Widening Inequality Means a Democracy at Risk

Benjamin M. Friedman

The recent slowing of economic growth in the United States threatens not just financial markets, but also the livelihoods of millions of Americans. The aftermath of even the fairly mild recession of earlier this decade increased the number of families living in poverty by 22 percent (from 6.4 million families to more than 7.8 million). The impact of the previous recession in the early 1990s, likewise only a mild one, was slightly greater. As the economy's pace of expansion continues to slow—from 3.6 percent in 2004, after allowing for rising prices, to 3.1 percent in 2005, then 2.9 percent in 2006, 2.2 percent in 2007 and now perhaps nothing at all in 2008—the important questions that the national debate about economic policy will have to confront will include not just how to restore the economy's growth but also how to think about those whom this newest slowdown will inevitably place under harsher stress.

That debate will be more difficult because of the recent widening of inequality. Even when an economy is growing, as America's has been over the past six years, the interaction between economic growth and changes in distribution governs the extent to which the majority of a country's citizens enjoy rising living standards. A rising standard of living, for the broad bulk of the citizenry, is normally a crucial condition determining whether any society also makes progress in a variety of other dimensions that Western thinking has traditionally regarded as positive in explicitly moral terms: generosity toward the disadvantaged, to be sure, but also tolerance, openness of opportunity, and commitment to democracy, among others. The broader question, therefore, is what measures U.S. public policy can and should take to address not just the immediate economic slowdown but the ongoing combination of modest growth and widening inequality that has resulted in declining incomes for the majority of Americans throughout the current decade.

Rising Incomes and Improving Living Standards

The experience of many countries suggests that when a society experiences rising standards of living, broadly distributed across the population at large, it is also likely to make progress along a variety of dimensions that Western thinking has long held to be not merely positive but morally positive. Experience also demonstrates that when a society is either stagnating economically or, worse yet, suffering a pervasive decline in living standards, it is unlikely to make much progress on these social, political, and moral dimensions.

The reason that economic growth and inequality matter for these positive goals is that most people evaluate their living standards primarily on a relative basis. When asked whether they are well off, most people's normal reaction is to think: relative to what? But at the same time, most people typically have in mind two distinct benchmarks for comparison. Their sense of well-being depends both on how they live compared with how they have lived in the past and on how they live compared with others around them. If these two sources of satisfaction with one's life are substitutes for one another, as mostly appears to be the case, then getting ahead by either benchmark diminishes the urgency that people attach to getting ahead by the other one. Whenever economic circumstances allow most people to live better than in the past, therefore, the effect is to diminish the importance that people attach to living better than everyone else. Hence resistance to movements that allow others to get ahead is softened.

In America in particular, eras in which economic expansion delivered ongoing material improvement to the majority of the country's population have mostly corresponded to eras when opportunities and freedoms broadened, political institutions became more democratic, and the treatment of society's unfortunates became more generous. But when incomes have stagnated or declined, reaction and retreat have been the order of the day. On one issue after another—not just generosity to the poor, but race relations, religious prejudice, attitudes toward immigrants, even such basics as who gets to vote and under what circumstances—the historical record makes clear that America has made progress mostly when living standards for the majority of the nation's citizens are advancing. With the notable exception of the Depression of the 1930s, the opposite has been true when incomes have stagnated or fallen. And as I argue more fully in my recent book on the subject, this pattern is also characteristic of many other long-established Western democracies.

Consequences of Widening Inequality When Economic Growth Is Limited

When the fruits of an economy's growth accrue disproportionately to only a few people, aggregate growth is not always sufficient for others to get ahead as well. This is especially true in America today, where the labor force is highly heterogeneous (perhaps increasingly so as a result of trends in education and immigration), the economy's large investments in information technology are leading to ever wider differentials in what workers with differing skills are able to earn, and the economy's already-advanced status means that its aggregate growth is likely

to be modest even under the best of circumstances.

Since 2000, the median income among American families (that is, the income of the family just in the middle of the country's distribution) has consistently lagged behind rising prices. Only those who are already at the very top of the income scale have experienced any improvement. In 2006, the latest year for which information is available, the income of the median family was $58,400. But at the beginning of the decade, the median family earned $59,400 in 2006 dollars.

It is not the case that there was no aggregate economic growth over this period. Total economic output in the United States expanded on average by 2.4 percent per annum between 2000 and 2006, even after allowing for higher prices, while the population grew by a bit less than 1 percent per annum. The mean per capita income therefore rose in real terms. But widening inequality overwhelmed these gains, preventing any increases, and actually resulting in small decreases for a majority of the nation's families.

This situation differs sharply from what America had experienced throughout most of the nation's past. At times when productivity gains were strong, and the economy as a whole moved forward rapidly—for example, the middle of the 19th century, the early decades of the 20th, the quarter century immediately following World War II and, most recently, the mid to latter years of the 1990s—the bulk of the population likewise enjoyed rising incomes and improving living standards. Conversely, when productivity gains slowed, or the economy faltered for other reasons—in the late 19th century, during much of the period between the two world wars, and for roughly two decades running from the early 1970s to the early 1990s—the public at large naturally saw little increase. What is different today is that the link between the U.S. economy's aggregate productivity gains and output growth and the increase in incomes and living standards that they deliver to the great majority of American citizens has been severed. The reason is that widening inequality has meant that the fruits of our economic growth have accrued to only a minority of Americans at the top.

What Should Be Done?

With the economy slowing and perhaps entering a recession, much of today's discussion of economic policy revolves around the need to resolve the impasse in the financial markets left by the implosion of subprime mortgage lending and, at the same time, add short-run impetus to economic activity. The Federal Reserve System has already acted forcefully, both to lower interest rates and to provide additional liquidity to banks, and even to investment banks, via several new lending facilities. Congress has enacted a $164 billion economic stimulus package, of which roughly two-thirds consists of cash transfers mailed directly to individuals and one-third new benefits to businesses from additionally accelerated depreciation of their capital investment.

So far—unlike in most recent recessions—Congress has failed in its effort to extend unemployment benefits beyond the standard 26-week limit. Nor has there yet been any serious consideration of expanding the existing federal antipoverty programs, like food stamps and subsidized housing, nor of incremental public works programs (at either the federal or state-local level) to provide employment directly to those whom the weakened economy puts out of work. Although rising joblessness and reduced income growth inevitably create calls for the former, the success or inadequacy of the nation's poverty programs is more properly a matter for decision with longer horizons in mind. And except for the Depression of the 1930s, when public works programs like the WPA and the CCC made a major contribution to economic recovery by putting millions of Americans back to work, the record of public-sector job creation as an anti-recessionary device is not good; in most cases, by the time the jobs are created the recession is over.

The more important policy discussion, which would have been important even without the current economic slowdown, is what to do about increasing inequality. The principal force acting to widen income gaps in America in recent decades is a technological revolution that has sharply increased the demand for some kinds of skills while reducing the demand for others. As a result, workers who have those newly scarce skills (computer programming, for example, or certain forms of organizational management) have been able to command increasing premiums in the labor market, while those whose skills are in lesser demand (more basic industrial disciplines, or even brute-force manpower) have seen their wages decline and good jobs requiring such skills become harder to find.

Once the technological basis of production has stabilized, systematic economic forces are likely to work in the opposite

direction and counteract further increases in inequality. On the demand side, larger wage premiums for workers with certain skills lead business to innovate in yet further ways, so as to economize on the use of what has now become high-wage labor. At the same time, the larger wage premiums give workers an increased incentive to acquire the skills that are scarce, thereby introducing a supply response as well. Over time, therefore, the widening of inequality brought on by the recent technological revolution is likely to turn around. But this process may be a lengthy one, and along the way the wider inequality remains a fact with which the society must deal.

Public policy can play an important role in accelerating this dynamic response to skill-biased technical change. Education in America is largely the responsibility of the public sector. Numerous public education programs—ranging from improving the basic education that nearly everyone receives, to making college more affordable, to providing vocational training or retraining—could be included in our policy response. The evidence suggests that programs focused on the very young, such as Head Start for preschool children at risk of underperforming in the early grades of elementary school, offer the greatest prospect of success. Such programs simultaneously serve the objectives of rendering the distribution of skills and therefore wages more equal, and of improving the average productivity of the labor force as a whole, hence increasing aggregate economic growth.

There is evidence that other influences are at work too. For example, the skill mix among new immigrants to the United States (particularly legal immigrants) is in part the consequence of immigration policies, adopted in the 1960s, that give priority to immigrants seeking permanent admission to this country for purposes such as family unification or political asylum. From time to time, supplementary policies have sought to redress the resulting skill bias in a limited way. The H-1B temporary visa program, for example, allows up to 65,000 highly skilled immigrants per year to work in the United States for a maximum of three years before returning home. A larger-scale and more comprehensive shift in U.S. policies on permanent immigration would blunt at least some of the effect of skill-biased immigration in compounding the effect on wage differentials due to skill-biased technical change.

Presumably Congress had reasons for setting the immigration priorities that it did, a half a century ago, and objectives like family unification and political asylum are not to be dismissed lightly. But the economic condition of the United States is different today—specifically, economic growth on average is slower and incomes are becoming more unequal, so that the majority of families are no longer enjoying an increase in their standard of living—and so a reasoned assessment may plausibly lead to different choices now than what seemed appropriate then.

In addition, the increase in rewards paid to top executives has absorbed a sizeable share of American corporations' total compensation budgets during the last decade or two. For example, since the early 1990s, the compensation of just the five highest-paid executives at U.S. public companies doubled compared with their companies' earnings. This trend may be in part due to market forces. But it is also the consequence of corporate governance practices affecting how pay is set, and those rules are, in turn, partly set by public policy. Congress has recently acted to require greater disclosure of executive compensation, and tighter enforcement of existing laws has cut back on some of the patent abuses that contributed to soaring compensation in the past (for example, backdating of options granted to purchase company shares, or falsifying the reported earnings on which incentive pay is often based). Other steps, such as requiring "plain English" shareholder approval of certain forms of executive compensation, are also possible. Here too, redressing widening inequality is hardly the only concern in shaping such policies. But there is no reason to assume that the specific rules of corporate governance inherited from the distant past are the best ones under today's circumstances.

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

Whatever actions public policy might take to spur additional economic growth, the implications of today's ongoing increase in inequality in America are sobering. If part of what matters for tolerance and fairness and opportunity, not to mention the strength of a society's democratic political institutions, is that the broad cross-section of the population have a confident sense of getting ahead economically, then no society—no matter how rich it becomes or how well-formed its institutions may be—is immune from seeing its basic democratic values at risk whenever the majority of its citizens lose their sense of forward economic progress. This risk is not just a matter of the current cyclical slowdown. Experience suggests that if the combination of modest growth and widening inequality persists, once the slowdown is over, many of the social and political pathologies that have emerged in the past, both here and elsewhere, are likely to reappear.

Benjamin M. Friedman is the William Joseph Maier Professor of Political Economy at Harvard University. His most recent book, The Moral Consequences of Economic Growth, *was recently published by Knopf.*