How the Government Creates Wealth Inequality

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There are economic storm clouds on the horizon, but for now wages are rising, jobs are plentiful, and poverty is falling. Democrats running for president need an economic line of attack, so the solution has been to focus on wealth inequality. Senator Bernie Sanders claims that there has been a "massive transfer of wealth from the middle class to the top one percent." Senator Elizabeth Warren lambastes America's "extreme concentration of wealth." Even the establishment Joe Biden laments, "This wealth gap that exists in the United States of America is so profound now."

Wealth inequality has risen in recent years, but by far less than the Democrats and many media articles imply. The scarier claims about inequality usually stem from the flawed data created by French economist Thomas Piketty and his colleagues. More careful studies by other economists and the Federal Reserve Board reveal surprisingly modest changes in wealth inequality given the huge revolutions in globalization and technology that have occurred.

Are increases in wealth inequality the awful thing that Democrats claim? It depends on what causes them. Much of the recent modest rise in wealth inequality stems from innovations in our economy that are pulling everyone up. Brian Acton and Jan Koum, for example, built huge multibillion dollar fortunes by creating WhatsApp, which provides free phone service for 1.5 billion users globally.

Acton and Koum's success may have increased the wealth owned by the top 1 percent, but their product has created massive consumer value as well. Most of the wealthiest Americans are entrepreneurs who have fueled economic growth, which is clear in examining the *Forbes* 400 list. Wealth created this way is not the zero-sum struggle that Democrats imagine it is.

That is the good news. The bad news is that the government itself generates wealth inequality in at least two ways that make us worse off. First, governments give subsidies, regulatory preferences, and other crony-capitalist benefits to wealthy insiders. In the recent Fat Leonard scandal, for example, Leonard Francis gained hundreds of millions of dollars of government contracts by cozying up to Navy officers and providing them with gifts, prostitutes, and other favors to get them to do his bidding.

The other way that the government fuels wealth inequality is a deeper scandal. The expansion of social programs over the decades has undermined incentives for lower- and middle-income families to save while reducing their ability to save because of higher taxes. Government programs have displaced or "crowded out" wealth-building by all American families but the richest.

Politicians complain loudly about wealth inequality, but their own policies are generating it. This issue receives too little policy attention, but it is profoundly important and reveals the hypocrisy of the political left.

Many Americans have saved little for retirement because Social Security discourages them doing so, as does the heavy 12.4 percent wage tax that funds the program. Economist Martin Feldstein found that every dollar increase in Social Security benefits reduces private savings by about 50 cents.

Social Security accounts for a larger share of retirement income for the non-rich than for the rich, so this crowd-out effect increases wealth inequality. In a simulation model, Jagadeesh Gokhale and Laurence Kotlikoff estimated that Social Security raises the share of overall wealth held by the top 1 percent of wealth holders by about 80 percent. This occurs because the program leaves the non-rich with "proportionately less to save, less reason to save, and a larger share of their old-age resources in a nonbequeathable form."

A study by Baris Kaymak and Markus Poschke built a model of the U.S. economy to estimate the causes of rising wealth inequality. They found that most of the rise in the top 1 percent share of wealth in recent decades was caused by technological changes and wage dispersion, but the expansion of Social Security and Medicare caused about one-quarter of the increase. They concluded that the "redistributive nature of transfer payments was instrumental in curbing wealth accumulation for income groups outside the top 10% and, consequently, amplified wealth concentration in the U.S."

More government benefits result in less private wealth, especially for the non-rich. It is not just Social Security and Medicare that displaces private saving, but also unemployment insurance, welfare, and other social spending. Some social programs have "asset tests" that deliberately discourage saving.

Total federal and state social spending as a share of gross domestic product soared from 6.8 percent in 1970 to 14.3 percent in 2018. That increase in handouts occurred over the same period that wealth inequality appears to have increased. Generations of Americans have grown up assuming that the government will take care of them when they are sick, unemployed, and retired, so they put too little money aside for future expenses.

Cross-country studies support these conclusions. A 2015 study by Pirmin Fessler and Martin Schurz examined European data and found that "inequality of wealth is higher in countries with a relatively more developed welfare state . . . given an increase of welfare state expenditure, wealth inequality measured by standard relative inequality measures, such as the Gini coefficient, will increase."

A study by Credit Suisse found: "Strong social security programs — good public pensions, free higher education or generous student loans, unemployment and health insurance — can greatly reduce the need for personal financial assets. . . . This is one explanation for the high level of wealth inequality we identify in Denmark, Norway and Sweden: the top groups continue to accumulate for business and investment purposes, while the middle and lower classes have a less pressing need for personal saving."

That is why it is absurd for politicians such as Sanders and Warren to decry wealth inequality and then turn around and demand European-style expansions in our social programs. The bigger our welfare state, the more wealth inequality we will have.

The solution is to transition to savings-based social programs. Numerous countries have Social Security systems based on private savings accounts. Chile has unemployment-insurance savings accounts. Martin Feldstein proposed a savings-based approach to Medicare. The assets in such savings accounts would be inheritable, unlike the benefits from current U.S. social programs.

Sanders and Warren are right to criticize crony capitalism as a cause of wealth inequality. But their big government approaches to social policy would have the opposite effect on wealth inequality than what they may believe.

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