

† CHAPTER 5 †

The Rewards of the Game:

Systems of Inequality

In 1974 the typical corporate chief executive officer in the United States received $35 in pay for every dollar the average worker in manufacturing received. In the 1990s the typical American CEO received over $120 for every average worker’s dollar. This change strikingly illustrates how rapidly inequality can change (up to $225 in 1994).\(^1\)

Around 1990 the typical Japanese CEO earned only ¥16 for every yen earned by the average industrial worker, the typical German CEO made DM 21 for every Deutschmark of the average worker, and the typical British CEO received about £25 for every pound earned by the average working person.\(^2\) The contrast between these numbers and 1990’s 120:1 ratio in the United States clearly illustrates how much greater inequality in pay is there than it is elsewhere. In addition, executives in other countries pay higher taxes on their relatively lower incomes than do American executives, exemplifying the great difference between us and other nations in after-tax inequality as well.

The CEO numbers point us away from focusing, as we did in chapter 4, on who wins and loses in the race for riches looking instead at how these races are set up, in other words, at systems of inequality. In the previous chapters, we demonstrated that intelligence is not an immutable single trait, is not well-measured in The Bell Curve, and does not account for who succeeds or fails in life. In this chapter, we show that, even were The Bell Curve correct on all those matters, its psychological reductionism fails to explain the system of inequality. Using history, geography, and economics, we show that social structure and social policy shape inequality.

The Bell Curve addresses the timeless question: Why do some people have more than others — more money, a better standard of living, a higher quality of life? Herrnstein and Murray offer a timeless answer: Because some people have more natural talent than others do. To the more timely question of why some Americans today have more than others do, they answer: Because that is how today’s market rewards Americans’ natural talents. Whereas once employers paid for strong backs, today they pay for strong minds. In either case, inequality arises from the operation of a free market rewarding people according to their talents. This view of inequality assumes that the unequal distribution of outcomes we see around us essentially results from the unequal distribution of natural skills; the economy confirms that individual inequality.

The previous chapter showed that this “natural inequality” viewpoint misrepresents why individuals end up where they do in the distribution of income. This chapter will show that it fails altogether to explain systems of inequality — how much economic inequality there is and what rules determine the kinds of people who get ahead. Even if talent largely determined which individuals won and which lost in the race to get ahead, that would not explain the disparity in the rewards winners and losers get; that is, it would not explain the degree of inequality. Even if natural talent explained who became a film star, sports hero, or mortgage banker, it would not explain why people in those positions earn 200 times what child-care workers earn. Nor would natural talent explain why the richest 1 percent of Americans own about 40 percent of all the private wealth in America rather than, say, only 20 percent of that wealth.\(^3\) It would not explain why Americans who lag in the race for financial success still get free primary education for their children but do not get free medical care for their children, or why the also-rans are awarded subsidized old-age pensions but not subsidized housing. To understand the nature of inequality in America, we must look at economic, social, and political conditions — the systems of rules and rewards that shape inequality.

An analogy might be instructive. Talent, whatever combination of gifts or hard work created it, partly determines which baseball players become wealthy major leaguers and which forgotten journeymen. But their fortunes are also determined by the number of major and minor league teams, by recruiting procedures, by rules about the draft, call-up options, and free agency, by rules of the game such as the size of the strike zone and the designated hitter, by the market value of franchises and television contracts, by collective bargaining agreements, and so on. Free agency, for example, sharply increased inequality in salaries among major league players.\(^4\) Scarcity is crucial: So few positions are available in professional baseball that many highly talented players never earn a living playing the game. If the rewards of baseball—where pay is so strongly and directly tied to visible and measurable performance—are conditioned so much by circumstances other than individual talent, that must be even more so for the careers of ordinary Americans where the connection between talent and reward is so much harder to assess.

Herrnstein and Murray and their ideological fellows would probably
answer that variations among systems of inequality are basically variations in the free market, the difference between, say, a low-tech economy, such as America in our great-grandparents' day, and a high-tech one such as ours. The widening of the gap between rich and poor that has appeared in recent years is, they would argue, essentially the consequence of economic changes that increasingly reward natural, "cognitive" talent. This is a woefully incomplete account. In this chapter we will show how changeable systems of inequality are. They change in response to economic circumstances, certainly, but also in response to political decisions. Structures of inequality have varied over the course of American history. And most modern societies—technological, capitalist, and wealthy like America—have systems of inequality distinct from our own. We shall show that inequality is a property of how societies are structured, not of how individual talent is distributed. We shall also show that widening inequality in the United States today is not principally the consequence of natural talent operating in a natural market, but the consequence of political decisions that we, as citizens, have made and pursued through government policies. And we shall show that we have it in our power to alter inequality; we are not constrained by a dismal choice between equality and a high standard of living. Indeed, evidence suggests that the level of inequality we have may be retarding our economy. We can have—have had, as others now have—more growth and more equality.

A Brief History of American Inequality: The Long-Term

Over the nation's history, the inequality that Americans have experienced has varied greatly. Both the rules and the rewards of the "game" have changed. Economic historians can estimate the extent of inequality over a span of two centuries, although the farther back they go the harder it is, of course, to glean precise numbers. Still, the best estimates lead to the following, simplified, history of American inequality.

At the birth of our nation, America was far from a society of equals. On the top was a tiny elite comprised of wealthy merchants and owners of great estates. At the bottom, forming about one-fifth of the non-American Indian population, were African slaves who did not even own themselves. But the bulk of the free population lived in the rough equality of poor yeoman farmers. After about 1800, cities grew, commerce expanded, fac-

ories opened, new kinds of white-collar jobs appeared, and entrepreneurial opportunities arose. Americans, many fleeing from their farms, grabbed those opportunities, swelling the numbers of factory laborers, middle-class employees, and small-scale entrepreneurs. In grasping new opportunities, Americans also accentuated the inequalities of income and wealth among them. Immigration magnified that inequality by placing millions of workers at the bottom rung of the job ladder. This increasing division among Americans reversed briefly around the Civil War: The economy boomed and many workers went off to battle, thus making incomes more equal for a while.

During the Civil War two major policies also altered inequality in America. First, Lincoln emancipated the slaves, taking "property" from rich plantation owners and handing it to the "property" itself. The end of the Reconstruction era, however, returned power to the antebellum elites, doomed blacks to a lower caste position for generations, and set back the trend toward equality. Second, Lincoln's Republican party passed the Homestead Act. This law virtually gave away farmland to Americans who were willing and able to work it. It was manifestly an effort at "social leveling." The Homestead Act and its successor laws were, at best, only partially effective, but they did move white Americans toward slightly more equality.

The earlier trend toward greater inequality resumed after the 1860s. A short period of equalization occurred again around World War I, but inequality again widened in the 1920s. The Great Depression and World War II stopped and sharply reversed the tendency toward inequality. The new tendency toward more economic equality continued through the 1950s and 1960s, decades of growing prosperity for most Americans. Economists of the day projected slow but continued equalization of income and wealth into the future. They were wrong, as we shall see later.

We can summarize this history: In the nineteenth century, America's economy took off and inequality grew (excepting the emancipation of the slaves); then, in the mid-twentieth century, America's economy matured and inequality narrowed. Between World War II and 1970, middle- and working-class Americans reaped the benefits of economic growth and government programs; they grew richer faster than did rich Americans. By one estimate, the proportion of families in poverty dropped from 56 percent in 1900 to 14 percent in 1972. In political language, the postwar period saw most Americans—with certain groups, particularly blacks, notably excepted—realize the "American Dream."

104

105
We should also think of equality not simply in terms of monetary wealth, but in terms of living standards and quality of life. In that sense, twentieth-century equalization was yet more substantial than our account suggests. Virtually all Americans gained basic education and literacy. The vast majority acquired economic security through old-age pensions (mostly social security), unemployment insurance, disability coverage, Medicare, and Medicaid. Most Americans benefited widely from improving public health conditions, and their life expectancy lengthened. (Notably lagging behind were blacks. They were systematically excluded from many support programs, such as social security, until recently.) Almost all Americans found spouses as lifetime spinsterhood and bachelorhood became rare, both a consequence and a cause of increased security. Most Americans—whether winners or also-rans in the race to get ahead—shared in the good life, making America circa 1970 as equal a society as it had ever been.

As we have noted, it is difficult to measure inequality precisely before recent decades. But the lines in figure 5.1 summarize what historians have been able to learn. The vertical axis represents the degree of inequality. The dashed line displays changes in inequality of wealth and income; the solid one includes other qualities of life, too, such as public health and education. One conclusion we draw is that the magnitude of inequality has varied greatly in the course of American history.

This brief review of American history also suggests some conclusions about the sources of inequality. It would be hard to explain these trends in intelligence, whether rising, falling, stretching, or contracting. It would also be hard to explain it in terms of market demand for high-IQ workers. That is how Herrnstein and Murray try to explain why inequality increased after 1970. New high-skilled, high-stakes, high-pay jobs appeared and rewarded the people who had high IQs. One problem with their explanation is that the American economy changed in just these ways before 1970, too. Between 1930 and 1970, the percentage of Americans working on farms dropped from 21 to 4 percent, those in blue-collar jobs shrank a bit from 40 to 35 percent, and the percentage holding white-collar and professional jobs grew substantially, from 29 to 48 percent of all jobs. Such an increase in the demand for brainpower and book-learning should have, if we believe The Bell Curve, increased inequality between 1930 and 1970, but Americans actually became more equal in those years.

The reasons historians give for twentieth-century equalization include greater economic productivity, unionization, democratization of higher education, and government intervention. Government intervention, which we shall discuss in more detail in chapter 6, includes social security, minimum-wage legislation, expansion of public universities, the GI Bill, housing subsidies, and many other programs that effectively brought economic growth and middle-class life to more Americans.

## Inequality Since the 1970s

During the 1980s, politically engaged academics argued over whether the American middle class was “disappearing” and the nation was splitting into rich and poor. Defenders of freer markets denied that this was happening, blaming misinterpreted data or the business cycle. But the answer is clear now. The trend toward a more equal society that developed in the twentieth century stopped in the early 1970s. Income divisions widened and continued expanding through the 1980s.
A CASE OF HISTORICAL AMNESIA: CARING FOR THE NEEDED

While *The Bell Curve*'s treatment of American history is generally problematic, one of its greatest historical errors is the discussion of how a past America dealt with the unfortunate.* The authors of *The Bell Curve* recall a time when neighbors provided all the "safety net" that the poor needed. But such memories are notoriously unreliable.

There really was no such time in America. If the unfortunate were long-time residents of the town, victims of bad luck, and considered morally upright, then neighbors might pass the hat, allor funds from the municipal treasury, or board the destitute with a local family. Even so, the support was typically small and grudging. If the needy did not pass these tests, especially if they were newcomers, then usually nothing was forthcoming. (One historian wrote of a colonial Puritan village that "poor persons were aided if they were members of a townsman's family, otherwise they were sent packing no matter how hungry they might be.") From colonial days, when towns "warned out" newcomers whom residents feared might become public dependents, to the Great Depression, communities' major response was to move the needy out.

(We have forgotten how many Americans were on the move. Americans used to be much more mobile than they are now. Upon being laid off or losing a farm, hundreds of thousands moved on to find work for a while and then move again. These people do not appear in our Andy Hardy-like memories of small-town America, because, being poor and transient, they were anonymous residents on the wrong side of the tracks. But their stories belie the nostalgic image of the small town that succored the needy.)

The local structure for helping the needy, pinched as it was, satisfied most American voters well enough for generations. But the Great Depression destroyed that structure. Many long-time, middle-class, and "worthy" residents also became destitute. Would-be charity-givers themselves became needy. Local philanthropies, even where supplemented by town and county government contributions, could not keep up. In response, New Deal programs funnelled massive amounts of money into local communities directly and through work projects. Whether or not these programs actually ended the Depression, federal intervention certainly supported

many of the needy through the hard times. By now, the federal role in sustaining the poor, sick, and elderly has become essential, even for private charities.

Some have proposed that America today deal with the destitute by returning to private philanthropies and local communities the responsibility to do so, returning to an earlier "safety net." Advocates of such policies can appeal to nostalgia but they cannot appeal to history. The history of the local community shows that its "safety net" was composed mostly of holes.


**** Estimates are that replacing a proposed $400 billion cutback in federal programs for the needy by the year 2002 would require immense and improbable increases in private giving to charity (Steinfels, "As Government Aid Evaporates").

In the first roughly twenty-five years after World War II, American families of all classes shared in economic growth; since 1970 only the richest families have seen a significant rise in their standard of living. We saw in figure 1.1 the trend since 1959. In the ten years between 1959 and 1969, incomes for the richest 20 percent of households grew from $29,000 to $36,000 per person (in real spending power); incomes for the middle 60 percent of households grew from $11,500 to $16,000 per person; incomes for the poorest 20 percent grew from $2,900 to $5,400 per person. The percentage increase for the poorest households was larger, at 6.5 percent growth, than the others. In the twenty years after 1969, the incomes of the top 20 percent have risen an additional $28,000 per person, the incomes of the middle 60 percent have gone up by a modest $4,600 per person, and the incomes of the poorest 20 percent have actually fallen by $200 per person. For several reasons discussed below, the pattern displayed in figure 1.1 may underestimate the declining conditions of the middle group.

These converging and then diverging fortunes are further indicated in the data on the shares of the nation's total income that went to different

* See, especially, pp. 536–40.

From 1930 to 1970, the lowest-income 40% of American households began receiving almost as much of American income as the highest-income 5%, but that trend reversed after 1970.

![Graph showing the share received by top 5% and lowest 40% of households from 1930 to 1990.]


The rewards of the game

income groups. Figure 5.2 shows that, in 1930, the highest-income 5 percent of American households combined received over twice the total income that the bottom 40 percent of American households combined received. The highest-income 5 of every 100 families received about one-third of all the income received by American households that year, while the lowest-income 40 households out of 100 received one-eighth of national income. By 1968 equalization had developed to the point that the bottom two-fifths finally brought home almost as much as the top one-twentieth (15.3 percent versus 16.6 percent). Households between the 40th and 5th percentiles had increased their share from 58 to 68 percent (not shown). After the 1960s, however, the income share of the top 5 percent rose sharply and that of the lower 40 percent of families dropped sharply, reversing the earlier trend toward equality. The unequalizing trend has continued into the 1990s.\(^\text{17}\)

Economists and sociologists, working from different perspectives, have analyzed and reanalyzed the available data and have come to a consensus.\(^\text{18}\) Inequality in income expanded greatly after about 1970. People at the top made more money and people in the bottom half made less. In recent years, the chances of low-income Americans moving into the middle class have dropped and the chances of middle-class Americans moving into poverty have grown.\(^\text{19}\)

The growing inequality in annual income displayed in the figure actually understates the magnitude of the change. One reason is that gaps in annual income accumulate as some families invest and others pile up debts. Wealth has become even more unequal than has annual income. From about 1975 to 1992, the wealthiest 1 percent of families' share of the national household wealth rose from about 22 percent to about 42 percent; in the 1980s the wealth held by the poorest 40 percent of families actually dropped in absolute value. The middle class has also felt the strain. In the 1960s the middle one-third of Americans saved about 5 percent of their annual income; in the 1980s they saved virtually nothing.\(^\text{20}\)

Another reason the annual income changes shown in figure 5.2 underestimate the change is that the increase in inequality has been most acute in the younger generations. The proportion of young men earning a "family wage"—that is, enough income to keep a family of four out of poverty—has fallen sharply since the 1970s. Figure 5.3 shows the proportion of full-time, year-round employed men, divided into a few types, who earned at least a family wage from 1964 to 1994. We can see that the proportion that earned enough went up substantially from 1964 to 1974. But then the proportion declined. It declined dramatically for high school dropouts and for
The proportion of full-time employed men whose earnings could keep a family out of poverty rose until 1974 and then dropped.

18-to-24-year-olds, but it even declined for workers aged 25 to 34. Similarly, men turning 30 around 1990 were notably less likely to have already attained a middle-class income than were men who had turned 30 around 1980. These figures underestimate the sinking fortunes of workers because they count only fully employed men; in recent years, fewer men have been fully employed. Less able to save, less able to move up a career ladder, younger men are seeing differences in lifetime earnings and wealth widening yet further. All these compounding changes mean that inequality in economic security and independence has accelerated sharply. The proportion of Americans, aside from the elderly, who are poor has increased. Unlike the leveling that accompanied the economic growth of the 1950s, the economic growth of the late 1980s failed to stop or seriously slow this unequalizing trend.

Although young workers have been the most vulnerable to the economic dislocations since 1973, older male workers have also been affected. This can be seen most clearly in figure 5.4. It shows what has happened to the annual income (cost-adjusted) of men as they grew older, contrasting the 1950s and 1960s with the 1970s and 1980s. The gray arrows show what happened to men who started each decade aged between 25 and 35—the income they started the decade with and the income they ended the decade with, now aged 35–45. The black arrows show that pattern for men who started each decade aged between 35 and 45. In the period before 1973, men could expect to earn more, on average, at the end of the decade than they did at the beginning. For example, men who were between 25 and 35 in 1950 made about $12,000 in constant dollars, and by 1960 they averaged about $17,000. However, from 1973 to 1983, men who had started the decade aged 35–45 (black arrow) saw drops in income; men who had started the decade aged 25–35 (gray arrow) had stagnant incomes. And from 1983 to 1993, men in the 35–45 cohort had flat incomes. Men in the 25–35 cohort had growing incomes, but that cohort of 30-ish men started so far down that even the gains they had made by 1993 left them behind men who had been the same age in 1973. The assumption that men will move up the salary ladder as they mature now seems untenable.

M.I.T. economist Frank Levy, who developed the original version of figure 5.4, offers the image of "yesterday's $25,000 steelworker who now works in a K-Mart at $4.25 an hour." But it is not only that workers in declining industries like steel had to move on to new jobs. Men in many sectors of the economy were displaced. A 1995 Census Bureau report compared job mobility in the late 1980s to mobility in the early 1990s and found that workers in the 1990s were more likely to lose jobs. And full-
Before the 1970s, 30- and 40-year-old men made major gains in income over a decade, but that has not been true since 1970.


The rewards of the game

Time workers who lost their jobs more frequently ended up as part-time workers; even those who found a full-time job after a period of joblessness saw a 20 percent drop in their average weekly earnings 25

There has been some controversy about the claim of growing inequality that we just made. Few observers deny that the rich have gotten much richer faster than everyone else in the United States. But the dissenting voices claim that the economic situations of average and poor Americans have also improved in the last decade or so, if not as rapidly as those of the wealthy. If that were true, one might be able to claim that the fortunes of the wealthy have trickled down to the rest of Americans.

Some argue, for example, that the way the Bureau of Labor Statistics calculates the cost of living exaggerates the year-to-year cost increases, perhaps by as much as 1.5 points. All the numbers we have used here, which adjust incomes for increases in cost of living, would therefore underestimate the growth in real earning power and overestimate the growth in poverty. Instead of concluding that the median earnings of fully employed men dropped 12 percent in buying power from 1979 to 1994, we would conclude that they rose 14 percent. Recalculating the price index would not change our conclusion that the gap between classes has increased, “but instead of the usual story of the rich getting richer and the poor getting poorer, the new story would be that the rich got a lot richer while the poor held their own.”26 The debate over this claim can get arcane, dealing with exactly how to weigh apples and oranges in the typical consumer’s “market basket” and how to account for changes in products. Is, for example, a 1995 television set that costs the same as a 1975 television set but has stereo sound and a cable socket a “cheaper” television set? Is a visit to an HMO doctor the same “value” as a visit to a private practitioner? A few points seem clear, however: One is that the debate over earning power applies only to those who are earning. As noted earlier, fewer men are earning incomes today than before.27 A second is that the “big-ticket” items of the middle-class life-style, such as a home and college education for the children, have risen in “real” cost much more rapidly than the little items that fill up the statisticians’ market basket. Americans have had to work a lot harder and go into more debt to attain those pieces of the “American Dream.”28 A third point is that between 1975 and 1993 many more wives with children at home started working, from fewer than half to over two-thirds of them29—a great many because they believed, rightly or wrongly, that maintaining a middle-class life-style required it. As mothers took paying jobs, much of the free labor they had contributed to the household in
cleaning, cooking, child care, and the like had to be purchased or done without. If one takes these points into account, the decline in living standards has probably been greater, not less, than the crude numbers indicate.

Another line of defense charges that the apparent increase in poverty among the nonelderly is also a statistical anomaly. Some commentators point out that often government aid to the poor such as food stamps is not counted as income. But add into the calculations government assistance and the trends are still the same. (Recall that the problem of inequality is not so much a problem of the poor, although it is that, too, as it is a problem of most American families falling behind the wealthy, as well as behind their own expectations.) Others have argued that the increase in poverty is the product of family change—the increase in divorce and in the number of women bearing children out of wedlock. This argument implies that the structural situation is fine, the problem is that many women have, in effect, chosen to be poor by making poor life decisions. This argument also fails. First, divorce and single-parenthood are often (if not usually) the results of economic strain, typically the inability of a man to help support his family. Therefore, much of the family dislocation itself is the consequence, not the cause, of economic dislocation. (Recall that we found in chapter 4 that having been poor was the key determinant of whether a woman would later have a child out of wedlock.) Second, even if we were to assume that every divorce and out-of-wedlock birth were not the result of economic distress, such family changes account for only about one-third of the rise in inequality. And, at the same time, other family changes have actually slowed down the inequality trend. More lower-income women are working than before, and they are having fewer children. If not for these last two changes, the trend toward greater inequality would have been more severe still. In sum, the growing inequality is real, it is substantial, and it is not simply a matter of the rich outpacing an advancing field; the rich have been advancing and the rest have been retreating.

The post-1970 increase in income inequality largely arose from increasing inequality in workers' earnings. (Increasing wealth inequality was, in great measure, the result of the escalation in the value of financial instruments relative to owner-occupied homes during this period.) Earnings, especially those of younger men, have become much more unequal. In particular, earning differences by education have widened. During the 1980s the hourly wage (adjusted for inflation) went up 13 percent for men who had graduated college but declined 8 percent for men who had dropped out of college, dropped 13 percent for men who had only graduated from high school, and plummeted 18 percent for male high school dropouts. Inequality in earnings has also expanded among workers of comparable education, and workers in all sorts of industries have been affected. In turn, explaining why wages have diverged is more difficult.

University of Massachusetts economist Barry Bluestone lists ten different theories for explaining why the market seems to be rewarding education and skill more than it used to. One part of the explanation appears to be technological change, especially computerization, which would make more highly educated workers more valuable to employers. Some evidence points to this as a factor, although it is still a controversial claim. Many technological changes simplify jobs instead of making them more complex and therefore encourage employers to hire less-skilled rather than more-skilled workers. "Deindustrialization"—the process by which manufacturing jobs move overseas or are automated, leaving more poorly paid service jobs in America—explains what happened in terms of reduced demand for the work of the less-educated. Generally, competition from other nations' workers has depressed middle Americans' wages. When, for example, software programming can be done in India at a fraction of the cost here, it is hard for American workers to demand higher pay. (This pressure seems not, however, to have depressed CEO salaries, as we saw earlier. Indeed, Disney executive Michael Eisner banked a record $203 million the year his company suffered a 63 percent drop in profits.) Also contributing to the free-fall in less-skilled workers' wages are the weakening of unions, the stagnation in the minimum wage, and cutbacks in higher education (see chapter 6).

It is important to understand that this widening inequality in earnings has occurred, not only in the United States, but in most affluent Western nations during recent years. However, as we shall see in the section below that compares the American experience to that of other nations, expanding inequality has been greater and its consequences more severe here than anywhere else (except perhaps for the United Kingdom).

Analysts often treat inequality in earnings as simply the result of "market" operations and separate those effects from the effects of governments' after-market interventions—taxes and transfer payments. We will do that, too. But we first note that the distinction between market and policy is misleading. The market is permeated with policy. (See box, p. 118.)

By its taxes and by its "transfers"—social security, Medicare, food stamps, unemployment insurance, and the like—government can blunt inequalities in income created by inequalities in earnings from the market. American government today does reduce inequalities of income, but largely for older people.
CHAPTER 5

HOW THE "FREE" MARKET RESTS ON GOVERNMENT POLICY

What people earn in the labor market cannot be separated from policies that structure the market. We discuss such policies in detail in the next chapter, but pause here to consider just a few examples of how government policies shape differences in earnings:

—Licensing laws: Governments stipulate the requirements necessary to practice a wide range of professions, from hair-cutting to neurosurgery. The tighter those requirements, the fewer the practitioners, and the higher their earnings. Imagine what would happen to the incomes of the top-earning 5 percent of Americans if entry into medicine, or law, or the professorate were made considerably easier? (As professors, we are not necessarily recommending this move.)

—Direct subsidies: Direct subsidies, such as agricultural farm supports and urban transit construction, divert income from some people to others. American economic development in the early nineteenth century depended heavily on federal gifts of land to the states and on state borrowing for infrastructure. (Jeffersonian-Jacksonian Democrats largely opposed such spending, and Hamiltonian Federalists, predecessors of today's "Wall Street" Republicans, supported it.) Later, sizable subsidies to railroad companies spurred the interconnection of American towns.

—Laws governing property and finance: Fundamental to the economic system are the laws that govern property. In the early nineteenth century, American courts provided critical rulings that enabled the creation of limited-liability corporations and that protected businesses from paying for the incidental damages they caused. Different rulings would have meant different earnings. Later, the Supreme Court ruled that the Fourteenth Amendment's protections for people extended as well to corporations, further aiding the expansion of the large corporate sector.

Other examples of how policy shapes the market, such as unionization rules, tax deductions, and regulations, will be discussed in chapter 6. But even these few illustrations show us that the way the "market" apportions income is far from a pristine economic process. It is embedded in a set of policies, many of which may be so longstanding that we assume them to be "natural." Nevertheless, they are policy choices. "There is no such thing as a free lunch," the laissez-faire economists remind us. True, and there is also no such thing as a "free" market.


Not so long ago, older people were poorer than the rest of Americans, and their poverty was a social problem of wide concern. But, as we first pointed out in chapter 4, poverty among older people has dropped dramatically (see figure 5.5). By 1994 under 12 percent of older people were poor, compared with 15 percent of the nonelderly. The single major reason for this reversal is social security. For decades, it has allowed older people to retire early. In 1940, 42 percent of older men worked; in 1994, only 17 percent did. Then, in more recent years, cost-of-living adjustments accelerated the increase in social security payments. In the 1980s, while the median income of all American households increased just 5 percent, the median income of older households increased 20 percent. By 1993 the wealth of the typical older household was over twice the national average. America's social policy has successfully fought the "war on poverty"—but mostly on behalf of older people.
Inequality has widened since 1970 not just in money, but also in the quality of life money can buy. We see it, for example, in homeownership, something Americans value greatly. Between 1983 and 1994 rates of homeownership fell for every age group under 60 while rising for every age group over 60. For example, the percentage of heads of household 40-44 years old who owned their homes dropped from 73 percent to 68 percent, but the percentage of those aged 70-74 who owned their homes grew from 75 percent to 80 percent. People’s sense of security relies in part on having health insurance, to take another example, but the proportion of Americans covered by any health insurance (increasingly this has meant Medicaid) for an entire year has fallen recently, from about 87 percent in 1987 to 85 percent in 1993 and is still falling (though not among older people, covered as they are by Medicare). More dramatically yet, about one-third of men who changed jobs recently found that they had lost health insurance in the process. Also paralleling the widening income and wealth gaps is a widening gap in health and mortality among social classes. Inequality defined broadly in such ways is also growing.

Conclusion

What have we learned about inequality from this quick look at American history? We see that systems of inequality are changeable. In little more than a generation, Americans became notably more equal and then notably more unequal. These changes cannot be explained by changes in individuals’ “natural” talents, be it IQ or other inherent traits. (Changes in Americans’ acquired traits probably played a role. Far more Americans were college graduates in the 1980s than in the 1940s.) Even if, as some testing data suggest, Americans became “smarter” during the twentieth century (see chapter 2), inequality changed in different directions, and the scale of the changes was just too great. Market forces also cannot explain these variations in inequality. Certainly, technological developments and global trade have helped shape inequality in the United States, but much has been under the control of policy—policy that structures how the market works and policy that corrects how the market works. This point emerges again when we compare the United States with other nations.

INEQUALITY HERE AND THERE

A glance behind us to American history shows that our pattern of inequality is far from fixed or naturally determined. A glance sideways to other wealthy nations makes the same point. The United States has the greatest degree of economic inequality of any developed country. It is a level of inequality that is not fated by Americans’ talents nor necessitated by economic conditions but is the result of policy choices. The nations with which we will compare the United States are also modern, affluent, democratic, and capitalist—they are our competitors in the global market—and yet they have ways to reduce inequality and remain competitive.

At the beginning of this chapter, we noted how much wider the gap in earnings is between CEOs and average workers in the United States than it is elsewhere. America’s distinctive inequality is greater even than these illustrative numbers indicate. In general, our high earners earn relatively more and our low earners earn relatively less than do workers elsewhere. The best and latest evidence on how nations compare in levels of inequality comes from the Luxembourg Income Study (so named because the project is headquartered in Luxembourg). Social scientists affiliated with the study have collected detailed, comparable data on earnings and income from over a dozen nations. Our first use of their research appears in figure 5.6, which speaks to the question of inequality in earnings, specifically earnings of men, aged 25–54, who worked full-time, all year during the mid- to late 1980s. (Comparable data on earnings were available for only five nations. We are looking just at men here, because the situation of women in the labor force was in such flux and varied so much among nations.) The vertical line in the figure serves as an anchor for looking at inequality in each nation. It represents the earnings of the average (median) worker. The horizontal bars to the left of the median line display the ratio of the earnings that men near, but not at the top of, the earnings ladder received—those at the 90th percentile in earnings—to the earnings of men at the median. In 1986 the 90th percentile American male worker earned 1.8 times what the median worker earned. The bars stretching to the right represent the same comparison between the median earner and a low-paid worker, one at the 10th percentile of earnings. In the United States, the median worker brought home 2.8 times the amount the 10th percentile worker did. The left-hand bars, therefore, display inequality of earnings between the high-earners and the average; the right-hand bars display inequality between the average and the low-earners. Together, they display total inequality. In the United States, the 90th percentile worker earned five times that of the 10th percentile worker.

These numbers are highest in the United States. That is, the gap in earnings between the rich and the average worker is greater here than elsewhere, as is the gap between the average and the low-paid worker. The contrast between the United States and Europe sharpens further when non-
The gap between the highest- and the average-earning men was widest in the United States—as was the gap between the average- and the lowest-earning men.

<table>
<thead>
<tr>
<th>Country</th>
<th>90th percentile to median</th>
<th>Median</th>
<th>10th percentile</th>
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</thead>
<tbody>
<tr>
<td>United States</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Canada</td>
<td>2</td>
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<tr>
<td>Australia</td>
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<tr>
<td>West Germany</td>
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<td>Netherlands</td>
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<td>Sweden</td>
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</tbody>
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5.6. Ratios of Earnings for High-, Median-, and Low-Earners in Six Nations (Source: Adapted from Gottschalk and Smeeding, “Crossnational Comparisons,” table 1)

monetary compensation is added to the picture. In most European nations, national law requires that virtually all workers have the kinds of benefits such as strong job security and four-week vacations that in the United States only workers with seniority in major firms have.

These national differences expanded in the 1980s, when inequality increased globally. International economic forces widened the gaps between what the better- and the worse-educated earned in most industrialized nations, but this chasm opened up farthest and fastest in the United States and the United Kingdom. (These were the years of Thatcherite reforms that reduced the role of government in the United Kingdom.) Elsewhere, the gap in earnings between the better- and worse-educated widened less, barely at all, or even narrowed. There seems no clear connection between these differences and other economic trends such as growth rates. The reasons lie in government policies, notably the relative power of unions and the expansions of higher education in the other Western countries.

The biggest contrast in income inequality between the United States and the rest of the developed world, however, appears after taking into account how government deals with the results of the market. That means accounting for taxes, tax deductions, transfer payments, housing subsidies, and the like. (Again, we note that this before-and-after-government distinction understates the role of government. Where, for example, governments require employers to provide certain benefits, there is more market equality.)

To look at international differences in household income, we turn again to the Luxembourg Income Study. Peter Gottschalk and Timothy Smeeding compiled comparable data on households' disposable incomes— income after taxes and government support, adjusted for household size—in seventeen nations. In Figure 5.7, we use just the figures for nations with over ten million residents in 1980; our conclusions about the United States would be virtually the same if we showed the smaller nations, too.

As in figure 5.6, the bars to the left of the median display the ratio of a rich household's income (at the 90th percentile) to an average one's income, while the right-hand bars show the ratio of an average household's income to that of a poor one (10th percentile). The rich-to-average ratio is greatest in the United States, 2.1, as is the average-to-poor ratio, 2.9, and so the rich-to-poor ratio, 5.9 (not shown) is much higher than that of the next most unequal nations (4.0 for Italy, Canada, and Australia). In short, the United States has the greatest degree of income inequality in the West whether one focuses on the gap between the poor and the middle or the gap between the middle and the rich. Even these numbers underestimate America's distinctiveness, because they do not count the sorts of "in-kind" help that middle- and lower-income families receive in most other nations, such as free health care, child care, and subsidized housing and transportation. They also underestimate inequality in America by not displaying the concentration of income at the very top of the income ladder.

Western nations generally take two routes to reducing inequality. As we discuss in chapter 6, some intervene in the market to ensure relatively equal distributions of earnings by, for example, brokering nationwide wage agreements, assisting unions, or providing free child care. Others use taxes and government benefits to reduce inequality of income after the market. A few do both seriously, such as the Scandinavian countries. The United States does the least of either. If one sets aside older people, who benefit a
The income gap between the richest and the average household and the gap between the average household and the poorest are both wider in the United States than elsewhere.

<table>
<thead>
<tr>
<th>Country</th>
<th>Ratio of 90th percentile to median</th>
<th>Ratio of median to 10th percentile</th>
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<tr>
<td>United States</td>
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<td>W. Germany</td>
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<td>Netherlands</td>
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5.7. Ratios of Incomes for High-, Median-, and Low-Income Households in Eight Nations (Source: Adapted from Gottschalk and Smeeding, "Crossnational Comparisons," table 3)

great deal from government action in the United States, the net effect of taxes and transfers here is to leave the degree of inequality virtually unchanged from the way it was determined by market earnings. (See also chapter 6.)

When everything is accounted for, the Western nation with the most income inequality is the United States. But the United States is also exceptionally unequal in terms of wealth. At the end of the 1980s, the richest 1 percent of families owned about 40 percent of household wealth here,

more than in any other advanced nation; the richest 1 percent owned only 25 percent of the wealth in Canada and 18 percent of the wealth in Great Britain, for example. Add the less tangible features of "wealth," such as vacations and security of medical care, and the conclusion is reinforced that Americans are remarkably unequal.

(Some critics of crossnational comparisons contend that one ought not to contrast the United States to other nations, because the United States is distinct in certain ways. We have so many single-parent families, for example. But even looking only at two-parent families, the United States is still unusually unequal. America also seems exceptionally diverse racially and ethnically. But other Western nations also have ethnic diversity, if not the racial caste system we do. And poverty among American whites only still exceeds that among white or majority populations elsewhere. Such reservations do not challenge the conclusion that the United States is unusually unequal.)

America's level of inequality is by design. It is not given by nature, nor by the distribution of its people's talents, nor by the demands of a "natural" market. Other Western nations face the same global competition that we do and are about as affluent as we are and yet have managed to develop patterns of inequality less divisive than ours. Ironically, it was not so long ago that Americans were proud of comparing their relatively egalitarian society to the class-riven, hierarchical, decadent societies of Europe. In the last couple of decades, America has become the more class-riven and hierarchical society.

The United States is unusually unequal and Americans are unusually supportive of this inequality. Surveys show that Americans back moves toward expanding opportunity but oppose moves toward equalizing outcomes. They endorse wage differences among jobs that are pretty similar to the wage differences that they believe exist today (although the real differences are greater than Americans imagine), and they do not approve of government programs to narrow those differences. In a survey of people in six nations, only 28 percent of Americans agreed that government should reduce income differences. The next lowest percentage was 42 percent (Australians), while in the other countries majorities supported reducing income differences. Whether we have as much opportunity as Americans want is debatable (see chapters 4 and 8), but we seem to have a rough match between the desired and the perceived level of outcome inequality. That may be because Americans think that considerable inequality is needed for stimulating productivity and a high standard of living. Is it?
CHAPTER 5

IS INEQUALITY THE PRICE OF GROWTH?

Some commentators straightforwardly defend our current level of inequality. A congressional report in 1995 conceded that the recent trends toward inequality were real but argued, “All societies have unequal wealth and income dispersion, and there is no positive basis for criticizing any degree of market determined [sic] inequality.” Disparities in income and wealth, some analysts argue, encourage hard work and saving. The rich, in particular, can invest their capital in production and thus create jobs for all. This was the argument of “supply-side” economics in the 1980s, that rewarding the wealthy—for example, by reducing income taxes on returns from their investments—would stimulate growth to the benefit of all. The 1980s did not work out that way, as we have seen, but the theory is still influential. We could force more equal outcomes, these analysts say, but doing so would reduce living standards for all Americans.

Must we have so much inequality for overall growth? The latest economic research concludes not; it even suggests that inequality may retard economic growth. In a detailed statistical analysis, economists Torsten Persson and Guido Tabellini reported finding that, historically, societies that had more inequality of earnings tended to have lower, not higher, subsequent economic growth. Replications by other scholars substantiated the finding: More unequal nations grew less quickly than did more equal societies. That fits more casual observations as well: We saw that, in the United States, our era of greatest recent growth was also an era of greater equalization. And we saw, at the beginning of this chapter, that America’s economic rivals do not need to pay their CEOs exorbitant salaries to give us stiff competition. In fact, during the 1970s and 1980s, America’s national wealth did not grow as fast as that of the more egalitarian European nations.

Close examination of detailed policies also suggests that greater equality helps, or at least does not harm, productivity. Researchers affiliated with the National Bureau of Economic Research closely examined the effects on economic flexibility (that is, the ability to shift resources to more productive uses) of several redistributive policies used by Western nations—job security laws, homeowner subsidies, health plans, public child care, and so on. They found that such programs did not inhibit the functioning of those economies. Indeed, a study of over one hundred U.S. businesses found

that the smaller the wage gap between managers and workers, the higher
the business’s product quality.

This recent research has not demonstrated precisely how greater equality helps economic growth, but we can consider a few possibilities. Increasing resources for those of lower income might, by raising health, educational attainment, and hope, increase people’s abilities to be productive and entrepreneurial. Reducing the income of those at the top might reduce
unproductive and speculative spending. Take, as a concrete example, the way American corporations are run compared with German and Japanese ones. The American companies are run by largely autonomous managers whose main responsibility is to return short-term profits and high stock prices to shareholders and—because they are often paid in stock options—themselves as well. Japanese and German managers are more like top employees whose goals largely focus on keeping the company a thriving enterprise. The latter is more conducive to reinvesting profits and thus to long-term growth. Whatever the mechanisms may be, inequality appears to undermine growth. Americans certainly need not feel that they must accept the high levels of inequality we currently endure in order to have a robust economy.

A related concern for Americans is whether “leveling” stifles the drive to get ahead. Americans prefer to encourage Horatio Alger striving and to provide opportunities for everyone. Lincoln once said “that some would be rich shows that others may become rich.” Many, if not most, Americans believe that inequality is needed to encourage people to work hard. But, if so, how much inequality is needed?

For decades, sociologists have been comparing the patterns of social mobility across societies, asking: In which countries are people most likely to overcome the disadvantages of birth and move up the ladder? In particular, does more or less equality encourage such an “open” society? The answer is that Western societies vary little in the degree to which children’s economic successes are constrained by their parents’ class positions. America, the most unequal Western society, has somewhat more fluid intergenerational mobility than do other nations, but so does Sweden, the most equal Western society. There is no case for encouraging inequality in this evidence, either.

In sum, the assumption that considerable inequality is needed for, or even encourages, economic growth appears to be false. We do not need to make a morally wrenching choice between more affluence and more

equality; we can have both. But even if such a choice were necessary, both
sides of the debate, the “altruists” who favor intervention for equalizing and the supposed “realists” who resist it, agree that inequality can be shaped by policy decisions: wittingly or unwittingly, we choose our level of inequality.

**Conclusion**

Either we Americans have come to desire the inequality we live with or the inequality we live with reflects our desires (or both). Certainly, there are values and beliefs—individualism, capitalism, freedom—that can justify a more unequal society. But many Americans also believe that such levels of inequality are inevitable, the result of inequality in natural ability or of the market or both. This belief has no basis in evidence. Income and, more generally, wealth, standard of living, and quality of life have been more equal in other times and are more equal in other places, without any evidence that talents were more equal earlier or are more equal elsewhere, or that market pressures are different there.

Perhaps today’s trend toward inequality will reverse; it has reversed before in American history, as economic and political conditions changed. But the keys to understanding inequality will remain. The degree of inequality we live with is not a “natural” result of either inherent human talents or a “free” market. Certainly, people’s skills and societies’ economic conditions strongly influence the shape of inequality. But a people, acting through its government, can contract or expand that inequality. The policy changes enacted by the 1995–96 Congress will, certainly in the short run and most probably in the long run, widen inequality. We explore the choices we have in more detail in the next chapter.

**How Unequal?**

America’s Invisible Policy Choices

**A**mericans can significantly alter how much inequality there is among them. In chapter 5, we showed how inequality changes over time and how much it varies from nation to nation. Such fluidity results in large measure from changes and variations in policy. In this chapter we focus on several specific American policy choices that shape inequality.

Obvious redistributive programs, such as welfare spending, are not the only policies, or even the most important ones, that affect inequality. Many “invisible” practices are more significant. For example, American housing and road-building programs have largely subsidized the expansion of suburban homeownership for the middle class. Other largely unnoticed policies set the ground rules for the competition to get ahead. Just as in baseball, where the height of the pitcher’s mound affects whether pitchers or batters have the advantage (see box, p. 130), so in the marketplace laws and regulations favor some competitors and disadvantage others. We saw in the last chapter that the United States has the greatest inequality in earnings among full-time workers and that that inequality has increased since 1970.

Some policies narrow inequality and some widen it. Again and again we will see that the basic dimensions of social inequality—how rich the rich are and how poor the poor are, and even who becomes rich or poor—are a result of our social and political choices. Many of our policies operate indirectly, and hence invisibly. The programs that help the poor are glaringly obvious, but those that aid the rich and middle class tend to be invisible. Obscured even more are the policies that set the rules of “the game” for the labor market. In this chapter, we will reveal some of the many ways that social policy shapes inequality.

We will begin by looking at one general pattern of American social policy, which is to provide, with one hand, limited direct help to some of the poor and indirectly to subsidize, with another, the middle class and the wealthy. Next, we will uncover one of the most hidden arenas of social policy, the regulation of the labor market, and show how the ground rules shape inequality. Finally, through an examination of higher education, we