NATIONAL REVIEW

Democrats vs. the Facts on Inequality

They get it all wrong on the causes and effects of income inequality.

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October 21, 2015

Inequality was a big topic in last week's Democratic debate. Of course, it was no surprise that self-described democratic socialist Bernie Sanders decried the "casino capitalist process by which so few have so much and so many have so little." But he was matched by Hillary Clinton, who promised to heal the divides that exist "because there's too much inequality." And Martin O'Malley worried, "Our middle class is shrinking . . . the poor are getting poorer." Even Lincoln Chafee "want[s] to address income inequality."

The class warfare was greeted rapturously by the partisans in the audience. Unfortunately for the candidates, though, the latest research suggests that they have once again gotten it all wrong.

For example, it is an article of faith on the Left that inequality exists because the rich fail to pay their fair share of taxes and our social-welfare programs are too stingy. Of course, this ignores the facts that (a) the rich, who earn around 19 percent of U.S. income, pay more than 42 percent of federal income taxes, and (b) federal and state governments spend nearly $1 trillion on welfare and anti-poverty programs. But why let a few facts get in the way of a good narrative?

And now we have a new study from the Brookings Institution. Yes, the liberal Brookings Institution. Authored by former Obama economic adviser Peter Orszag and others, the study concludes that even raising the top individual-income-tax rate to 50 percent from its current 39.6 percent and redistributing all the new revenue to those with incomes in the lowest 20 percent would do surprisingly little to reduce inequality. Hillary, Bernie, et al. could tax the rich as much as they want and pour the money into welfare programs, but that still wouldn't do more than dent inequality.

The Left also believes that most rich people don't earn their wealth, they inherit it, resulting in a new aristocracy. That was the central thesis of Thomas Piketty's oft-cited book, *Capital in the Twenty-First Century*. In reality, however, roughly 80 percent of American millionaires are the first generation of their families to have that much money. Most of the rich are entrepreneurs who earned their wealth through hard work.

The last nails should have been put in the coffin of Piketty's theory of dynastic wealth by a new study for the Cato Institute by Robert Arnott, William Bernstein, and Lillian Wu, which shows that "each generation spawns its own entrepreneurs, who create vast pools of entirely new wealth," while the wealth accumulated by previous generations is dissipated. As the authors show, the massive fortunes of the 19th century have been almost entirely depleted, and even the fortunes generated just a half-century ago are diminished, replaced by a new set of fortunes, which will someday be lost in turn. Capitalism, as Joseph Schumpeter noted, is a process of creative destruction.

Indeed, as Harvard's Philippe Aghion and others showed in a new National Bureau of Economic Research working paper, roughly 17 percent of the total increase in the share of income going to the top 1 percent from 1975 to 2010 resulted just from innovation — new ideas and new products that benefited all of us. The authors conclude that this "vindicates the Schumpeterian view whereby the rise in top income shares is partly related to innovation-led growth, where innovation itself fosters social mobility at the top through creative destruction."
In a similar vein, researchers led by Jae Song of the Social Security Administration found little evidence that inequality is caused by a growing wage gap between corporate executives and other workers. Instead, nearly all the growth in inequality from 1978 to 2012 resulted from disparities in wages between companies. Similar jobs at different companies pay different wages. Duh! And workers sometimes choose other compensation or benefits or conveniences instead of higher wages. Therefore, traditional liberal proposals such as capping CEO pay would have little impact on inequality.

And if that's not enough to spoil the inequality story, there is also a new report on poverty from the World Bank. Critics of inequality would have us believe that rising inequality is responsible for poverty. But at a time of increasing inequality, world poverty has never been lower. The researchers project that fewer than 10 percent of the world's population will live in extreme poverty this year.

I suppose those concerned about inequality can take some comfort from a new study by Sutirtha Bagchi of the University of Michigan and Jan Svejnar of Columbia University, which concludes that inequality can slow economic growth if the inequality results from government favors and other vestiges of crony capitalism. But even this study points out that inequality can be good for growth when it is the result of free markets. So, as everyone who isn't backing green-energy subsidies and the Export-Import Bank understands, capitalism works, but crony capitalism doesn't. Now which side of that divide do Hillary and Bernie fall on?

The evidence just keeps rolling in, day after day, study after study. Unlike the Left's constantly repeated claims about climate change, in this case the science really is clear.

Whoever wins the Democratic nomination next year, it is a safe bet that he or she will campaign against inequality and in favor of increased redistribution. After all, what was the Democratic debate if not an endless list of freebies to be paid for by punitive taxes on the rich?

If the Republicans, in contrast, ignore strident populism and choose a proponent of economic growth, that will set up one of the most important philosophical and economic debates of any recent presidential election. If that happens, the evidence piles up that they will have the better of the argument.

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