pushing for in negotiations with the Senate, as Congress attempts to pass a long-stalled extension of the farm bill, would cut back the meager aid to our country’s most vulnerable and use the proceeds to continue fattening up a small number of wealthy American farmers.

The House has proposed cutting food stamp benefits by $40 billion over 10 years—that’s on top of $5 billion in cuts that already came into effect this month with the expiration of increases to the food stamp program that were included in the 2009 stimulus law. Meanwhile, House Republicans appear satisfied to allow farm subsidies, which totaled some $14.9 billion last year, to continue apace. Republican proposals would shift government assistance from direct payments—paid at a set rate to farmers every year to encourage them to keep growing particular crops, regardless of market fluctuations—to crop insurance premium subsidies. But this is unlikely to be any cheaper. Worse, unlike direct payments, the insurance premium subsidies carry no income limit for the farmers who would receive this form of largesse.

The proposal is a perfect example of how growing inequality has been fed by what economists call rent seeking. As small numbers of Americans have grown extremely wealthy, their political power has also ballooned to a disproportionate size. Small, powerful interests—in this case, wealthy commercial farmers—help create market-skewing public policies that benefit only themselves, appropriating a larger slice of the nation’s economic pie. Their larger slice means everyone else gets a smaller one—the pie doesn’t get any bigger—though the rent seekers are usually adept at taking little enough from individual Americans that they are hardly aware of the loss. While the money that they’ve picked from each individual American’s pocket is small, the aggregate is huge for the rent seeker. And this in turn deepens inequality.

The nonsensical arrangement being proposed in the House Republicans’ farm bill is an especially egregious version of this process. It takes real money, money that is necessary for bare survival, from the poorest Americans, and gives it to a small group of the undeserving rich, in return for their campaign contributions and political support. There is no economic justification: The bill actually distorts our economy by promoting
the kind of production we don’t need and shrinking the consumption of those with the smallest incomes. There is no moral justification either: It actually increases misery and precariousness of daily life for millions of Americans.

**Farm subsidies were** much more sensible when they began eight decades ago, in 1933, at a time when more than 40 percent of Americans lived in rural areas. Farm incomes had fallen by about a half in the first three years of the Great Depression. In that context, the subsidies were an antipoverty program.

Now, though, the farm subsidies serve a quite different purpose. From 1995 to 2012, 1 percent of farms received about $1.5 million each, which is more than a quarter of all subsidies, according to the Environmental Working Group. Some three-quarters of the subsidies went to just 10 percent of farms. These farms received an average of more than $30,000 a year—about 20 times the amount received by the average individual beneficiary last year from the federal Supplemental Nutrition Assistance Program, or SNAP, commonly called food stamps.

Today, food stamps are one of the main support beams in our antipoverty efforts. More than 80 percent of the 45 million or so Americans who participated in SNAP in 2011, the last year for which there is comprehensive data from the United States Department of Agriculture, had gross household incomes below the poverty level. (Since then, the total number of participants has expanded to nearly 48 million.) Even with that support, many of them experience food insecurity, that is, they had trouble putting food on the table at some point during the year.

Historically, food stamp programs and agricultural subsidies have been tied together. The two may seem strange bedfellows, but there is a rationale: There is a need to address both sides of the economics of food—production and consumption. Having a bounteous supply within a country does not ensure that the citizens of that country are well fed. The radical imbalance between farm subsidies to the wealthy and nutritional assistance to the neediest—an imbalance that the farm bill proposals would directly promote—is a painful testament to this established economic fact.

The Nobel Prize–winning economist Amartya Sen has reminded us that even famines are not necessarily caused by a lack of supply, but by a failure to get the food that exists to the people who need it. This was true in the Bengal famine of 1943 and in the Irish potato famine a century earlier: Ireland, controlled by its British masters, was exporting food even as its citizens died of starvation.

A similar dynamic is playing out in the United States. American farmers are heralded as among the most efficient in the world. Our country is the largest producer and exporter of corn and soybeans, to name just two of its biggest crops. And yet millions of Americans still suffer from hunger, and millions more would, were it not for the vital programs that government provides to prevent hunger and malnutrition—the programs that the Republicans are now seeking to cut back.
And there is an extra layer of irony to America’s food policies: While they encourage overproduction, they pay little attention to the quality and diversity of foods our farms produce. The heavy subsidization of corn, for instance, means that many unhealthful foods are relatively cheap. So grocery shopping on a tight budget often means choosing foods that are not nutritious. This is part of the reason that Americans face the paradox of hunger out of proportion to their wealth, along with some of the world’s highest obesity rates, and a high incidence of Type 2 diabetes. Poor Americans are especially at risk for obesity.

A few years ago, I was in India, a country of 1.2 billion, in which tens of millions face hunger on a daily basis, when a front-page headline blared that one in seven Americans faced food insecurity because they couldn’t afford the basic necessities of life. Indian friends I met that day and in the following week were puzzled by this news: How could it be that in the richest country of the world there was still hunger?

Their puzzlement was understandable: Hunger in this rich land is unnecessary. What my Indian friends didn’t understand is that 15 percent of Americans—and 22 percent of America’s children—live in poverty. Someone working full-time (2,080 hours a year) at the minimum wage of $7.25 would earn about $15,000 a year, far less than the poverty threshold for a family of four ($23,492 in 2012), and even less than the poverty level of a family of three.

This grim picture is a result of political decisions made in Washington that have helped create an economic system in which the undereducated must work exceptionally hard simply to remain in poverty.

This is not how America is supposed to work. In his famous 1941 “four freedoms” speech, Franklin D. Roosevelt enunciated the principle that all Americans should have certain basic economic rights, including “freedom from want.” These ideas were later embraced by the international community in the Universal Declaration of Human Rights, which also enshrined the right to adequate food. But while the United States was instrumental in advocating for these basic economic human rights on the international scene—and getting them adopted—America’s performance back home has been disappointing.

It is, of course, no surprise that with the high level of poverty millions of Americans have had to turn to the government to meet the basic necessities of life. And those numbers increased drastically with the onset of the Great Recession. The number of Americans on food stamps went up by more than 80 percent between 2007 and 2013.

To say that most of these Americans are technically poor only begins to get at the depth of their need. In 2012, for example, two in five SNAP recipients had gross incomes that were less than half of the poverty line. The amount they get from the program is very small—$4.39 a day per recipient. This is hardly enough to survive on, but it makes an enormous difference in the lives of those who get it: The Center on
Budget and Policy Priorities estimates that SNAP lifted four million Americans out of poverty in 2010.

Given the inadequacies of the existing programs to combat hunger and poor nutrition, and given the magnitude of poverty in the aftermath of the Great Recession, one might have thought that the natural response of our political leaders would be to expand programs enhancing food security. But the members of the Republican caucus in the House of Representatives see things differently. They seem to want to blame the victims—the poor who have been provided an inadequate public education and so lack marketable skills, and those who earnestly seek work, but can’t find any, because of an economic system that has stalled, with almost one out of seven Americans who would like to find full-time employment still unable to obtain it. Far from alleviating the impacts of these problems, the Republicans’ proposal would reinforce privation and inequalities.

And the calamitous effects of the Republicans’ proposal will reach even beyond our borders.

Viewed from a larger perspective, the farming subsidies, combined with the cutbacks in food stamps, increase global poverty and hunger. This is because, with American consumption diminished from what it otherwise would be and production increased, food exports will inevitably increase. Greater exports drive down global prices, hurting poor farmers around the world. Agriculture is the main source of livelihood for the 70 percent of the world’s poor living in rural areas, who overwhelmingly reside in developing countries.

The adoption of the House Republicans’ plan will reverberate in our economy through several channels. One is simply that poor families with diminished resources will tamp down growth. More pernicious is that the Republicans’ farm bill would deepen inequality—and not just through the immediate giveaways to wealthy farmers and corresponding cuts to the poor. Children with poor nutrition—whether they are hungry or ill because of bad diets—do not learn as well as those who are better fed.

By cutting back on food stamps, we are ensuring the perpetuation of inequality, and at that, one of its worst manifestations: the inequality of opportunity. When it comes to opportunity, America is doing an alarmingly bad job, as I’ve written before in this series. We are endangering our future because there will be a large coterie of people at the bottom who will not live up to their potential, who will not be able to make the contribution that they could have made, to the prosperity of the country as a whole.

All of this exposes the Republicans’ argument in favor of these food policies—a concern for our future, particularly the impact of the national debt on our children—as a dishonest and deeply cynical pretense. Not only has the intellectual undergirding of debt fetishism been knocked out (with the debunking of work by the Harvard economists Carmen M. Reinhart and Kenneth S. Rogoff that tied slowed growth to...
debt-to-GDP ratios above 90 percent). The Republicans’ farm bill also clearly harms both America’s children and the world’s in a variety of ways.

For these proposals to become law would be a moral and economic failure for the country.

ON THE WRONG SIDE OF GLOBALIZATION*

Trade agreements are a subject that can cause the eyes to glaze over, but we should all be paying attention. Right now, there are trade proposals in the works that threaten to put most Americans on the wrong side of globalization.

The conflicting views about the agreements are actually tearing at the fabric of the Democratic Party, though you wouldn’t know it from President Obama’s rhetoric. In his State of the Union address, for example, he blandly referred to “new trade partnerships” that would “create more jobs.” Most immediately at issue is the Trans-Pacific Partnership, or TPP, which would bring together 12 countries along the Pacific Rim in what would be the largest free-trade area in the world.

Negotiations for the TPP began in 2010, for the purpose, according to the United States Trade Representative, of increasing trade and investment, through lowering tariffs and other trade barriers among participating countries. But the TPP negotiations have been taking place in secret, forcing us to rely on leaked drafts to guess at the proposed provisions. At the same time, Congress introduced a bill this year that would grant the White House filibuster-proof fast-track authority, under which Congress simply approves or rejects whatever trade agreement is put before it, without revisions or amendments.

Controversy has erupted, and justifiably so. Based on the leaks—and the history of arrangements in past trade pacts—it is easy to infer the shape of the whole TPP, and it doesn’t look good. There is a real risk that it will benefit the wealthiest sliver of the American and global elite at the expense of everyone else. The fact that such a plan is under consideration at all is testament to how deeply inequality reverberates through our economic policies.

Worse, agreements like the TPP are only one aspect of a larger problem: our gross mismanagement of globalization.

Let’s tackle the history first. In general, trade deals today are markedly different from those made in the decades following World War II, when negotiations focused on lowering tariffs. As tariffs came down on all sides, trade expanded, and each country could develop the sectors in which it had strengths and as a result, standards of living would rise. Some jobs would be lost, but new jobs would be created.

Today, the purpose of trade agreements is different. Tariffs around the world are already low. The focus has shifted to “nontariff barriers,” and the most important of these—for the corporate interests pushing agreements—are regulations. Huge multinational corporations complain that inconsistent regulations make business costly. But most of the regulations, even if they are imperfect, are there for a reason: to protect workers, consumers, the economy, and the environment.
What’s more, those regulations were often put in place by governments responding to the democratic demands of their citizens. Trade agreements’ new boosters euphemistically claim that they are simply after regulatory harmonization, a clean-sounding phrase that implies an innocent plan to promote efficiency. One could, of course, get regulatory harmonization by strengthening regulations to the highest standards everywhere. But when corporations call for harmonization, what they really mean is a race to the bottom.

When agreements like the TPP govern international trade—when every country has agreed to similarly minimal regulations—multinational corporations can return to the practices that were common before the Clean Air and Clean Water Acts became law (in 1970 and 1972, respectively) and before the latest financial crisis hit. Corporations everywhere may well agree that getting rid of regulations would be good for corporate profits. Trade negotiators might be persuaded that these trade agreements would be good for trade and corporate profits. But there would be some big losers—namely, the rest of us.

These high stakes are why it is especially risky to let trade negotiations proceed in secret. All over the world, trade ministries are captured by corporate and financial interests. And when negotiations are secret, there is no way that the democratic process can exert the checks and balances required to put limits on the negative effects of these agreements.

The secrecy might be enough to cause significant controversy for the TPP. What we know of its particulars only makes it more unpalatable. One of the worst is that it allows corporations to seek restitution in an international tribunal, not only for unjust expropriation, but also for alleged diminution of their potential profits as a result of regulation. This is not a theoretical problem. Philip Morris has already tried this tactic against Uruguay, claiming that its antismoking regulations, which have won accolades from the World Health Organization, unfairly hurt profits, violating a bilateral trade treaty between Switzerland and Uruguay. In this sense, recent trade agreements are reminiscent of the Opium Wars, in which Western powers successfully demanded that China keep itself open to opium because they saw it as vital in correcting what otherwise would be a large trade imbalance.

Provisions already incorporated in other trade agreements are being used elsewhere to undermine environmental and other regulations. Developing countries pay a high price for signing on to these provisions, but the evidence that they get more investment in return is scant and controversial. And though these countries are the most obvious victims, the same issue could become a problem for the United States, as well. American corporations could conceivably create a subsidiary in some Pacific Rim country, invest in the United States through that subsidiary, and then take action against the United States government—getting rights as a “foreign” company that they would
not have had as an American company. Again, this is not just a theoretical possibility: There is already some evidence that companies are choosing how to funnel their money into different countries on the basis of where their legal position in relation to the government is strongest.

There are other noxious provisions. America has been fighting to lower the cost of health care. But the TPP would make the introduction of generic drugs more difficult, and thus raise the price of medicines. In the poorest countries, this is not just about moving money into corporate coffers: thousands would die unnecessarily. Of course, those who do research have to be compensated. That’s why we have a patent system. But the patent system is supposed to carefully balance the benefits of intellectual protection with another worthy goal: making access to knowledge more available. I’ve written before about how the system has been abused by those seeking patents for the genes that predispose women to breast cancer. The Supreme Court ended up rejecting those patents, but not before many women suffered unnecessarily. Trade agreements provide even more opportunities for patent abuse.

The worries mount. One way of reading the leaked negotiation documents suggests that the TPP would make it easier for American banks to sell risky derivatives around the world, perhaps setting us up for the same kind of crisis that led to the Great Recession.

In spite of all this, there are those who passionately support the TPP and agreements like it, including many economists. What makes this support possible is bogus, debunked economic theory, which has remained in circulation mostly because it serves the interests of the wealthiest.

Free trade was a central tenet of economics in the discipline’s early years. Yes, there are winners and losers, the theory went, but the winners can always compensate the losers, so that free trade (or even freer trade) is a win-win. This conclusion, unfortunately, is based on numerous assumptions, many of which are simply wrong.

The older theories, for instance, simply ignored risk, and assumed that workers could move seamlessly between jobs. It was assumed that the economy was at full employment, so that workers displaced by globalization would quickly move from low-productivity sectors (which had thrived simply because foreign competition was kept at bay through tariffs and other trade restrictions) to high-productivity sectors. But when there is a high level of unemployment, and especially when a large percentage of the unemployed have been out of work long-term (as is the case now), there can’t be such complacency.

Today, there are 20 million Americans who would like a full-time job but can’t get one. Millions have stopped looking. So there is a real risk that individuals moved from low productivity-employment in a protected sector will end up zero-productivity members of the vast ranks of the unemployed. This hurts even those who keep their
jobs, as higher unemployment puts downward pressure on wages.

We can argue over why our economy isn’t performing the way it’s supposed to—whether it’s because of a lack of aggregate demand, or because our banks, more interested in speculation and market manipulation than lending, are not providing adequate funds to small and medium-size enterprises. But whatever the reasons, the reality is that these trade agreements do risk increasing unemployment.

One of the reasons that we are in such bad shape is that we have mismanaged globalization. Our economic policies encourage the outsourcing of jobs: Goods produced abroad with cheap labor can be cheaply brought back into the United States. So American workers understand that they have to compete with those abroad, and their bargaining power is weakened. This is one of the reasons that the real median income of full-time male workers is lower than it was 40 years ago.

American politics today compounds these problems. Even in the best of circumstances, the old free-trade theory said only that the winners could compensate the losers, not that they would. And they haven’t—quite the opposite. Advocates of trade agreements often say that for America to be competitive, not only will wages have to be cut, but so will taxes and expenditures, especially on programs that are of benefit to ordinary citizens. We should accept the short-term pain, they say, because in the long run, all will benefit. But there is little evidence that the trade agreements will lead to faster or more profound growth or that in the long run most workers will benefit.

Critics of the TPP are so numerous because both the process and the theory that undergird it are bankrupt. Opposition has blossomed not just in the United States, but also in Asia, where the talks have stalled.

By leading a full-on rejection of fast-track authority for the TPP, the Senate majority leader, Harry Reid, seems to have given us all a little respite. Those who see trade agreements as enriching corporations at the expense of the 99 percent seem to have won this skirmish. But there is a broader war to ensure that trade policy—and globalization more generally—is designed so as to increase the standards of living of most Americans. The outcome of that war remains uncertain.

In this series, I have repeatedly made two points: The first is that the high level of inequality in the United States today, and its enormous increase during the past 30 years, is the cumulative result of an array of policies, programs, and laws. Given that the president himself has emphasized that inequality should be the country’s top priority, every new policy, program, or law should be examined from the perspective of its impact on inequality. Agreements like the TPP have contributed in important ways to this inequality. Corporations may profit, and it is even possible, though far from assured, that gross domestic product as conventionally measured will increase. But the well-being of ordinary citizens is likely to take a hit.
And this brings me to the second point that I have repeatedly emphasized: Trickle-down economics is a myth. Enriching corporations—as the TPP would—will not necessarily help those in the middle, let alone those at the bottom.

THE FREE-TRADE CHARADE*

Though nothing has come of the World Trade Organization’s Doha Development Round of global trade negotiations since they were launched almost a dozen years ago, another round of talks is in the works. But this time the negotiations will not be held on a global, multilateral basis; rather, two huge regional agreements—one transpacific, and the other transatlantic—are to be negotiated. Are the coming talks likely to be more successful?

The Doha round was torpedoed by the United States’ refusal to eliminate agricultural subsidies—a sine qua non for any true development round, given that 70 percent of those in the developing world depend on agriculture directly or indirectly. The U.S. position was truly breathtaking, given that the WTO had already judged that America’s cotton subsidies—paid to fewer than 25,000 rich farmers—were illegal. America’s response was to bribe Brazil, which had brought the complaint, not to pursue the matter further, leaving in the lurch millions of poor cotton farmers in sub-Saharan Africa and India, who suffer from depressed prices because of America’s largesse to its wealthy farmers.

Given this recent history, it now seems clear that the negotiations to create a free-trade area between the U.S. and Europe, and another between the U.S. and much of the Pacific (except for China), are not about establishing a true free-trade system. Instead, the goal is a managed trade regime—managed, that is, to serve the special interests that have long dominated trade policy in the West.

There are a few basic principles that those entering the discussions will, one hopes, take to heart. First, any trade agreement has to be symmetrical. If, as part of the Trans-Pacific Partnership (TPP), the U.S. demands that Japan eliminate its rice subsidies, the US should, in turn, offer to eliminate its production (and water) subsidies, not just on rice (which is relatively unimportant in the U.S.) but on other agricultural commodities as well.

Second, no trade agreement should put commercial interests ahead of broader national interests, especially when non-traderelated issues like financial regulation and intellectual property are at stake. America’s trade agreement with Chile, for example, impedes Chile’s use of capital controls—even though the International Monetary Fund now recognizes that capital controls can be an important instrument of macro-prudential policy.

Other trade agreements have insisted on financial liberalization and deregulation as well, even though the 2008 crisis should have taught us that the absence of good regulation can jeopardize economic prosperity. America’s pharmaceutical industry, which wields considerable clout with the office of the U.S. Trade Representative
(USTR), has succeeded in foisting on other countries an unbalanced intellectual-property regime, which, designed to fight generic drugs, puts profit ahead of saving lives. Even the U.S. Supreme Court has now said that the U.S. Patent Office went too far in granting patents on genes.

Finally, there must be a commitment to transparency. But those engaging in these trade negotiations should be forewarned: the U.S. is committed to a lack of transparency. The USTR’s office has been reluctant to reveal its negotiating position even to members of the U.S. Congress; on the basis of what has been leaked, one can understand why. The USTR’s office is backtracking on principles—for example, access to generic medicines—that Congress had inserted into earlier trade agreements, like that with Peru.

In the case of the TPP, there is a further concern. Asia has developed an efficient supply chain, with goods flowing easily from one country to another in the process of producing finished goods. But the TPP could interfere with that if China remains outside of it.

With formal tariffs already so low, negotiators will focus largely on nontariff barriers—such as regulatory barriers. But the USTR’s office, representing corporate interests, will almost surely push for the lowest common standard, leveling downward rather than upward. For example, many countries have tax and regulatory provisions that discourage large automobiles—not because they are trying to discriminate against U.S. goods, but because they worry about pollution and energy efficiency.

The more general point, alluded to earlier, is that trade agreements typically put commercial interests ahead of other values—the right to a healthy life and protection of the environment, to name just two. France, for example, wants a “cultural exception” in trade agreements that would allow it to continue to support its films—from which the whole world benefits. This and other broader values should be nonnegotiable.

Indeed, the irony is that the social benefits of such subsidies are enormous, while the costs are negligible. Does anyone really believe that a French art film represents a serious threat to a Hollywood summer blockbuster? Yet Hollywood’s greed knows no limit, and America’s trade negotiators take no prisoners. And that’s precisely why such items should be taken off the table before negotiations begin. Otherwise, arms will be twisted, and there is a real risk that an agreement will sacrifice basic values to commercial interests.

If negotiators created a genuine free-trade regime that put the public interest first, with the views of ordinary citizens given at least as much weight as those of corporate lobbyists, I might be optimistic that what would emerge would strengthen the economy and improve social well-being. The reality, however, is that we have a managed trade regime that puts corporate interests first, and a process of negotiations that is undemocratic and nontransparent.
The likelihood that what emerges from the coming talks will serve ordinary Americans’ interests is low; the outlook for ordinary citizens in other countries is even bleaker.

*Project Syndicate, July 4, 2013.*
HOW INTELLECTUAL PROPERTY REINFORCES INEQUALITY*

In the war against inequality, we’ve become so used to bad news that we’re almost taken aback when something positive happens. And with the Supreme Court having affirmed that wealthy people and corporations have a constitutional right to buy American elections, who would have expected it to bring good news? But a decision in the term that just ended gave ordinary Americans something that is more precious than money alone—the right to live.

At first glance, the case, *Association for Molecular Pathology v. Myriad Genetics*, might seem like scientific arcana: the court ruled, unanimously, that human genes cannot be patented, though synthetic DNA, created in the laboratory, can be. But the real stakes were much higher, and the issues much more fundamental, than is commonly understood. The case was a battle between those who would privatize good health, making it a privilege to be enjoyed in proportion to wealth, and those who see it as a right for all—and a central component of a fair society and well-functioning economy. Even more deeply, it was about the way inequality is shaping our politics, legal institutions, and the health of our population.

Unlike the bitter battles between Samsung and Apple, in which the referees (American courts), while making a pretense at balance, seem to consistently favor the home team, this was a case that was more than just a battle between corporate giants. It is a lens through which we can see the pernicious and far-reaching effects of inequality, what a victory over self-serving corporate behavior looks like and—just as important—how much we still risk losing in such fights.

Of course, the court and the parties didn’t frame the issues that way in their arguments and decision. A Utah firm, Myriad Genetics, had isolated two human genes, BRCA1 and BRCA2, that can contain mutations that predispose women who carry them to breast cancer—crucial knowledge for early detection and prevention. The company had successfully obtained patents for the genes. “Owning” the genes gave it the right to prevent others from testing for them. The core question of the case was seemingly technical: Are isolated, naturally occurring genes something that can be patented?

But the patents had devastating real-world implications, because they kept the prices for the diagnostics artificially high. Gene tests can actually be administered at low cost—a person can in fact have all 20,000 of her genes sequenced for about $1,000, to say nothing of much cheaper tests for a variety of specific pathologies. Myriad, however, charged about $4,000 for comprehensive testing on just two genes. Scientists have argued that there was nothing inherently special or superior about Myriad’s methods—it simply tested for genes that the company claimed to own, and did so by relying on data
that was not available to others because of the patents.

Hours after the Supreme Court’s ruling in favor of the plaintiffs—a group of universities, researchers, and patient advocates, represented by the American Civil Liberties Union and the Public Patent Foundation—other laboratories quickly announced that they would also begin offering tests for the breast cancer genes, underlining the fact that Myriad’s “innovation” was identifying existing genes, not developing the test for them. (Myriad is not done fighting, though, having filed two new lawsuits this month that seek to block the companies Ambry Genetics and Gene by Gene from administering their own BRCA tests, on the grounds that they violate other patents that Myriad holds.)

It should not be very surprising that Myriad has done everything it can to prevent its tests’ revenue stream from facing competition—indeed, after recovering somewhat from a 30 percent drop in the wake of the court ruling, its share price is still nearly 20 percent below what it was beforehand. It owned the genes, and didn’t want anybody trespassing on its property. In obtaining the patent, Myriad, like most corporations, seemed motivated more by maximizing profits than by saving lives—if it really cared about the latter, it could and would have done better at providing tests at lower costs and encouraged others to develop better, more accurate, and cheaper tests. Not surprisingly, it made labored arguments that its patents, which allowed monopolistic prices and exclusionary practices, were essential to incentivize future research. But when the devastating effects of its patents became apparent, and it remained adamant in exerting its full monopoly rights, these pretensions of interest in the greater good were woefully unconvincing.

The drug industry, as always, claimed that without patent protection, there would be no incentives for research and all would suffer. I filed an expert declaration with the court (pro bono), explaining why the industry’s arguments were wrong, and why this and similar patents actually impeded rather than fostered innovation. Other groups that filed amicus briefs supporting the plaintiffs, like AARP, pointed out that Myriad’s patents prevented patients from obtaining second opinions and confirmatory tests. Recently, Myriad pledged it would not block such tests—a pledge it made even as it filed the lawsuits against Ambry Genetics and Gene by Gene.

Myriad denied the test to two women in the case by rejecting their Medicaid insurance—according to the plaintiffs, because the reimbursement was too low. Other women, after one round of Myriad’s testing, had to make agonizing decisions about whether to have a single or double mastectomy, or whether to have their ovaries removed, with severely incomplete information—either Myriad’s testing for additional BRCA mutations was unaffordable (Myriad charges $700 extra for information that national guidelines say should be provided to patients), or second opinions were unattainable because of Myriad’s patents.
The good news coming from the Supreme Court was that in the United States, genes could not be patented. In a sense, the court gave back to women something they thought they already owned. This had two enormous practical implications: one is it meant that there could now be competition to develop better, more accurate, less expensive tests for the gene. We could once again have competitive markets driving innovation. And the second is that poor women would have a more equal chance to live—in this case, to conquer breast cancer.

But as important a victory as this is, it is ultimately only one corner of a global intellectual property landscape that is heavily shaped by corporate interests—usually American. And America has attempted to foist its intellectual property regime on others, through the World Trade Organization and bilateral and other multilateral trade regimes. It is doing so now in negotiations as part of the so-called Trans-Pacific Partnership. Trade agreements are supposed to be an important instrument of diplomacy: closer trade integration brings closer ties in other dimensions. But attempts by the office of the United States Trade Representative to persuade others that, in effect, corporate profits are more important than human lives undermines America’s international standing: if anything, it reinforces the stereotype of the crass American.

Economic power often speaks louder, though, than moral values; and in the many instances in which American corporate interests prevail in intellectual property rights, our policies help increase inequality abroad. In most countries, it’s much the same as in the United States: the lives of the poor are sacrificed at the altar of corporate profits. But even in those where, say, the government would provide a test like Myriad’s at affordable prices for all, there is a cost: when a government pays monopoly prices for a medical test, it takes money away that could be spent for other lifesaving health expenditures.

The Myriad case was an embodiment of three key messages in my book *The Price of Inequality*. First, I argued that societal inequality was a result not just of the laws of economics, but also of how we shape the economy—through politics, including through almost every aspect of our legal system. Here, it’s our intellectual property regime that contributes needlessly to the gravest form of inequality. The right to life should not be contingent on the ability to pay.

The second is that some of the most iniquitous aspects of inequality creation within our economic system are a result of “rent seeking”: profits, and inequality, generated by manipulating social or political conditions to get a larger share of the economic pie, rather than increasing the size of that pie. And the most iniquitous aspect of this wealth appropriation arises when the wealth that goes to the top comes at the expense of the bottom. Myriad’s efforts satisfied both these conditions: the profits the company gained from charging for its test added nothing to the size and dynamism of the economy, and simultaneously decreased the welfare of those who could not afford it.
While all of the insured contributed to Myriad’s profits—premiums had to go up to offset its fees, and millions of uninsured middle-income Americans who had to pay Myriad’s monopoly prices were on the hook for even more if they chose to get the test—it was the uninsured at the bottom who paid the highest price. With the test unaffordable, they faced a higher risk of early death.

Advocates of tough intellectual property rights say that this is simply the price we have to pay to get the innovation that, in the long run, will save lives. It’s a trade-off: the lives of a relatively few poor women today, versus the lives of many more women sometime in the future. But this claim is wrong in many ways. In this particular case, it is especially wrong, because the two genes would likely have been isolated (“discovered,” in Myriad’s terminology) soon anyway, as part of the global Human Genome Project. But it is wrong on other counts, as well. Genetic researchers have argued that the patent actually prevented the development of better tests, and so interfered with the advancement of science. All knowledge is based on prior knowledge, and by making prior knowledge less available, innovation is impeded. Myriad’s own discovery—like any in science—used technologies and ideas that were developed by others. Had that prior knowledge not been publicly available, Myriad could not have done what it did.

And that’s the third major theme. I titled my book to emphasize that inequality is not just morally repugnant but also has material costs. When the legal regime governing intellectual property rights is designed poorly, it facilitates rent seeking—and ours is poorly designed, though this and other recent Supreme Court decisions have led to one that is better than it otherwise would have been. And the result is that there is actually less innovation and more inequality.

Indeed, one of the important insights of Robert W. Fogel, a Nobel Prize–winning economic historian who died last month, was that a synergy between improved health and technology accounts for a good part of the explosive economic growth since the 19th century. So it stands to reason that intellectual property regimes that create monopoly rents that impede access to health both create inequality and hamper growth more generally.

There are alternatives. Advocates of intellectual property rights have overemphasized their role in promoting innovation. Most of the key innovations—from the basic ideas underlying the computer, to transistors, to lasers, to the discovery of DNA—were not motivated by pecuniary gain. They were motivated by the quest for knowledge. Of course, resources have to be made available. But the patent system is only one way, and often not the best way, of providing these resources. Government-financed research, foundations, and the prize system (which offers a prize to whoever makes a discovery, and then makes the knowledge widely available, using the power of the market to reap the benefits) are alternatives, with major advantages, and without the inequality-
increasing disadvantages of the current intellectual property rights system.

Myriad’s effort to patent human DNA was one of the worst manifestations of the inequality in access to health, which in turn is one of the worst manifestations of the country’s economic inequality. That the court decision has upheld our cherished rights and values is a cause for a sigh of relief. But it is only one victory in the bigger struggle for a more egalitarian society and economy.

INDIA’S PATENTLY WISE DECISION*

with Arjun Jayadev

THE INDIAN SUPREME COURT’S REFUSAL TO UPHOLD the patent on Gleevec, the blockbuster cancer drug developed by the Swiss pharmaceutical giant Novartis, is good news for many of those in India suffering from cancer. If other developing countries follow India’s example, it will be good news elsewhere, too: more money could be devoted to other needs, whether fighting AIDS, providing education, or making investments that enable growth and poverty reduction.

But the Indian decision also means less money for the big multinational pharmaceutical companies. Not surprisingly, this has led to an overwrought response from them and their lobbyists: the ruling, they allege, destroys the incentive to innovate, and thus will deal a serious blow to public health globally.

These claims are wildly overstated. In both economic and social-policy terms, the Indian court’s decision makes good sense. Moreover, it is only a localized effort at rebalancing a global intellectual property (IP) regime that is tilted heavily toward pharmaceutical interests at the expense of social welfare. Indeed, there is a growing consensus among economists that the current IP regime actually stifles innovation.

The impact of strong IP protection on social welfare has long been considered ambiguous. The promise of monopoly rights can spur innovation (though the most important discoveries, like that of DNA, typically occur within universities and government-sponsored research labs, and depend on other incentives). But there often are serious costs as well: higher prices for consumers, the dampening effect on further innovation of reducing access to knowledge, and, in the case of life-saving drugs, death for all who are unable to afford the innovation that could have saved them.

The weight given to each of these factors depends on circumstances and priorities, and should vary by country and time. Advanced industrialized countries in earlier stages of their development benefited from faster economic growth and greater social welfare by explicitly adopting weaker IP protection than is demanded of developing countries today. Even in the United States, there is growing concern that so-called hold-up patents and me-too patents—and the sheer thicket of patents, in which any innovation is likely to become entangled in someone else’s IP claims—are diverting scarce research resources away from their most productive uses.

India represents only about 1–2 percent of the global pharmaceutical market. But it has long been a flashpoint in battles over expansion of pharmaceutical companies’ global IP rights, owing to its dynamic generics industry and its willingness to challenge patent provisions both domestically and in foreign jurisdictions.
The revocation of patent protection for medicines in 1972 greatly expanded access to essential medicines, and led to the growth of a globally competitive domestic industry that is often called the “pharmacy of the developing world.” For example, production of antiretroviral drugs by Indian generic manufacturers such as Cipla has reduced the cost of life-saving AIDS treatment in sub-Saharan Africa to just 1 percent of the cost a decade ago.

Much of this globally valuable capacity was built under a regime of weak—in fact, non-existent—protection for pharmaceutical patents. But India is now bound by the World Trade Organization’s TRIPS agreement, and has revised its patent laws accordingly, causing widespread anxiety in the developing world about the implications for global provision of affordable medicines.

Indeed, the Gleevec decision is still only a small reversal for Western pharmaceuticals. Over the last two decades, lobbyists have worked to harmonize and strengthen a far stricter and globally enforceable IP regime. As a result, there are now numerous overlapping protections for pharmaceutical companies that are very difficult for most developing countries to contest, and that often pit their global obligations against their domestic obligations to protect their citizens’ lives and health.

According to the Indian Supreme Court, the country’s amended patent law still places greater weight on social objectives than in the U.S. and elsewhere: the standards of non-obviousness and novelty required to obtain a patent are stricter (especially as they pertain to medicines), and no “evergreening” of existing patents—or patent protection for incremental follow-up innovations—is allowed. The court thus reaffirmed India’s primary commitment to protecting its citizens’ lives and health.

The decision also highlighted an important fact: Despite its severe limitations, the TRIPS agreement does have some (rarely used) safeguards that give developing countries a certain degree of flexibility to limit patent protection. That is why the pharmaceutical industry, the U.S., and others have pushed since its inception for a wider and stronger set of standards through add-on agreements.

Such agreements would, for example, limit opposition to patent applications; prohibit national regulatory authorities from approving generic medicines until patents have expired; maintain data exclusivity, thereby delaying the approval of biogenic drugs; and require new forms of protection, such as anticounterfeiting measures.

There is a curious incoherence in the argument that the Indian decision undermines property rights. A critical institutional foundation for well-functioning property rights is an independent judiciary to enforce them. India’s Supreme Court has shown that it is independent, interprets the law faithfully, and does not easily succumb to global corporate interests. It is now up to the Indian government to use the TRIPS agreement’s safeguards to ensure that the country’s intellectual property regime advances both innovation and public health.
Globally, there is growing recognition of the need for a more balanced IP regime. But the pharmaceutical industry, trying to consolidate its gains, has been pushing instead for an ever stronger and more imbalanced IP regime. Countries considering agreements like the Trans-Pacific Partnership or bilateral “partnership” agreements with the U.S. and Europe need to be aware that this is one of the hidden objectives. What are being sold as “free-trade agreements” include IP provisions that could stifle access to affordable medicines, with a potentially significant impact on economic growth and development.

* Project Syndicate, April 8, 2013.
At the United Nations Millennium Summit in September 2000, UN member states took a dramatic step by putting people rather than states at the center of the UN’s agenda. In their Millennium Declaration, the assembled world leaders agreed to a set of breathtakingly broad goals touching on peace through development, the environment, human rights, the protection of the vulnerable, the special needs of Africa, and reforms of UN institutions. Particularly influential was the codification of the declaration’s development related objectives, which emerged in the summer of 2001 as the now familiar eight Millennium Development Goals (MDGs), to be realized by 2015:

1. Eradicate extreme poverty and hunger.
   • Halve the proportion of people living on less than a dollar a day and those who suffer from hunger.
2. Achieve universal primary education.
   • Ensure that all boys and girls complete primary school.
3. Promote gender equality and empower women.
   • Eliminate gender disparities in primary and secondary education preferably by 2005, and at all levels by 2015.
4. Reduce child mortality.
   • Reduce by two-thirds the mortality rate among children under five.
5. Improve maternal health.
   • Reduce by three-quarters the ratio of women dying in childbirth.
   • Halt and begin to reverse the spread of HIV/AIDS and the incidence of malaria and other major diseases.
7. Ensure environmental sustainability.
   • Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources.
   • By 2015, reduce by half the proportion of people without access to safe drinking water.
   • By 2020, achieve significant improvement in the lives of at least 100 million slum dwellers.
8. Develop a global partnership for development.
   • Develop further an open trading and financial system that includes a commitment to good governance, development, and poverty reduction—nationally and internationally.
• Address the special needs of the least developed countries, and the special needs of landlocked and small island developing states.
• Deal comprehensively with the debt problems of developing countries.
• Develop decent and productive work for youth.
• In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries.
• In cooperation with the private sector, make available the benefits of new technologies—especially information and communications technologies.

As UN Secretary-General Kofi Annan later described them, the MDGs were a remarkable effort in international coordination. They established common ground among competitive development agencies, inspired concerted action by international organizations and national governments, and offered an opportunity for citizens to insist that governments focus on the “we the peoples” they claimed to represent. In short, they transformed the agenda of world leaders.4

Fourteen years later, the MDG record has been mixed. Some goals, such as halving the proportion of people living in extreme poverty, have been met at the global level, but none have been fulfilled in all countries. Others, such as universal access to primary education, are unlikely to be achieved by 2015.5

However, while the accomplishment of these goals would have been an impressive achievement, even taken together they do not represent a complete or comprehensive vision of human development. They were constrained by what the member states could agree upon in 2000 and, in particular, they lacked a vision of equitable development.6 As the international community thinks about the set of goals that will follow the MDGs, it is time to address that shortcoming by adding the goal of “eliminating extreme inequality” to the original eight.

**Why Inequality Matters**

Every country has a distinct political economy that shapes the extent and effects of inequalities; each requires separate assessment. The marked differences in the extent and nature of inequality across countries demonstrate that inequality is not just determined by economic forces; it is shaped by politics and policies.

Full equality is not the goal. Some economic inequalities may be conducive to economic growth. Other inequalities may not be worth addressing because doing so infringes on cherished liberties. While the precise point at which inequalities turn harmful may differ from country to country, once inequality becomes extreme, harmful social, economic, and political effects become evident. Extreme inequalities tend to hamper economic growth and undermine both political equality and social stability. And because inequalities have cumulative economic, social, and political effects, each of these contributing factors requires separate and concerted attention. We turn first to the
economic arguments for reducing extreme inequalities, and then to the political and social arguments.

**Economic Arguments**

Economists of widely differing philosophical outlooks agree that inequalities of incomes and assets have harmful economic effects. Increasing inequalities, with top-heavy income distributions, lessen aggregate demand (the rich tend to spend a smaller fraction of their income than the poor), which can slow economic growth. The attempt of monetary authorities to offset these effects can contribute to credit bubbles, and these bubbles in turn lead to economic instability. That is why inequality is often associated with economic instability. In this perspective, it is not a surprise that inequality reached high levels before the Great Recession of 2008 and before the Great Depression of the 1930s. Recent International Monetary Fund research shows that high inequality is associated with shorter growth cycles.

Much of the inequality observed around the world is associated with rent seeking (for example, the exercise of monopoly power), and such inequality manifestly undermines economic efficiency. But perhaps the worse dimension of inequality is inequality of opportunity, which is both the cause and the consequence of inequality of outcomes, and causes economic inefficiency and reduced development, as large numbers of individuals are not able to live up to their potential. Countries with high inequality tend to invest less in public goods, such as infrastructure, technology, and education, which contribute to long-term economic prosperity and growth.

Reducing inequality, on the other hand, has clear economic as well as social benefits. It strengthens people’s sense that society is fair; improves social cohesion and mobility, making it more likely that more citizens live up to their potential; and broadens support for growth initiatives. Policies that aim for growth but ignore inequality may ultimately be self-defeating, whereas policies that decrease inequality by, for example, boosting employment and education have beneficial effects on the human capital that modern economies increasingly need.

**Political and Social Arguments**

Gaps between the rich and the poor are partly the result of economic forces, but equally, or even more, they are the result of public policy choices, such as taxation, the level of the minimum wage, and the amount invested in health care and education. This is why countries whose economic circumstances are otherwise similar can have markedly different levels of inequality. These inequalities in turn affect policy making because even democratically elected officials respond more attentively to the views of affluent
constituents than they do to the views of poor people. The more that wealth is allowed unrestricted roles in funding elections, the more likely it is that economic inequality will get translated into political inequality.

As noted, extreme inequalities undermine not only economic stability but also social and political stability. But there is no simple causal relation between economic inequality and social stability, as measured by crime or civil violence. Neither form of violence correlates with Gini indices or Palma ratios (the top 10 percent of the population’s share of gross national income [GNI] divided by the poorest 40 percent of the population’s share of GNI). There are, however, substantial links between violence and “horizontal inequalities” that combine economic stratification with race, ethnicity, religion, or region. When the poor are from one race, ethnicity, religion, or region, and the rich are from another, a lethal, destabilizing dynamic often emerges.

Drawing on 123 national surveys in 61 developing countries, one study carefully documents the effects of inequalities in assets among ethnicities. For a typical country with average values on all the variables accounting for violence, the probability of civil conflict in a given year is 2.3 percent. If the level of horizontal asset inequality among ethnic groups is increased to the 95th percentile (and the other variables remain at their average values), the probability of conflict increases to 6.1 percent—more than a twofold increase. A similar comparison focused on differences in income among religious groups shows an increase from 2.9 percent to 7.2 percent—again, more than twofold. Another study using similar methods finds regional disparities in wealth to be correlated with an especially high risk of conflict onset in sub-Saharan Africa.

Using a different methodology that focuses on geographical disparities in income that are linked with ethnic differentiation, rather than surveys to measure inequalities, other authors confirm the dangers of large horizontal inequalities. Focusing on the post–Cold War period (1991–2005), Lars-Erik Cederman, Nils Weidmann, and Kristian Gleditsch divide the total sum of economic production in a given ethnic settlement area by the group’s population size to get ethnic group–specific measures of per capita economic production. They find that both relatively poorer and relatively richer ethnic groups have higher likelihoods of experiencing civil war. Demonstrating that not just ethnographic factors are at work, they show that the richer (or the poorer) the ethnographic group is, the greater the likelihood of the extreme groups experiencing civil war with other ethnographic groups.

The Many Dimensions of Inequality

Just as discussions of poverty and poverty reduction expanded from a single-minded focus on income to many other dimensions of deprivation—including health and the environment—so too did they evolve in the case of inequality. Indeed, in most countries it appears that inequalities in wealth exceed those in income. Especially in
countries without adequate public health systems, a Palma ratio reflecting health status would almost surely show even greater inequalities than a Palma ratio for income. A Palma ratio based on exposures to environmental hazards would likely demonstrate a similar trend.

One of the most pernicious forms of inequality relates to inequality of opportunity, reflected in a lack of socioeconomic mobility, condemning those born into the bottom of the economic pyramid to almost surely remain there. Alan Krueger, former chairman of the U.S. Council of Economic Advisers, has pointed to this link between inequality and opportunity. Inequality of income tends to be associated with less economic mobility and fewer opportunities across generations. The fact that those born into the bottom of the economic pyramid are condemned to never reach their potential reinforces the correlation between inequality and slower long-term economic growth.

That these dimensions of inequality are related suggests that focusing on one dimension at a time may underestimate the true magnitude of societal inequalities and provide an inadequate basis for policy. For example, health inequality is both a cause and consequence of income inequality. Inequalities in education are a primary determinant of inequalities in income and opportunity. In turn, as we have emphasized, when there are distinct social patterns of these multiple inequalities (for example, those associated with race or ethnicity), the consequences for society (including social instability) are increased.

Measuring the Goal

We propose that the following goal—call it “Goal Nine”—be added to revisions and updates of the original eight: Eliminate extreme inequality at the national level in every country. For this goal, we propose the following targets:

- By 2030, reduce extreme income inequalities in all countries such that the post-tax income of the top 10 percent is no more than the post-transfer income of the bottom 40 percent.
- By 2020, establish a public commission in every country that will assess and report on the effects of national inequalities.

There is a growing consensus that the best indicator for these targets is the Palma ratio, which effectively focuses on extremes of inequality—the ratio of incomes at the very top to those at the bottom. In many countries around the world it is changes in these extremes that are most noticeable and most invidious, while the share of income in the middle is relatively stable. All countries should focus on their “extreme” inequalities, that is, the inequalities that do most harm to equitable and sustainable economic growth and that undermine social and political stability. A Palma ratio of 1 is an ideal reached in only a few countries. For example, countries in Scandinavia, with Palma ratios at 1 or less, do not seem to suffer from the liabilities associated with
extreme inequalities. Indeed, in some accounts they seem to benefit from a positive “equality multiplier” across the various aspects of their socioeconomic development, making them efficient and flexible as well as equitable and stable.\textsuperscript{23}

But countries differ not just in how unequal they are now but also in their culture, tolerance of inequality of various kinds, and capacity for social change. Hence, the more important target is the second one: a national dialogue by 2020 on what should be done to address the inequalities of most relevance to the particular country. Such a dialogue would draw attention to the policies in each country that exacerbate inequality (for example, deficiencies in the education system, the legal system, or the tax and transfer system); those that simultaneously distort the economy and contribute to economic, political, and social instability; and those that might most easily be altered.\textsuperscript{24}

Support for reducing extreme inequalities is widespread.\textsuperscript{25} In a letter to Dr. Homi Kharas, lead author and executive secretary of the secretariat supporting the High-Level Panel of Eminent Persons on the Post-2015 Development Agenda, 90 economists, academics, and development experts urged that reduction in inequality in the post-2015 development framework be made a priority, and suggested that inequality be measured using the Palma ratio.\textsuperscript{26} They argue—consistent with our analysis—that inequality threatens poverty eradication, sustainable development, democratic processes, and social cohesion.\textsuperscript{27}

Awareness of the adverse effects of inequality has moved beyond academics and social activists. A July 2013 speech by U.S. President Barack Obama outlined the role of inequality in creating credit bubbles (like the one that precipitated the Great Recession) and the way it deprives people of opportunity, which in turn fosters an inefficient economy in which the talents of many cannot be mobilized for the good of all.\textsuperscript{28} And Pope Francis, in his address in the Varginha slum of Rio de Janeiro on World Youth Day 2013, emphasized the need for greater solidarity, greater social justice, and special attention to the circumstances of youth. And, again consistent with the studies cited earlier, he declared that peace cannot be maintained in unequal societies with marginalized communities.\textsuperscript{29}

There are many dimensions to inequality—some with more invidious effects than others—and many ways to measure these inequalities. One thing is certain, however: sustainable development cannot be achieved while ignoring extreme disparities. It is imperative that the post-MDG agenda have as one of its central points a focus on inequality.

\textit{Notes}


2. As announced in the appendix to the “Roadmap Report,” UN document A/56/326 of September 6, 2001. The UN member states tasked the UN secretary-general with preparing a “roadmap” that would develop and monitor “results and benchmarks” (“Follow-up to the Outcome of the Millennium Summit,” UN document A/RES/55/162, December 18, 2000). For an analysis of the origins and significance of

3. The original indicator was $1 a day, which has since been raised to $1.25 to reflect inflation.


8. Ibid.


11. Easterly, “Inequality Does Cause Underdevelopment.”


13. We would prefer a measure of post-tax (after all income and other taxes) and post-transfer incomes (after housing, child care, social security, and other subsidies), but this is not yet widely available. Unofficial Palma ratios by country available upon request. To request this unofficial data, please contact Alicia Evangelides at ame2148@columbia.edu.


17. The World Bank’s classic study Voices of the Poor highlighted that the poor suffered not just from a lack of income but from insecurity and a lack of voice. This was subsequently reflected in the decennial World Bank’s World Development Report on Poverty in 2000. The International Commission on the Measurement of Economic Performance and Social Well-Being (2010) emphasized that metrics of performance (including output and inequality) had to be expanded beyond just conventional measures of GDP and/or income. The OECD has carried on this work in their Better Living Initiative, including the construction of the Better Life Index. An important part of the agenda of the OECD High Level Expert Group on the Measurement of Economic Performance and Social Well-Being is the construction/evaluation of alternative measures of inequality.


This is not true, however, for all countries. In the United States, for instance, there has been a hollowing out of the middle class, with a declining fraction of the population between, say, twice and half median income and a declining fraction of income going to this group. It has long been thought that a stable democracy depends on a thriving middle class. If so, the decline of the middle class should be of special concern. (For a fuller discussion of these issues, see Stiglitz, *The Price of Inequality.*) Part of the national dialogues on inequality that we recommend below would focus on the nature of the inequality that is emerging in various countries.


For instance, in the United States, such a dialogue would note inequalities in access to education and health; a bankruptcy code that gives first priority to derivatives and makes student loans difficult to discharge, even in bankruptcy; a tax system that taxes income of the rich derived from speculation at much lower rates than wage income; a minimum wage that, adjusted for inflation, has not increased in half a century; and a system of social protection that does a much poorer job in “correcting” inequalities in income than systems in other advanced industrial countries. It would analyze the extent to which disparities in income are a result of differences in productivities, with differences in productivity in turn partly explained by disparities in access to quality education; the extent to which disparities in income are related to rent seeking; and the extent to which such disparities can be accounted for by inheritances.


See the letter to Dr. Homi Kharas of the Brookings Institution from 90 economists, academics, and development experts supporting the use of the Palma ratio as a measure of inequality at www.post2015hlp.org/wp-content/uploads/2013/03/Dr-Homi-Kharas.pdf.


* Ethics and International Affairs, March 20, 2014. The authors have benefited from the research assistance of Alicia Evanglades, Eamon Kircher-Allen, and Laurence Wilsé-Samson.
IN THE SHADOW OF THE EURO CRISIS AND AMERICA’S FISCAL CLIFF, IT IS EASY TO IGNORE THE GLOBAL ECONOMY’S LONG-TERM PROBLEMS. BUT, WHILE WE FOCUS ON IMMEDIATE CONCERNS, THEY CONTINUE TO FESTER, AND WE OVERLOOK THEM AT OUR PERIL.

THE MOST SERIOUS IS GLOBAL WARMING. WHILE THE GLOBAL ECONOMY’S WEAK PERFORMANCE HAS LED TO A CORRESPONDING SLOWDOWN IN THE INCREASE IN CARBON EMISSIONS, IT AMOUNTS TO ONLY A SHORT RESPITE. AND WE ARE FAR BEHIND THE CURVE: BECAUSE WE HAVE BEEN SO SLOW TO RESPOND TO CLIMATE CHANGE, ACHIEVING THE TARGETED LIMIT OF A TWO-DEGREE (CENTIGRADE) RISE IN GLOBAL TEMPERATURE WILL REQUIRE SHARP REDUCTIONS IN EMISSIONS IN THE FUTURE.

SOME SUGGEST THAT, GIVEN THE ECONOMIC SLOWDOWN, WE SHOULD PUT GLOBAL WARMING ON THE BACKBURNER. ON THE CONTRARY, RETROFITTING THE GLOBAL ECONOMY FOR CLIMATE CHANGE WOULD HELP TO RESTORE AGGREGATE DEMAND AND GROWTH.

AT THE SAME TIME, THE PACE OF TECHNOLOGICAL PROGRESS AND GLOBALIZATION NECESSITATES RAPID STRUCTURAL CHANGES IN BOTH DEVELOPED AND DEVELOPING COUNTRIES ALIKE. SUCH CHANGES CAN BE TRAUMATIC, AND MARKETS OFTEN DO NOT HANDLE THEM WELL.

JUST AS THE GREAT DEPRESSION AROSE IN PART FROM THE DIFFICULTIES IN MOVING FROM A RURAL, AGRARIAN ECONOMY TO AN URBAN, MANUFACTURING ONE, SO TODAY’S PROBLEMS ARISE PARTLY FROM THE NEED TO MOVE FROM MANUFACTURING TO SERVICES. NEW FIRMS MUST BE CREATED, AND MODERN FINANCIAL MARKETS ARE BETTER AT SPECULATION AND EXPLOITATION THAN THEY ARE AT PROVIDING FUNDS FOR NEW ENTERPRISES, ESPECIALLY SMALL AND MEDIUM-SIZE COMPANIES.

MOREOVER, MAKING THE TRANSITION REQUIRES INVESTMENTS IN HUMAN CAPITAL THAT INDIVIDUALS OFTEN CANNOT AFFORD. AMONG THE SERVICES THAT PEOPLE WANT ARE HEALTH CARE AND EDUCATION, TWO SECTORS IN WHICH GOVERNMENT NATURALLY PLAYS AN IMPORTANT ROLE (OWING TO INHERENT MARKET IMPERFECTIONS IN THESE SECTORS AND CONCERNS ABOUT EQUITY).

BEFORE THE 2008 CRISIS, THERE WAS MUCH TALK OF GLOBAL IMBALANCES, AND THE NEED FOR THE TRADE-SURPLUS COUNTRIES, LIKE GERMANY AND CHINA, TO INCREASE THEIR CONSUMPTION. THAT ISSUE HAS NOT GONE AWAY; INDEED, GERMANY’S FAILURE TO ADDRESS ITS CHRONIC EXTERNAL SURPLUS IS PART AND PARCEL OF THE EURO CRISIS. CHINA’S SURPLUS, AS A PERCENTAGE OF GDP, HAS FALLEN, BUT THE LONG-TERM IMPLICATIONS HAVE YET TO PLAY OUT.

AMERICA’S OVERALL TRADE DEFICIT WILL NOT DISAPPEAR WITHOUT AN INCREASE IN DOMESTIC SAVINGS AND A MORE FUNDAMENTAL CHANGE IN GLOBAL MONETARY ARRANGEMENTS. THE FORMER WOULD EXACERBATE THE COUNTRY’S SLOWDOWN, AND NEITHER CHANGE IS IN THE CARDS. AS CHINA INCREASES ITS CONSUMPTION, IT WILL NOT NECESSARILY BUY MORE GOODS FROM THE UNITED STATES. IN FACT, IT IS MORE LIKELY TO INCREASE CONSUMPTION OF NONTRADED GOODS—LIKE HEALTH CARE AND EDUCATION—RESULTING IN PROFOUND DISTURBANCES TO THE GLOBAL SUPPLY CHAIN, ESPECIALLY IN COUNTRIES THAT HAD BEEN SUPPLYING THE INPUTS TO CHINA’S MANUFACTURING EXPORTERS.
Finally, there is a worldwide crisis in inequality. The problem is not only that the top income groups are getting a larger share of the economic pie, but also that those in the middle are not sharing in economic growth, while in many countries poverty is increasing. In the U.S., equality of opportunity has been exposed as a myth.

While the Great Recession has exacerbated these trends, they were apparent long before its onset. Indeed, I (and others) have argued that growing inequality is one of the reasons for the economic slowdown, and is partly a consequence of the global economy’s deep, ongoing structural changes.

An economic and political system that does not deliver for most citizens is one that is not sustainable in the long run. Eventually, faith in democracy and the market economy will erode, and the legitimacy of existing institutions and arrangements will be called into question.

The good news is that the gap between the emerging and advanced countries has narrowed greatly in the last three decades. Nonetheless, hundreds of millions of people remain in poverty, and there has been only a little progress in reducing the gap between the least developed countries and the rest.

Here, unfair trade agreements—including the persistence of unjustifiable agricultural subsidies, which depress the prices upon which the income of many of the poorest depend—have played a role. The developed countries have not lived up to their promise in Doha in November 2001 to create a pro-development trade regime, or to their pledge at the G-8 summit in Gleneagles in 2005 to provide significantly more assistance to the poorest countries.

The market will not, on its own, solve any of these problems. Global warming is a quintessential “public goods” problem. To make the structural transitions that the world needs, we need governments to take a more active role—at a time when demands for cutbacks are increasing in Europe and the U.S.

As we struggle with today’s crises, we should be asking whether we are responding in ways that exacerbate our long-term problems. The path marked out by the deficit hawks and austerity advocates both weakens the economy today and undermines future prospects. The irony is that, with insufficient aggregate demand the major source of global weakness today, there is an alternative: invest in our future, in ways that help us to address simultaneously the problems of global warming, global inequality and poverty, and the necessity of structural change.

*Project Syndicate, January 7, 2013.*
INEQUALITY IS NOT INEVITABLE*

An insidious trend has developed over this past third of a century. A country that experienced shared growth after World War II began to tear apart, so much so that when the Great Recession hit in late 2007, one could no longer ignore the fissures that had come to define the American economic landscape. How did this “shining city on a hill” become the advanced country with the greatest level of inequality?

One stream of the extraordinary discussion set in motion by Thomas Piketty’s timely, important book, Capital in the Twenty-First Century, has settled on the idea that violent extremes of wealth and income are inherent in capitalism. In this scheme, we should view the decades after World War II—a period of rapidly falling inequality—as an aberration.

This is actually a superficial reading of Mr. Piketty’s work, which provides an institutional context for understanding the deepening of inequality over time. Unfortunately, that part of his analysis received somewhat less attention than the more fatalistic-seeming aspects.

Over the past year and a half, The Great Divide, a series in the New York Times for which I have served as moderator, has also presented a wide range of examples that undermine the notion that there are any truly fundamental laws of capitalism. The dynamics of the imperial capitalism of the 19th century needn’t apply in the democracies of the 21st. We don’t need to have this much inequality in America.

Our current brand of capitalism is an ersatz capitalism. For proof of this go back to our response to the Great Recession, where we socialized losses, even as we privatized gains. Perfect competition should drive profits to zero, at least theoretically, but we have monopolies and oligopolies making persistently high profits. CEOs enjoy incomes that are on average 295 times that of the typical worker, a much higher ratio than in the past, without any evidence of a proportionate increase in productivity.

If it is not the inexorable laws of economics that have led to America’s great divide, what is it? The straightforward answer: our policies and our politics. People get tired of hearing about Scandinavian success stories, but the fact of the matter is that Sweden, Finland, and Norway have all succeeded in having about as much growth in per capita incomes as, or even faster growth than, the United States and with far greater equality.

So why has America chosen these inequality-enhancing policies? Part of the answer is that as World War II faded into memory, so too did the solidarity it had engendered. As America triumphed in the Cold War, there didn’t seem to be a viable competitor to our economic model. Without this international competition, we no longer had to show that our system could deliver for most of our citizens.

Ideology and interests combined nefariously. Some drew the wrong lesson from the
collapse of the Soviet system. The pendulum swung from much too much government there to much too little here. Corporate interests argued for getting rid of regulations, even when those regulations had done so much to protect and improve our environment, our safety, our health, and the economy itself.

But this ideology was hypocritical. The bankers, among the strongest advocates of laissez-faire economics, were only too willing to accept hundreds of billions of dollars from the government in the bailouts that have been a recurring feature of the global economy since the beginning of the Thatcher-Reagan era of “free” markets and deregulation.

The American political system is overrun by money. Economic inequality translates into political inequality, and political inequality yields increasing economic inequality. In fact, as he recognizes, Mr. Piketty’s argument rests on the ability of wealth-holders to keep their after-tax rate of return high relative to economic growth. How do they do this? By designing the rules of the game to ensure this outcome; that is, through politics.

So corporate welfare increases as we curtail welfare for the poor. Congress maintains subsidies for rich farmers as we cut back on nutritional support for the needy. Drug companies have been given hundreds of billions of dollars as we limit Medicaid benefits. The banks that brought on the global financial crisis got billions while a pittance went to the homeowners and victims of the same banks’ predatory lending practices. This last decision was particularly foolish. There were alternatives to throwing money at the banks and hoping it would circulate through increased lending. We could have helped underwater homeowners and the victims of predatory behavior directly. This would not only have helped the economy, it would have put us on the path to robust recovery.

Our divisions are deep. Economic and geographic segregation have immunized those at the top from the problems of those down below. Like the kings of yore, they have come to perceive their privileged positions essentially as a natural right. How else to explain the recent comments of the venture capitalist Tom Perkins, who suggested that criticism of the 1 percent was akin to Nazi fascism, or those coming from the private equity titan Stephen A. Schwarzman, who compared asking financiers to pay taxes at the same rate as those who work for a living to Hitler’s invasion of Poland.

Our economy, our democracy, and our society have paid for these gross inequities. The true test of an economy is not how much wealth its princes can accumulate in tax havens, but how well off the typical citizen is—even more so in America, where our self-image is rooted in our claim to be the great middle-class society. But median incomes are lower than they were a quarter-century ago. Growth has gone to the very, very top, whose share has almost quadrupled since 1980. Money that was meant to have trickled down has instead evaporated in the balmy climate of the Cayman Islands.

With almost a quarter of American children younger than five living in poverty, and
with America doing so little for its poor, the deprivations of one generation are being visited upon the next. Of course, no country has ever come close to providing complete equality of opportunity. But why is America one of the advanced countries where the life prospects of the young are most sharply determined by the income and education of their parents?

Among the most poignant stories in The Great Divide were those that portrayed the frustrations of the young, who yearn to enter our shrinking middle class. Soaring tuitions and declining incomes have resulted in larger debt burdens. Those with only a high school diploma have seen their incomes decline by 13 percent over the past 35 years.

Where justice is concerned, there is also a yawning divide. In the eyes of the rest of the world and a significant part of its own population, mass incarceration has come to define America—a country, it bears repeating, with about 5 percent of the world’s population but around a fourth of the world’s prisoners.

Justice has become a commodity, affordable to only a few. While Wall Street executives used their high-retainer lawyers to ensure that their ranks were not held accountable for the misdeeds that the crisis in 2008 so graphically revealed, the banks abused our legal system to foreclose on mortgages and evict people, some of whom did not even owe money.

More than a half-century ago, America led the way in advocating for the Universal Declaration of Human Rights, adopted by the United Nations in 1948. Today, access to health care is among the most universally accepted rights, at least in the advanced countries. America, despite the implementation of the Affordable Care Act, is the exception. It has become a country with great divides in access to health care, life expectancy, and health status.

In the relief that many felt when the Supreme Court did not overturn the Affordable Care Act, the implications of the decision for Medicaid were not fully appreciated. Obamacare’s objective—to ensure that all Americans have access to health care—has been stymied: 24 states have not implemented the expanded Medicaid program, which was the means by which Obamacare was supposed to deliver on its promise to some of the poorest.

We need not just a new war on poverty but a war to protect the middle class. Solutions to these problems do not have to be newfangled. Far from it. Making markets act like markets would be a good place to start. We must end the rent-seeking society we have gravitated toward, in which the wealthy obtain profits by manipulating the system.

The problem of inequality is not so much a matter of technical economics. It’s really a problem of practical politics. Ensuring that those at the top pay their fair share of taxes
—ending the special privileges of speculators, corporations, and the rich—is both pragmatic and fair. We are not embracing a politics of envy if we reverse a politics of greed. Inequality is not just about the top marginal tax rate but also about our children’s access to food and the right to justice for all. If we spent more on education, health, and infrastructure, we would strengthen our economy, now and in the future. Just because you’ve heard it before doesn’t mean we shouldn’t try it again.

We have located the underlying source of the problem: political inequities and policies that have commodified and corrupted our democracy. It is only engaged citizens who can fight to restore a fairer America, and they can do so only if they understand the depths and dimensions of the challenge. It is not too late to restore our position in the world and recapture our sense of who we are as a nation. Widening and deepening inequality is not driven by immutable economic laws, but by laws we have written ourselves.

PART VII

REGIONAL PERSPECTIVES
Inequality has become an international issue. There is a general pattern here: those countries that have followed the U.S. economic model, including the heavy financialization of the economy, have wound up with similar results. Thus the UK, which has followed the U.S. model most closely (and in some cases was its inspiration: there were many similarities between the policies and ideologies of Prime Minister Thatcher and those of President Reagan), has, not surprisingly, the highest level of inequality among the advanced countries, next to that of the United States. Countries pay a high price for this inequality; at stake is not just inequality of incomes but also inequality of opportunity.

Over the past quarter century, I have had the good fortune to be able to travel around the world, talking to governments, students, fellow economists, labor groups, civic societies, and business people. I have been particularly interested in how economics and politics interact differently in different countries: how some countries have been able to achieve more equal societies and societies with greater equality of opportunity.

The articles presented in this section sample these different developments around the world. I begin with “The Mauritius Miracle.” One can never predict when an article will hit a resonant chord, but this one did. Tiny Mauritius, in the Indian Ocean east of Africa, has long been viewed as one of the real success cases of development. Its economy has grown rapidly. One of the reasons for my visit was to understand better why. The not-surprising answer, told to me by the president, who had been prime minister in the early days of the country’s rapid growth, was that they had been greatly influenced by the model of East Asia’s development, where the state played a central role in promoting development (giving rise to the term “developmental state”).

But what especially intrigued me about Mauritius was how this relatively poor country managed to provide free health care and free college education for all of its citizens—when the United States seemingly says it can’t afford them. It even provides free transportation to its youth and elderly—the former because they are the country’s future, the latter because of what they have done for society. The point I made was a simple one: we could afford to provide these services to all Americans. The investments in our young people would make our country stronger. Most countries view access to basic health care as a basic human right. The fact that we don’t is a matter of choice, a reflection of priorities—priorities set by a political process where disproportionate weight is given to the interests and views of the top.

Nothing made this so clear as the events surrounding the recent financial crisis. Shortly before then, President Bush had vetoed a bill providing health insurance for poor children, saying that we couldn’t afford it. Somehow, though, we suddenly found $700 billion to bail out banks—and more than $150 billion to rescue one wayward company. We had money to provide a safety net for the rich, but not for the poor. The argument was that, in doing so, the economy would be saved and everyone would
benefit. This was, of course, nothing more than a naked version of trickle-down economics. It didn’t work that way—those at the top did very well, while the typical American is worse off than he was a quarter-century ago.

The experience of Mauritius shows that, on the contrary, investing in people does pay off.

East Asia, as I noted earlier, is the region of the world that has been most successful in development—with per capita incomes increasing by as much as eightfold in 30 years. Indeed, previously no one, not even the most optimistic economist, had thought such rapid growth was possible. No wonder, then, that what happened in these countries has been a subject of intense study. What is clear is that these countries did not follow the market fundamentalist model; markets played a critical role in their success, but it was managed markets, managed for the benefits of society as a whole, not for that of a few shareholders or managers; it was a market economy in which the government played the role of an orchestra conductor. It catalyzed growth, investing heavily in technology, education, and infrastructure.

A central feature of most of these countries was a shared prosperity—inequality, as conventionally measured, was low; there was heavy investment in female education. They created the middle-class society that America had thought of itself as being—back in the years after World War II.

Among the most successful economically of the East Asian countries was Singapore, a small island state with today some five and a half million people. When it was thrown out of what was then called Malaya in 1969, it was a desperately poor country, with an unemployment rate of 25 percent. Its leader, Prime Minister Lee Kuan Yew, famously cried on television as he thought about the country’s bleak prospects. But the developmental state worked for Singapore, so much so that per capita income today is more than $55,000, ninth among the highest-income countries of the world. And (putting aside those wealthy people who have moved to Singapore because it is viewed by many as a safe haven in a turbulent part of the world) it has relatively low inequality.

There were strong reactions to the article on Singapore, as to the one about Mauritius. Many Americans evidently don’t like to see their country placed in a bad light. The idea that in some dimensions others were doing better (particularly given their limited resources) than the United States was anathema. In the case of Singapore there was another problem. Deficiencies in its democracy have long been pointed out, and I carefully made note of them in my article. Increasingly, though, those in other countries have commented on the deficiencies in our democracy, which have given such scope to the power of money.

The next two articles deal with Japan. Its economic miracle was ending just at the time I was doing my study of East Asia’s miracle at the end of the 80s and beginning of 90s.² It has now gone through more than a quarter-century of near stagnation—often
referred to as the Japanese malaise. But somehow, even as it passed through those difficult times, it managed to keep unemployment low (typically, around 5 percent, half of the peak hit by the United States in its downturn). Its inequality was lower and its safety net much better than that of the United States (including its provision of health care), so that one has the sense that there was much less suffering. Still, “Japan Should Be Alert” points to the dangers of increasing inequality. Large changes in Japan’s economy have occurred over the past quarter-century, and Japan has been under pressure to make some of the “market reforms” that contributed to the growth of inequality elsewhere. There are signs of a troubling increase in inequality—and matters could get worse.

Nonetheless, on balance, I believe “Japan is a model—not a cautionary tale.” The image of Japan’s lackluster growth is distorted by the decline of its labor force (working-age population). If one takes that into account, in the past decade or so Japan has been toward the top of the league tables—hard as that is for many to believe, given the criticisms that have been leveled at Japan. Even more, as I mentioned earlier, it has so far been able to manage more inclusive growth than America has.

This article was written not long after Shinzo Abe became prime minister. I went to Tokyo twice in the early months of his administration, to discuss with him and his advisers the policies that have come to be called Abenomics. I was impressed with their recognition that one couldn’t rely on monetary policy; one also needed to stimulate the economy with fiscal policy (expenditures and/or tax cuts) and with pro-growth structural policies. These were the three arrows of Abenomics. Monetary policy (under my good friend Haruhiko Kuroda) was remarkably successful. Fiscal policy unfortunately wavered. Initial expansionary policies were followed by a tax increase; and the tax increase had the predicted effect: growth was thrown off track. Other policies might have worked far better—a carbon tax would have raised money and stimulated firms to make energy-saving investments, thus actually helping the macroeconomy. But the politics seemingly did not allow this.

The structural policies were far slower to get off the ground. Some of them were perhaps more symbolic than real (though they might have real effects on particular industries). For instance, Prime Minister Abe proposed joining discussions over the creation of the Trans-Pacific Partnership, a trade agreement that the United States was pushing among several countries around the Pacific Rim. One of the reasons for doing so was allegedly his hope that it would help facilitate the restructuring of Japan’s highly subsidized agricultural sector. The irony, of course, was that the United States itself highly subsidizes its agricultural sector—indeed, how else could one grow rice in the middle of what otherwise would be a desert? But even if he succeeded in restructuring agriculture, the sector is so small that it would have only a small effect on the economy.

Interestingly, one of the most promising structural reforms is one that would
simultaneously promote equity. We noted above the country’s declining workforce, caused by a decrease in population combined with a resistance to immigration. Abe proposed tapping into an important part of the country’s labor force that has been long underutilized—its highly educated women.

The next two chapters deal with China. I have been actively involved in China’s development since early on in its transition from Communism to a market economy. My first extended visit to the country was in 1981. A second extended visit was part of my research project on the East Asia Miracle. Beginning in the mid-1990s, I had the opportunity to go to China once or more every year, with annual meetings with the premier and other senior officials, first as a member of the U.S. government, then as chief economist of the World Bank, and then as a participant in the annual China Development Forum, where I was often asked to reflect on the new economic strategies as they evolved.

“China’s Roadmap” was written in 2006, shortly after the announcement of the 11th five-year plan. (Every five years, China formulates a “roadmap” to provide guidance for the coming period.) As I discuss in the article, central to that plan was creating a harmonious society—trying to avoid the divides that have come to characterize America’s society. In the case of China, the concern is not just the divide between rich and poor but between the urban and the rural areas, and between the coastal areas—where the country’s transition to a market economy began—and the western regions.

“Reforming China’s State–Market Balance” was written some eight years later, shortly after a new government had taken over and begun to formulate the economic strategy that would guide the country over the coming decade. China had a mixed record of ensuring that its citizens widely shared in the country’s growing prosperity. It succeeded in moving some 500 million people out of poverty—the most successful antipoverty program in the world, ever. At the same time, when I wrote this article, the level of inequality, as measured by the standard metrics (the Gini coefficient), was comparable to that of the United States. In some ways, it was impressive: 30 years earlier, the country had been relatively equal. It had taken America a long time to achieve the same level of inequality that China had achieved in 30 years!

But it is important to understand the difference between developed and developing countries. In the initial stages of development, some parts of the country start to grow more than others. Almost always, development is about industrialization and urbanization; with urban incomes so much higher than those in the rural areas, early on inequality grows. But as the rural sector diminishes in importance, inequality diminishes. That’s one of the reasons that Simon Kuznets had anticipated that the widely observed increases in inequality in early stages of development would be reversed. China is so far no exception to this pattern. The United States (and increasingly other advanced countries) are. The diminution of inequality did mark the
United States in the first three-fourths of the last century, but beginning with the Reagan era, matters reversed.

My message to China in this article was a note of caution, especially regarding how its leaders saw the continuing transition to a market economy. Yes, in many sectors that should be welcome. But many of the pressing problems confronting their economy—including inequality and pollution—were largely the making of the private sector, and it would take active government policies to reverse the disturbing trends.

As I travel around the world, every once in a while I experience something almost totally unexpected, something that provides hope, a source of inspiration. My visit to Mauritius produced one such experience. A visit to Medellín, Colombia, in April 2014 yielded another. I had gone there to participate in a meeting of the World Urban Forum, an event that occurs every three years. This meeting was the largest ever—some 22,000 people, some 7,000 of whom listened enthusiastically to my address. In “A Light unto Cities” I describe the turnaround in this city once notorious for its drug gangs. At the heart of its success was its fight against inequality. Although the brunt of the struggle to create a fairer and more egalitarian society, where there is shared prosperity and all live with a modicum of dignity, has to occur at the national level, Medellín shows that much can be done at the local level, especially since so many of the essential services that are vital to the living standards of all individuals are provided locally—housing, public transportation, amenities like parks, and education. This is an important message for the United States, where political gridlock means that progress at the national level will be minimal; indeed, the concern is that national politics will lead to an increase in inequality in the coming years. If there is to be progress, then, on these issues, it will have to be at the local level.

The battles between those trying to create a more equal society and those opposing such changes are being fought all over the world. I often got drawn into these fights, even during my more academic lecture tours. This occurred during my visits to Australia in 2011 and 2014. “American Delusions Down Under” was written after my return from Australia in early July 2014. Tony Abbott had assumed the prime ministership the preceding September and was determined to reverse the policies undertaken by previous administrations that had led to enormous success for that country—to the point that its per capita income was some $67,000 (among the highest in the world, and well above that of the United States). Those policies had resulted in a more shared prosperity: a minimum wage that was twice that of the United States, with an unemployment rate (at the time) that was much lower, a national debt that was a fraction of that of the United States, a way of financing higher education that provided opportunity for all (loans where payments were adjusted according to the individual’s income), and a health care system that led to higher life expectancy and better health at a fraction of the cost of that of the United States. In spite of these successes, Abbott was somehow trying to push Australia to follow the American model—an example of blind
ideology dominating all else.

That same year I got drawn into the debate over Scottish independence. I had served (with Sir James Mirrlees, my good friend and fellow Nobel laureate) on an advisory council to the Scottish government. Scotland had been active in implementing ideas I had been promoting about how to measure economic performance better. I had chaired the international Commission on the Measurement of Economic Performance and Social Progress, and we had unanimously agreed that GDP was an inadequate—sometimes misleading—measure of economic performance. I was enthusiastic about countries that were interested in implementing our ideas, and Scotland was one. There were other innovative ideas, like policies to promote a better environment and active industrial policies to create jobs and foster innovation.

In September 2014 Scotland voted on independence. There had been much scaremongering by the opponents, portraying the disastrous effects that might follow independence. Although I was concerned about a world of increasing national fragmentation, I was unconvinced by the scaremongering, and I was impressed with the tone of the discussion on the part of the advocates of independence—it was positive, about the possibilities that might be opened up, far different from the parochial nationalism that characterized many similar movements. This small country had been the birthplace of the Enlightenment, the intellectual movement to which we all owe a great debt both in terms of our democratic values and the advances in science and technology to which it gave rise. Most importantly for purposes of this book, while England was following the American economic model—with inequality increasing as a result in the expected way—Scotland saw itself as following the Scandinavian model, with greater equality of opportunity. “Scottish Independence” was published in Scotland in the days before the election.

Independence was rejected in the referendum, though a remarkable 45 percent of the voters in a very high turnout voted to sever the 300-year-old union. Interestingly, in the aftermath, there was a surge of support for the Scottish Independence Party, and the increased devolution of powers that was promised meant that Scotland would almost surely pursue policies promoting more equality.

While Scotland provides a note of optimism in a world of increasing inequality, Spain does just the opposite. I visit Spain often. Among the protests that marked the spring of 2011, those in Spain were particularly large, and understandably so, given the hardship that that country was going through. I spoke to the young protesters in Retiro Park, in Madrid. I agreed with them that something was wrong with our economic and political systems: we had unemployed workers and homeless people, in a world in which there were vast unmet needs and empty homes; while ordinary citizens were suffering, those who had brought on the crisis—the bankers and their cronies—were doing very well.
“Spain’s Depression” was written as the preface to the Spanish edition of The Price of Inequality. Spain was one of the countries that had actually managed to reduce inequality in the years before the Great Recession—just the opposite of the trend in the United States. But all of the progress was being lost in the Great Recession. While most in Europe—and especially its political leaders—are hesitant to call what was going on in Spain a depression, that’s what it was—with a huge decline in incomes and with a youth unemployment rate in excess of 50 percent. I argue here that the problems lie squarely with the structure of the eurozone and the policies of austerity that have been imposed on that country—and not so much with the policies of Spain or its economic structure.

Notes


Suppose someone were to describe a small country that provided free education through university for all of its citizens, transportation for schoolchildren, and free health care—including heart surgery—for all. You might suspect that such a country is either phenomenally rich or on the fast track to fiscal crisis.

After all, rich countries in Europe have increasingly found that they cannot pay for university education, and are asking young people and their families to bear the costs. For its part, the United States has never attempted to give free college for all, and it took a bitter battle just to ensure that America’s poor get access to health care—a guarantee that the Republican Party is now working hard to repeal, claiming that the country cannot afford it.

But Mauritius, a small island nation off the east coast of Africa, is neither particularly rich nor on its way to budgetary ruin. Nonetheless, it has spent the last decades successfully building a diverse economy, a democratic political system, and a strong social safety net. Many countries, not least the U.S., could learn from its experience.

In a recent visit to this tropical archipelago of 1.3 million people, I had a chance to see some of the leaps Mauritius has taken—accomplishments that can seem bewildering in light of the debate in the U.S. and elsewhere. Consider homeownership: while American conservatives say that the government’s attempt to extend homeownership to 70 percent of the U.S. population was responsible for the financial meltdown, 87 percent of Mauritians own their own homes—without fueling a housing bubble.

Now comes the painful number: Mauritius’s GDP has grown faster than 5 percent annually for almost 30 years. Surely, this must be some “trick.” Mauritius must be rich in diamonds, oil, or some other valuable commodity. But Mauritius has no exploitable natural resources. Indeed, so dismal were its prospects as it approached independence from Britain, which came in 1968, that the Nobel Prize–winning economist James Meade wrote in 1961: “It is going to be a great achievement if [the country] can find productive employment for its population without a serious reduction in the existing standard of living … [T]he outlook for peaceful development is weak.”

As if to prove Meade wrong, the Mauritians have increased per capita income from less than $400 around the time of independence to more than $6,700 today. The country has progressed from the sugar-based monoculture of 50 years ago to a diversified economy that includes tourism, finance, textiles, and, if current plans bear fruit, advanced technology.

During my visit, my interest was to understand better what had led to what some have called the Mauritius Miracle, and what others might learn from it. There are, in fact, many lessons, some of which should be borne in mind by politicians in the U.S. and elsewhere.
elsewhere as they fight their budget battles.

First, the question is not whether we can afford to provide health care or education for all, or ensure widespread homeownership. If Mauritius can afford these things, America and Europe—which are several orders of magnitude richer—can, too. The question, rather, is how to organize society. Mauritians have chosen a path that leads to higher levels of social cohesion, welfare, and economic growth—and to a lower level of inequality.

Second, unlike many other small countries, Mauritius has decided that most military spending is a waste. The U.S. need not go as far: just a fraction of the money that America spends on weapons that don’t work against enemies that don’t exist would go a long way toward creating a more humane society, including provision of health care and education to those who cannot afford them.

Third, Mauritius recognized that without natural resources, its people were its only asset. Maybe that appreciation for its human resources is also what led Mauritius to realize that, particularly given the country’s potential religious, ethnic, and political differences—which some tried to exploit in order to induce it to remain a British colony—education for all was crucial to social unity. So was a strong commitment to democratic institutions and cooperation between workers, government, and employers—precisely the opposite of the kind of dissension and division being engendered by conservatives in the U.S. today.

This is not to say that Mauritius is without problems. Like many other successful emerging-market countries, Mauritius is confronting a loss of exchange-rate competitiveness. And, as more and more countries intervene to weaken their exchange rates in response to America’s attempt at competitive devaluation through quantitative easing, the problem is becoming worse. Almost surely, Mauritius, too, will have to intervene.

Moreover, like many other countries around the world, Mauritius worries today about imported food and energy inflation. To respond to inflation by increasing interest rates would simply compound the difficulties of high prices with high unemployment and an even less competitive exchange rate. Direct interventions, restrictions on short-term capital inflows, capital-gains taxes, and stabilizing prudential banking regulations will all have to be considered.

The Mauritius Miracle dates to independence. But the country still struggles with some of its colonial legacies: inequality in land and wealth, as well as vulnerability to high-stakes global politics. The U.S. occupies one of Mauritius’s offshore islands, Diego Garcia, as a naval base without compensation, officially leasing it from the United Kingdom, which not only retained the Chagos Islands in violation of the UN and international law, but expelled its citizens and refuses to allow them to return.
The U.S. should now do right by this peaceful and democratic country: recognize Mauritius’s rightful ownership of Diego Garcia, renegotiate the lease, and redeem past sins by paying a fair amount for land that it has illegally occupied for decades.

* Project Syndicate, March 7, 2011.
INEQUALITY HAS BEEN RISING IN MOST COUNTRIES AROUND the world, but it has played out in different ways across countries and regions. The United States, it is increasingly recognized, has the sad distinction of being the most unequal advanced country, though the income gap has also widened, to a lesser extent, in Britain, Japan, Canada, and Germany. Of course, the situation is even worse in Russia, and some developing countries in Latin America and Africa. But this is a club of which we should not be proud to be a member.

Some big countries—Brazil, Indonesia, and Argentina—have become more equal in recent years, and other countries, like Spain, were on that trajectory until the economic crisis of 2007–8.

Singapore has had the distinction of having prioritized social and economic equity while achieving very high rates of growth over the past 30 years—an example par excellence that inequality is not just a matter of social justice but of economic performance. Societies with fewer economic disparities perform better—not just for those at the bottom or the middle, but over all.

It’s hard to believe how far this city-state has come in the half-century since it attained independence from Britain, in 1963. (A short-lived merger with Malaysia ended in 1965.) Around the time of independence, a quarter of Singapore’s workforce was unemployed or underemployed. Its per capita income (adjusted for inflation) was less than a tenth of what it is today.

There were many things that Singapore did to become one of Asia’s economic “tigers,” and curbing inequalities was one of them. The government made sure that wages at the bottom were not beaten down to the exploitative levels they could have been.

The government mandated that individuals save into a “provident fund”—36 percent of the wages of young workers—to be used to pay for adequate health care, housing, and retirement benefits. It provided universal education, sent some of its best students abroad, and did what it could to make sure they returned. (Some of my brightest students came from Singapore.)

There are at least four distinctive aspects of the Singaporean model, and they are more applicable to the United States than a skeptical American observer might imagine.

First, individuals were compelled to take responsibility for their own needs. For example, through the savings in their provident fund, around 90 percent of Singaporeans became homeowners, compared to about 65 percent in the United States.
since the housing bubble burst in 2007.

Second, Singaporean leaders realized they had to break the pernicious, self-sustaining cycle of inequality that has characterized so much of the West. Government programs were universal but progressive: while everyone contributed, those who were well off contributed more to help those at the bottom, to make sure that everyone could live a decent life, as defined by what Singaporean society, at each stage of its development, could afford. Not only did those at the top pay their share of the public investments; they were asked to contribute even more to helping the neediest.

Third, the government intervened in the distribution of pretax income—to help those at the bottom, rather than, as in the United States, those at the top. It weighed in, gently, on the bargaining between workers and firms, tilting the balance toward the group with less economic power—in sharp contrast to the United States, where the rules of the game have shifted power away from labor and toward capital, especially during the past three decades.

Fourth, Singapore realized that the key to future success was heavy investment in education—and more recently, scientific research—and that national advancement would mean that all citizens—not just the children of the rich—would need access to the best education for which they were qualified.

Lee Kuan Yew, Singapore’s first prime minister, who was in power for three decades, and his successors took a broader perspective on what makes for a successful economy than a single-minded focus on gross domestic product, though even by that imperfect measure of success, it did splendidly, growing 5.5 times faster than the United States has since 1980.

More recently, the government has focused intensively on the environment, making sure that this packed city of 5.3 million retains its green spaces, even if that means putting them on the tops of buildings.

In an era when urbanization and modernization have weakened family ties, Singapore has realized the importance of maintaining them, especially across generations, and has instituted housing programs to help its aging population.

Singapore realized that an economy could not succeed if most of its citizens were not participating in its growth or if large segments lacked adequate housing, access to health care, and retirement security. By insisting that individuals contribute significantly toward their own social welfare accounts, it avoided charges of being a nanny state. But by recognizing the different capacities of individuals to meet these needs, it created a more cohesive society. By understanding that children cannot choose their parents—and that all children should have the right to develop their innate capacities—it created a more dynamic society.

Singapore’s success is reflected in other indicators, as well. Life expectancy is 82
years, compared with 78 in the United States. Student scores on math, science, and reading tests are among the highest in the world—well above the average for the Organization of Economic Cooperation and Development, the world’s club of rich nations, and well ahead of the United States.

The situation is not perfect: In the last decade, growing income inequality has posed a challenge for Singapore, as it has for many countries in the world. But Singaporeans have acknowledged the problem, and there is a lively conversation about the best ways to mitigate adverse global trends.

Some argue that all of this was possible only because Mr. Lee, who left office in 1990, was not firmly committed to democratic processes. It’s true that Singapore, a highly centralized state, has been ruled for decades by Mr. Lee’s People’s Action Party. Critics say it has authoritarian aspects: limitations on civil liberties; harsh criminal penalties; insufficient multiparty competition; and a judiciary that is not fully independent. But it’s also true that Singapore is routinely rated one of the world’s least corrupt and most transparent governments, and that its leaders have taken steps toward expanding democratic participation.

Moreover, there are other countries, committed to open, democratic processes, that have been spectacularly successful in creating economies that are both dynamic and fair—with far less inequality and far greater equality of opportunity than in the United States.

Each of the Nordic countries has taken a slightly different path, but each has impressive achievements of growth with equity. A standard measure of performance is the United Nations Development Program’s inequality-adjusted Human Development Index, which is less a measure of economic output than it is of human well-being. For each country, it looks at citizens’ income, education, and health, and makes an adjustment for how access to these is distributed among the population. The Northern European countries (Sweden, Denmark, Finland, and Norway) stand towards the top. In comparison—and especially considering its No. 3 ranking in the non-inequality-adjusted index—the United States is further down the list, at No. 16. And when other indicators of well-being are considered in isolation, the situation is even worse: the United States ranks 33rd on the United Nations Development Program’s inequality-adjusted life expectancy index, just behind Chile.

Economic forces are global; the fact that there are such differences in outcomes (both levels of inequality and opportunity) suggests that what matters is how local forces—most notably, politics—shape these global economic forces. Singapore and Scandinavia have shown that they can be shaped in ways to ensure growth with equity.

Democracy, we now recognize, involves more than periodic voting. Societies with a high level of economic inequality inevitably wind up with a high level of political inequality: the elites run the political system for their own interests, pursuing what
economists call rent-seeking behavior, rather than the general public interest. The result is a most imperfect democracy. The Nordic democracies, in this sense, have achieved what most Americans aspire toward: a political system where the voice of ordinary citizens is fairly represented, where political traditions reinforce openness and transparency; where money does not dominate political decision-making; where government activities are transparent.

I believe the economic achievements of the Nordic countries are in large measure a result of the strongly democratic nature of these societies. There is a positive nexus not just between growth and equality, but between these two and democracy. (The flip side is that greater inequality not only weakens our economy; it also weakens our democracy.)

A measure of the social justice of a society is the treatment of children. Many a conservative or libertarian in the United States asserts that poor adults are responsible for their own plight—having brought their situation on themselves by not working as hard as they could. (That assumes, of course, that there are jobs to be had—an increasingly dubious assumption.)

But the well-being of children is manifestly not a matter for which children can be blamed (or praised). Only 7.3 percent of children in Sweden are poor, in contrast to the United States, where a startling 23.1 percent are in poverty. Not only is this a basic violation of social justice, but it does not bode well for the future: these children have diminished prospects for contributing to their country’s future.

Discussions of these alternative models, which seem to deliver more for more people, often end by some contrarian assertion or other about why these countries are different, and why their model has few lessons for the United States. All of this is understandable. None of us likes to think badly of ourselves or of our economic system. We want to believe that we have the best economic system in the world.

Part of this self-satisfaction, though, comes from a failure to understand the realities of the United States today. When Americans are asked what is the ideal distribution of income, they recognize that a capitalist system will always yield some inequality—without it, there would be no incentive for thrift, innovation, and industry. And they realize that we do not live up to what they view as their “ideal.” The reality is that we have far more inequality than they believe we have, and that their view of the ideal is not too different from what the Nordic countries actually manage to achieve.

Among the American elite—that sliver of Americans who have seen historic gains in wealth and income since the mid-1970s even as most Americans’ real incomes have stagnated—many look for rationalizations and excuses. They talk, for instance, about these countries’ being homogeneous, with few immigrants. But Sweden has taken in large numbers of immigrants (roughly 14 percent of the population is foreign-born, compared with 11 percent in Britain and 13 percent in the United States). Singapore is a
city-state with multiple races, languages, and religions. What about size? Germany has 82 million people and has substantially greater equality of opportunity than the United States, a nation of 314 million (although inequality has been rising there, too, though not as much as in the United States).

It is true that a legacy of discrimination—including, among many things, the scourge of slavery, America’s original sin—makes the task of achieving a society with more equality and more equality of opportunity, on a par with the best-performing countries around the world, particularly tricky. But a recognition of this legacy should reinforce our resolve, not diminish our efforts, to achieve an ideal that is within our reach, and is consistent with our best ideals.

JAPAN SHOULD BE ALERT*

INEQUALITY IS A GLOBAL PROBLEM. IT PLAGUES RICH AND POOR COUNTRIES, AND COUNTRIES IN EVERY CONTINENT. THERE ARE MANY DIMENSIONS TO THE CHANGING FACE OF INEQUALITY—GREATER EXCESSES AT THE TOP, A HOLLOWING OUT OF THE MIDDLE, AN INCREASE IN POVERTY AT THE BOTTOM. ONE THESIS OF THIS BOOK IS THAT SOCIETIES PAY A HIGH PRICE FOR THIS INEQUALITY—POORER ECONOMIC PERFORMANCE, A WEAKENING OF DEMOCRACY, COMPROMISES IN OTHER FUNDAMENTAL VALUES, SUCH AS THE RULE OF LAW. A COROLLARY IS THAT THERE CAN BE LARGE DIVIDENDS FROM CURBING THE GROWTH OF INEQUALITY AND CREATING A MORE EQUAL SOCIETY: NOT JUST ECONOMIC RETURNS, BUT AN INCREASE IN A SENSE OF FAIRNESS AND FAIR PLAY, IMPORTANT IN ALL CULTURES. THIS BOOK SHOWS THAT THIS CAN BE DONE, AND DESCRIBES THE ECONOMIC POLICIES THAT CAN BRING THESE IMPROVEMENTS IN THE FUNCTIONING OF OUR ECONOMY AND SOCIETY.

But while there are many similarities among countries, there are some important differences. There are a few countries for which inequality is not increasing, in the standard overall summary statistic (the Gini coefficient, described in chapter 1). The United States, upon which I focus much of the analysis of this book, has the most inequality of any of the advanced industrial countries. And contrary to a widely held belief—and contrary to America’s own self-image—it is the country with the least equality of opportunity. Of course, there are famous instances of individuals who made it by dint of hard work from the bottom to the top. But these are exceptions. What matters are the statistics: What are the life prospects of someone born to a family with poor education and low income? And life prospects in the U.S. are more dependent on the income and education of one’s parents than elsewhere.

Inevitably, there will be inequalities in outcomes and opportunities, but I argue here that those inequities don’t have to be as large as they’ve become in the U.S. Other countries do far better. The fact that others do better, and others have managed to keep inequality from increasing, should give us hope: today’s inequalities are not just the inevitable consequence of market forces. Markets do not exist in a vacuum. They are shaped by public policy. The successes of other countries in tempering inequality—in creating a more shared prosperity—show that the kinds of policies that I describe here can actually work to limit the growth of inequality and increase fairness in the economic system.

Over the last forty years, the countries with the most rapid growth have been the countries of East Asia. The increases in income that have occurred were beyond the imagination a half-century ago. There are many factors which have contributed to that success, such as a high savings rate. But one factor, I and others have argued, has been central, at least in most of the countries: the high level of equality, and especially the investments in education, which have extended opportunity far more broadly. Historically, there has been a strong social contract, limiting, for instance, the excesses at
the top—the ratio of CEO pay to that of the typical worker is but a fraction of that in the U.S. There has not always been this social contract. Labor relations in Japan in the prewar period were far more fractious. The fact that matters could change so dramatically provides hope.

Many Americans worry that the path that the U.S. is on, with a nexus of ever-increasing economic and political inequality, will be near to impossible to reverse. But in other periods when the U.S. faced high levels of inequality, it pulled back from the brink and reversed course: the Gilded Age was followed by the Progressive Era, the unprecedented inequality of the Roaring 20s was followed by the landmark social legislation of the 30s. That Japan, Brazil, and the U.S. have, at various times in their histories, changed course, undertaking policies that have brought their citizens closer together, should provide a counterweight to the growing sense of despair.

But if America does not change course, it will pay a high price for its high and worsening inequality. This book explains why societies with greater equality are likely to get better economic performance. Unfortunately, there can be vicious as well as virtuous circles: higher economic inequality can lead to a weakening of the social contract, an increase in the imbalances of political power, which in turn can lead to laws, regulations, and policies that increase economic inequality still further.

The experiences of the U.S. should be an important warning to other countries, including Japan. Even as Japanese growth has weakened, it has managed to avoid some of the extremes exposed by recent U.S. data. For instance, even those in the middle lost almost 40 percent of their wealth in the period 2008–10, wiping out two decades of wealth accumulation for the typical American. In the recovery year of 2010, 93 percent of the gains accrued to the top 1 percent. While the U.S. labor market remains anemic—with almost one out of six Americans who would like a full-time job unable to find one—even the long slump in Japan has resulted in relatively low unemployment. America’s system of social protection is among the worst in the advanced industrial countries. But as tax revenues have declined, the already inadequate system of social protection is becoming even more frayed. There have been major cutbacks in public services that are essential to the well-being of ordinary Americans. The inevitable result is that the economic downturn leads to increasing poverty.

There is, in the United States, another vicious circle: high inequality leads to a weaker economy, and the weak economy leads in turn to more inequality. High unemployment, for instance, leads to downward pressure on wages, hurting the middle class. As I explain in the book, high inequality lowers total demand, and it is lack of demand that is inhibiting growth in the U.S. and many other countries.

While all the other countries can claim some satisfaction in performing better than the U.S.—at least in this dimension—there is a risk of smugness. Success at one moment of time does not guarantee success at later dates.
Although inequality in Japan is still markedly less than that in the U.S., it has been increasing in Japan—just as it has been in the U.S. Could Japan revert to the fractiousness that marked the prewar period?

This book thus provides an important set of warnings and lessons for Japan: It should not take for granted its past successes in creating a more equal and fair society and economy. It should worry about increasing inequality. It should worry about the economic consequences. It should worry about the consequences for politics and society.

Even more than the U.S., Japan faces a problem of a large debt and an aging society. Its economy has been growing even more slowly than that of the U.S. It may be tempted to resort to cutbacks in investments in the common good or to undermining the system of social protections. But such policies would put at risk basic values and future economic prospects.

There are policies available (described in the last chapter) that would simultaneously increase growth and equality—creating a shared prosperity. For Japan, as for the U.S., the question is more one of politics than of economics. Will Japan be able to curb its rent seekers, in their pursuit of their own narrow interests, which inevitably harms the economy as a whole? Will it be able to construct a social contract for the 21st century, ensuring that the benefits of what growth that occurs will be fairly shared?

The answers to these questions are crucial to Japan’s future—both as a society and as an economy.

* Preface to the Japanese edition of The Price of Inequality.
JAPAN IS A MODEL, NOT A CAUTIONARY TALE*

In the five years since the financial crisis crippled the American economy, a favorite warning of those who have urged forceful government action, myself included, has been that the United States risked entering a long period of “Japanese-style malaise.” Japan’s two decades of anemic growth, which followed a crash in 1989, have been the quintessential cautionary tale about how not to respond to a financial crisis.

Now, though, Japan is leading the way. The recently elected prime minister, Shinzo Abe, has embarked on a crash course of monetary easing, public works spending, and promotion of entrepreneurship and foreign investment to reverse what he has called “a deep loss of confidence.” The new policies look to be a major boon for Japan. And what happens in Japan, which is the world’s third-largest economy and was once seen as America’s fiercest economic rival, will have a big impact in the United States and around the world.

Of course, not everyone is convinced: though Japan reported a robust 3.5 percent annualized growth rate for the first quarter of this year, the stock market has dipped from a five-year high amid doubts about whether “Abenomics” will go far enough. But we shouldn’t read anything into short-term stock fluctuations. Abenomics is, without a doubt, a huge step in the right direction.

To really understand why things look good for Japan requires not only looking closely at Mr. Abe’s platform, but also reexamining the popular narrative of Japanese stagnation. The last two decades are hardly a one-sided story of failure. On the surface, it does look as if there’s been sluggish growth. In the first decade of this century, Japan’s economy grew at a measly average annual rate of 0.78 percent from 2000 to 2011, compared with 1.8 percent for the United States.

But Japan’s slow growth does not look so bad under close examination. Any serious student of economic performance needs to look not at overall growth, but at growth related to the size of the working-age population. Japan’s working-age population (ages 15 to 64) shrank 5.5 percent from 2001 to 2010, while the number of Americans of that age increased by 9.2 percent—so we should expect to see slower GDP growth. But even before Abenomics, Japan’s real economic output, per member of the labor force, grew at a faster rate over the first decade of the century than that of the United States, Germany, Britain, or Australia.

Still, Japan’s growth is far lower than it was before its crisis, in 1989. From our own recent experience in America, we know the devastating effects of even a short (albeit much deeper) recession: in America, we’ve had soaring inequality (with the top 1 percent securing all of the gains of the “recovery,” and even more income), increased joblessness, and a middle that has been falling farther and farther behind. Japan’s
example shows that full recovery doesn’t happen on its own. Luckily for Japan, its government took steps to ensure that the extremes in inequality that happened in the United States weren’t manifest there, and now is finally being proactive about its growth.

And if we broaden the range of metrics we consider, we see that even after two decades of “malaise,” Japan’s performance is far superior to that of the United States.

Consider, for instance, the Gini coefficient, the standard measure of inequality. Zero represents perfect equality, and 1 stands for perfect inequality. While Japan’s Gini coefficient stands today at around 0.33, the number for the United States is 0.38, according to the Organization for Economic Cooperation and Development. (Other data sources put the United States’ level of inequality at even higher levels.) In the United States, the average income of the top 10 percent is 15.9 times that of the bottom 10 percent—compared with 10.7 times for Japan.

The reasons for these differences are political choices, not economic inevitability. Also according to the OECD, the Gini coefficient before taxes and transfer payments is about the same in the two countries: 0.499 for the United States, and 0.488 for Japan. But the United States does only a little to modulate its inequality, bringing it down to 0.38. Japan does much more, reducing the Gini coefficient to 0.33.

To be sure, Japan’s situation is not perfect. The country needs to do better in caring for its “older old,” those over 75. This cohort constitutes a growing share of the world’s aging population. In 2008, the OECD estimated that 25.4 percent of Japan’s “older old” lived in relative poverty—that is, with incomes less than half the national median—a figure only marginally better than the United States’ (27.4 percent), and far above the OECD average of 16.1 percent. While neither we nor Japan may be as rich as we once thought we were, it is unconscionable that such a large fraction of our elderly should face such hardship.

But if Japan has a problem with poverty among the very aged, it does much better on another front, one that has important implications for any country’s future: Some 14.9 percent of Japan’s children are poor, compared to a disheartening 23.1 percent of American children.

Broader measures of performance are equally indicative. Life expectancy at birth (a good measure of the health of the economy) is a world-leading 83.6 years in Japan, versus 78.7 years for Americans. And even this data does not expose the full scope of inequality in life expectancies. It’s been estimated that the longest-living 10th of Americans—who tend to be the wealthiest Americans—live almost as long as the average Japanese person. But those in our bottom 10th live about as long as the average person in Mexico or Argentina. The United Nations Development Program estimates that the effect of inequality on life expectancy in America is nearly twice as strong as it is in Japan.
Other measures also show Japan’s strengths. It is second-highest in the world for attainment of university education, well ahead of the United States. And even in periods of slow growth, Japan has run its economy in a way that has kept a lid on the unemployment rate. During the global financial crisis, the rate peaked at 5.5 percent; in the two decades of its malaise, it never surpassed 5.8 percent. This low unemployment is one of the reasons Japan has fared so much better than the United States.

Those are numbers we now look on with envy. American unemployment, and an overall weak labor market, hurts those in the middle and bottom in four ways.

First, those who lose their jobs obviously suffer—and in America, especially so, because until Obamacare, they overwhelmingly depended on their employers for health insurance. The combination of the loss of a job and an illness sends many Americans to the brink of bankruptcy, or over it. Second, a weak labor market means that even those who have a job are likely to see their hours cut short. The official unemployment rate hides the huge numbers of Americans who have accepted part-time work, not because that’s what they wanted, but because that’s all there was. But even those who are supposed to be working full-time see their incomes erode when their hours are cut back. Third, with so many seeking work and not getting it, employers are under no pressure to raise wages; wages do not even keep up with inflation. Real incomes decline—and that’s what’s been happening to most middle-class American families. Finally, public expenditures of all sorts—so important to those in the middle and bottom—are cut back.

**With his three-pronged** approach—structural, monetary, and fiscal policies—Mr. Abe, who took office last December, has done what America should have done long ago. Though the structural policies have not been fully fleshed out, they are likely to include measures aimed at increasing labor-force participation, especially among women, and hopefully by facilitating employment for the large number of healthy elderly. Some have suggested encouraging immigration as well. These are areas in which the United States has done well in the past, and are crucial for Japan to address, for the sake of both growth and inequality.

Though Japan has long prioritized equal access to education for women—with a result that Japanese girls score higher in science than boys, and are not as far behind boys in math as American girls are—it still has a relatively low labor-force participation rate for women (49 percent, according to the World Bank, compared with 58 percent for the United States). And an astonishingly small portion of Japanese women—7 percent, according to one—occupy senior positions in management.

Achieving better labor participation by Japan’s highly educated female population is of course as much a matter of social mores and customs as it is of government policy. And while governments can have only a limited role in changing social mores, they can tilt the playing field—making it easier for woman to participate actively in the labor
market through pro-family policies (like pregnancy leaves and child-care facilities) and strongly enforced antidiscrimination laws. National statistics typically assess inequality among households or families—they don’t get into what happens within the family. Yet inequalities within families can be marked, and differ markedly across countries.

Other likely reforms address the fact that Japan, like other advanced industrial countries, needs to go through some major structural transformations—moving from a manufacturing economy to a service-sector economy, and adapting to the dramatic changes in global comparative advantage, to the realities of climate change, and to the challenges of an aging population. While its powerful manufacturing sector has long showed good productivity growth, other sectors have lagged. Japan has the potential to extend its demonstrated innovativeness to the service sector.

With an aging population, increased efficiencies in the health care sector will be crucial; combining its manufacturing and technological prowess with new diagnostic devices is an example of an arena in which it can make global breakthroughs. Investments in research and higher education will help ensure that young Japanese have the skills and mind-set needed to succeed in globalization. Markets don’t make these structural transformations easily on their own. And that’s why government cutbacks in such situations are particularly foolish.

In fact, that is one reason the second pillar of Abenomics, its fiscal stimulus, is so important. Stimulus is needed, as we should have all learned, to increase aggregate demand. But it’s also needed to complete the structural transformation. Investments in infrastructure, research, and education promise high dividends. Yet just as deficit hawks blocked stronger action in the United States, critics claim that Japan, with a debt that is more than twice the size of its GDP, is not in a position to pursue this critical aspect of the new policies. They point to the fact that Japan’s indebtedness coincides with its long period of low growth. But even here, the data tell a more nuanced story. It is not the debt that caused the slow growth, but the slow growth that caused the deficit. Growth would have been even slower had the government not stimulated the economy.

What’s more, the foundation of austerity advocates’ logic—that high levels of debt-spending always slow growth, anywhere in the world—has been debunked. Europe is providing ever more evidence that austerity breeds austerity, which brings on recession and depression.

The final facet of Abenomics is its monetary policy, which reinforces stimulus with monetary stimulus. We should have learned that monetary stimulus—even strong and unprecedented actions like quantitative easing—has, at most, limited effects. Attention is focused on reversing deflation, which I believe is mainly a concern because it is a symptom of underutilization. While weakening the yen’s exchange rate will make Japanese goods more competitive and thus stimulate the economy’s growth, this is the reality of the international interdependence of monetary policy. It is equally true that the
Federal Reserve’s policy of “quantitative easing” weakens the dollar. We can look forward to a day when global coordination improves in this area.

As the pieces of evidence fall into place, the pressing issue turns out to be not whether Abenomics is a good plan, but how the United States could achieve a similarly integrated plan, and what the consequences would be if it fails. The obstacle is not economic science but, as usual, America’s raging political battles. For example, despite austerity advocates’ dubious intellectual foundation, we have allowed public expenditures to slip in all sorts of areas, including those necessary for ensuring a future of shared prosperity. As a result, even as some states’ financial situations start to edge toward improvement, public employment is still some 500,000 lower than it was before the crisis; the decrease in jobs has occurred almost completely at the state and local level. To regain the prerecession levels of employment and public services is a tremendous task, to say nothing of bringing them to where they would have been without a recession. (If the economy had been expanding normally, public employment would have increased significantly.) With inequality still high, the burdens are being felt, disproportionately, by our country’s most vulnerable.

A major theme of my research has been that any country pays a high price for its inequality. Societies can have higher growth and more equality—the two are not mutually exclusive. Abenomics has already laid out some policies aimed to produce both. And one hopes that as further details are worked out, there will be more policies that promote greater gender equality in the labor market and tap into one of that country’s underutilized resources. It will enhance growth, efficiency, and equality. Mr. Abe’s plan also reflects an understanding that monetary policy can only go so far. One needs to have coordinated monetary, fiscal, and structural policies.

Those who see Japan’s performance over the last decades as an unmitigated failure have too narrow a conception of economic success. Along many dimensions—greater income equality, longer life expectancy, lower unemployment, greater investments in children’s education and health, and even greater productivity relative to the size of the labor force—Japan has done better than the United States. It may have quite a lot to teach us. If Abenomics is even half as successful as its advocates hope, it will have still more to teach us.

China is about to adopt its 11th five-year plan, setting the stage for the continuation of probably the most remarkable economic transformation in history, while improving the well-being of almost a quarter of the world’s population. Never before has the world seen such sustained growth; never before has there been so much poverty reduction.

Part of the key to China’s long-run success has been its almost unique combination of pragmatism and vision. While much of the rest of the developing world, following the Washington Consensus, has been directed at a quixotic quest for higher GDP, China has once again made clear that it seeks sustainable and more equitable increases in real living standards.

China realizes that it has entered a phase of economic growth that is imposing enormous—and unsustainable—demands on the environment. Unless there is a change in course, living standards will eventually be compromised. That is why the new five-year plan places great emphasis on the environment.

Even many of the more backward parts of China have been growing at a pace that would be a marvel, were it not for the fact that other parts of the country are growing even more rapidly. While this has reduced poverty, inequality has been increasing, with growing disparities between cities and rural areas, and between coastal regions and the interior. This year’s World Bank *World Development Report* explains why inequality, not just poverty, should be a concern, and China’s 11th five-year plan attacks the problem head-on. The government has for several years talked about a more harmonious society, and the plan describes ambitious programs for achieving this.

China recognizes, too, that what separates less developed from more developed countries is not only a gap in resources, but also a gap in knowledge. So it has laid out bold plans not only to reduce that gap, but to create a basis for independent innovation.

China’s role in the world and the world’s economy has changed, and the plan reflects this, too. Its future growth will have to be based more on domestic demand than on exports, which will require increases in consumption. Indeed, China has a rare problem: excessive savings. People save partly because of weaknesses in government social-insurance programs; strengthening social security (pensions) and public health and education will simultaneously reduce social inequalities, increase citizens’ sense of well-being, and promote current consumption.

If successful—and, so far, China has almost always surpassed even its own high expectations—these adjustments may impose enormous strains on a global economic system that is already unbalanced by America’s huge fiscal and trade imbalances. If China saves less—and if, as officials have announced, it pursues a more diversified policy of investing its reserves—who will finance America’s more than $2 billion a day?
trade deficit? This is a topic for another day, but that day may not be far off.

With such a clear vision of the future, the challenge will be implementation. China is a large country, and it could not have succeeded as it has without widespread decentralization. But decentralization raises problems of its own.

Greenhouse gases, for example, are global problems. While America says that it cannot afford to do anything about it, China’s senior officials have acted more responsibly. Within a month of the adoption of the plan, new environmental taxes on cars, gasoline, and wood products were imposed: China was using market-based mechanisms to address its and the world’s environmental problems. But the pressures on local government officials to deliver economic growth and jobs will be enormous. They will be sorely tempted to argue that if America cannot afford to produce in a way that preserves our planet, how can we? To translate its vision into action, the Chinese government will need strong policies, such as the environmental taxes already imposed.

As China has moved toward a market economy, it has developed some of the problems that have plagued the developed countries: special interests that clothe self-serving arguments behind a thin veil of market ideology.

Some will argue for trickle-down economics: don’t worry about the poor, eventually everybody will benefit from growth. And some will oppose competition policy and strong corporate governance laws: let Darwinian survival work its wonders. Growth arguments will be advanced to counter strong social and environmental policies: higher gasoline taxes, for example, will kill our nascent auto industry.

Such allegedly pro-growth policies would not only fail to deliver growth; they would threaten the entire vision of China’s future. There is only one way to prevent this: open discussion of economic policies in order to expose fallacies and provide scope for creative solutions to the many challenges facing China today. George W. Bush has shown the dangers of excessive secrecy and confining decision-making to a narrow circle of sycophants. Most people outside China do not fully appreciate the extent to which its leaders, by contrast, have engaged in extensive deliberations and broad consultations (even with foreigners) as they strive to solve the enormous problems they face.

Market economies are not self-regulating. They cannot simply be left on autopilot, especially if one wants to ensure that their benefits are shared widely. But managing a market economy is no easy task. It is a balancing act that must constantly respond to economic changes. China’s 11th five-year plan provides a roadmap for that response. The world watches in awe, and hope, as the lives of 1.3 billion people continue to be transformed.

*Project Syndicate, April 6, 2006.*
No country in recorded history has grown as fast—and moved as many people out of poverty—as China over the last 30 years. A hallmark of China’s success has been its leaders’ willingness to revise the country’s economic model when and as needed, despite opposition from powerful vested interests. And now, as China implements another series of fundamental reforms, such interests are already lining up to resist. Can the reformers triumph again?

In answering that question, the crucial point to bear in mind is that, as in the past, the current round of reforms will restructure not only the economy, but also the vested interests that will shape future reforms (and even determine whether they are possible). And today, while high-profile initiatives—for example, the government’s widening anti-corruption campaign—receive much attention, the deeper issue that China faces concerns the appropriate roles of the state and the market.

When China began its reforms more than three decades ago, the direction was clear: the market needed to play a far greater role in resource allocation. And so it has, with the private sector far more important now than it was. Moreover, there is a broad consensus that the market needs to play what officials call a “decisive role” in many sectors where state-owned enterprises (SOEs) dominate. But what should its role be in other sectors, and in the economy more generally?

Many of China’s problems today stem from too much market and too little government. Or, to put it another way, while the government is clearly doing some things that it should not, it is also not doing some things that it should.

Worsening environmental pollution, for example, threatens living standards, while inequality of income and wealth now rivals that of the United States and corruption pervades public institutions and the private sector alike. All of this undermines trust within society and in government—a trend that is particularly obvious with respect to, say, food safety.

Such problems could worsen as China restructures its economy away from export-led growth toward services and household consumption. Clearly, there is room for growth in private consumption; but embracing America’s profligate materialist lifestyle would be a disaster for China—and the planet. Air quality in China is already putting people’s lives at risk; global warming from even higher Chinese carbon emissions would threaten the entire world.

There is a better strategy. For starters, Chinese living standards could and would increase if more resources were allocated to redress large deficiencies in health care and education. Here, government should play a leading role, and does so in most market economies, for good reason.
America’s privately based health care system is expensive, inefficient, and achieves far worse outcomes than those in European countries, which spend far less. A more market-based system is not the direction in which China should be going. In recent years, the government has made important strides in providing basic health care, especially in rural areas, and some have likened China’s approach to that of the United Kingdom, where private provision is layered atop a public base. Whether that model is better than, say, French-style government-dominated provision may be debated. But if one adopts the UK model, the level of the base makes all the difference; given the relatively small role of private health care provision in the UK, the country has what is essentially a public system.

Likewise, though China has already made progress in moving away from manufacturing toward a service-based economy (the GDP share of services exceeded that of manufacturing for the first time in 2013), there is still a long way to go. Already, many industries are suffering from overcapacity, and efficient and smooth restructuring will not be easy without government help.

China is restructuring in another way: rapid urbanization. Ensuring that cities are livable and environmentally sustainable will require strong government action to provide sufficient public transport, public schools, public hospitals, parks, and effective zoning, among other public goods.

One major lesson that should have been learned from the post-2008 global economic crisis is that markets are not self-regulating. They are prone to asset and credit bubbles, which inevitably collapse—often when cross-border capital flows abruptly reverse direction—imposing massive social costs.

America’s infatuation with deregulation was the cause of the crisis. The issue is not just the pacing and sequencing of liberalization, as some suggest; the end result also matters. Liberalization of deposit rates led to America’s savings-and-loan crisis in the 1980s. Liberalization of lending rates encouraged predatory behavior that exploited poor consumers. Bank deregulation led not to more growth, but simply to more risk.

China, one hopes, will not take the route that America followed, with such disastrous consequences. The challenge for its leaders is to devise effective regulatory regimes that are appropriate for its stage of development.

That will require the government to raise more money. Local governments’ current reliance on land sales is a source of many of the economy’s distortions—and much of the corruption. Instead, the authorities should boost revenue by imposing environmental taxes (including a carbon tax), a more comprehensive progressive income tax (including capital gains), and a property tax. Moreover, the state should appropriate, through dividends, a larger share of SOEs’ value (some of which might be at the expense of these firms’ managers).
The question is whether China can maintain rapid growth (though somewhat slower than its recent breakneck pace), even as it reins in credit expansion (which could cause an abrupt reversal in asset prices), confronts weak global demand, restructures its economy, and fights corruption. In other countries, such daunting challenges have led to paralysis, not progress.

The economics of success is clear: higher spending on urbanization, health care, and education, funded by increases in taxes, could simultaneously sustain growth, improve the environment, and reduce inequality. If China’s politics can manage the implementation of this agenda, China and the entire world will be better off.

*Project Syndicate*, April 2, 2014
MEDELLÍN: A LIGHT UNTO CITIES*

Last month, a remarkable gathering occurred in Medellín, Colombia. Some 22,000 people came together to attend the World Urban Forum and discuss the future of cities. The focus was on creating “cities for life”—that is, on promoting equitable development in the urban environments in which a majority of the world’s citizens already live, and in which two-thirds will reside by the year 2050.

The location itself was symbolic: Once notorious for its drug gangs, Medellín now has a well-deserved reputation as one of the most innovative cities in the world. The tale of the city’s transformation holds important lessons for urban areas everywhere.

In the 1980s and 1990s, cartel bosses like the infamous Pablo Escobar ruled Medellín’s streets and controlled its politics. The source of Escobar’s power was not just the hugely profitable international cocaine trade (fueled by demand in the United States), but also extreme inequality in Medellín and Colombia. On the steep Andean slopes of the valley that cradles the city, vast slums, virtually abandoned by the government, provided a ready supply of recruits for the cartels. In the absence of public services, Escobar won the hearts and minds of Medellín’s poorest with his largesse—even as he terrorized the city.

One can hardly recognize those slums today. In the poor neighborhood of Santo Domingo, the city’s new Metrocable system, consisting of three lines of aerial gondolas, serves residents hundreds of vertical feet up a mountainside, ending their isolation from the city center. The commute is now minutes, and the social and economic barriers between the informal settlements and the rest of the city are on their way to being broken down.

The problems of the city’s poor neighborhoods have not been erased, but the benefits that the infrastructure improvements have brought are brilliantly evident in the well-kept houses, murals, and soccer fields perched near the gondola stations. The cable cars are only the most iconic of the projects for which Medellín last year won Harvard University’s Veronica Rudge Green Prize in Urban Design, the most prestigious award in the field.

Beginning with the mayoralty of Sergio Fajardo (now the governor of Medellín’s department, Antioquia), who took office in 2004, the city has made major efforts to transform its slums, improve education, and promote development. (The current mayor, Aníbal Gaviria, has affirmed his commitment to continuing on this path.)

Medellín constructed avant-garde public buildings in areas that were the most rundown, provided house paint to citizens living in poor districts, and cleaned up and improved the streets—all in the belief that if you treat people with dignity, they will value their surroundings and take pride in their communities. And that faith has been
more than borne out.

Throughout the world, cities are both the locus and the focus of society’s major debates, and for good reason. When individuals live in close quarters, they cannot escape major societal problems: growing inequality, environmental degradation, and inadequate public investment.

The forum reminded participants that livable cities require planning—a message at odds with prevailing attitudes in much of the world. But without planning and government investment in infrastructure, public transportation and parks, and the provision of clean water and sanitation, cities won’t be livable. And it is the poor who inevitably suffer the most from the absence of these public goods.

Medellín holds some lessons for America, too. Indeed, recent research shows how inadequate planning has fueled economic segregation in the United States, and how poverty traps have formed in cities without public transportation, owing to a shortage of accessible jobs.

The conference went beyond this, emphasizing that “livable cities” are not enough. We need to create urban areas in which individuals can flourish and innovate. It is no accident that the Enlightenment—which led in turn to the fastest and largest increases in living standards in human history—unfolded in cities. New thinking is a natural consequence of high population density, provided the right conditions are met—conditions that include public spaces in which people can interact and culture can thrive, and a democratic ethos that welcomes and encourages public participation.

A key theme of the forum was the emerging consensus on the need for environmentally, socially, and economically sustainable development. All of these aspects of sustainability are intertwined and complementary, and cities provide the context in which this is most clear.

One of the biggest obstacles to achieving sustainability is inequality. Our economies, our democracies, and our societies pay a high price for the growing gap between the rich and poor. And perhaps the most invidious aspect of the widening income and wealth gap in so many countries is that it is deepening inequality of opportunity.

Some cities have shown that these widely observed patterns are not the result of immutable economic laws. Even in the advanced country with the most inequality—the U.S.—some cities, like San Francisco and San Jose, are comparable to the best-performing economies in terms of equality of opportunity.

With political gridlock afflicting so many national governments around the world, forward-thinking cities are becoming a beacon of hope. A divided U.S. seems incapable of addressing its alarming increase in inequality. But in New York City, Mayor Bill de Blasio was elected on the promise of doing something about it.
While there are limits to what can be done at the local level—national taxation, for instance, is far more important than municipal taxes—cities can help ensure the availability of affordable housing. And they have a special responsibility to provide high-quality public education and public amenities for all, regardless of income.

Medellín and the World Urban Forum have shown that this is not just a pipe dream. Another world is possible; we need only the political will to pursue it.

*Project Syndicate, May 7, 2014.*
For better or worse, economic-policy debates in the United States are often echoed elsewhere, regardless of whether they are relevant. Australian Prime Minister Tony Abbott’s recently elected government provides a case in point.

As in many other countries, conservative governments are arguing for cutbacks in government spending, on the grounds that fiscal deficits imperil their future. In the case of Australia, however, such assertions ring particularly hollow—though that has not stopped Abbott’s government from trafficking in them.

Even if one accepts the claim of the Harvard economists Carmen Reinhart and Kenneth Rogoff that very high public debt levels mean lower growth—a view that they never really established and that has subsequently been discredited—Australia is nowhere near that threshold. Its debt-to-GDP ratio is only a fraction of that of the U.S., and one of the lowest among the OECD countries.

What matters more for long-term growth are investments in the future—including crucial public investments in education, technology, and infrastructure. Such investments ensure that all citizens, no matter how poor their parents, can live up to their potential.

There is something deeply ironic about Abbott’s reverence for the American model in defending many of his government’s proposed “reforms.” After all, America’s economic model has not been working for most Americans. Median income in the U.S. is lower today than it was a quarter-century ago—not because productivity has been stagnating, but because wages have.

The Australian model has performed far better. Indeed, Australia is one of the few commodity-based economies that has not suffered from the natural-resource curse. Prosperity has been relatively widely shared. Median household income has grown at an average annual rate above 3 percent in the last decades—almost twice the OECD average.

To be sure, given its abundance of natural resources, Australia should have far greater equality than it does. After all, a country’s natural resources should belong to all of its people, and the “rents” that they generate provide a source of revenue that could be used to reduce inequality. And taxing natural-resource rents at high rates does not cause the adverse consequences that follow from taxing savings or work (reserves of iron ore and natural gas cannot move to another country to avoid taxation). But Australia’s Gini coefficient, a standard measure of inequality, is one-third higher than that of Norway, a resource-rich country that has done a particularly good job of managing its wealth for the benefit of all citizens.

One wonders whether Abbott and his government really understand what has
happened in the U.S. Does he realize that since the era of deregulation and liberalization began in the late 1970s, GDP growth has slowed markedly, and that what growth has occurred has primarily benefited those at the top? Does he know that prior to these “reforms,” the U.S. had not had a financial crisis—now a regular occurrence around the world—for a half-century, and that deregulation led to a bloated financial sector that attracted many talented young people who otherwise might have devoted their careers to more productive activities? Their financial innovations made them extremely rich but brought America and the global economy to the brink of ruin.

Australia’s public services are the envy of the world. Its health care system delivers better outcomes than that of the U.S., at a fraction of the cost. It has an income-contingent education-loan program that permits borrowers to spread their repayments over more years if necessary, and in which, if their income turns out to be particularly low (perhaps because they chose important but low-paying jobs, say, in education or religion), the government forgives some of the debt.

The contrast with the U.S. is striking. In the U.S., student debt, now in excess of $1.2 trillion (more than all credit card debt), is becoming a burden for graduates and the economy. America’s failed financial model for higher education is one of the reasons that, among the advanced countries, America now has the least equality of opportunity, with the life prospects of a young American more dependent on his or her parents’ income and education than are those of a young person in other advanced countries.

Abbott’s notions about higher education also suggest that he clearly does not understand why America’s best universities succeed. It is not price competition or the drive for profit that has made Harvard, Yale, or Stanford great. None of America’s great universities are for-profit institutions. They are all not-for-profit institutions, either public or supported by large endowments, contributed largely by alumni and foundations.

There is competition, but of a different sort. They strive for inclusiveness and diversity. They compete for government research grants. America’s underregulated for-profit universities excel in two dimensions: the ability to exploit young people from poor backgrounds, charging them high fees without delivering anything of value, and the ability to lobby for government money without regulation and to continue their exploitative practices.

Australia should be proud of its successes, from which the rest of the world can learn a great deal. It would be a shame if a misunderstanding of what has happened in the U.S., combined with a strong dose of ideology, caused its leaders to fix what is not broken.

* Project Syndicate, July 9, 2014.
As Scotland contemplates independence, some, such as Paul Krugman, have questioned the “economics.”

Would Scotland, going it alone, risk a decline in standards of living or a fall in GDP? There are, to be sure, risks in any course of action: should Scotland stay in the UK, and the UK leave the EU, the downside risks are, by almost any account, significantly greater. If Scotland stays in the UK, and the UK continues in its policies that have resulted in growing inequality, even if GDP were slightly larger, the standards of living of most Scots could fall.

Cutbacks in UK public support to education and health could force Scotland to face a set of unpalatable choices—even with Scotland having considerable discretion over what it spends its money on.

But there is, in fact, little basis for any of the forms of fear-mongering that have been advanced. Krugman, for instance, suggests that there are significant economies of scale: a small economy is likely, he seems to suggest, not to do well. But an independent Scotland will still be part of Europe, and the great success of the EU is the creation of a large economic zone.

Besides, small political entities like Sweden, Singapore, and Hong Kong have prospered, while much larger entities have not. By an order of magnitude, far more important is pursuit of the right policies.

Another example of a nonissue is the currency. There are many currency arrangements that would work. Scotland could continue using sterling—with or without England’s consent.

Because the economies of England and Scotland are so similar, a common currency is likely to work far better than the euro—even without shared fiscal policy. But many small countries have managed to have a currency of their own—floating, pegged, or “managed.”

The fundamental issue facing Scotland is different. It is clear that there is, within Scotland, more of a shared vision and values—a vision of the country, the society, politics, the role of the state; values like fairness, equity, and opportunity. Not everyone in the country agrees on the precise policies, on the delicate balance.

But the Scottish vision and values are different from those dominant south of the border. Scotland has free university education for all; England has increased student fees, forcing students with parents of limited means to take out loans.

Scotland has repeatedly stressed its commitment to the National Health Service. England has repeatedly made moves toward privatization. Some differences are of long
standing: even 200 years ago, male literacy in Scotland was 50 percent higher than in England, and Scottish universities charged one-tenth of the fees for Cambridge and Oxford.

Differences in these and other related policies can, over time, lead not only to markedly different growth rates, and thus to markedly different levels of GDP per capita—swamping any slight short-run impact—but also, and more importantly, to differences in the distribution of income and wealth. If the UK continues on its current course, imitating the American model, it is likely that the results will be like those of the U.S.—where the typical family has seen its income stagnate for a quarter-century, even as the rich get richer.

Independence may have its costs, although these have yet to be demonstrated convincingly, but it will also have its benefits.

Scotland can make investments in tidal energy, or in its young people; it can strive to increase female labor-force participation and provide for early-years education—both essential for creating a fairer society. It can make these investments, knowing that the country will recapture more of the benefits from them through taxation.

Under current arrangements, while Scotland bears the cost of these social investments, the extra tax revenue resulting from the additional growth from these investments will go overwhelming south of the border.

The difficult question that Scotland has to face is thus not about arcane issues about monetary arrangements or economies of scope, about the minutiae of the short-run gains and losses, but whether Scotland’s future—its shared vision and values, which have increasingly deviated from those dominant south of the border—will be better achieved through independence.

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* Herald (Glasgow), September 13, 2014.
Spain’s Depression

Spain is in depression. That’s the only word that one can use to describe the economy, with close to one out of four workers unemployed, and a youth unemployment rate of 50 percent (as of the time this book goes to press). The prognosis for the immediate future is more of the same, perhaps a little worse. This is in spite of promises from the government and international officialdom that prescribed the austerity packages on Spain that growth would, by now, have been restored. They have repeatedly underestimated the magnitude of the downturn that their policies would bring about, and as a result they have consistently overestimated the fiscal benefit that would be derived: deeper downturns inevitably result in lower revenues and more expenditures for unemployment and social programs. Though they then try to shift the blame back onto Spain for missing the fiscal targets, it is their misdiagnosis of the problem and the resulting wrong prescription that should be held accountable.

This book explains how flawed economic policies can lead to both more inequality and lower growth—and the policies being adopted in Spain and Europe more broadly provide a perfect illustration. In the years before the crisis (especially between 1985 and 2000), Spain was fairly unusual in that inequality in net labor earnings and household net disposable income fell. Even as before-tax inequality was reduced, government “corrected” the distribution of income through important social policies and measures directed at improving public health, and continued to do so through the early years of the crisis. But by now the prolonged recession has caused a dramatic increase in inequality.

But as we explain in chapter 1, downturns, especially a depression such as Spain is going through now, are bad for inequality. Those who are unemployed, especially the long-term unemployed, are more likely to move into poverty. The high unemployment rate puts downward pressure on wages, and wages at the bottom are especially sensitive. And as austerity has tightened, social programs essential to the well-being of those in the middle and bottom get cut back. As in the United States, compounding these effects is the decline in real estate prices, the most important asset for those at the bottom and in the middle.

The implications of Spain’s growing inequality and its deep depression should be profoundly worrying for its future. It’s not just that resources are being wasted; the country’s human capital is deteriorating. Those who are skilled and can’t get a job in Spain are migrating: there is a global market for the country’s talents. Whether they will come back when and if recovery sets in will depend, in part, on how long the depression lasts.

Spain’s problems today are largely a result of the same mix of ideology and special interests that (as this book describes) led to financial market liberalization and
deregulation and other “market fundamentalist” policies in the United States—policies that contributed to the high level of inequality and instability in the U.S., and which have resulted in growth rates far lower than those in the preceding decades. (These “market fundamentalist” policies are also referred to as “neoliberalism.” As I explain, they rest not on a deep understanding of modern economic theory, but on a naïve reading of economics, based on assumptions of perfect competition and perfect markets.)

In some cases, the ideology did little more than masquerade the attempt by some vested interests to garner more for themselves. A nexus developed between banks, property developers, and some politicians: environmental and zoning regulations were set aside and/or not effectively enforced; banks were not only inadequately regulated, but what regulations existed were not tightly enforced. There was a party. Money flowed everywhere. Some of it flowed back to the politicians who allowed this to happen, either in campaign contributions or in lucrative jobs after serving their time in office. Even tax revenues increased, and the politicians could pride themselves both on the growth that the real estate bubble had brought about and on the improvement in the country’s fiscal position. But it was all a chimera: the economy was based on shaky, unsustainable foundations.

In Europe, the neoliberal, market fundamentalist ideas get encoded into basic economic structure underlying the European Union, and especially the eurozone. These principles were supposed to lead to greater efficiency and stability; and everybody, it was presumed, would benefit from the enhanced growth, so little attention was paid to what the new rules would imply for inequality.

In fact, they have led to lower growth, more instability. And in most countries in the European Union, already before the crisis but even more so afterwards, those at the bottom and in the middle have not done well. This book lays out many of the fallacies in the market fundamentalist ideology, and explains why policies based on that have repeatedly failed. But it is worth looking more closely at how these issues have played out in Europe.

Take the principle of free labor mobility. That was supposed to lead to an efficient allocation of labor, and there are circumstances in which that may be the case. With debt burdens in several countries so high, however, young people can escape repaying the debts of their parents simply by moving; taxes to repay these debts induce inefficient migration. But it also creates an adverse dynamic: as young people move out, the tax burden on the rest increases, providing even more incentives for inefficient migration.

Or take the principle of free movement of goods, combined with the failure to have tax harmonization. Companies (and individuals) have an incentive to move to low-taxed jurisdictions, from which they can ship their goods anywhere within the EU. Location is not based on where production is most efficient, but on where taxes are lowest. This in
turn sets off a race to the bottom: creating pressure not only to lower taxes on capital and corporations but also to lower wages and working conditions. The burden of taxation is shifted to workers. And with so much inequality associated with the inequality of capital and corporate profits, overall inequality in (after-tax and transfer) income inevitably increases.

The so-called single-market principle, whereby a bank regulated by any European government can operate anywhere else in the EU, combined with the free mobility of capital, has been perhaps the worst of the neoliberal policies. In the years before the crisis, we saw one aspect of that: financial products and deposits from underregulated countries caused havoc in other countries; the host countries failed to fulfill their responsibilities of protecting their citizens and their economies. By the same token, the doctrine that markets are efficient—and that governments should not interfere with their wondrous workings—led to the decision not to interfere with real estate bubbles as they formed in Ireland, Spain, and the United States. But markets have repeatedly been subject to bouts of irrational optimism and pessimism: they were excessively optimistic in the years after the beginning of the euro, and money flowed into real estate in Spain and Ireland; today they are excessively pessimistic, and money is flowing out. The outflow weakens the economy further. And the single-market principle exacerbates the problem: it’s relatively easy for someone in Greece or Spain or Portugal to shift his or her euros into a German bank account.

But the banking system, like the other aspects of the euro economy, is distorted. It’s not a level playing field. Confidence in a bank rests on the ability of the government to rescue the bank’s depositors should things go wrong, and this is especially the case as we have allowed banks to become bigger and to trade in complex, nontransparent, hard-to-value financial products. German banks are advantaged over Spanish banks simply because there is greater confidence in Germany’s ability to rescue its banks. There is a hidden subsidy. But this again creates a downward spiral: as money leaves the country, the economy weakens, undermining confidence in the ability of the government to rescue the country’s banks, enhancing an outflow of money.

There are other aspects of Europe’s economic framework that contribute to its problems now: the European Central Bank has a single-minded focus on inflation (in contrast with the U.S., where the mandate includes growth, employment, and financial stability). Chapter 9 explains why a focus on inflation contributes to more inequality. But the disparity in mandates is especially disadvantageous for Europe now. As the U.S. has lowered its interest rates essentially to zero and Europe has not, the euro is stronger than it otherwise would have been, and this makes exports weaker, imports stronger, destroying still more jobs.

The fundamental problem with the euro was that it took away two of the critical mechanisms for adjustment in the face of a shock that affected some countries
differently from others—the interest rate and exchange rate mechanisms—and put nothing in its place. The eurozone was not what economists call an “optimal currency area,” a group of countries that could viably share the same currency. When countries face a shock, one way they adjust is to change the exchange rate. This is true even for similar countries, like the United States and Canada; the exchange rate between the two has varied markedly. But the euro imposes a constraint on adjustment.

Some suggest that an alternative to adjusting the exchange rate is to lower all wages and prices within the country. This is called internal devaluation. If internal devaluation were easy, the gold standard would not have posed a barrier to adjustment in the Great Depression. It is easier for countries like Germany to adjust through a real appreciation of their currency (as China is now doing) than it is for its trading partners to adjust through a real depreciation of their currency. Real appreciation can be accomplished through inflation. It is easier to get moderate inflation than a corresponding level of deflation. But Germany has been resistant.

The consequence of Germany’s real exchange rate being too low is just like that of China’s: Germany has a surplus (like China), and its trading partners (like Spain) have a trade deficit. When there are imbalances, it is the surplus country as much as the deficit country that is to blame, and the burden of adjustment should be assigned to where the adjustment is easiest. This is the doctrine that the rest of the world has enunciated in discussions with China. China has responded, with a remarkably large increase in its real exchange rate since 2005. The necessary adjustment has not occurred within Europe.

Not every country can have a surplus, and so the view of some of those in Germany that others should imitate its policy is, in a sense, simply incoherent. For every surplus, there has to be a deficit. And particularly today, the surplus countries are imposing costs on others: the global problem today is a lack of global aggregate demand, a problem to which surpluses contribute.

It is instructive to compare Europe with the U.S. The 50 states of the United States have a common currency. Some contrasts between the U.S., where there is a common currency, which works, and Europe, may be illustrative. In the U.S., two-thirds of all public expenditures occur at the federal level. The federal government bears the brunt of welfare payments, unemployment insurance, and capital investments, such as roads and R&D. The locus of countercyclical policies lies with the federal government. The federal government backs the banks—even most of the state banks—through the Federal Deposit Insurance Corporation (FDIC). There is free mobility, but in the U.S., no one cares if some state, like North Dakota, becomes devoid of population as a result of out-migration. Indeed, it lowers the cost of buying that state’s congressmen.

The euro was a political project, but one where the politics was not strong enough to “complete” the project, to do what had to be done to make a currency area bringing
together such a diverse group of countries work. The hope was that, with time, the project would be completed as the euro would bring the countries together. In practice, its effect has been just the opposite. Old wounds have been reopened, and new enmities have developed.

When things were going well, no one thought of these problems. I was hopeful that the Greek debt crisis that broke out in January 2010 would provide the impetus for more fundamental reforms. But little was done. As this book goes to press, interest rates faced by Spain are at levels that are not sustainable, and there is no prospect of recovery anytime soon.

The major mistake that Europe, prodded by Germany, has made is that it ascribed the difficulties of the periphery countries, like Spain, to profligate spending. Though it is true that Greece had run large deficits in the years before the crisis, both Spain and Ireland had surpluses and low debt levels (relative to their GDP). Thus, the focus on austerity would not even have prevented a recurrence of a crisis, let alone solved the crisis confronting Europe.

Earlier I described how the high level of unemployment is increasing inequality. But because those at the top spend a smaller fraction of their income than those at the bottom—who have no choice but to spend everything—inequality leads to a weaker economy. There is a downward vicious circle. And austerity exacerbates all of this. Today, the problem in Europe is inadequate overall demand. As the depression continues, banks are less willing to lend, housing prices decline, and households become poorer and poorer, and more uncertain of the future, depressing consumption further.

No large economy—and Europe is a large economy—has ever emerged from a crisis at the same time that it has imposed austerity. Austerity always, inevitably, and predictably makes matters worse. The only examples where fiscal stringency has been associated with recovery are small countries, typically with flexible exchange rates, and whose trading partners were growing robustly, so exports filled in the gap created by the cutbacks in government spending. But that is hardly the situation confronting Spain today: its major trading partners are in recession, and it has no control over its exchange rate.

European leaders have recognized that its problems will not be solved without growth. But they have failed to explain how growth can be achieved with austerity. So too, they assert that what is needed is a restoration of confidence. Austerity will not bring about either growth or confidence. The failed policies of the last two years on the part of Europe, as it has tried, repeatedly, patchwork solutions, misdiagnosing Europe’s problems, have undermined confidence. Because austerity has destroyed growth, it has also destroyed confidence, and will continue to do so, no matter how many speeches are given about the importance of confidence and growth.
The austerity measures have been particularly ineffective, because the market understood that they would bring with them recessions, political turmoil, and disappointing improvements in the fiscal position, as tax revenues declined. Rating agencies downgraded countries undertaking austerity measures, and rightly so. Spain was downgraded as the first austerity measures were passed: the rating agency believed that Spain would do what it promised, and it knew that that meant low growth and an increase in its economic problems.

While austerity was designed to resolve the “sovereign debt” crisis, to save the banking system, Europe has resorted to a series of equally ineffective temporary measures. For the past year, Europe has been engaged in a costly, fruitless bootstrap operation: providing more money to banks to buy sovereigns helped support the sovereigns; and providing more money to the sovereigns that helped support the banks. But it was nothing but voodoo economics, a hidden gift to the banks in the tens of billions of dollars, but one that the markets quickly saw through. Each measure was but a short-term palliative, the effects disappearing faster than even the pundits had warned. With the inefficacy of the bootstrap operations fully exposed, the financial system of the crisis countries has been put into jeopardy. Finally, almost two and a half years after the beginning of the crisis, it seemed to recognize the folly of this strategy. But even then, it couldn’t devise an effective alternative.

There is a second prong (besides getting their fiscal house in order) to Europe’s strategy: structural reforms to make the afflicted economies more competitive. Structural reforms are important, but they take time, and they are supply-side measures; but it is demand that is limiting production today. The wrong so-called supply-side measures—those that lead to lower incomes today—may exacerbate the lack of aggregate demand. Thus, measures to improve the labor market won’t lead to more hiring if there is no demand for the goods produced by firms. So too, weakening unions and job protections may well result in lower wages, weaker demand, and higher unemployment. Neoliberal doctrines held that moving workers away from subsidized sectors to more productive uses would increase growth and efficiency. But in situations such as that of Spain, where unemployment is already high, and especially so when the financial sector is weak, what happens is that workers move from low-productivity, subsidized sectors to unemployment; and the economy is further weakened by the resulting reduced consumption.

For years, now, Europe has struggled, and the only result is that, as this book goes to press, not just the crisis countries but Europe as a whole has slid into recession. There is an alternative set of policies that might work—might at least end the depression, end the corrosive increase in poverty and inequality, and perhaps even restore growth.

A long-recognized principle is that a balanced expansion of taxes and spending stimulates the economy, and if the program is well designed (taxes at the top, spending
on education) the increase in GDP and employment can be significant.

But what Spain can do is limited. Europe must act if the euro is to survive. Europe as a whole is not in a bad fiscal position—it’s debt-to-GDP ratio compares favorably with that of the U.S. If each state in the U.S. were totally responsible for its own budget, including paying for all unemployment benefits, the U.S., too, would be in fiscal crisis. The lesson is obvious: the whole is more than the sum of the parts. There are a variety of ways in which Europe could act together, beyond the measures already taken.

There are already institutions within Europe, such as the European Investment Bank, that could help finance needed investments in the cash-starved economies. It should expand its lending. So too, funds available to support small and medium-size enterprises should be enhanced, while large firms can turn to capital banks. Credit contraction by banks hits these enterprises particularly hard, and in all economies these firms are the source of job creation. Those measures are already on the table, but they are unlikely to suffice.

What is required is much more akin to a common treasury: a larger European solidarity fund for stabilization or Eurobonds. If Europe (and the ECB in particular) were to borrow, and relend the proceeds, the costs of servicing Europe’s debt would decrease, and that would make room for the kinds of expenditure that promote growth and employment.

But the common policies currently being discussed are little more than a suicide pact—an agreement to limit spending to revenues, even in a recession, without a commitment from the countries that are in a strong position to help the weaker. One of the victories of the Clinton administration was the defeat of a similar attempt by the Republicans to force a balanced budget amendment to the U.S. Constitution. We had not, of course, anticipated the fiscal profligacy of the Bush administration, the irresponsible deregulatory policies, the inadequate supervision, that led to a ballooning of the federal debt. But even if we had, I believe we would have come to the same conclusion. It is wrong not to use tools in a country’s toolkit; a primary obligation in modern economy is to maintain full employment, and monetary policy alone often cannot suffice.

Some in Germany say Europe is not a transfer union. Many economic relationships are not transfer unions—a free-trade zone is an example. But the system of a single currency sought to go beyond that. Europe and Germany will have to face the reality—if they are not willing to change the economic framework beyond an agreement of fiscal stringency, the euro will not work. It may survive for a little longer, causing untold pain in its death throes. But it will not survive.

So too, there is only one way out of the banking crisis—a common banking framework, a Europe-wide backing of the financial system. Not surprisingly, the banks receiving the implicit subsidies of the governments in a better financial position don’t
want this. They enjoy their competitive advantage. And bankers everywhere have undue sway over their governments.

The consequences will be deep and long-lasting. Young people long deprived of a decent job become alienated. When they eventually get a job, it will be at a much lower wage. Normally, youth is a time when skills get built up. Now it’s a time when they atrophy. Society’s most valuable asset, the talents of its people, is being wasted and even destroyed.

There are so many natural disasters in the world—earthquakes, floods, typhoons, hurricanes, tsunamis. It’s a shame to add to these a man-made disaster. But that’s what Europe is doing. Indeed, the willful ignorance of the lessons of the past is criminal. The pain that Europe is experiencing, especially its poor and its young people, is so unnecessary.

There is, I have suggested, an alternative. But Spain cannot act alone. The policies that are required are European policies. Delay in grasping this alternative will be very costly.

Right now, unfortunately, the kind of reform that would make the euro work is not being discussed, at least not openly. As I noted earlier, all that we have is platitudes about fiscal responsibility, and restoring growth and confidence. Quietly, academics and others are beginning to discuss a Plan B: what happens if the lack of political will that was evidenced at the founding of the euro—a political will to create the institutional structures that would make a common currency work—continues. As the widely used metaphor puts it, unscrambling a scrambled egg is costly. But so is maintaining the current flawed institutional arrangements. Flawed currency arrangements have collapsed before. There is a price to be paid. But life continues after debt and devaluation. And that life can be far better than the depression confronting some of the countries in Europe today. If there were light at the end of this tunnel, that would be one thing. But austerity provides no promise of a better world anytime in the foreseeable future. History and experience provide no basis for reassurance.

And if the depression does continue, it is those at the bottom and in the middle who will suffer the most.

Notes


3. A standard measure of inequality, discussed in chapter 1, is the Gini coefficient. Under that measure, perfect equality has a value of 0; perfect inequality, of 1. Reasonably good countries have a measure of .3. The United States, the worst of the advanced industrial countries, has a measure of around .47, and highly unequal countries have a measure in excess of .5. A country’s Gini coefficient usually moves very slowly, but Spain’s rose from 32.6 in 2005 to 34.7 in 2010. See IMF, “Income Inequality and Fiscal Policy,” June 2012, available at http://www.imf.org/external/pubs/ft/sdn/2012/sdn1208.pdf, accessed July 30, 2012.
† Foreword to the Spanish edition of *The Price of Inequality*.
PART VIII

PUTTING AMERICA BACK TO WORK
I began this book with a short section on the making of the Great Recession, focusing on the linkages between that recession and inequality—how it was both consequence and cause. I end by returning to these themes.

By the close of 2009 it was clear that we had saved the banks and that the country had avoided another Great Depression. But it was also clear to me by then that we had not set the economy on a course for a quick recovery. As I noted in the introduction to the prelude, and especially in “How to Get Out of the Financial Crisis,” we needed a strong, well-designed, large, and long-term stimulus; we needed a bailout, but one that induced banks to lend to small and medium-size enterprises. The appropriate regulatory reforms would help do this, reducing the scope for them to engage in speculation and market manipulation. We needed a housing policy that would help the millions of Americans losing their homes. We didn’t do any of these things. While we had saved the banks, we had not prevented millions and millions of Americans from losing their homes and millions more from losing their jobs. The Obama administration and the Fed seemed more confident than I was that we were about to turn the corner. By the middle of 2011 disillusionment was setting in. Something more was clearly needed to put more Americans back to work. “How to Put America Back to Work” was written for Politico to provide an alternative agenda.

It was 2013, and the economy still remained weak. A new national debate was breaking out. Was there a new normal? Should we come to accept a new higher level of unemployment? I continued to believe that the main reason for the weakness in our economy was the lack of demand, and a main reason for that was our inequality—which had become even worse since the beginning of the recession. In “Inequality Is Holding Back the Recovery” I again explain, in some detail, why inequality was so bad for the economy, what we could do to reduce it, and how, accordingly, we could have both better economic performance and less inequality.

As the recovery remained anemic, questions began to be raised about whether the original diagnosis of the economy’s problem was correct: Was there something more fundamentally wrong with the economy? At the time of the crisis, the common diagnosis was that the banks had engaged in reckless lending; the banks were bankrupt, and without a functioning banking system, the economy itself could not function. The money provided by the banks was like blood to the body. That’s why, it was argued, it was essential to save the banks. It wasn’t because we loved the banks and the bankers; it was that we couldn’t do without them. The Obama-Bush prescription followed from this diagnosis: put the banks into the emergency room, give them a massive transfusion (or, more accurately, infusion of cash), and within a year or two things will be back to normal. The economy would need a short-term boost—a stimulus—in the interim; but since the stimulus was merely a temporary measure, required only while the banks were mending, one didn’t have to be too finicky about the details. And so we wound up with
a stimulus that was too small, too short, and not particularly well designed.

(Of course, as I explained in Freefall and earlier in this book, one could save the banks without saving the bankers and the banks’ shareholders and bondholders. The irony was that what we did was unnecessarily expensive to the taxpayer, and less effective than it could or should have been.)

Two years after the collapse of Lehman Brothers, the banks were largely back to health. Lending to small and medium-size enterprises was still markedly below the crisis, but this was partly because we had focused rescue efforts on the big banks, letting hundreds of the smaller, local, and regional banks that are disproportionately engaged in such lending to be shut down. Still, the American economy was not doing well, and especially not if one focused on the average citizen. Indeed, as this book goes to press, some eight years after the breaking of the bubble and the start of the Great Recession, almost seven years after the collapse of Lehman Brothers, median incomes are still below the level attained a quarter-century ago.

“The Book of Jobs” was written to explain what was going on. The basic insight comes from history, looking at the Great Depression and seeing the parallel between what happened then and what is happening now. Increases in productivity in agriculture had contributed to a dramatic fall in incomes in agriculture—down 50 percent and more. These farmers couldn’t afford to buy goods made in the cities, and so incomes there declined as well. And farmers with declining income were locked into their farms—they couldn’t move elsewhere. Interestingly, those in the city who couldn’t get jobs were forced to migrate back to farms; and because of mechanization in the more prosperous farming areas, they were forced to migrate to some of the poorer areas.

What was required was a structural transformation of the economy, from agriculture to manufacturing; but markets don’t do this well on their own. Those whose houses had plummeted in value didn’t even have the money to move into the cities. Government assistance was required—and it finally came, with World War II: we needed to move people to the cities to make the armaments and other things necessary to win the war. And then after the war, we provided everyone who had fought in the war—which was essentially every young man—a free college education, equipping him for the “new economy” that was then emerging.

The article argues that underlying the economy’s malaise today are similar events: a growth of productivity in manufacturing that has outpaced growth in demand, so that global employment in manufacturing is declining; changes in comparative advantage and globalization—which we pushed—which imply that the United States will have a smaller share of this declining employment. Like the people then, we are the victims of our own success. And again as then, the markets on their own don’t do well in such structural transformations. But things are even worse now: the new sectors that should be growing are service sectors, like health and education, in which government’s role is
essential. But government, rather than stepping up to help in this transformation, is actually stepping back.

If this analysis is correct, it suggests a bleak future. And in the years since I wrote this article, the predictions have largely been borne out. The mediocre performance of the U.S. economy is in spite of forces that one might have expected to lead to a strong recovery: a high-tech sector that is the envy of the rest of the world, and a boom in shale gas and oil that has brought down prices of gas to new lows. Though as this book goes to press, it appears that growth is at last returning to the economy—a full eight years after the beginning of the recession in 2007—the growth is still barely robust enough to create employment for the new entrants into the labor force. The unemployment rate is down, but mainly because labor-force participation is down, to a level not seen in almost four decades—millions of Americans have dropped out of the labor force.

But as I explain here and elsewhere, this long-term (or as it has sometimes been called secular) stagnation into which the United States seems to be descending is a result not so much of underlying laws of economics as of our policies: the failure of government to facilitate the structural transformation and its failure to do anything about our increasing inequality.

The final chapters of this part pursue the implications of changing technology—and the enigmas it seemingly presents—somewhat further. The first two were written before the onset of the Great Recession, but when it was already very clear to me that there was something wrong with the way our economy was functioning. In “Scarcity in an Age of Plenty” I asked how it could be in this age of plenty, with all the advances of technology that we constantly trumpet, that so many in America and elsewhere seem to have an increasingly difficult time. The answer, in part, was increasing inequality: the fruits of progress were so unequally shared that, in the United States, those in the middle were actually getting worse off.

At the global level, there were two further problems. Some of the policies in the United States were helping the rich in the richest country in the world, at the expense of the poorest in the poorest countries: the subsidies to our farmers took badly needed money that could have been used so much better—to invest in infrastructure or technology or education—and gave it to well-off farmers, driving down global prices and further impoverishing poor farmers in developing countries.

And some of our corporate welfare policies were enriching our coal and oil companies at the expense of future generations. We were subsidizing these polluters, which were worsening climate change, again with money that could so much better have been used in other ways. But even worse, it was distorting innovation. Our innovations were directed too much at saving labor—in a world in which there was an abundance of workers relative to jobs—and too little at saving our environment.
Success at improving our standards of living over the long run will depend on growth—the right kind of growth, which means shared prosperity that protects the environment. In “Turn Left for Growth” I explain how this kind of growth can be achieved, why unfettered markets won’t on their own create that kind of growth, and what government can do. The crisis showed, to the contrary, that markets are not even efficient or stable. Even when interest rates were very low, the money—and innovation—didn’t go to creating well-paying jobs and increasing productivity in key sectors of the economy. It went to building shoddy homes in the middle of the Nevada desert and into speculation. Innovation was directed at creating new financial products that increased risks rather than managing them better. The article presents the outlines of a comprehensive growth agenda—far more promising than the instability and stagnation that we have experienced in recent decades.

In “The Innovation Enigma” I ask, How is it that we claim to be an innovation economy, and yet this innovation doesn’t show up in the macroeconomic data, for instance, in GDP per capita? I suggest it is partly because our GDP statistics do not really capture what is going on in our economy (the major theme of the International Commission on the Measurement of Economic Performance and Social Progress, which I chaired). But it is also partly because there has been some hype around innovation. It is important to be able to target advertising more efficiently, as Google and Facebook do, but are these innovations at all comparable to the development of electricity, the computer, the laser, or the transistor?

The flip side of innovation, however, is real: if productivity increases faster than demand, jobs and incomes will decline. This is what happened in the Great Depression. Some 70 percent of the labor force used to be required to produce the food we needed to survive. Now less than 3 percent can produce more than even an obese society can consume. It is not automatic that those who lose their jobs can find jobs elsewhere. Techno-optimists cite the automobile: jobs were lost making buggy whips, but far more jobs were created repairing and making cars. But there is nothing inevitable about this. And the new jobs won’t be created if aggregate demand is weak, as it is now.

Note

HOW TO PUT AMERICA BACK TO WORK*

THE COUNTRY IS—OR SHOULD BE—FOCUSED ON JOBS. Some 25 million Americans who want a full-time job can’t get one. The youth unemployment rate is as much as twice that of the already unacceptable national average.

America has always thought of itself as a land of opportunity—but where is the opportunity for our youngsters who face such bleak prospects? Historically, those who lost their job quickly got another, but an increasingly large fraction of the unemployed—now more than 40 percent—have been out of work for more than six months.

President Barack Obama will deliver an address Thursday outlining his vision of what can be done. Others should be doing the same.

Around the country there is growing pessimism. The rhetoric will be fine. But is there anything that anyone can really do—given the country’s looming debt and deficit?

The answer from economics is: There is plenty we can do to create jobs and promote growth.

There are policies that can do this and, over the intermediate to long term, lower the ratio of debt to gross domestic product. There are even things that, if less effective in creating jobs, could also protect the deficit in the short run.

But whether politics allows us to do what we can—and should—do is another matter.

The pessimism is understandable. Monetary policy, one of the main instruments for managing the macroeconomy, has proved ineffective—and will likely continue to be. It’s a delusion to think it can get us out of the mess it helped create. We need to admit it to ourselves.

Meanwhile, the large deficits and national debt apparently preclude the use of fiscal policy. Or so it is claimed. And there is no consensus on which fiscal policy might work.

Are we doomed to an extended period of Japanese-style malaise—until the excess leverage and real capacity works its way out? The answer, I have suggested, is a resounding “no.” More accurately: This outcome is not inevitable.

First, we must dispose of two myths. One is that reducing the deficit will restore the economy. You don’t create jobs and growth by firing workers and cutting spending. The reason that firms with access to capital are not investing and hiring is that there is insufficient demand for their products. Weakening demand—what austerity means—only discourages investment and hiring.

As Paul Krugman emphasizes, there is no “confidence fairy” that magically inspires investors once they see the deficit go down. We’ve tried that experiment—over and
over. Using the austerity formula, President Herbert Hoover converted the stock market crash into the Great Depression. I saw firsthand how the International Monetary Fund’s imposed austerity on East Asian countries converted downturns into recessions and recessions into depressions.

I don’t understand why, with such strong evidence, any country would impose this on itself. Even the IMF now recognizes you need fiscal support.

The second myth is that the stimulus didn’t work. The purported evidence for this belief is simple: Unemployment peaked at 10 percent—and is still more than 9 percent. (More accurate measures put the number far higher.) The administration had announced, however, that with the stimulus, it would reach only 8 percent.

The administration did make one big error, which I pointed out in my book *Freefall*—it vastly underestimated the severity of the crisis it inherited.

Without the stimulus, however, unemployment would have peaked at more than 12 percent. There is no doubt that the stimulus could have been better designed. But it did bring unemployment down significantly from what it otherwise would have been. The stimulus worked. It was just not big enough, and it didn’t last long enough: The administration underestimated the crisis’s durability as well as its depth.

Thinking about the deficit, we need to reflect back 10 years, when the country had such a large surplus at 2 percent of GDP that the Federal Reserve Bank chairman worried we would soon pay off the entire national debt—making the conduct of monetary policy difficult. Knowing how we went from that situation to this one helps us think through how to solve the deficit problem.

There have been four major changes: First, tax cuts beyond the country’s ability to afford. Second, two costly wars and soaring military expenditures—contributing roughly $2.5 trillion to our debt. Third, Medicare Part D—and the provision restricting government, the largest drug buyer, from negotiating with pharmaceutical companies, at a cost of hundreds of billions of dollars over 10 years. Fourth, the recession.

Reversing these four policies would quickly put the country on the road of fiscal responsibility. The single most important thing, however, is putting America back to work: Higher incomes mean higher tax revenues.

But how do we get America back to work now? The best way is to use this opportunity—with remarkably low long-term interest rates—to make long-term investments that America so badly needs in infrastructure, technology and education.

We should focus on investments that both yield high returns and are labor intensive. These complement private investments—they increase private returns and so simultaneously encourage the private sector.

Helping states pay for education would also quickly save thousands of jobs. It makes
no sense for a rich country, which recognizes education’s importance, to be laying off teachers—especially when global competition is so fierce. Countries with a better-educated labor force will do better. Moreover, education and job training are essential if we are to restructure our economy for the 21st century.

The advantage of having underinvested in the public sector for so long is that we have many high-return opportunities. The increased output in the short run and increased growth in the long run can generate more than enough tax revenues to pay the low interest on the debt. The result is that our debt will decrease, our GDP will increase, and the debt-to-GDP ratio will improve.

No analyst would ever look at just a firm’s debt—he would examine both sides of the balance sheet, assets and liabilities. What I am urging is that we do the same for the U.S. government—and get over deficit fetishism.

If we can’t, there is another, not as powerful but still very effective, way of creating jobs. Economists have long seen that simultaneously increasing expenditures and taxes in a balanced way increases GDP. The amount that GDP is increased for every dollar of increased taxes and spending is called the “balanced-budget multiplier.”

With well-designed tax increases—focused on upper-income Americans, corporations that aren’t investing in America, or closing tax loopholes—and smart expenditure programs that are focused on investments, the multiplier is between 2 and 3.

This means asking the upper 1 percent of our country, who now garner some 25 percent of all U.S. income, to pay a little more in taxes—or just pay their fair share. Investing this could have a significant effect on output and employment. And because the economy would grow more in the future, again, the debt-to-GDP ratio would come down.

There are some taxes that could actually improve the efficiency of the economy and the quality of life, with an even bigger effect on national output, if we correctly measure output. I chaired an International Commission on the Measurement of Economic Performance and Social Progress, which identified large flaws in our current system of measurement.

There is a basic principle in economics: It is better to tax bad things that generate negative externalities than good things. The implication is that we should tax pollution or destabilizing financial transactions. There are also other ways of raising revenues—better auctions of our country’s natural resources, for example.

If, for some reason, such revenue enhancements are ruled out—and there is no good economic reason why they should be—there is still room to maneuver. The government can change the design of tax and expenditure programs—even within the current budget envelope.
Increasing taxes at the top, for example, and lowering taxes at the bottom will lead to more consumption spending. Increasing taxes on corporations that don’t invest in America and lowering them on those that do would encourage more investment. The multiplier—the amount GDP increases per dollar spent—for spending on foreign wars, for example, is far lower than for spending on education, so shifting money here stimulates the economy.

There are things we can do beyond the budget. The government should have some influence over the banks, particularly given the enormous debt they owe us for their rescue. Carrots and sticks can encourage more lending to small and medium-size businesses and to restructure more mortgages. It is inexcusable that we have done so little to help homeowners, and as long as the foreclosures continue apace, the real estate market will continue to be weak.

The banks’ anticompetitive credit card practices also essentially impose a tax on every transaction—but it is a tax with revenues that go to fill the banks’ coffers, not for any public purpose—including lowering the national debt. Stronger enforcement of antitrust laws against the banks would also be a boon to many small businesses.

In short, we are not out of ammunition. Our predicament is not a matter of economics. Theory and experience show that our arsenal is still strong. Of course, the deficit and debt do limit what we can do. But even within these confines, we can create jobs and expand the economy—and simultaneously bring down the debt-to-GDP ratio.

It is simply a matter of politics whether we choose to take the steps we need to take to restore our economy to prosperity.

INEQUALITY IS HOLDING BACK THE RECOVERY*

The reelection of President Obama was like a Rorschach test, subject to many interpretations. In this election, each side debated issues that deeply worry me: the long malaise into which the economy seems to be settling, and the growing divide between the 1 percent and the rest—an inequality not only of outcomes but also of opportunity. To me, these problems are two sides of the same coin: with inequality at its highest level since before the Depression, a robust recovery will be difficult in the short term, and the American dream—a good life in exchange for hard work—is slowly dying.

Politicians typically talk about rising inequality and the sluggish recovery as separate phenomena, when they are in fact intertwined. Inequality stifles, restrains, and holds back our growth. When even the free-market-oriented magazine *The Economist* argues—as it did in a special feature in October—that the magnitude and nature of the country’s inequality represent a serious threat to America, we should know that something has gone horribly wrong. And yet, after four decades of widening inequality and the greatest economic downturn since the Depression, we haven’t done anything about it.

There are four major reasons inequality is squelching our recovery. The most immediate is that our middle class is too weak to support the consumer spending that has historically driven our economic growth. While the top 1 percent of income earners took home 93 percent of the growth in incomes in 2010, the households in the middle—who are most likely to spend their incomes rather than save them and who are, in a sense, the true job creators—have lower household incomes, adjusted for inflation, than they did in 1996. The growth in the decade before the crisis was unsustainable—it was reliant on the bottom 80 percent consuming about 110 percent of their income.

Second, the hollowing out of the middle class since the 1970s, a phenomenon interrupted only briefly in the 1990s, means that they are unable to invest in their future, by educating themselves and their children and by starting or improving businesses.

Third, the weakness of the middle class is holding back tax receipts, especially because those at the top are so adroit in avoiding taxes and in getting Washington to give them tax breaks. The recent modest agreement to restore Clinton-level marginal income-tax rates for individuals making more than $400,000 and households making more than $450,000 did nothing to change this. Returns from Wall Street speculation are taxed at a far lower rate than other forms of income. Low tax receipts mean that the government cannot make the vital investments in infrastructure, education, research, and health that are crucial for restoring long-term economic strength.

Fourth, inequality is associated with more frequent and more severe boom-and-bust cycles that make our economy more volatile and vulnerable. Though inequality did not
directly cause the crisis, it is no coincidence that the 1920s—the last time inequality of income and wealth in the United States was so high—ended with the Great Crash and the Depression. The International Monetary Fund has noted the systematic relationship between economic instability and economic inequality, but American leaders haven’t absorbed the lesson.

Our skyrocketing inequality—so contrary to our meritocratic ideal of America as a place where anyone with hard work and talent can “make it”—means that those who are born to parents of limited means are likely never to live up to their potential. Children in other rich countries like Canada, France, Germany, and Sweden have a better chance of doing better than their parents did than American kids have. More than a fifth of our children live in poverty—the second worst of all the advanced economies, putting us behind countries like Bulgaria, Latvia, and Greece.

Our society is squandering its most valuable resource: our young. The dream of a better life that attracted immigrants to our shores is being crushed by an ever-widening chasm of income and wealth. Tocqueville, who in the 1830s found the egalitarian impulse to be the essence of the American character, is rolling in his grave.

Even were we able to ignore the economic imperative of fixing our inequality problem, the damage it is doing to our social fabric and political life should prompt us to worry. Economic inequality leads to political inequality and a broken decision-making process.

Despite Mr. Obama’s stated commitment to helping all Americans, the recession and the lingering effects of the way it was handled have made matters much, much worse. While bailout money poured into the banks in 2009, unemployment soared to 10 percent that October. The rate today (7.8 percent) appears better partly because so many people have dropped out of the labor force, or never entered it, or accepted part-time jobs because there was no full-time job for them.

High unemployment, of course, depresses wages. Adjusted for inflation, real wages have stagnated or fallen; a typical male worker’s income in 2011 ($32,986) was lower than it was in 1968 ($33,880). Lower tax receipts, in turn, have forced state and local cutbacks in services vital to those at the bottom and middle.

Most Americans’ most important asset is their home, and as home prices have plummeted, so has household wealth—especially since so many had borrowed so much on their homes. Large numbers are left with negative net worth, and median household wealth fell nearly 40 percent, to $77,300 in 2010 from $126,400 in 2007, and has rebounded only slightly. Since the Great Recession, most of the increase in the nation’s wealth has gone to the very top.

Meanwhile, as incomes have stagnated or fallen, tuition has soared. In the United States now, the principal way to get education—the only sure way to move up—is to
borrow. In 2010, student debt, now $1 trillion, exceeded credit card debt for the first time.

Student debt can almost never be wiped out, even in bankruptcy. A parent who co-signs a loan can’t necessarily have the debt discharged even if his child dies. The debt can’t be discharged even if the school—operated for profit and owned by exploitative financiers—provided an inadequate education, enticed the student with misleading promises, and failed to get her a decent job.

Instead of pouring money into the banks, we could have tried rebuilding the economy from the bottom up. We could have enabled homeowners who were “underwater”—those who owe more money on their homes than the homes are worth—to get a fresh start, by writing down principal, in exchange for giving banks a share of the gains if and when home prices recovered.

We could have recognized that when young people are jobless, their skills atrophy. We could have made sure that every young person was either in school, in a training program, or on a job. Instead, we let youth unemployment rise to twice the national average. The children of the rich can stay in college or attend graduate school, without accumulating enormous debt, or take unpaid internships to beef up their résumés. Not so for those in the middle and bottom. We are sowing the seeds of ever more inequality in the coming years.

The Obama administration does not, of course, bear the sole blame. President George W. Bush’s steep tax cuts in 2001 and 2003 and his multitrillion-dollar wars in Iraq and Afghanistan emptied the piggy bank while exacerbating the great divide. His party’s new-found commitment to fiscal discipline—in the form of insisting on low taxes for the rich while slashing services for the poor—is the height of hypocrisy.

There are all kinds of excuses for inequality. Some say it’s beyond our control, pointing to market forces like globalization, trade liberalization, the technological revolution, the “rise of the rest.” Others assert that doing anything about it would make us all worse off, by stifling our already sputtering economic engine. These are self-serving, ignorant falsehoods.

Market forces don’t exist in a vacuum—we shape them. Other countries, like fast-growing Brazil, have shaped them in ways that have lowered inequality while creating more opportunity and higher growth. Countries far poorer than ours have decided that all young people should have access to food, education, and health care so they can fulfill their aspirations.

Our legal framework and the way we enforce it has provided more scope here for abuses by the financial sector; for perverse compensation for chief executives; for monopolies’ ability to take unjust advantage of their concentrated power.

Yes, the market values some skills more highly than others, and those who have
those skills will do well. Yes, globalization and technological advances have led to the loss of good manufacturing jobs, which are not likely ever to come back. Global manufacturing employment is shrinking, simply because of enormous increases in productivity, and America is likely to get a shrinking share of the shrinking number of new jobs. If we do succeed in “saving” these jobs, it may be only by converting higher-paid jobs to lower-paid ones—hardly a long-term strategy.

Globalization, and the unbalanced way it has been pursued, has shifted bargaining power away from workers: firms can threaten to move elsewhere, especially when tax laws treat such overseas investments so favorably. This in turn has weakened unions, and though unions have sometimes been a source of rigidity, the countries that responded most effectively to the global financial crisis, like Germany and Sweden, have strong unions and strong systems of social protection.

As Mr. Obama’s second term begins, we must all face the fact that our country cannot quickly, meaningfully recover without policies that directly address inequality. What’s needed is a comprehensive response that should include, at least, significant investments in education, a more progressive tax system, and a tax on financial speculation.

The good news is that our thinking has been reframed: it used to be that we asked how much growth we would be willing to sacrifice for a little more equality and opportunity. Now we realize that we are paying a high price for our inequality and that alleviating it and promoting growth are intertwined, complementary goals. It will be up to all of us—our leaders included—to muster the courage and foresight to finally treat this beleaguering malady.

IT HAS NOW BEEN ALMOST FIVE YEARS SINCE THE bursting of the housing bubble, and four years since the onset of the recession. There are 6.6 million fewer jobs in the United States than there were four years ago. Some 23 million Americans who would like to work full-time cannot get a job. Almost half of those who are unemployed have been unemployed long-term. Wages are falling—the real income of a typical American household is now below the level it was in 1997.

We knew the crisis was serious back in 2008. And we thought we knew who the “bad guys” were—the nation’s big banks, which through cynical lending and reckless gambling had brought the U.S. to the brink of ruin. The Bush and Obama administrations justified a bailout on the grounds that only if the banks were handed money without limit—and without conditions—could the economy recover. We did this not because we loved the banks but because (we were told) we couldn’t do without the lending that they made possible. Many, especially in the financial sector, argued that strong, resolute, and generous action to save not just the banks but the bankers, their shareholders, and their creditors would return the economy to where it had been before the crisis. In the meantime, a short-term stimulus, moderate in size, would suffice to tide the economy over until the banks could be restored to health.

The banks got their bailout. Some of the money went to bonuses. Little of it went to lending. And the economy didn’t really recover—output is barely greater than it was before the crisis, and the job situation is bleak. The diagnosis of our condition and the prescription that followed from it were incorrect. First, it was wrong to think that the bankers would mend their ways—that they would start to lend, if only they were treated nicely enough. We were told, in effect: “Don’t put conditions on the banks to require them to restructure the mortgages or to behave more honestly in their foreclosures. Don’t force them to use the money to lend. Such conditions will upset our delicate markets.” In the end, bank managers looked out for themselves and did what they are accustomed to doing.

Even when we fully repair the banking system, we’ll still be in deep trouble—because we were already in deep trouble. That seeming golden age of 2007 was far from a paradise. Yes, America had many things about which it could be proud. Companies in the information-technology field were at the leading edge of a revolution. But incomes for most working Americans still hadn’t returned to their levels prior to the previous recession. The American standard of living was sustained only by rising debt—debt so large that the U.S. savings rate had dropped to near zero. And “zero” doesn’t really tell the story. Because the rich have always been able to save a significant percentage of their income, putting them in the positive column, an average rate of close to zero means that everyone else must be in negative numbers. (Here’s the reality: in the years
leading up to the recession, according to research done by my Columbia University
colleague Bruce Greenwald, the bottom 80 percent of the American population had been
spending around 110 percent of its income.) What made this level of indebtedness
possible was the housing bubble, which Alan Greenspan and then Ben Bernanke,
chairmen of the Federal Reserve Board, helped to engineer through low interest rates
and nonregulation—not even using the regulatory tools they had. As we now know, this
enabled banks to lend and households to borrow on the basis of assets whose value was
determined in part by mass delusion.

The fact is the economy in the years before the current crisis was fundamentally
weak, with the bubble, and the unsustainable consumption to which it gave rise, acting
as life support. Without these, unemployment would have been high. It was absurd to
think that fixing the banking system could by itself restore the economy to health.
Bringing the economy back to “where it was” does nothing to address the underlying
problems.

The trauma we’re experiencing right now resembles the trauma we experienced 80
years ago, during the Great Depression, and it has been brought on by an analogous set
of circumstances. Then, as now, we faced a breakdown of the banking system. But
then, as now, the breakdown of the banking system was in part a consequence of
deeper problems. Even if we correctly respond to the trauma—the failures of the
financial sector—it will take a decade or more to achieve full recovery. Under the best
of conditions, we will endure a Long Slump. If we respond incorrectly, as we have
been, the Long Slump will last even longer, and the parallel with the Depression will
take on a tragic new dimension.

Until now, the Depression was the last time in American history that unemployment
exceeded 8 percent four years after the onset of recession. And never in the last 60 years
has economic output been barely greater, four years after a recession, than it was before
the recession started. The percentage of the civilian population at work has fallen by
twice as much as in any post–World War II downturn. Not surprisingly, economists
have begun to reflect on the similarities and differences between our Long Slump and
the Great Depression. Extracting the right lessons is not easy.

Many have argued that the Depression was caused primarily by excessive tightening of
the money supply on the part of the Federal Reserve Board. Ben Bernanke, a scholar of
the Depression, has stated publicly that this was the lesson he took away, and the reason
he opened the monetary spigots. He opened them very wide. Beginning in 2008, the
balance sheet of the Fed doubled and then rose to three times its earlier level. Today it is
$2.8 trillion. While the Fed, by doing this, may have succeeded in saving the banks, it
didn’t succeed in saving the economy.

Reality has not only discredited the Fed but also raised questions about one of the
conventional interpretations of the origins of the Depression. The argument has been
made that the Fed caused the Depression by tightening money, and if only the Fed back then had increased the money supply—in other words, had done what the Fed has done today—a full-blown Depression would likely have been averted. In economics, it’s difficult to test hypotheses with controlled experiments of the kind the hard sciences can conduct. But the inability of the monetary expansion to counteract this current recession should forever lay to rest the idea that monetary policy was the prime culprit in the 1930s. The problem today, as it was then, is something else. The problem today is the so-called real economy. It’s a problem rooted in the kinds of jobs we have, the kind we need, and the kind we’re losing, and rooted as well in the kind of workers we want and the kind we don’t know what to do with. The real economy has been in a state of wrenching transition for decades, and its dislocations have never been squarely faced. A crisis of the real economy lies behind the Long Slump, just as it lay behind the Great Depression.

For the past several years, Bruce Greenwald and I have been engaged in research on an alternative theory of the Depression—and an alternative analysis of what is ailing the economy today. This explanation sees the financial crisis of the 1930s as a consequence not so much of a financial implosion but of the economy’s underlying weakness. The breakdown of the banking system didn’t culminate until 1933, long after the Depression began and long after unemployment had started to soar. By 1931 unemployment was already around 16 percent, and it reached 23 percent in 1932. Shantytown “Hoovervilles” were springing up everywhere. The underlying cause was a structural change in the real economy: the widespread decline in agricultural prices and incomes, caused by what is ordinarily a “good thing”—greater productivity.

At the beginning of the Depression, more than a fifth of all Americans worked on farms. Between 1929 and 1932, these people saw their incomes cut by somewhere between one-third and two-thirds, compounding problems that farmers had faced for years. Agriculture had been a victim of its own success. In 1900, it took a large portion of the U.S. population to produce enough food for the country as a whole. Then came a revolution in agriculture that would gain pace throughout the century—better seeds, better fertilizer, better farming practices, along with widespread mechanization. Today, 2 percent of Americans produce more food than we can consume.

What this transition meant, however, is that jobs and livelihoods on the farm were being destroyed. Because of accelerating productivity, output was increasing faster than demand, and prices fell sharply. It was this, more than anything else, that led to rapidly declining incomes. Farmers then (like workers now) borrowed heavily to sustain living standards and production. Because neither the farmers nor their bankers anticipated the steepness of the price declines, a credit crunch quickly ensued. Farmers simply couldn’t pay back what they owed. The financial sector was swept into the vortex of declining farm incomes.
The cities weren’t spared—far from it. As rural incomes fell, farmers had less and less money to buy goods produced in factories. Manufacturers had to lay off workers, which further diminished demand for agricultural produce, driving down prices even more. Before long, this vicious circle affected the entire national economy.

The value of assets (such as homes) often declines when incomes do. Farmers got trapped in their declining sector and in their depressed locales. Diminished income and wealth made migration to the cities more difficult; high urban unemployment made migration less attractive. Throughout the 1930s, in spite of the massive drop in farm income, there was little overall out-migration. Meanwhile, the farmers continued to produce, sometimes working even harder to make up for lower prices. Individually, that made sense; collectively, it didn’t, as any increased output kept forcing prices down.

Given the magnitude of the decline in farm income, it’s no wonder that the New Deal itself could not bring the country out of crisis. The programs were too small, and many were soon abandoned. By 1937, FDR, giving way to the deficit hawks, had cut back on stimulus efforts—a disastrous error. Meanwhile, hard-pressed states and localities were being forced to let employees go, just as they are now. The banking crisis undoubtedly compounded all these problems, and extended and deepened the downturn. But any analysis of financial disruption has to begin with what set off the chain reaction.

The Agriculture Adjustment Act, FDR’s farm program, which was designed to raise prices by cutting back on production, may have eased the situation somewhat, at the margins. But it was not until government spending soared in preparation for global war that America started to emerge from the Depression. It is important to grasp this simple truth: it was government spending—a Keynesian stimulus, not any correction of monetary policy or any revival of the banking system—that brought about recovery. The long-run prospects for the economy would, of course, have been even better if more of the money had been spent on investments in education, technology, and infrastructure rather than munitions, but even so, the strong public spending more than offset the weaknesses in private spending.

Government spending unintentionally solved the economy’s underlying problem: it completed a necessary structural transformation, moving America, and especially the South, decisively from agriculture to manufacturing. Americans tend to be allergic to terms like “industrial policy,” but that’s what war spending was—a policy that permanently changed the nature of the economy. Massive job creation in the urban sector—in manufacturing—succeeded in moving people out of farming. The supply of food and the demand for it came into balance again: farm prices started to rise. The new migrants to the cities got training in urban life and factory skills, and after the war the GI Bill ensured that returning veterans would be equipped to thrive in a modern industrial society. Meanwhile, the vast pool of labor trapped on farms had all but
disappeared. The process had been long and very painful, but the source of economic distress was gone.

The parallels between the story of the origin of the Great Depression and that of our Long Slump are strong. Back then we were moving from agriculture to manufacturing. Today we are moving from manufacturing to a service economy. The decline in manufacturing jobs has been dramatic—from about a third of the workforce 60 years ago to less than a tenth of it today. The pace has quickened markedly during the past decade. There are two reasons for the decline. One is greater productivity—the same dynamic that revolutionized agriculture and forced a majority of American farmers to look for work elsewhere. The other is globalization, which has sent millions of jobs overseas, to low-wage countries or those that have been investing more in infrastructure or technology. (As Greenwald has pointed out, most of the job loss in the 1990s was related to productivity increases, not to globalization.) Whatever the specific cause, the inevitable result is precisely the same as it was 80 years ago: a decline in income and jobs. The millions of jobless former factory workers once employed in cities such as Youngstown and Birmingham and Gary and Detroit are the modern-day equivalent of the Depression’s doomed farmers.

The consequences for consumer spending, and for the fundamental health of the economy—not to mention the appalling human cost—are obvious, though we were able to ignore them for a while. For a time, the bubbles in the housing and lending markets concealed the problem by creating artificial demand, which in turn created jobs in the financial sector and in construction and elsewhere. The bubble even made workers forget that their incomes were declining. They savored the possibility of wealth beyond their dreams, as the value of their houses soared and the value of their pensions, invested in the stock market, seemed to be doing likewise. But the jobs were temporary, fueled on vapor.

Mainstream macroeconomists argue that the true bogeyman in a downturn is not falling wages but rigid wages—if only wages were more flexible (that is, lower), downturns would correct themselves! But this wasn’t true during the Depression, and it isn’t true now. On the contrary, lower wages and incomes would simply reduce demand, weakening the economy further.

Of four major service sectors—finance, real estate, health, and education—the first two were bloated before the current crisis set in. The other two, health and education, have traditionally received heavy government support. But government austerity at every level—that is, the slashing of budgets in the face of recession—has hit education especially hard, just as it has decimated the government sector as a whole. Nearly 700,000 state- and local-government jobs have disappeared during the past four years, mirroring what happened in the Depression. As in 1937, deficit hawks today call for balanced budgets and more and more cutbacks. Instead of pushing forward a structural
transition that is inevitable—instead of investing in the right kinds of human capital, technology, and infrastructure, which will eventually pull us where we need to be—the government is holding back. Current strategies can have only one outcome: they will ensure that the Long Slump will be longer and deeper than it ever needed to be.

Two conclusions can be drawn from this brief history. The first is that the economy will not bounce back on its own, at least not in a time frame that matters to ordinary people. Yes, all those foreclosed homes will eventually find someone to live in them, or be torn down. Prices will at some point stabilize and even start to rise. Americans will also adjust to a lower standard of living—not just living within their means but living beneath their means as they struggle to pay off a mountain of debt. But the damage will be enormous. America’s conception of itself as a land of opportunity is already badly eroded. Unemployed young people are alienated. It will be harder and harder to get some large proportion of them onto a productive track. They will be scarred for life by what is happening today. Drive through the industrial river valleys of the Midwest or the small towns of the Plains or the factory hubs of the South, and you will see a picture of irreversible decay.

Monetary policy is not going to help us out of this mess. Ben Bernanke has, belatedly, admitted as much. The Fed played an important role in creating the current conditions—by encouraging the bubble that led to unsustainable consumption—but there is now little it can do to mitigate the consequences. I can understand that its members may feel some degree of guilt. But anyone who believes that monetary policy is going to resuscitate the economy will be sorely disappointed. That idea is a distraction, and a dangerous one.

What we need to do instead is embark on a massive investment program—as we did, virtually by accident, 80 years ago—that will increase our productivity for years to come, and will also increase employment now. This public investment, and the resultant restoration in GDP, increases the returns to private investment. Public investments could be directed at improving the quality of life and real productivity—unlike the private-sector investments in financial innovations, which turned out to be more akin to financial weapons of mass destruction.

Can we actually bring ourselves to do this, in the absence of mobilization for global war? Maybe not. The good news (in a sense) is that the United States has underinvested in infrastructure, technology, and education for decades, so the return on additional investment is high, while the cost of capital is at an unprecedented low. If we borrow today to finance high-return investments, our debt-to-GDP ratio—the usual measure of debt sustainability—will be markedly improved. If we simultaneously increased taxes—for instance, on the top 1 percent of all households, measured by income—our debt sustainability would be improved even more.

The private sector by itself won’t and can’t undertake structural transformation of the
magnitude needed—even if the Fed were to keep interest rates at zero for years to come. The only way it will happen is through a government stimulus designed not to preserve the old economy but to focus instead on creating a new one. We have to transition out of manufacturing and into services that people want—into productive activities that increase living standards, not those that increase risk and inequality. To that end, there are many high-return investments we can make. Education is a crucial one—a highly educated population is a fundamental driver of economic growth. Support is needed for basic research. Government investment in earlier decades—for instance, to develop the Internet and biotechnology—helped fuel economic growth. Without investment in basic research, what will fuel the next spurt of innovation? Meanwhile, the states could certainly use federal help in closing budget shortfalls. Long-term economic growth at our current rates of resource consumption is impossible, so funding research, skilled technicians, and initiatives for cleaner and more efficient energy production will not only help us out of the recession but also build a robust economy for decades. Finally, our decaying infrastructure, from roads and railroads to levees and power plants, is a prime target for profitable investment.

The second conclusion is this: If we expect to maintain any semblance of “normality,” we must fix the financial system. As noted, the implosion of the financial sector may not have been the underlying cause of our current crisis—but it has made it worse, and it’s an obstacle to long-term recovery. Small and medium-size companies, especially new ones, are disproportionately the source of job creation in any economy, and they have been especially hard-hit. What’s needed is to get banks out of the dangerous business of speculating and back into the boring business of lending. But we have not fixed the financial system. Rather, we have poured money into the banks, without restrictions, without conditions, and without a vision of the kind of banking system we want and need. We have, in a phrase, confused ends with means. A banking system is supposed to serve society, not the other way around.

That we should tolerate such a confusion of ends and means says something deeply disturbing about where our economy and our society have been heading. Americans in general are coming to understand what has happened. Protesters around the country, galvanized by the Occupy Wall Street movement, already know.

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SCARCITY IN AN AGE OF PLENTY*

AROUND THE WORLD, PROTESTS AGAINST SOARING FOOD and fuel prices are mounting. The poor—and even the middle classes—are seeing their incomes squeezed as the global economy enters a slowdown. Politicians want to respond to their constituents’ legitimate concerns, but do not know what to do.

In the United States, both Hillary Clinton and John McCain took the easy way out, and supported a suspension of the gasoline tax, at least for the summer. Only Barack Obama stood his ground and rejected the proposal, which would have merely increased demand for gasoline—and thereby offset the effect of the tax cut.

But if Clinton and McCain were wrong, what should be done? One cannot simply ignore the pleas of those who are suffering. In the U.S., real middle-class incomes have not yet recovered to the levels attained before the last recession, in 1991.

When George Bush was elected, he claimed that tax cuts for the rich would cure all the economy’s ailments. The benefits of tax-cut-fueled growth would trickle down to all—policies that have become fashionable in Europe and elsewhere, but that have failed. Tax cuts were supposed to stimulate savings, but household savings in the U.S. have plummeted to zero. They were supposed to stimulate employment, but labor-force participation is lower than in the 1990s. What growth did occur benefited only the few at the top. Productivity grew, for a while, but it wasn’t because of Wall Street financial innovations. The financial products being created didn’t manage risk; they enhanced risk. They were so nontransparent and complex that neither Wall Street nor the ratings agencies could properly assess them. Meanwhile, the financial sector failed to create products that would help ordinary people manage the risks they faced, including the risks of homeownership. Millions of Americans will likely lose their homes and, with them, their life savings.

At the core of America’s success is technology, symbolized by Silicon Valley. The irony is that the scientists making the advances that enable technology-based growth, and the venture capital firms that finance it were not the ones reaping the biggest rewards in the heyday of the real estate bubble. These real investments are overshadowed by the games that have been absorbing most participants in financial markets.

The world needs to rethink the sources of growth. If the foundations of economic growth lie in advances in science and technology, not in speculation in real estate or financial markets, then tax systems must be realigned. Why should those who make their income by gambling in Wall Street’s casinos be taxed at a lower rate than those who earn their money in other ways. Capital gains should be taxed at least at as high a rate as ordinary income. (Such returns will, in any case, get a substantial benefit because
the tax is not imposed until the gain is realized.) In addition, there should be a windfall profits tax on oil and gas companies.

Given the huge increase in inequality in most countries, higher taxes for those who have done well—to help those who have lost ground from globalization and technological change—are in order, and could also ameliorate the strains imposed by soaring food and energy prices. Countries, like the U.S., with food stamp programs clearly need to increase the value of these subsidies in order to ensure that nutrition standards do not deteriorate. Those countries without such programs might think about instituting them.

Two factors set off today’s crisis: the Iraq war contributed to the run-up in oil prices, including through increased instability in the Middle East, the low-cost provider of oil, while bio-fuels have meant that food and energy markets are increasingly integrated. Although the focus on renewable energy sources is welcome, policies that distort food supply are not. America’s subsidies for corn-based ethanol contribute more to the coffers of ethanol producers than they do to curtailing global warming. Huge agriculture subsidies in the U.S. and the European Union have weakened agriculture in the developing world, where too little international assistance was directed at improving agriculture productivity. Development aid for agriculture has fallen from a high of 17 percent of total aid to just 3 percent today, with some international donors demanding that fertilizer subsidies be eliminated, making it even more difficult for cash-strapped farmers to compete.

Rich countries must reduce, if not eliminate, distortional agriculture and energy policies, and help those in the poorest countries improve their capacity to produce food. But this is just a start: we have treated our most precious resources—clean water and air—as if they were free. Only new patterns of consumption and production—a new economic model—can address that most fundamental resource problem.

* Project Syndicate, June 6, 2008.*
**TURN LEFT FOR GROWTH**

**Both the left and the right say they stand for economic growth.** So should voters trying to decide between the two simply look at it as a matter of choosing alternative management teams?

If only matters were so easy! Part of the problem concerns the role of luck. America’s economy was blessed in the 1990s with low energy prices, a high pace of innovation, and a China increasingly offering high-quality goods at decreasing prices, all of which combined to produce low inflation and rapid growth.

President Clinton and then-chairman of the U.S. Federal Reserve Alan Greenspan deserve little credit for this—though, to be sure, bad policies could have messed things up. By contrast, the problems faced today—high energy and food prices and a crumbling financial system—have, to a large extent, been brought about by bad policies.

There are, indeed, big differences in growth strategies, which make different outcomes highly likely. The first difference concerns how growth itself is conceived. Growth is not just a matter of increasing GDP. It must be sustainable: growth based on environmental degradation, a debt-financed consumption binge, or the exploitation of scarce natural resources, without reinvesting the proceeds, is not sustainable.

Growth also must be inclusive; at least a majority of citizens must benefit. Trickle-down economics does not work: an increase in GDP can actually leave most citizens worse off. America’s recent growth was neither economically sustainable nor inclusive. Most Americans are worse off today than they were seven years ago.

But there need not be a trade-off between inequality and growth. Governments can enhance growth by increasing inclusiveness. A country’s most valuable resource is its people. So it is essential to ensure that everyone can live up to their potential, which requires educational opportunities for all.

A modern economy also requires risk-taking. Individuals are more willing to take risks if there is a good safety net. If not, citizens may demand protection from foreign competition. Social protection is more efficient than protectionism.

Failures to promote social solidarity can have other costs, not the least of which are the social and private expenditures required to protect property and incarcerate criminals. It is estimated that within a few years, America will have more people working in the security business than in education. A year in prison can cost more than a year at Harvard. The cost of incarcerating two million Americans—one of the highest per capita rates in the world—should be viewed as a subtraction from GDP, yet it is added on.

A second major difference between left and right concerns the role of the state in
promoting development. The left understands that the government’s role in providing infrastructure and education, developing technology, and even acting as an entrepreneur is vital. Government laid the foundations of the Internet and the modern biotechnology revolutions. In the 19th century, research at America’s government-supported universities provided the basis for the agricultural revolution. Government then brought these advances to millions of American farmers. Small business loans have been pivotal in creating not only new businesses, but whole new industries.

The final difference may seem odd: the left now understands markets, and the role that they can and should play in the economy. The right, especially in America, does not. The new right, typified by the Bush-Cheney administration, is really old corporatism in a new guise.

These are not libertarians. They believe in a strong state with robust executive powers, but one used in defense of established interests, with little attention to market principles. The list of examples is long, but it includes subsidies to large corporate farms, tariffs to protect the steel industry, and, most recently, the mega-bailouts of Bear Stearns, Fannie Mae, and Freddie Mac. But the inconsistency between rhetoric and reality is long-standing: protectionism expanded under Reagan, including through the imposition of so-called voluntary export restraints on Japanese cars.

By contrast, the new left is trying to make markets work. Unfettered markets do not operate well on their own—a conclusion reinforced by the current financial debacle. Defenders of markets sometimes admit that they do fail, even disastrously, but they claim that markets are “self-correcting.” During the Great Depression, similar arguments were heard: government need not do anything, because markets would restore the economy to full employment in the long run. But, as John Maynard Keynes famously put it, in the long run we are all dead.

Markets are not self-correcting in the relevant time frame. No government can sit idly by as a country goes into recession or depression, even when caused by the excessive greed of bankers or misjudgment of risks by security markets and rating agencies. But if governments are going to pay the economy’s hospital bills, they must act to make it less likely that hospitalization will be needed. The right’s deregulation mantra was simply wrong, and we are now paying the price. And the price tag—in terms of lost output—will be high, perhaps more than $1.5 trillion in the United States alone.

The right often traces its intellectual parentage to Adam Smith, but while Smith recognized the power of markets, he also recognized their limits. Even in his era, businesses found that they could increase profits more easily by conspiring to raise prices than by producing innovative products more efficiently. There is a need for strong antitrust laws.

It is easy to host a party. For the moment, everyone can feel good. Promoting sustainable growth is much harder. Today, in contrast to the right, the left has a
coherent agenda, one that offers not only higher growth, but also social justice. For voters, the choice should be easy.

*Project Syndicate, August 6, 2008.*
AROUND THE WORLD, THERE IS ENORMOUS ENTHUSIASM for the type of technological innovation symbolized by Silicon Valley. In this view, America’s ingenuity represents its true comparative advantage, which others strive to imitate. But there is a puzzle: it is difficult to detect the benefits of this innovation in GDP statistics.

What is happening today is analogous to developments a few decades ago, early in the era of personal computers. In 1987, the economist Robert Solow—awarded the Nobel Prize for his pioneering work on growth—lamented, “You can see the computer age everywhere but in the productivity statistics.” There are several possible explanations for this.

Perhaps GDP does not really capture the improvements in living standards that computer-age innovation is engendering. Or perhaps this innovation is less significant than its enthusiasts believe. As it turns out, there is some truth in both perspectives.

Recall how a few years ago, just before the collapse of Lehman Brothers, the financial sector prided itself on its innovativeness. Given that financial institutions had been attracting the best and brightest from around the world, one would have expected nothing less. But, upon closer inspection, it became clear that most of this innovation involved devising better ways of scamming others, manipulating markets without getting caught (at least for a long time), and exploiting market power.

In this period, when resources flowed to this “innovative” sector, GDP growth was markedly lower than it was before. Even in the best of times, it did not lead to an increase in living standards (except for the bankers), and it eventually led to the crisis from which we are only now recovering. The net social contribution of all of this “innovation” was negative.

Similarly, the dot-com bubble that preceded this period was marked by innovation—Web sites through which one could order dog food and soft drinks online. At least this era left a legacy of efficient search engines and a fiber-optic infrastructure. But it is not an easy matter to assess how the time savings implied by online shopping, or the cost savings that might result from increased competition (owing to greater ease of price comparison online), affects our standard of living.

Two things should be clear. First, the profitability of an innovation may not be a good measure of its net contribution to our standard of living. In our winner-takes-all economy, an innovator who develops a better Web site for online dog-food purchases and deliveries may attract everyone around the world who uses the Internet to order dog food, making enormous profits in the process. But without the delivery service, much of those profits simply would have gone to others. The Web site’s net contribution to economic growth may in fact be relatively small.
Moreover, if an innovation, such as ATMs in banking, leads to increased unemployment, none of the social cost—neither the suffering of those who are laid off nor the increased fiscal cost of paying them unemployment benefits—is reflected in firms’ profitability. Likewise, our GDP metric does not reflect the cost of the increased insecurity individuals may feel with the increased risk of a loss of a job. Equally important, it often does not accurately reflect the improvement in societal well-being resulting from innovation.

In a simpler world, where innovation simply meant lowering the cost of production of, say, an automobile, it was easy to assess an innovation’s value. But when innovation affects an automobile’s quality, the task becomes far more difficult. And this is even more apparent in other arenas: How do we accurately assess the fact that, owing to medical progress, heart surgery is more likely to be successful now than in the past, leading to a significant increase in life expectancy and quality of life?

Still, one cannot avoid the uneasy feeling that, when all is said and done, the contribution of recent technological innovations to long-term growth in living standards may be substantially less than the enthusiasts claim. A lot of intellectual effort has been devoted to devising better ways of maximizing advertising and marketing budgets—targeting customers, especially the affluent, who might actually buy the product. But standards of living might have been raised even more if all of this innovative talent had been allocated to more fundamental research—or even to more applied research that could have led to new products.

Yes, being better connected with each other, through Facebook or Twitter, is valuable. But how can we compare these innovations with those like the laser, the transistor, the Turing machine, and the mapping of the human genome, each of which has led to a flood of transformative products?

Of course, there are grounds for a sigh of relief. Although we may not know how much recent technological innovations are contributing to our well-being, at least we know that, unlike the wave of financial innovations that marked the precrisis global economy, they have had a positive effect.

*Project Syndicate*, March 9, 2014.
The final chapter is different from the others. It is an interview conducted by Cullen Murphy, my editor at *Vanity Fair*, in which I respond to one of the claims made by conservatives, that the rich are net job creators. Taking money away from the rich—or even forcing the rich to pay their fair share of taxes—would, in this view, be counterproductive. Ordinary Americans would suffer. This is just a 21st-century version of the old trickle-down economics, attempting to defend societal inequalities.

My view was that trickle-down economics was *totally* wrong. Around the world there is a wealth of creativity, an abundance of entrepreneurship, *if there is adequate demand* (and if certain other preconditions are satisfied, such as access to capital and adequate infrastructure). In this view, the real “job creators” are consumers; and the reason that the American and European economies have not been creating jobs is that stagnant incomes mean stagnant demand. Indeed, as this book goes to press, wages in many European countries are below their level at the start of the crisis; and, as I have repeatedly pointed out, the income of the typical American family is lower than it was a quarter-century ago. No wonder, then, that demand has been stagnant.

The editors of *Vanity Fair* asked me another question, one that I heard frequently as I traveled around the country: To what time do we date that increase in inequality? And to what do we attribute it? The answer I provided corresponds to what other scholars have found: roughly to the beginning of the Reagan administration. While certain actions that President Reagan took almost surely contributed to this growth in inequality—including tax changes that were of enormous benefit to the very rich—one needs to take a broader perspective, as Thomas Piketty does in his book: an increase in inequality in many advanced countries started around the same time. The “reforms” that were part of the zeitgeist of the 1980s had impacts in country after country. These reforms included not only the lowering of top tax rates but also the liberalization of financial markets.

Thus we end the book repeating themes with which we began: our inequality—the extremes to which it has grown, the forms it has taken—is not inevitable; it is not the result of inexorable laws of economics or physics; it is a matter of choice, of our policies; and these in turn are the result of our politics. We have paid a high price for this inequality, a price we have felt most intensely in the past decade, with the making of the crisis and its aftermath. But it’s a price we will pay—in increasing amounts—in the future unless we change the policies that have given rise to it.
Q&A:

Joseph Stiglitz on the Fallacy That the Top 1 Percent Drives Innovation, and Why the Reagan Administration Was America’s Inequality Turning Point*

Cullen Murphy: In your new book, *The Price of Inequality*, you range very widely both historically and geographically. Looking at American history, what period strikes you as most similar to our own in terms of lack of concern for widening inequality?

Joseph Stiglitz: Two periods come to mind: the Gilded Age of the late 19th century and the boom times of the 1920s. Both were marked by high levels of inequality and corruption, including in the political process (such as the notorious Teapot Dome Scandal that marked the beginning of the 1920s). In fact, until the middle part of the last decade, income inequality had never reached the levels of the 20s. Of course, some of those who made their fortunes in both periods made great contributions to our society—the Robber Barons in building the railroads that transformed the country, or James B. Duke, who was instrumental in bringing electricity to parts of America. But both periods were also marked by speculation, instability, and excess.

There are some, like Edward Conard in his book *Unintended Consequences*, who argue that extreme inequality is not only not a sign of deep trouble but in fact is something to be celebrated. You’ll have many bones to pick with that argument. What are the central flaws?

Conard argues that greater inequality is good because as rich people accumulate more money, they will invest it and improve the economy. Further, their wealth is proof positive of their contributions to innovation. As you mention, there are so many problems with this view it is hard to know where to begin. Let me highlight three.

First, it is based on the notion of “trickle-down economics,” the idea that if those at the top do well, so will the rest of society. But the evidence is overwhelmingly to the contrary: the real income (adjusted for inflation) of most Americans today is lower than it was almost a decade and half ago, in 1997.

Secondly, it is based on the fallacy that inequality is good for economic growth, but again, the evidence is to the contrary. Time and again, inequality has been shown to retard economic growth and promote instability. These are findings based on mainstream studies. Even the International Monetary Fund, not known for its radical economic stances, has come to recognize the adverse effects of inequality on economic performance.

Thirdly, it is not true that the extremely wealthy use their money to take innovation-
driving risks. What we have seen quite clearly is that a much more common use of wealth is to gain advantage in “rent seeking.” When small groups of people have disproportionate wealth, they will use their power to seek special treatment from the government. Some of the wealthiest (historically, and even today) have gained their riches by the exercise of monopoly, preventing others from competing with them on a level playing field. Such rent-seeking behavior is a terribly inefficient use of resources: Rent seekers don’t create value. Rather, they use their privileged positions in markets to capture larger and larger portions of existing value. They distort the economy, lowering efficiency and economic growth.

The real drivers of growth and innovation are young businesses and small and medium-size businesses, especially in high-tech areas, typically based on government-supported research. Part of America’s problem today is that too many of those at the top don’t want to contribute their fair share to these “public goods,” with many paying taxes that are but a fraction of the rates paid by those who are much less well off. But it shouldn’t be a big surprise that some of the wealthiest Americans are promoting an economic fantasy in which their further enrichment is beneficial to everyone.

In the “recovery” of 2009–2010, the top 1 percent of American income earners captured 93 percent of the income growth. I don’t think Conard will persuade the nearly 23 million Americans who would like a full-time job but can’t get one to find comfort in that.

If you had to locate a fork-in-the-road moment when we started down the path toward widening inequality, when would that moment be? And what were the precipitating events?

It’s hard to pinpoint a single critical moment, but clearly the election of President Ronald Reagan represented a turning point. In the decades immediately after World War II, we had economic growth in which most people shared, with those at the bottom doing proportionately better than those at the top. (It was also the period that saw the country’s most rapid economic growth.) Among the precipitating events leading to greater inequality were the beginning of the deregulation of the financial sector and the reduction in the progressivity of the tax system. Deregulation led to the excessive financialization of the economy—to the point that, before the crisis, 40 percent of all corporate profits went to the financial sector. And the financial sector has been marked by extremes in compensation at the top, and has made its profits partly by exploiting those at the bottom and middle, with, for instance, predatory lending and abusive credit card practices. Reagan’s successors, unfortunately, continued down the path of deregulation. They also extended the policy of lowering taxes at the top, to the point where today, the richest 1 percent of Americans pay only around 15 percent of their income in taxes, far lower than those with more moderate incomes.

Reagan’s breaking of the air-traffic controllers’ strike is often cited as a critical
juncture in the weakening of unions, one of the factors explaining why workers have done so badly in recent decades. But there are other factors as well. Reagan promoted trade liberalization, and some of the growth in inequality is due to globalization and the replacement of semiskilled jobs with new technologies and outsourced labor. Some of the increase in inequality common to both Europe and America can be ascribed to that. But what’s different about America is the remarkable growth in incomes of the very top—especially the top 0.1 percent. This is orders of magnitude greater than in most of Europe and comes partly out of Reagan’s deregulatory fervor, particularly in finance, partly out of inadequate enforcement of competition laws, partly out of America’s greater willingness to take advantage of inadequate corporate governance laws.

Throughout its history, America has struggled with inequality. But with the tax policies and regulations that existed in the postwar period, we were on the right track toward ameliorating some of that. The tax cuts and deregulation that began in the Reagan years reversed the trend. Income disparities before tax and transfers (help that is given to the poor through, for instance, food stamps) is now larger, and because government is doing less for the poor and favoring the rich, inequalities in income, after taxes and transfers, are even larger.

One of the activities you criticize at length is “rent seeking.” Do you see rent seeking at play in the J.P. Morgan fiasco?

The huge losses that J.P. Morgan recently reported show that we have not curbed the excesses of the banks; we have not cured the problems that led to the crisis. There is still a lack of transparency, predatory lending, and reckless behavior—with taxpayers still at risk. The failure to reform the financial sector is a clear manifestation of rent seeking. We have continued with a system where we privatize profits and socialize losses; in effect, the banks have been the recipients of massive (often hidden) subsidies.

The financial industry has used its revolving door with the government first to weaken the regulations that constrain them; and even after it was manifestly clear that they were inadequate, to prevent the imposition of adequate new regulations. We have a deficient regulatory structure because of rent seeking. Banks use their muscle to get special treatment, including bailouts. They have seen that if a loss would put them into bankruptcy, the American taxpayer is there for them with cheap financing (direct injections, zero percent interest rates, propping up the mortgage market, paying AIG’s obligations, and so on). In that way, they extract rents from the rest of us. These rents are then paid out in dividends to shareholders and “bonuses” to the management. What upset so many Americans was that those who brought their companies to the brink of ruin still received bonuses. And even as the Fed lent the banks money at close to zero percent interest, and they could make easy money by simply buying a long-term government bond, bankers received bonuses as if the profits were a result of their hard work or genius.
In your book you offer a number of policy options that together, over time, would redress the inequality problem. If you could press a button and achieve only one of them, which one would it be and why? If you could press the button once again, what would the second one be?

There is simply no silver bullet, partly because there are so many different parts to America’s inequality: the extremes of income and wealth at the top, the hollowing out of the middle, the increase of poverty at the bottom. Each has its own causes, and each needs its own remedies.

What disturbs me most is the fact that America has ceased to be a land of opportunity, with the chances of those at the bottom making it to the middle or top being much lower even than in old Europe; in fact, it is worse here than in any of the other advanced industrial countries for which there is data. This lack of equality of opportunity translates, over the years, into increasing inequality, and can lead to the creation of an inherited plutocracy. So for me, the single most important action is to ensure a quality education for all. At the same time, improved education would help Americans compete in the increasingly competitive global market.

The policies that I propose in The Price of Inequality follow directly from my diagnosis of the sources of inequality: at the top, excessive financialization, abuses of corporate governance that lead CEOs to take a disproportionate share of corporate profits, and rent seeking; in the middle, the weakening of unions; at the bottom, discrimination and exploitation. Creating good financial regulations, better systems of corporate governance, and laws that curb further discrimination and predatory lending practices would all help. So too would campaign-finance and other political reforms that would curb opportunities for rent seeking by those at the top.

These steps would all reduce the extent of inequality in before-tax incomes. But equally important is a reduction in after-tax income inequality. An easy place to start is with taxation itself—the current system taxes capital gains, which can be profits from speculation, at a much lower rate than salaries and wages. Not only is there no good reason for that, such tax policies distort the economy and increase instability. The wealthy should not be paying a smaller proportion of their incomes in taxes than the middle class. This worsens inequality, further distorts our politics, and makes it harder to restore the country’s fiscal health. The increased revenues could, furthermore, help finance the needed public investments in infrastructure, education, and research that will get our economy back on track—and, if well designed, would also increase both equality and equality of opportunity.

There must be voices among the 1 percent who make the same arguments you do about why inequality matters and why the wealthy have a stake in the welfare of everyone. Who are they?

There are many, including George Soros and Warren Buffett. Hundreds have signed on
to a petition coordinated by a group called the Patriotic Millionaires to increase taxes on
the rich, which can be found at patrioticmillionaires.org. They understand that a house
divided cannot stand; they understand that their own long-term well-being, and that of
their children, depends on there being a cohesive American society, one that invests
adequately in education, infrastructure, and technology. Many of these are individuals
who lived the American dream, who did not inherit their fortunes, and who want others
to have the same opportunities that they enjoyed. Above all, I suspect that they believe
strongly in certain values—exemplified by Buffett’s lifestyle—and they worry that in an
increasingly divided America those values will become an increasing rarity. As the
Patriotic Millionaires wrote in their petition in support of the Buffett rule, “Our country
has been good to us. It provided a foundation through which we could succeed. Now,
we want to do our part to keep that foundation strong so that others can succeed as we
have.”

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