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Inequality Is Back, But Should You Care?

A viral video has everyone talking about the 1 percent again, but is inequality really hurting anyone?

By: Danielle Kurtzleben – March 6, 2013

Occupy is by now forgotten (if not gone), but the top 1 percent came roaring back into view this week with a viral video that has been seemingly inescapable for anyone on Facebook or Twitter. The slick, graph-heavy animation shows the results of a 2011 study that found not only that Americans vastly underestimate wealth inequality in the U.S. but that current inequality is very far from what most Americans see as ideal. In addition, the Dow Jones stock index reaching record highs this week led some to ask why corporate America is doing so well while millions remain unemployed.

The gut reaction to any of this is simple enough: that it's all unfair, that the average American works her fingers to the bone but the fatcat CEO reaps the benefits. But from a cold, rational economic perspective, there's a more interesting question: does it matter? That is, does the economy hum along just fine, regardless of who is sitting on all the cash?

As with any sweeping question of macroeconomics, the answer is muddy: yes, too much inequality is bad for the economy. But the exact location of that "too much" point is tough to nail down.

As the video points out, some inequality is good because it creates incentives. One key reason why people get educated and invent iPhones is that there are financial incentives, says one economist.

"Some inequality is necessary for the market economy to function correctly. it builds incentives, it creates opportunity, it leads to growth and investment," says Steven Cunningham, president of the American Institute for Economic Research, a Massachusetts-based research organization.

But inequality hurts the economy when those incentives look too unattainable, he adds. At a certain point, people throw up their hands and decide that they can't climb the ladder. In addition, inequality can be a signal that the economy is far below potential growth, as workers sit unemployed and unused.

Inequality can also wreak havoc on an entire national economy, not just on individuals' lives. A 2011 IMF study found that more inequality is linked to less stable economic growth: "a 10 percentile decrease in inequality...increases the expected length of a growth spell by 50 percent," wrote the authors.

In Cunningham's opinion, inequality can hurt the economy not necessarily because it lowers growth levels but because it makes that growth shakier, as fewer people participate in it.

"When you have more people participating in the expansion ... it drives firms in all those industries to invest and build up capital and hire and therefore create growth. It's more of a stability and robustness issue," he says.

Still, some would argue that not all inequality is created equal. According to one expert, the problem is far worse when it's a function of bad government than when it's a function of private industry growth.

"If you're a very corrupt, cronyist type economy like Argentina or Mexico, you have a huge degree of income inequality and it's driven by the fact that the elites control the levers of power," says Dan Mitchell, a senior fellow at the Cato Institute, a libertarian think tank.

Meanwhile, a less-corrupt, high-inequality, but fast-growing economy--Marshall uses the example of Hong Kong--might be healthier, more stable, and more likely to have a rising tide of growth lifting all boats, even if it's lifting some boats more than others.

In other words, as long as everyone is benefiting, albeit to different degrees, he says, that's one key test of whether inequality is "good" or "bad."

In recent decades, incomes rose for all quintiles of U.S. earners, according to a recent CBO study. However, those at the top reaped far more benefits than those at the bottom. The lowest quintile's average inflation-adjusted income moved from around $16,000 to $23,000. The top quintile, meanwhile, went from $99,000 to nearly $172,000 over that same period. (It should be noted that these numbers represent inequality in incomes, not the more-heavily-skewed wealth inequality, which is the focus of the popular video.)

As for the question of where U.S. inequality is coming from, Mitchell says he fears that corporate influence in Washington may be creating inequality of what he might call the Mexican or Argentinian type. That is, he believes that big banks and healthcare companies are skewing the system in their own favor via legislation like Dodd-Frank and healthcare reform.

If that's true--that those at the top are able to entrench their places at the top, at the expense of others--it is reason to angrily hit the share button. As Cunningham says, the problem with being poor isn't just being poor; it's the difficulty of becoming richer.

"It's about opportunity," he says. "That's one of the greatest tragedies of low income: it limits opportunities for the future, individuals, and families."