SPEECHES & PAPERS

We Have the Tools to Reverse the Rise in Inequality

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Inequality is widening, posing major moral, social, and political challenges to which policymakers must react. A combination of forces since the 1980s—globalization, new technologies, and institutional changes—has generated strong centrifugal effects in advanced economies, deepening existing divisions and creating new ones. Groups with the assets, skills, talents, and (sometimes) political connections needed to take advantage of these changes have benefited handsomely from the economic opportunities that were created. For many others, however, the same underlying trends have weakened employment prospects, suppressed incomes, and heightened economic insecurity.

Reacting to this evidence, we organized a major conference on inequality at the Peterson Institute for International Economics in October 2019. The conference focused on the tools that policymakers already have or could have to combat inequality.

The conference started with a statistical overview by Lucas Chancel of the changes in the distributional landscape. Among the key takeaways: After declining for many decades, the income shares of the richest 1 percent in Western Europe and the United States have increased from around 8 percent in the 1970s and 1980s to 11 and 20 percent, respectively, today. In 1980, the income share of the bottom 50 percent stood at 20 percent in both regions. Over the subsequent three-and-a-half decades, this figure dropped to 12.5 percent in the United States and 18 percent in Europe.

Even though the United States and Europe have been exposed to broadly similar trends in globalization and technology, the rise in inequality has been much sharper in the United States, where the wealth share of the top 1 percent has risen from 25 percent in the late 1970s to around 40 percent today. Also, greater income and wealth inequality in the United States has been accompanied by reductions in key indicators of social mobility. The percentage of children in the United States earning more than their parents has fallen from 90 percent in the 1940s to around 50 percent today (reflecting in part lower underlying economic growth rates). On the positive side, gender and racial inequalities have generally come down (but remain high).

As Chancel noted, these differences suggest that countries have dealt differently with the effects of global economic and technological forces on wealth and income distribution. Income and wealth gaps widened less in countries with more progressive tax regimes, strong labor market institutions (such as trade unions and minimum wage laws), broad-based access to education and health services, and generous social transfers.

As striking as some of the numbers are, conventional economic measures of inequality such as top income shares do not tell the entire story of deepening gaps within advanced economies. Important geographic and cultural divisions have also emerged, mainly between small towns, rural areas, and outer cities, on the one hand, and large cities and metropolitan zones on the other. These divisions reflect divergences in economic opportunities and cultural orientations—social conservatism versus social liberalism—that reinforce each other. They manifest themselves in reduced trust in political elites, social discontent, and support for the far-right. This kind of social polarization along largely (but not exclusively) geographic lines has played a significant role even in countries such as France where top income shares have not risen much.

How intractable are such inequalities, and can they be fixed with the existing toolkit? The conference was aimed at answering these questions. The presentations and discussions focused on a wide range of remedies, discussed below. We cannot claim that there was general consensus on the answers. Producing a detailed action plan was not our goal. Some proposals—especially wealth taxes—generated significant and heated debate. At the same time, the conference reflected a broad convergence around a multi-pronged attack on inequality, encompassing a wide set of tools.

A GROWING CONSENSUS

Importantly, there was widespread (if often implicit) agreement on many aspects of inequality that would have been more contentious some years back. For one thing, nobody at the conference challenged the view that inequality is a first-order problem requiring significant policy attention. (True, when you invite researchers and policymakers who work on inequality, they are likely to think that this is indeed an important issue. But we sensed a much stronger belief than in the past that inequality is an urgent issue and should be at the top of policymakers' agendas.)

There was widespread agreement that policies should focus on more than poverty reduction. There was not much discussion of an equity-efficiency tradeoff (i.e., tradeoff between income equality and economic performance). If anything, the implicit assumption in many of the presentations was that inequality is holding economic growth back —by reducing economic opportunities for the lower and middle classes and fostering (or reflecting) monopolistic rents for the very wealthy.

Nobody proposed giving market forces freer rein by deregulating labor markets or cutting social programs as remedies of inequality. These were almost always discussed as causes of—rather than solutions to—inequality. Had our conference taken place, say, a decade ago, participants would probably have pointed to government interventions, blunted economic incentives to work, and rigid labor markets as the causes for incomes languishing at the bottom of the income distribution.

Finally, nobody asked in relation to expanding social programs: "Can we pay for it?" There was broad agreement that taxes (at least in the United States) have to rise. The only debate here was about whether progressivity should focus on the revenue side or the expenditure side. Some would fund public spending directed at the lower and middle parts of the income distribution through broad-based taxes such as the value added tax (VAT), which are easy to collect. Others prefer to redress inequality at the very top using wealth taxes and more progressive income taxes. At the end of the day, most would probably agree that we need some of both.

Hence the conference revealed widespread acceptance that we need to do something about inequality and that removing government interventions or just stimulating economic growth will not do the job. Instead, we need the government to play a more forceful direct role in closing gaps in living standards. The conversation among economists has indeed changed.

WHICH POLICIES?

Our conference covered a very wide range of policies to combat inequality. It helps to think about them by distinguishing across two dimensions.

First, policies vary with respect to the stage of the economy they target. We organized the conference panels around three types of policies that differ along this dimension. They are shown as column headings in table 1.

Table 1 Taxonomy of policies affecting inequality

		At what stage of the economy does policy intervene?		
		Pre-production	**Production**	**Post-production**
What kind of inequality do we care about?	**Bottom**	Endowment policies (healthcare, education); universal basic income	Minimum wage; job guarantees	Social transfers (e.g., earned income tax credit); full-employment macro policies
	Middle	Public spending on higher education	"Good jobs" policies; industrial relations and labor laws; sectoral wage boards; trade agreements; innovation policies	Safety nets; social insurance policies
	Top	Inheritance/estate taxes	Regulations; antitrust laws	Wealth taxes

Some policies focus on the **pre-production** stage. These policies shape the endowments with which people enter the workforce, such as educational, health, and financial access policies. David Deming, Lawrence Katz, Tharman Shanmugaratnam, Gregory Mankiw, Lawrence Summers, and Emmanuel Saez discussed these policies.

Some policies intervene directly at the **production** stage, i.e., by affecting the composition and organization of production. Such policies help determine relative prices and incentives in hiring, investment, and innovation decisions. They also affect the bargaining power of those with claims on output (workers, shareholders, managers, suppliers). Examples of such policies are minimum wages, trade agreements, investment and R&D subsidies, place-based policies, and other types of "industrial policies." We heard from David Autor, Christian Dustmann, Caroline Freund, Daron Acemoglu, Philippe Aghion, Laura Tyson, Marianne Bertrand, Sandra Black, Richard Freeman, William Darity Jr., David Ellwood, and Heidi Shierholz on these types of policies.

Finally, some policies focus on the **post-production** stage, to redistribute income and wealth. Progressive income taxation, wealth taxation, income support policies such as the negative income tax (earned income tax credit [EITC] in the United States), and food stamps fall in this category. We had contributions here from Jason Furman, Hilary Hoynes, Jesse Rothstein, Wojciech Kopczuk, Stefanie Stantcheva, and Gabriel Zucman.

A second dimension along which policies differ is the part of the income distribution they seek to "fix." The choices here relate to the question: What kind of inequality do we care about? Some policies target the **bottom** of the distribution. Poverty reduction policies are the key example of this type of policy. Others try to lift incomes in the **middle** to support the middle class. Yet others focus on reducing incomes at the **top**. These three types of policies are shown as the rows in table 1.

Combining the two dimensions yields a 3x3 matrix with nine different sets of possible policies. Which cells of the table should we focus on to tackle inequality more effectively? Economics provides some guidance here but is not enough on its own. Economic analysis must be combined with values and normative judgments (or a political philosophy), at least implicitly. And it must be combined with views on how the economy and polity interact.

PHILOSOPHY AND POLITICS

Consider the role of political philosophy. As the three scholars of justice on our first panel (Danielle Allen, Thomas Scanlon, and Philippe van Parijs) reminded us, what we want to do about inequality must start with answering the questions: What is wrong with it? Do we want to reduce inequality because its consequences are bad, or because it is bad in itself? If we think it is bad in itself, how do we distinguish between objectionable and unobjectionable inequality? The answers to these questions help us orient ourselves in table 1.

As Scanlon emphasizes, there are good reasons to promote equity beyond simply increasing the incomes of the poor. Inequality can be objectionable because of its adverse consequences or because of the unjustifiability of the institutions that generate it. In the latter case, if high concentration of wealth is the consequence of unfair institutions, we may want to tax the top 1 percent regardless of the economic consequences, say, on economic growth. If not, such taxes must be justified otherwise—by appealing, for example, to the revenues they could generate to fund social programs. A Rawlsian perspective (advocated by both Scanlon and van Parijs) would lead us to demand that any increase in inequality must improve the well-being of the worst off in society. An emphasis on political equality (supported by Allen) may require more radical interventions in markets that level the playing field among different groups and ensure equal access to rulemaking (in labor markets, corporate governance, regulation, and so on).

Understanding what is achievable (and how) also requires a view on political economy. The difficulty here lies in teasing out the effect of inequality on politics and vice versa. The presentations in our second panel by political scientists (Ben Ansell, Sheri Berman, and Nolan McCarty) focused mostly on the effects of economic inequality on political outcomes. But clearly *political* inequality exacerbates economic inequality as well. Even in democracies, some have more power than others. Our current policies and institutional arrangements reflect the power of prevailing coalitions of special interests and reinforce that power in turn. But if that is the case, how can we move to a different, more equitable equilibrium without the wealthy and powerful rejecting or subverting the best policy ideas? What is the implicit theory of change? Is it enough to target the worst symptoms of inequality? Or do we need a more comprehensive overhaul that tackles the root causes in the political system? And if the latter, what is the relationship between specific sets of interventions, as shown in table 1, and the operation of the political system?

If the very wealthy exert too much political influence, what is the more effective (and feasible) strategy? Preventing wealth accumulation by taxing it (as Saez and Zucman advocate) or reforms in corporate governance, antitrust, and labor markets that thwart winner-take-all and superstar effects (which Summers pointed at)? If the poor are disenfranchised and therefore have little voice in determining the economic policies that affect them, is improving their economic circumstances adequate? Or should we also contemplate changes in political rules, such as making it easier to vote or restricting campaign finance? While our conference did not discuss political reforms, one implication of our discussions is that they may well be needed to alter the political-economic equilibrium in a more equitable direction.

URGENCY, AMBITION, AND EVIDENCE

A further question has to do with the scope of our ambition. Do we only pursue policies for which there is good evidence, or are we willing to be bolder and to experiment? Do we seek a gradual evolution of our policies or a more wholesale revolution? This is perhaps at least as much a question of temperament as of economics. In his presentation David Deming urged us to be "small c conservatives," by which he meant that we should prioritize reforms for which there is good evidence. (In his case, he was referring to empirical findings that indicate high returns to expanding college enrollment.) Of course, evidence should always guide policy. But a high evidentiary threshold also restricts us to the margins of existing policies and small-scale changes. We necessarily have good evidence only on policies that have been tried. Policies that are fundamentally innovative are, well, untested.

Franklin D. Roosevelt famously called for "bold, persistent experimentation" during the New Deal. Even John Maynard Keynes, whose ideas on fiscal stimulus were revolutionary at the time, thought FDR's more structural policies—for example, facilitating labor unions and increasing their bargaining power via the National Industrial Recovery Act of 1933 (NIRA) or introducing a massive regulation of businesses (a measure later declared unconstitutional by the Supreme Court)—were "crack-brained and queer" (as he wrote in a letter to FDR in late 1933). There was little prior evidence on how these new rules would work. If New Deal policies had been subject to the "evidence-based" test, few of them would have been implemented. Yet many if not most eventually became commonplace elements of modern economies and are credited with saving capitalism from its excesses.

The extent to which policies should be experimental is a question that is especially germane for policies in the middle cell of table 1, those that address middle-class incomes at the production stage. The literature on the drivers of authoritarian populism makes it clear that the scarcity of good jobs and attendant economic anxieties have played a substantial role in the rise of the far right. As some contributors emphasized, an adequate economic response will require policies that aim to influence the direction of technological change and the employment practices of firms. Many of the potential remedies are untested and their effects are unclear. Daron Acemoglu's suggestion that the structure of taxation should be amended to remove (or reduce) subsidies to capital (and to automation) and strengthen rewards for the use of labor makes intuitive sense: Innovators and employers presumably respond to price incentives. But will the effects be large enough on the direction of technological change? Or do we also need more ambitious government programs that integrate innovation policy with job creation policies and require government collaboration with firms, as Laura Tyson calls for? In the latter case, we need a range of new instruments and programs and are largely in uncharted territory.

Similar considerations come into play in policies addressing other segments of the income distribution as well. Are joblessness and low incomes best addressed through the expansion of existing (and well-tested) programs such as the EITC, or do we need a more fundamental restructuring of labor laws and a federal job guarantee (as advocated by William Darity Jr.)? Should wealth concentration at the very top be addressed by a wealth tax, which has never been implemented in the United States and may not even be constitutional (Saez and Zucman versus Summers)?

The more deep-seated we think the drivers of inequality are, the more radical the needed surgery. There was general agreement in the conference that the playing field of our market economies has tilted away from the poor and the middle class. Corporations and the wealthy exercise too much power and have excessive influence on determining the rules of the game. At his dinner speech, Angus Deaton laid out the harrowing consequences of corporate power blunting sensible regulation of painkillers and promoting "deaths of despair" in the American heartland. In his presentation, Philippe Aghion described how big tech platforms such as Facebook may reduce innovation and productivity in the long run. David Autor's presentation made it clear that the terms under which the United States allowed China to accede to the World Trade Organization were detrimental to workers in many regional labor markets (even as China's accession generated significant benefits for US workers and investors in the export sector). Others mentioned declining trade unions and growing "monopsony power" of a handful of firms controlling local labor markets as important factors behind the stagnation of median wages. Monopsony power of employers was indeed a recurring theme in many of the presentations.

Any stable social order reflects an underlying social contract. As Peter Diamond put it in his comments on the Chancel paper, "corporations have limited liability because the government gives it to them." The privileges corporations are given—legal personhood—entail a quid pro quo with society. In the old days, the sovereign chartered companies so they could enrich the crown's—and his/cronies'— coffers. Today, presumably the goal is

loftier and entails social well-being. Looming large behind our discussions was the question of how the social contract has frayed—though nobody explicitly mentioned the term—and what it will take to patch it up.

THE PATH AHEAD

Our discussions yielded a large set of policy proposals, leaving no blank cells in table 1. We either are all over the map or have a lot of good ideas! We believe it is the latter. The conference demonstrates that there is no shortage of ideas and policy instruments to combat inequality. No specific proposal will do the job by itself. But we have different margins to work with. And many areas have low-hanging fruits: expansion of EITC-type programs, increased public funding of both pre-K and tertiary education; redirection of subsidies to employment-friendly innovation, greater overall progressivity in taxation, and policies to help workers reorganize in the face of new production modes.

This conference gives us hope that economists will be at the vanguard of policy reform, rather than playing their habitual role of naysayer ("we can't afford it," "we don't have enough evidence," "incentives will be distorted," and so on). We both came out of this conference more optimistic about the economics profession's capacity to contribute to reducing inequality.

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