THE ONE PERCENT

THE 1 PERCENT'S PROBLEM

Why won't America's 1 percent—such as the six Walmart heirs, whose wealth equals that of the entire bottom 30 percent—be a bit more . . . selfish? As the widening financial divide cripples the U.S. economy, even those at the top will pay a steep price.

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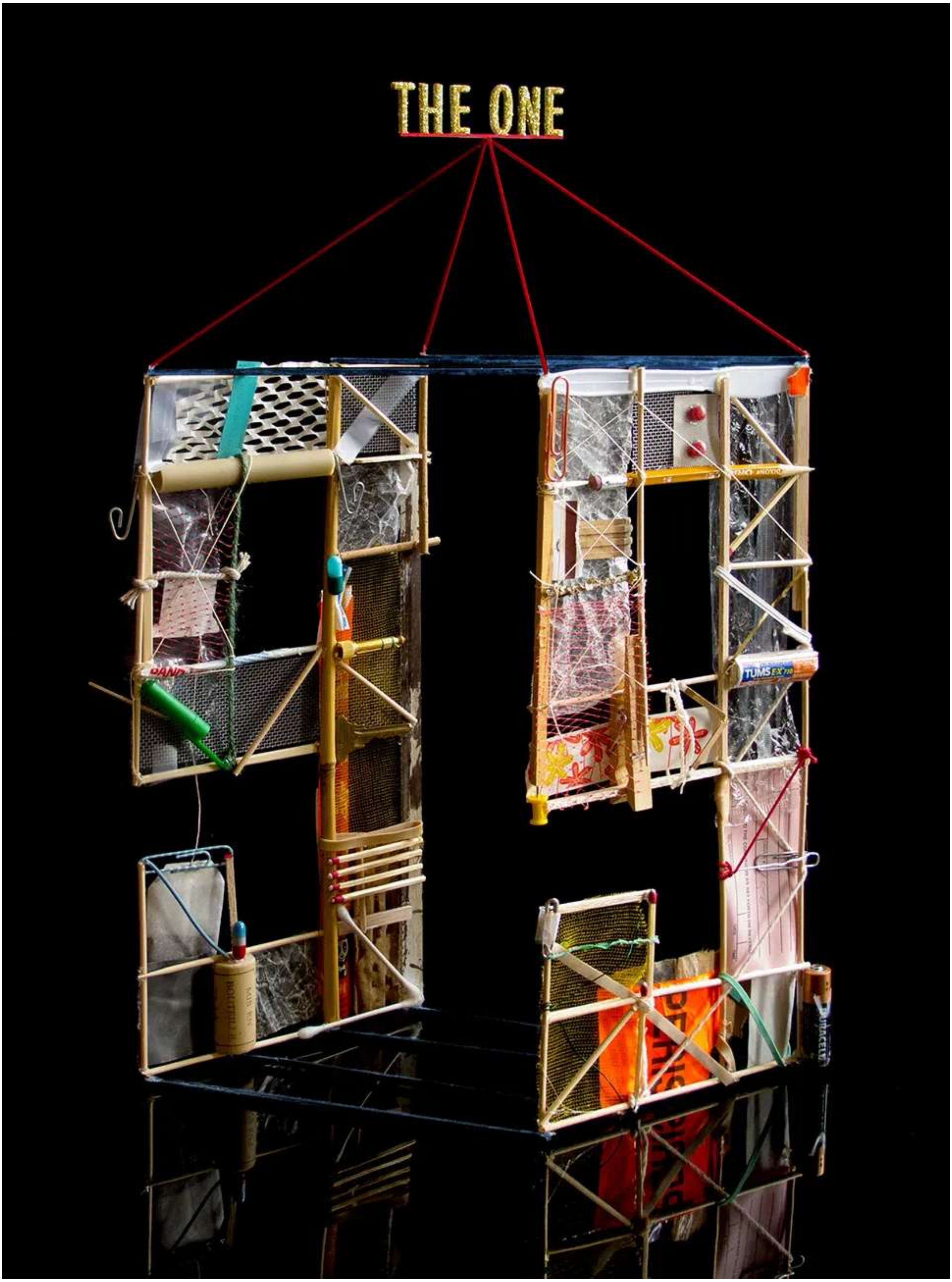

Let’s start by laying down the baseline premise: inequality in America has been widening for decades. We’re all aware of the fact. Yes, there are some on the right who deny this reality, but serious analysts across the political spectrum take it for granted. I won't run through all the evidence here, 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.

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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.

The "Rent Seeking" Problem

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 C.E.O.'s to take a disproportionate share of corporate revenue (though Dodd-Frank has made matters better by requiring a non-binding 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 re-distributions 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 re-distributes 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 C.E.O.'s 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

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.