“Inequality and Insecurity”

Statement of

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Thank you for holding this forum, Mr. Chairman. I’d like to use my brief time to focus on two broad-brush, long-term issues, one pertaining to income disparities and one to economic insecurity—which were two of the themes listed in your invitation.

Rising income inequality: First, do no harm

The first problem has been with us for so long that I fear we may be becoming inured to it. The plain fact is that America does a poor job of caring for its poor, for its weak, and for its downtrodden—as was illustrated vividly by the heart-rending pictures of the victims of Hurricane Katrina. Those images breathed life into what sometimes appears to be a dry statistical story of rising income inequality in our country.

Although specific statistical measures of poverty and inequality can be--and have been--disputed, the basic outlines of the story are clear enough. Inequality in America was mostly falling for the 35 years or so from World War II until the late 1970s, but has been mostly rising since. The one notable exception was the boom years of the late 1990s, when labor markets were extraordinarily tight.

This phenomenon has *not* been mainly a story of vast capital gains accruing to a tiny minority, nor of a massive income shift from labor to capital—although both of these have played roles at intervals. Rather, the basic story is that *earnings from work* have grown vastly more unequal over the last quarter-century. There are many ways to measure that change, but here is one that I find both dramatic and understandable. According to IRS data, in 1979 the average taxpayer in the top $1/10^{th}$ of 1 percent of all wage and salary earners earned about as much as 44 average taxpayers in the bottom half.[1] By 2001, that number had risen to almost 160.[2] And we know from other data sources that inequality has gotten worse since.

What accounts for this alarming trend? Let me be clear: The main culprit is *not* the government but the marketplace. While there are a number of competing theoretical explanations, the fact is that, starting sometime in the late 1970s, the market turned ferociously against the less skilled and the less well educated.

How should the government have reacted to such a development? One clearly *wrong* approach would have been to try to stop the market forces that were generating rising inequality. Such an effort would have produced undesirable side effects and would probably have failed anyway. A more reasonable approach would have been to use the tax-and-transfer system to cushion the blow, to devote more resources to compensatory

[1] The unit of observation in tax data is the tax return, not the individual or the family.
[2] These are my calculations, based on data in Table 8 of Ian Dew-Becker and Robert Gordon, "Where did the Productivity Growth Go?," *Brookings Papers on Economic Activity*, 2005:2, forthcoming. 2001 is the last year for which comprehensive tax data are available.

education, to guarantee health insurance coverage, etc. These are still good and useful ideas.

A Social Darwinist would reject palliatives and say: Let the market rule and the chips fall where they may. (By the way, it strikes me as ironic that some of these Social Darwinists question Darwinian evolution.) That may sound heartless. But, with a few notable exceptions, the U.S. government followed an even harsher policy for most of the past quarter century.[3] As natural market forces turned against the middle class and the poor, the federal government piled on by enacting tax cuts for the rich while either permitting or causing large holes to appear in the social safety net. In football, that would be called "unnecessary roughness"--and penalized. It's a policy direction that, in my view, needs to be changed. The first step would be to stop piling on.

Offshoring: The sleeping giant

Let me now turn to a job security issue whose present importance has been greatly exaggerated, but whose future importance, ironically, appears to be underappreciated: offshoring. While no hard numbers are available, it appears likely that fewer than a million American jobs have been lost to offshoring to date. A million may sound like a lot, but in a nation with over 140 million jobs, it is not even one month's normal turnover. No big deal, in other words.

[3] The main exception was the Clinton administration's huge increase in the Earned Income Tax Credit in 1993.

However, I believe we have seen only the tip of a very big iceberg. Here's why. Only a minority of American workers—including almost all manufacturing workers—have historically faced job competition from abroad. They haven't welcomed it, of course. But they see foreign competition as one of the hazards of industrial life, like bankruptcies and business cycles.

But most American workers, including the vast majority of service workers, have not grown up worrying about foreign competition. Until recently, neither low-skill work like call centers nor high-skill work like radiology could easily be moved offshore. Now both can be. My main point is that the share of American jobs that is vulnerable to offshoring is certain to rise as the technology improves and as countries like India modernize and prosper. As this occurs, tens of millions of *additional* American workers will start to experience an element of job insecurity that has heretofore been reserved for manufacturing workers. It is predictable that they will not like it.

Many people have concluded that offshoring will be a particularly acute problem for less-skilled and less-well-educated workers--precisely the people who have been left behind for the last 25 years. I disagree. As I see it, the key labor-market distinction in the Information Age will not be high-skilled versus low-skilled, as in the recent past, but rather services that can be delivered electronically with little loss of quality versus those that cannot.

Consider a few examples. It seems unlikely that the services of either waiters or brain surgeons will ever be delivered over long distance. On the other hand, typing services and security analysis are already being delivered electronically from India--albeit on a small scale. These disparate examples illustrate two fundamentally important points. First, the dividing line between jobs that are readily deliverable electronically (and thus are threatened by offshoring) and those that are not does *not* correspond to traditional distinctions between high-end and low-end work. Frankly, I have no idea whether the downward pressure on wages caused by offshoring will make the distribution of wages more or less equal. Second, the fraction of U.S. jobs that can be moved offshore is certain to rise inexorably as technology improves. Despite all the fuss, it is pretty low now. But it will eventually be quite high.

What can or should the government do about all this? I certainly don't have concrete answers; I've barely begun to ponder the problem myself. But I think I know two things. First, the government will not be able to hold back the tides of history—and it shouldn't try. Second, if we once again follow a policy of Social Darwinism or worse, a huge fraction of the U.S. population—perhaps the majority--is going to experience a great deal of anxiety and economic distress. These people will constitute a much larger, more vocal, and more politically-engaged group than the poor and uneducated. It seems unlikely that they will just sit there passively and take their medicine. Congress will hear from them. So Congress would be well advised to start thinking about this problem now.

Thank you.