

The New Inequality Debate

More mainstream economists now find that the income mal-distribution reflects the political sway of elites, not economic imperatives.

By Robert Kuttner

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More and more mainstream economists have lately discovered a phenomenon that their discipline too often assumes away. They have discovered power. And this fundamentally changes the nature of the debate about inequality.

In the usual economic model, markets are mostly efficient. Power is not relevant, because competition will generally thwart attempts to place a thumb on the market scale. Thus if the society is becoming more unequal it *must* be (a favorite verb form) because skills are receiving greater rewards, and the less-skilled are necessarily left behind; or because technology is appropriately displacing workers; or because in a global market, lower-wage nations can out-compete Americans; or because deregulation makes markets more efficient, with greater rewards to winners; or because new financial instruments add such efficiency to the economy that they justify billion-dollar paydays for their inventors.

Increasingly, however, influential orthodox economists are having serious second thoughts. What if market outcomes and the very rules of the market game reflect political power, not market efficiency? Indeed, what if gross inequality is not efficient, and there is a broad zone of indeterminate income distributions consistent with strong economic performance? What if greater

liberalization of financial markets produced tens of trillions of costs to the economy, benefits that are hard to discern, and billion-dollar paydays for traders that don't comport with their contributions to general economic welfare? Evidence like this is piling up, and hard to ignore.

ANTHONY ATKINSON'S NEW BOOK, *Inequality: What Can Be Done?*, is both emblem and evidence of this shift in mainstream economic thinking.

Atkinson, of the London School of Economics and Oxford's Nuffield College, is the dean of economists who study inequality. After an exhaustive compilation of data and trends, Atkinson bluntly attributes rising inequality directly or indirectly to "changes in the balance of power." Thus, he adds, "Measures to reduce inequality can be successful only if countervailing power is brought to bear."

Though it has not attracted the celebrity attention, in many respects Atkinson's work is more important than Thomas Piketty's pathbreaking *Capital in the Twenty-First Century*, and is the perfect sequel. Where Piketty explained the tendency of wealth and income to concentrate, Atkinson digs deeper into what drove this shift and why conventional remedies will not reverse the trends. He has a far surer grasp than Piketty of the political dynamics that made possible the anomalous egalitarian era of the 30 glorious years after World War II.

In Atkinson's telling, the postwar social bargain drastically reduced inequality using several levers. Progressive taxes and welfare-state transfers were part of the story. Likewise a more highly regulated form of globalization. Worker and trade-union power resulted in a larger share of the total national product going to wage and salaries. Antitrust and some public ownership helped, too. All of these instruments, and more, have been reversed since about 1980—due mainly to a shift in political power. This shift increases the influence as well as the wealth of the rich, which leads to a self-reinforcing circle of more such policies, and more inequality.

In the labor market, the greater “flexibility” long promoted by many economists, Atkinson writes, has produced “a transfer of power from workers to employers. The growth of multi-national companies, and trade and capital-market liberalization, have strengthened the position of companies vis-à-vis customers, workers, and governments.” Even technology, he adds, needs to be understood in terms of power. “Technological progress is not a neutral force but reflects social and economic decisions. Choices by firms, by individuals and by governments can influence the direction of technology and hence the distribution of income.” He adds that inequality “is embedded in our social and economic structure, and a significant reduction requires us to examine all aspects of our society.”

Isn't this account familiar? Yes, and no. Some further to the left have long made these arguments. But for most of the economics profession, widening inequality of earnings has been primarily a reflection of widening differentials in worker skills in the face of changes in technology that require more advanced workers. Therefore, the logical cure is better education and training. Lawrence Mishel and colleagues at the Economic Policy Institute have been challenging this account for years. But only lately has the mainstream conceded that the EPI view is substantially right. Three of the principal proponents of the view, Harvard's Lawrence Katz, MIT's David Autor, as well as *Prospect* co-founder Robert Reich, have walked back their previous embrace of the skills explanation, known in academia as skill-biased technological change, or SBTC.

As Paul Krugman recently wrote, “While one still encounters people invoking skill-biased technological change as an explanation of rising inequality and lagging wages—it's especially popular among moderate Republicans in denial about what's happened to their party and among ‘third way’ types lamenting the rise of Democratic populism—the truth is that SBTC has fared very badly over the past quarter-century, to the point where it no longer deserves to be taken seriously as an account of what ails us.”

THIS REVISIONISM HAS HUGE implications for economic theory, for possible remedies, and for politics. If greater inequality does not reflect market efficiencies, then market distributions of income are not efficient. And policies that produce greater equality will, at worst, do no damage to economic growth—and quite possibly will improve it.

As an illustration of how pervasive was the previous consensus, consider a piece that the *Prospect* published in 1995 by Barry Bluestone, a well-known left-of-center economist. Bluestone's article, "The Inequality Express," invoked Agatha Christie's detective mystery *Murder on the Orient Express*, which contained the surprise twist that all of the suspects did it. Bluestone listed ten suspects on the Inequality Express: technology, trade, a shift from manufacturing to services, deregulation, declining unionization, downsizing, winner-take-all labor markets, capital mobility, immigration, and trade deficits. Each of these factors played a part, Bluestone concluded. They all did it.

Invoking another classic, Michael Young's essay "The Rise of the Meritocracy," Bluestone fretted that the new inequality was substantially earned. It was *meritocratic*. Better-equipped people simply commanded higher wages, while routine workers were swamped by outsourcing, offshoring, and technology. And if inequality is earned, it becomes much harder to justify tampering with it. Atkinson's list of causes is not all that different from Bluestone's—but with one huge difference: Atkinson doubts that today's increased inequality is earned. Thus the obstacles to reversing it are not economic, but political.

Reich's influential 1991 book, *The Work of Nations*, shared the view that skills accounted for widening earnings disparities. In his new book, *Saving*

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Capitalism: For the Many, Not the Few, Reich recants. The real story, he writes, is a power-shift. Reich previewed those ideas in our Spring 2015 issue.

Reich's new work is the best statement since Karl Polanyi's 1944 masterwork, *The Great Transformation*, of how markets are creatures of government and politics rather than a default state of nature. As Reich writes, "Government doesn't 'intrude' on the 'free market.' It creates the market." (Polanyi likewise wrote, in a famous oxymoron, "Laissez-faire was planned.") Reich's latest book is a compendium of all the ways that political power by economic elites rigs the rules of how markets work—in favor not of efficiency, but of the rich and the powerful—increasing both inefficiency and inequality. With increased market power comes increased concentration of wealth, and still more concentration of both political and economic power.

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More and more mainstream economists have been paying increasing attention to the connection between political power, market power, and the income distribution. As David Dayen wrote in a recent *Prospect* piece, anti-trust has ceased to be a meaningful brake on economic concentration, just as new business models have come up with new ways to exploit market power. Jason Furman, current chair of the Council of Economic Advisers, in a research paper with Peter Orszag, former head of the Office of Management and Budget, confirms that increasing numbers of firms enjoy monopoly or oligopoly profits not reduced by competition, as free-market theory would predict. Once, in the postwar era, when unions were stronger, oligopoly profits were shared with workers. Today, they go to CEOs, shareholders, and hedge fund operators.

Another emblem of the shift in mainstream economic thinking is the award of the 2014 Nobel Prize in Economics to the French economist Jean Tirole. The citation explicitly credited his contribution to “the science of taming powerful firms,” recognizing that concentrated economic power undermines efficiency as well as equality.

A further example is revisionism of the relationship of inequality to consumption and debt, and the knock-on costs to economic efficiency. In traditional economic theory, mainstream economists ignored the role of income distribution in one’s propensity to consume, as well as its macroeconomic effect. In recent decades, however, people with stagnant or declining earnings maintained consumption levels by running up consumer debt. A Federal Reserve substantially captured by bankers cooperated by lowering interest rates and blessing new, risky debt instruments like securities backed by subprime mortgages. What the British economist Colin Crouch termed “privatized Keynesianism” went abruptly into reverse when the crash of 2008 came, deepening the slump. Thus, widening inequality set off dynamics that resulted in an intensified collapse. In a new book, *Income Inequality: Why It Matters and Why Most Economists Didn’t Notice*, Matthew Drennan explains how traditional theories of consumption, shared by relatively liberal economists such as Franco Modigliani and conservative Milton Friedman (both Nobelists), got the story wrong by leaving out the income distribution.

Still other examples include Joseph Stiglitz’s latest book, *Rewriting the Rules of the American Economy*. He writes, “Today’s inequality is not the result of the inevitable evolution of capitalism. Instead, the rules that govern the economy got us here.” Stiglitz has always been something of an outlier, but enough of a mainstream economist to have won a Nobel and have served in senior posts in the Clinton administration and at the World Bank. At a festschrift conference for Stiglitz last October, people more mainstream than he, from Robert Solow to Jason Furman and Peter Orszag, paid tribute to the prescience of his work. “In Joe’s honor,” Furman and Orszag wrote, “we thought it appropriate to

collaborate on a paper that explores two of his core interests: the rise in inequality and how the assumption of a perfectly competitive marketplace is often misguided.”

At the festschrift, Solow, another eminently mainstream economist with a history of challenging received assumptions, observed that we would never solve the problem of extreme inequality without dealing with wages—an issue that is as much the consequence of power as of marginal productivity. Solow was coming back to his own roots. In 1990, he wrote a book titled *The Labor Market as a Social Institution*, challenging the idea that this is a market just like others, since workers are also human beings and “participants, on both sides, have well-developed notions of what is fair and what is not.”

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FOR PROGRESSIVES, WHO HAVE ASSUMED since Teddy Roosevelt that the state is the logical counterweight to the market, the new insights about the connection between political and economic inequality illuminate a huge practical problem. When large corporations and mega-banks capture the machinery of the state, regulation itself is undermined as remedy. The standard liberal story—that we need government to help tame the market for the benefit of ordinary citizens—loses credibility as well as veracity, since the plutocrats are inside the gates. This helps explain why right-wing populists have some credibility: Wall Street and Washington are all the same crowd.

Conservative economists, going back to public-choice theorists such as Gordon Tullock and James Buchanan, have long argued that regulatory capture by interest groups is inevitable; hence, the best policy is to minimize the role of the state altogether. This is why Atkinson is so refreshing. Not at all, he says;

with a shift in political power, the state may yet be redeemed as an instrument of greater and more efficient equality.

Atkinson's book closes with a short manifesto of remedies. The good news: We could return the income distribution to something more like the one that prevailed during the postwar boom, a golden age both for income equality and for dynamic managed capitalism. His policy package calls for using "the whole of government" to reverse inequality on all fronts and "rebalancing power in the economy."

The inequality of earned income began creeping up in the late 1940s, Atkinson reports, but until the 1980s an expanding redistributive welfare state and the entry of women into the labor market were sufficient to keep inequality of final household income from rising. Since then, wage inequality has far outstripped redistributive capacity.

First, he proposes, we need a restoration of progressive taxation. Specifically, he calls for a top personal tax rate of 65 percent, higher than the current top rate but lower than the top rate in the Eisenhower era. Yet he also observes that inequality has become so extreme that more progressive taxes and more generous social transfers can no longer solve the inequality problem. That will take a drastic shift in primary income from wages, salaries, and capital.

To illustrate just how the shift in power from citizens to capitalists has made progressive taxation far more difficult politically, Atkinson quotes the current British Chancellor of the Exchequer, George Osborne, boasting to the 2014 Conservative Party Conference, "In a modern global economy where people can move their investment from one country to another at the touch of a button and companies can relocate jobs overnight—the economics of high taxation are a thing of the past." Standard economics interprets these shifts as expressions of economic efficiency. Atkinson explains them as shifts of power.

In addition to calling for stronger trade unions, Atkinson calls for reducing the unemployment rate to 2 percent, a goal that was achieved throughout Europe

in the early postwar era, with guaranteed public employment as one of the strategies. To equalize wealth, he calls for the creation of public sovereign wealth funds, with the aim of “building up the net worth of the state by holding investments in companies and in property,” and the payout of a universal capital endowment, or inheritance, to all citizens upon their reaching adulthood. That way, the wealth that allows the affluent to pass along inherited advantage to their children would be spread around.

He also has a wonderfully creative proposal to replace estate taxes with a “progressive lifetime capital receipts tax.” At present, estate taxes (which cover less than half of 1 percent of estates) are paid by the donor’s estate. Instead, Atkinson suggests, all gifts including bequests should simply be treated as income. They should incur taxes to be paid by the recipient, with the rate based on the income of the recipient, not the giver. Atkinson also calls for a different set of rules for globalization, consistent with a more equitable income distribution at home.

So after decades of market-loving economists helping to push politics to the center-right, we now have the anomalous spectacle of some influential economists being on the left edge of mainstream politics—a happy throwback to the prophetic role of John Maynard Keynes in the 1920s and 1930s. As Atkinson himself points out, most of these ideas are not especially radical compared with the norms and policies that were prevalent during the postwar era. The bad news: They are far to the left of what passes for mainstream politics today.

Nonetheless, the news that egalitarian policies are both attainable and salutary should be tonic for the liberal soul. It’s also propitious that the unmistakable increase in inequality to levels that violate broadly shared norms of what’s reasonable is a useful embarrassment to conservative economists and their political allies.

SINCE REAGAN, AMERICA HAS embraced much of the conservative package. Taxes are lower and less redistributive. Many benefits to the poor have been drastically cut. There is far less regulation, and the regulation that does operate is largely pro-corporate. Global trade is freer than ever and outsourcing easier. However, the basic growth trajectory has not changed and if anything is slightly slower than it was in the postwar decades. Financial deregulation caused growth to take a huge hit beginning in 2007, from which the economy is only now recovering. But inequality has soared. While some of it can be justified as meritocratic, billion-dollar hedge fund managers have few defenders and even some Republican presidential candidates want to increase their taxes.

Rising inequality is simply a mirage if you make the right adjustments to the data.

On the inequality conundrum, conservative economists divide four ways. Some are denialists. Rising inequality is simply a mirage if you make the right adjustments to the data. Scott Winship of the Manhattan Institute operates a small cottage industry purporting to demonstrate that if you correct for a variety of factors ranging from household size to counting health insurance as income, the statistical rise in inequality mostly vanishes.

A second group concedes increasing inequality but blames it on the deterioration of values. Marry everyone off and poverty largely disappears. The income distribution is indeed much flatter if you limit the sample to married couples. The trouble with this view is that it still has to reckon with immense and widening wage and salary inequality.

A third group, latter-day supply-siders, insist that if we really get government out of the way, then the poor as well as the rich will share in a burst of entrepreneurship. That, of course, has been the conservative story ever since Reagan, yet inequality keeps increasing.

And then there are the self-described “reformicons,” who seek to define a conservative version of government anti-poverty policy, more or less in the spirit of Jack Kemp. Last year, a group of conservative intellectuals led by Yuval Levin, editor of *National Affairs*, and Peter Wehner, a former adviser to three Republican presidents, published a pamphlet titled “Room to Grow.” The piece begins by frankly acknowledging trends that liberals usually emphasize—persistent poverty and reduced mobility, flat earnings for the broad middle class, a general sense of diminishing life horizons. The trouble with the reformicons, however, is the disconnect between their analysis and their remedies—which are mostly small-bore, such as the expanded use of tax credits. Nor do they address the policies that have produced grotesque inequality at the top.

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MEANWHILE, BACK INSIDE THE Capital Beltway, a group of center-left and center-right policy experts (mostly non-economists) have sought to reckon with power in a very different sense. They have been working for 14 months to see whether a new policy consensus is possible to reduce poverty. The group, under the auspices of the American Enterprise Institute (AEI) and the Brookings Institution, deliberately focused on poverty, not inequality, expressing a very different conception of political realism.

After a good deal of horse-trading and nearly breaking apart at several points, the group delivered an 85-page report in early December titled “Opportunity, Responsibility, and Security: A Consensus Plan for Reducing Poverty and Restoring the American Dream.” The working group included anti-poverty scholars Lawrence Aber, Sheldon Danziger, and David Ellwood on the moderate left, and Stuart Butler, Ron Haskins, and Lawrence Mead on the

right. Basically, the liberals in the group conceded more than they really wanted to in terms of blaming poverty on family structure, and the conservatives conceded more than they wanted in accepting that low and stagnant wages were a big part of the story.

The manifesto blends suggestions ranging from increasing work and the rewards for working, to promoting marriage and “delayed, responsible childbearing” as well as parenting education. The liberals on the panel did win some important concessions. Conservatives agreed to a higher minimum wage and major improvements in preschool and post-secondary education. The liberals beat back demands to attach onerous conditions to food stamps.

The price that the liberals paid was that the larger issue of the income distribution was not part of the discussion or the report. It focused on a relatively narrow stratum of the income distribution—the working poor and near-poor. The group largely ignored the struggles of the very poor, of the sort addressed in Kathryn Edin and H. Luke Shaefer’s new book, *\$2.00 a Day: Living on Almost Nothing in America* (see our review, also in this issue). Nor did the report engage the downward mobility and economic stress on the broad, working middle class. Nor did the group did address the extreme pulling-away of the top.

The elephant in the room, in more senses than one, was the Republican war on the welfare state.

And unlike the Atkinson book, the panel did not discuss power. To read the report, one would think that cuts in outlays on the poor, the brutal slashing of welfare benefits in TANF, wage stagnation, and what the authors delicately termed “weakening” of “collective bargaining” just happened. The elephant in the room, in more senses than one, was the Republican war on the welfare state. This was never mentioned. Instead, there was the usual imputation of partisan symmetry to legislative blockage (“When one political party offers a proposal, the other usually disagrees...”), of the sort that Jacob Hacker and

Paul Pierson so powerfully refuted in their book, *Off Center*, and in other research. The report also clings to the largely discredited story that low earnings are mainly a reflection of low skills.

Despite these omissions, a large majority of Americans would probably accept these policy ideas as a reasonable way of combating poverty, if they could just get a legislative hearing. I interviewed several members of the working group and they generally agreed that these policy proposals, if accepted, would probably reduce the rate of poverty in America by a few percentage points—no small achievement.

The aspiration of serving as a kind of role model for Congress, to show that sensible right and sensible left can agree on a core common program, is not a crazy idea. But as one of the panelists ruefully admitted, “these proposals do not stand a snowball’s chance” of making it through the current Congress. Just as Atkinson’s newly mainstream ideas are somewhere to the left of Senator Bernie Sanders’s presidential campaign, the report of the Brookings-AEI working group is to the left of the entire Republican House—thus neatly proving Atkinson’s point that it really is about power.

The conservatives in the group, looking over their shoulders at their political allies, demanded and got some changes that bordered on the absurd. The report is emphatic on the point that child-bearing should be delayed—but the report distances itself from the most effective form of contraception, long-acting reversible contraceptives (LARCs), the new generation of IUDs that are far safer and more effective than earlier ones, and which have dramatically reduced unwanted pregnancies. Why the distance? As the report tactfully puts it, some opponents of LARCs see them “as potentially a form of abortion.” Yet the concessions by the liberals on the panel are unlikely to change a single Republican vote in Congress.

A report such as this one would nicely fit an era when there were still moderate Republicans in Congress. Indeed, the groundwork for the 1996 reform “ending welfare as we know it” was laid by similar left-right academic

efforts. And because of the hard line of the Gingrich Congress, the welfare reform that Clinton signed, after vetoing two even worse versions, features a TANF block-grant design that is brutally punitive on people who really need help. Indeed, three subcabinet members who had designed the original Clinton welfare reform resigned in protest.

Conservatives organizing liberals to support center-right policies in the name of realism dates at least to the Reagan era. In 1987, AEI organized a similar working group that published a report titled “The New Consensus on Family and Welfare.” The participants ranged from Charles Murray on the right to Robert Reischauer and Alice Rivlin on the moderate left. The recommendations, many of which parallel those of the latest report, are more Murray than Reischauer. The working groups on deficit reduction grew in the same soil of centrist policy intellectuals (including some of the same people) desperately seeking bipartisanship and mostly getting rolled by conservatives, culminating in the disastrous Bowles-Simpson Commission. That commission utterly failed to win popular support, but it created an elite policy consensus that combined with Republican political hardball to lock a Democratic administration into a decade of relentless budget cuts in domestic social programs, one that moots the calls for increased spending in the AEI-Brookings report.

The keynote speaker at the December 3 event unveiling the Brookings-AEI report was *New York Times* columnist David Brooks. That choice speaks volumes. Brooks is emblematic of the sort of moderate conservative who no longer exists in the Republican caucus.

If one can indulge optimism bordering on euphoria, it’s possible to imagine a scenario in which Donald Trump wins the Republican nomination, Hillary Clinton is elected in a landslide, and the Senate goes narrowly Democratic, though the House is virtually certain to stay Republican. In those circumstances, some of the modest Brookings-AEI ideas might actually become law.

Paul Ryan, the new House Speaker, professes to care about poverty.

Paul Ryan, the new House Speaker, professes to care about poverty. His own anti-poverty program, unveiled when he was chair of the House Budget Committee, was more or less reformicon. It accepted that increased poverty was a problem, and he even made some policy proposals. But as critics noted at the time, Ryan's numbers didn't compute. They added up to massive cuts in existing outlays and largely precluded new ones.

However, it's possible that with a Democratic president, a Democratic Senate, and a Republican House with a reduced majority, some elements of the Brookings-AEI package might make it through Congress. At the same time, Republicans are still working to turn food stamps into a block grant, which would drastically cut benefits, and they have continued to try to kill the Affordable Care Act and slash other social outlays. If everything breaks right politically in 2016 (which is a big if), poverty could be modestly reduced, especially for the working poor, but the larger problems of income inequality will continue to worsen.

So which group represents the greater realism? Is it the pursuit of incremental policy changes aimed at modest reductions in poverty? Or is it work like Atkinson's, acknowledging that a real improvement in the broader income distribution would require a sure grasp of power dynamics as well as policy changes well to the left of anything currently in mainstream debate?

I suppose you might say we need both. The AEI-Brookings effort seems more rooted in the near-term politics of the possible, though, as noted, the several members whom I interviewed don't believe that the current Republican Congress will touch even these toned-down ideas. The Atkinson analysis reflects a deeper understanding of the economic realities. Possibly, the AEI-Brookings effort will serve as a role model to a post-Tea Party generation of Republicans picking up the pieces from what could be a 2016 blowout, though

if Trump self-destructs and Marco Rubio is the nominee, it's a whole other story. One must also hope that the work of Atkinson, Reich, Stiglitz, Solow, and others will energize a muscular progressive realism that pushes outward the politics of the possible.

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