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From the January - February 2011 issue:

The Inequality That Matters

Tyler Cowen

Does growing wealth and income inequality in the United States presage the downfall of the American republic? Will we evolve into a new Gilded Age plutocracy, irrevocably split between the competing interests of rich and poor? Or is growing inequality a mere bump in the road, a statistical blip along the path to greater wealth for virtually every American? Or is income inequality partially desirable, reflecting the greater productivity of society's stars?

There is plenty of speculation on these possibilities, but a lot of it has been aimed at elevating one political agenda over another rather than elevating our understanding. As a result, there's more confusion about this issue than just about any other in contemporary American political discourse. The reality is that most of the worries about income inequality are bogus, but some are probably better grounded and even more serious than even many of their heralds realize. If our economic churn is bound to throw off political sparks, whether alarums about plutocracy or something else, we owe it to ourselves to seek out an accurate picture of what is really going on. Let's start with the subset of worries about inequality that are significantly overblown.

In terms of immediate political stability, there is less to the income inequality issue than meets the eye. Most analyses of income inequality neglect two major points. First, the inequality of personal well-being is sharply *down* over the past hundred years and perhaps over the past twenty years as well. Bill Gates is much, much richer than I am, yet it is not obvious that he is much happier if, indeed, he is happier at all. I have access to penicillin, air travel, good cheap food, the Internet and virtually all of the technical innovations that Gates does. Like the vast majority of Americans, I have access to some important new pharmaceuticals, such as statins to protect against heart disease. To be sure, Gates receives the very best care from the world's top doctors, but our health outcomes are in the same ballpark. I don't have a private jet or take luxury vacations, and—I think it is fair to say—my house is much smaller than his. I can't meet with the world's elite on demand. Still, by broad historical standards, what I share with Bill Gates is far more significant than what I don't share with him.

Compare these circumstances to those of 1911, a century ago. Even in the wealthier countries, the average person had little formal education, worked six days a week or more, often at hard physical labor, never took vacations, and could not access most of the world's culture. The living standards of Carnegie and Rockefeller towered above those of typical Americans, not just in terms of money but also in terms of comfort. Most people today may not articulate this truth to themselves in so many words, but they sense it keenly enough. So when average people read about or see income inequality, they don't feel the moral outrage that radiates from the more passionate egalitarian quarters of society. Instead, they think their lives are pretty

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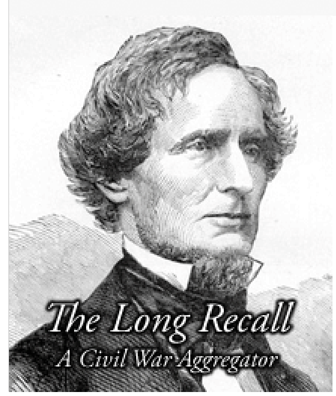

good and that they either earned through hard work or lucked into a healthy share of the American dream. (The persistently unemployed, of course, are a different matter, and I will return to them later.) It is pretty easy to convince a lot of Americans that unemployment and poverty are social problems because discrete examples of both are visible on the evening news, or maybe even in or at the periphery of one's own life. It's much harder to get those same people worked up about generalized measures of inequality.

This is why, for example, large numbers of Americans oppose the idea of an estate tax even though the current form of the tax, slated to return in 2011, is very unlikely to affect them or their estates. In narrowly self-interested terms, that view may be irrational, but most Americans are unwilling to frame national issues in terms of rich versus poor. There's a great deal of hostility toward various government bailouts, but the idea of "undeserving" recipients is the key factor in those feelings. Resentment against Wall Street gamesters hasn't spilled over much into resentment against the wealthy more generally. The bailout for General Motors' labor unions wasn't so popular either—again, obviously not because of any bias against the wealthy but because a basic sense of fairness was violated. As of November 2010, congressional Democrats are of a mixed mind as to whether the Bush tax cuts should expire for those whose annual income exceeds $250,000; that is in large part because their constituents bear no animus toward rich people, only toward undeservedly rich people.

A neglected observation, too, is that envy is usually local. At least in the United States, most economic resentment is not directed toward billionaires or high-roller financiers—not even corrupt ones. It's directed at the guy down the hall who got a bigger raise. It's directed at the husband of your wife's sister, because the brand of beer he stocks costs $3 a case more than yours, and so on. That's another reason why a lot of people aren't so bothered by income or wealth inequality at the macro level. Most of us don't compare ourselves to billionaires. Gore Vidal put it honestly: "Whenever a friend succeeds, a little something in me dies."

Occasionally the cynic in me wonders why so many relatively well-off intellectuals lead the egalitarian charge against the privileges of the wealthy. One group has the status currency of money and the other has the status currency of intellect, so might they be competing for overall social regard? The high status of the wealthy in America, or for that matter the high status of celebrities, seems to bother our intellectual class most. That class composes a very small group, however, so the upshot is that growing income inequality won't necessarily have major political implications at the macro level.

What Matters, What Doesn't

All that said, income inequality does matter—for both politics and the economy. To see how, we must distinguish between inequality itself and what causes it. But first let's review the trends in more detail.

The numbers are clear: Income inequality has been rising in the United States, especially at the very top. The data show a big difference between two quite separate issues, namely income growth at the very top of the distribution and greater inequality throughout the distribution. The first trend is much more pronounced than the second, although the two are often confused.

When it comes to the first trend, the share of pre-tax income earned by the richest 1 percent of earners has increased from about 8 percent in 1974 to more than 18 percent in 2007. Furthermore, the richest 0.01 percent (the 15,000 or so richest families) had a share of less than 1 percent in 1974 but more than 6 percent of national income in 2007. As noted, those figures are from pre-tax income, so don't look to the George W. Bush tax cuts to explain the pattern. Furthermore, these gains have been sustained and have evolved over many years, rather than coming in one or two small bursts between 1974 and today.[1]

These numbers have been challenged on the grounds that, since various tax reforms have kicked in, individuals now receive their incomes in different and harder to measure ways, namely through corporate forms, stock options and fringe benefits. Caution is in order, but the overall trend seems robust. Similar broad patterns are indicated by different sources, such as studies of executive compensation. Anecdotal observation suggests extreme and unprecedented returns earned by investment bankers, fired CEOs, J.K. Rowling and Tiger Woods.

At the same time, wage growth for the median earner has slowed since 1973. But that slower wage growth has afflicted large numbers of Americans, and it is conceptually distinct from the higher relative share of top income earners. For instance, if you take the 1979–2005 period, the average incomes of the bottom fifth of households increased only 6 percent while the incomes of the middle quintile rose by 21 percent. That's a widening of the spread of incomes, but it's not so drastic compared to the explosive gains at the very top.

The broader change in income distribution, the one occurring beneath the very top earners, can be deconstructed in a manner that makes nearly all of it look harmless. For instance, there is usually greater inequality of income among both older people and the more highly educated, if only because there is more time and more room for fortunes to vary. Since America is becoming both older and more highly educated, our measured income inequality will increase pretty much by demographic fiat. Economist Thomas Lemieux at the University of British Columbia estimates that these demographic effects explain three-quarters of the observed rise in income inequality for men, and even more for women.[2]

Attacking the problem from a different angle, other economists are challenging whether there is much growth in inequality at all below the super-rich. For instance, real incomes are measured using a common price index, yet poorer people are more likely to shop at discount outlets like Wal-Mart, which have seen big price drops over the past twenty years.[3] Once we take this behavior into account, it is unclear whether the real income gaps between the poor and middle class have been widening much at all. Robert J. Gordon, an economist from Northwestern University who is hardly known as a right-wing apologist, wrote in a recent paper that "there was no increase of inequality after 1993 in the bottom 99 percent of the population", and that whatever overall change there was "can be entirely explained by the behavior of income in the top 1 percent."[4]

And so we come again to the gains of the top earners, clearly the big story told by the data. It's worth noting that over this same period of time, inequality of work hours increased too. The top earners worked a lot more and most other Americans worked somewhat less. That's another reason why high earners don't occasion more resentment: Many people understand how hard they have to work to get there. It also seems that most of the income gains of the top earners were related to performance pay—bonuses, in other words—and not wildly out-of-whack yearly salaries.[5]

It is also the case that any society with a lot of "threshold earners" is likely to experience growing income inequality. A threshold earner is someone who seeks to earn a certain amount of money and no more. If wages go up, that person will respond by seeking less work or by working less hard or less often. That person simply wants to "get by" in terms of absolute earning power in order to experience other gains in the form of leisure—whether spending time with friends and family, walking in the woods and so on. Luck aside, that person's income will never rise much above the threshold.

It's not obvious what causes the percentage of threshold earners to rise or fall, but it seems reasonable to suppose that the more single-occupancy households there are, the more threshold earners there will be, since a major incentive for earning money is to use it to take care of other people with whom one lives. For a variety of reasons, single-occupancy households in the United States are at an all-time high. There are also a growing number of late odyssey years graduate students who try to cover their own expenses but otherwise devote their time to study. If the percentage of threshold earners rises for whatever reasons, however, the aggregate gap between them and the more financially ambitious will widen. There is nothing morally or practically wrong with an increase in inequality from a source such as that.

The funny thing is this: For years, many cultural critics in and of the United States have been telling us that Americans should behave more like threshold earners. We should be less harried, more interested in nurturing friendships, and more interested in the non-commercial sphere of life. That may well be good advice. Many studies suggest that above a certain level more money brings only marginal increments of happiness. What isn't so widely advertised is that those same critics have basically been telling us, without realizing it, that we should be acting in such a manner as to increase measured income inequality. Not only is high inequality an inevitable concomitant of human diversity, but growing income inequality may be, too, if lots of us take the kind of advice that will make us happier.

Lonely at the Top?

Why is the top 1 percent doing so well?

The use of micro-data now makes it possible to trace some high earners by income and thus construct a partial picture of what is going on among the upper echelons of the distribution. Steven N. Kaplan and Joshua Rauh have recently provided a detailed estimation of particular American incomes.[6] Their data do not comprise the entire U.S. population, but from partial financial records they find a very strong role for the financial sector in driving the trend toward income concentration at the top. For instance, for 2004, nonfinancial executives of publicly traded companies accounted for less than 6 percent of the top 0.01 percent income bracket. In that same year, the top 25 hedge fund managers combined appear to have earned more than all of the CEOs from the entire S&P 500. The number of Wall Street investors earning more than $100 million a year was nine times higher than the public company executives earning that amount. The authors also relate that they shared their estimates with a former U.S. Secretary of the Treasury, one who also has a Wall Street background. He thought their estimates of earnings in the financial sector were, if anything, understated.

Many of the other high earners are also connected to finance. After Wall Street, Kaplan and Rauh identify the legal sector as a contributor to the growing spread in earnings at the top. Yet many high-earning lawyers are doing financial deals, so a lot of the income generated through legal activity is rooted in finance. Other lawyers are defending corporations against lawsuits, filing lawsuits or helping corporations deal with complex regulations. The returns to these activities are an artifact of the growing complexity of the law and government growth rather than a tale of markets *per se*. Finance aside, there isn't much of a story of *market* failure here, even if we don't find the results aesthetically appealing.

When it comes to professional athletes and celebrities, there isn't much of a mystery as to what has happened. Tiger Woods earns much more, even adjusting for inflation, than Arnold Palmer ever did. J.K. Rowling, the first billionaire author, earns much more than did Charles Dickens. These high incomes come, on balance, from the greater reach of modern communications and marketing. Kids all over the world read about Harry Potter. There is more purchasing power to spend on children's books and, indeed, on culture and celebrities more generally. For high-earning celebrities, hardly anyone finds these earnings so morally objectionable as to suggest that they be politically actionable. Cultural critics can complain that good schoolteachers earn too little, and they may be right, but that does not make celebrities into political targets. They're too popular. It's also pretty clear that most of them work hard to earn their money, by persuading fans to buy or otherwise support their product. Most of these individuals do not come from elite or extremely privileged backgrounds, either. They worked their way to the top, and even if Rowling is not an author for the ages, her books tapped into the spirit of their time in a special way. We may or may not wish to tax the wealthy, including wealthy celebrities, at higher rates, but there is no need to "cure" the structural causes of higher celebrity incomes.

If we are looking for objectionable problems in the top 1 percent of income earners, much of it boils down to finance and activities related to financial markets. And to be sure, the high incomes in finance should give us all pause.

The first factor driving high returns is sometimes called by practitioners "going short on volatility." Sometimes it is called "negative skewness." In plain English, this means that some investors opt for a strategy of betting against big, unexpected moves in market prices. Most of the time investors will do well by this strategy, since big, unexpected moves are outliers by definition. Traders will earn above-average returns in good times. In bad times they won't suffer fully when catastrophic returns come in, as sooner or later is bound to happen, because the downside of these bets is partly socialized onto the Treasury, the Federal Reserve and, of course, the taxpayers and the unemployed.

To understand how this strategy works, consider an example from sports betting. The NBA's Washington Wizards are a perennially hapless team that rarely gets beyond the first round of the playoffs, if they make the playoffs at all. This year the odds of the Wizards winning the NBA title will likely clock in at longer than a hundred to one. I could, as a gambling strategy, bet against the Wizards and other low-quality teams each year. Most years I would earn a decent profit, and it would feel like I was earning money for virtually nothing. The Los Angeles Lakers or Boston Celtics or some other quality team would win the title again and I would collect some surplus from my bets. For many years I would earn excess returns relative to the market as a whole.

Yet such bets are not wise over the long run. Every now and then a surprise team does win the title and in those years I would lose a huge amount of money. Even the Washington Wizards (under their previous name, the Capital Bullets) won the title in 1977–78 despite compiling a so-so 44–38 record during the regular season, by marching through the playoffs in spectacular fashion. So if you bet against unlikely events, most of the time you will look smart and have the money to validate the appearance. Periodically, however, you will look very bad. Does that kind of pattern sound familiar? It happens in finance, too. Betting against a big decline in home prices is analogous to betting against the Wizards. Every now and then such a bet will blow up in your face, though in most years that trading activity will generate above-average profits and big bonuses for the traders and CEOs.

To this mix we can add the fact that many money managers are investing other people's money. If you plan to stay with an investment bank for ten years or less, most of the people playing this investing strategy will make out very well most of the time. Everyone's time horizon is a bit limited and you will bring in some nice years of extra returns and reap nice bonuses. And let's say the whole thing does blow up in your face? What's the worst that can happen? Your bosses fire you, but you will still have millions in the bank and that MBA from Harvard or Wharton. For the people actually investing the money, there's barely any downside risk other than having to quit the party early. Furthermore, if everyone else made more or less the same mistake (very surprising major events, such as a busted housing market, affect virtually everybody), you're hardly disgraced. You might even get rehired at another investment bank, or maybe a hedge fund, within months or even weeks.

Moreover, smart shareholders will acquiesce to or even encourage these gambles. They gain on the upside, while the downside, past the point of bankruptcy, is borne by the firm's creditors. And will the bondholders object? Well, they might have a difficult time monitoring the internal trading operations of financial institutions. Of course, the firm's trading book cannot be open to competitors, and that means it cannot be open to bondholders (or even most shareholders) either. So what, exactly, will they have in hand to object to?

Perhaps more important, government bailouts minimize the damage to creditors on the downside. Neither the Treasury nor the Fed allowed creditors to take *any* losses from the collapse of the major banks during the financial crisis. The U.S. government guaranteed these loans, either explicitly or implicitly.

Guaranteeing the debt also encourages equity holders to take more risk. While current bailouts have not in general maintained equity values, and while share prices have often fallen to near zero following the bust of a major bank, the bailouts still give the bank a lifeline. Instead of the bank being destroyed, sometimes those equity prices do climb back out of the hole. This is true of the major surviving banks in the United States, and even AIG is paying back its bailout. For better or worse, we're handing out free options on recovery, and that encourages banks to take more risk in the first place.

In short, there is an unholy dynamic of short-term trading and investing, backed up by bailouts and risk reduction from the government and the Federal Reserve. This is not good. "Going short on volatility" is a dangerous strategy from a social point of view. For one thing, in so-called normal times, the finance sector attracts a big chunk of the smartest, most hard-working and most talented individuals. That represents a huge human capital opportunity cost to society and the economy at large. But more immediate and more important, it means that banks take far too many risks and go way out on a limb, often in correlated fashion. When their bets turn sour, as they did in 2007–09, everyone else pays the price.

And it's not just the taxpayer cost of the bailout that stings. The financial disruption ends up throwing a lot of people out of work down the economic food chain, often for long periods. Furthermore, the Federal Reserve System has recapitalized major U.S. banks by paying interest on bank reserves and by keeping an unusually high interest rate spread, which allows banks to borrow short from Treasury at near-zero rates and invest in other higher-yielding assets and earn back lots of money rather quickly. In essence, we're allowing banks to earn their way back by arbitraging interest rate spreads against the U.S. government. This is rarely called a bailout and it doesn't count as a normal budget item, but it is a bailout nonetheless. This type of implicit bailout brings high social costs by slowing down economic recovery (the interest rate spreads require tight monetary policy) and by redistributing income from the Treasury to the major banks.

The more one studies financial theory, the more one realizes how many different ways there are to construct a "going short on volatility" investment position. To an outsider, even to seasoned bank regulators, the net position of a bank or hedge fund may well be impossible to discern. It's not easy to unpack a balance sheet with hundreds of billions of dollars on it and with numerous hedged, offsetting, leveraged, or off-balance-sheet positions. Those who pack it usually know what's inside, but not always. In some cases, traders may not even know they are going short on volatility. They just do what they have seen others do. Their peers who try such strategies very often have Jaguars and homes in the Hamptons. What's not to like?

The upshot of all this for our purposes is that the "going short on volatility" strategy increases income inequality. In normal years the financial sector is flush with cash and high earnings. In implosion years a lot of the losses are borne by other sectors of society. In other words, financial crisis begets income inequality. Despite being conceptually distinct phenomena, the political economy of income inequality is, in part, the political economy of finance. Simon Johnson tabulates the numbers nicely:

> From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits. In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent. Pay rose just as dramatically. From 1948 to 1982, average compensation in the financial sector ranged between 99 percent and 108 percent of the average for all domestic private industries. From 1983, it shot upward, reaching 181 percent in 2007.[7]

If you're wondering, right before the Great Depression of the 1930s, bank profits and finance-related earnings were also especially high.[8]

There's a second reason why the financial sector abets income inequality: the "moving first" issue. Let's say that some news hits the market and that traders interpret this news at different speeds. One trader figures out what the news means in a second, while the other traders require five seconds. Still other traders require an entire day or maybe even a month to figure things out. The early traders earn the extra money. They buy the proper assets early, at the lower prices, and reap most of the gains when the other, later traders pile on. Similarly, if you buy into a successful tech company in the early stages, you are "moving first" in a very effective manner, and you will capture most of the gains if that company hits it big.

The moving-first phenomenon sums to a "winner-take-all" market. Only some relatively small number of traders, sometimes just one trader, can be first. Those who are first will make far more than those who are fourth or fifth. This difference will persist, even if those who are fourth come pretty close to competing with those who are first. In this context, first is first and it doesn't matter much whether those who come in fourth pile on a month, a minute or a fraction of a second later. Those who bought (or sold, as the case may be) first have captured and locked in most of the available gains. Since gains are concentrated among the early winners, and the closeness of the runner-ups doesn't so much matter for income distribution, asset-market trading thus encourages the ongoing concentration of wealth. Many investors make lots of mistakes and lose their money, but each year brings a new bunch of projects that can turn the early investors and traders into very wealthy individuals.

These two features of the problem—"going short on volatility" and "getting there first"—are related. Let's say that Goldman Sachs regularly secures a lot of the best and quickest trades, whether because of its quality analysis, inside connections or high-frequency trading apparatus (it has all three). It builds up a treasure chest of profits and continues to hire very sharp traders and to receive valuable information. Those profits allow it to make "short on volatility" bets faster than anyone else, because if it messes up, it still has a large enough buffer to pad losses. This increases the odds that Goldman will repeatedly pull in spectacular profits.

Still, every now and then Goldman will go bust, or would go bust if not for government bailouts. But the odds are in any given year that it won't because of the advantages it and other big banks have. It's as if the major banks have tapped a hole in the social till and they are drinking from it with a straw. In any given year, this practice may seem tolerable—didn't the bank earn the money fair and square by a series of fairly normal looking trades? Yet over time this situation will corrode productivity, because what the banks do bears almost no resemblance to a process of getting capital into the hands of those who can make most efficient use of it. And it leads to periodic financial explosions. That, in short, is the real problem of income inequality we face today. It's what *causes* the inequality at the very top of the earning pyramid that has dangerous implications for the economy as a whole.

A Fix That Fits?

A key lesson to take from all of this is that simply railing against income inequality doesn't get us very far. We have to find a way to prevent or limit major banks from repeatedly going short on volatility at social expense. No one has figured out how to do that yet.

It remains to be seen whether the new financial regulation bill signed into law this past summer will help. The bill does have positive features. First, it forces banks to put up more of their own capital, and thus shareholders will have more skin in the game, inducing them to curtail their risky investments. Second, it also limits the trading activities of banks, although to a currently undetermined extent (many key decisions were kicked into the hands of future regulators). Third, the new "resolution authority" allows financial regulators to impose selective losses, for instance, to punish bondholders if they wish.

We'll see if these reforms constrain excess risk-taking in the long run. There are reasons for skepticism. Most of all, the required capital cushions simply aren't that high, so a big enough bet against unexpected outcomes still will yield more financial upside than downside. Furthermore, high capital reserve requirements insulate bank managers from the pressures of both shareholders and bondholders. That could encourage risk-taking and make the underlying problem worse. Autonomous managers often push for risk-taking rather than constrain it.

What about controlling bank risk-taking directly with tight government oversight? That is not practical. There are more ways for banks to take risks than even knowledgeable regulators can possibly control; it just isn't that easy to oversee a balance sheet with hundreds of billions of dollars on it, especially when short-term positions are wound down before quarterly inspections. It's also not clear how well regulators can identify risky assets. Some of the worst excesses of the financial crisis were grounded in mortgage-backed assets—a very traditional function of banks—not exotic derivatives trading strategies. Virtually any asset position can be used to bet long odds, one way or another. It is naive to think that underpaid, undertrained regulators can keep up with financial traders, especially when the latter stand to earn billions by circumventing the intent of regulations while remaining within the letter of the law.

It's a familiar story, repeated many times in the past. If one recalls the Basel I capital agreements for banks, the view was that we would make banks safer by inducing them to hold a lot of AAA-rated mortgage-backed assets. How well did that work out? So, with no disrespect to the regulators or the sponsors of the recent bill, it is hardly clear that enhanced regulation will solve the basic problem.

For the time being, we need to accept the possibility that the financial sector has learned how to game the American (and UK-based) system of state capitalism. It's no longer obvious that the system is stable at a macro level, and extreme income inequality at the top has been one result of that imbalance. Income inequality is a symptom, however, rather than a cause of the real problem. The root cause of income inequality, viewed in the most general terms, is extreme human ingenuity, albeit of a perverse kind. That is why it is so hard to control.

Another root cause of growing inequality is that the modern world, by so limiting our downside risk, makes extreme risk-taking all too comfortable and easy. More risk-taking will mean more inequality, sooner or later, because winners always emerge from risk-taking. Yet bankers who take bad risks (provided those risks are legal) simply do not end up with bad outcomes in any absolute sense. They still have millions in the bank, lots of human capital and plenty of social status. We're not going to bring back torture, trial by ordeal or debtors' prisons, nor should we. Yet the threat of impoverishment and disgrace no longer looms the way it once did, so we no longer can constrain excess financial risk-taking. It's too soft and cushy a world.

That's an underappreciated way to think about our modern, wealthy economy: Smart people have greater reach than ever before, and nothing really can go so wrong for them. As a broad-based portrait of the new world, that sounds pretty good, and usually it is. Just keep in mind that every now and then those smart people will be making—collectively—some pretty big mistakes.

How about a world with no bailouts? Why don't we simply eliminate the safety net for clueless or unlucky risk-takers so that losses equal gains overall? That's a good idea in principle, but it is hard to put into practice. Once a financial crisis arrives, politicians will seek to limit the damage, and that means they will bail out major financial institutions. Had we not passed TARP and related policies, the United States probably would have faced unemployment rates of 25 percent of higher, as in the Great Depression. The political consequences would not have been pretty. Bank bailouts may sound quite interventionist, and indeed they are, but in relative terms they probably were the most libertarian policy we had on tap. It meant big one-time expenses, but, for the most part, it kept government out of the real economy (the General Motors bailout aside).

So what will happen next? One worry is that banks are currently undercapitalized and will seek out or create a new bubble within the next few years, again pursuing the upside risk without so much equity to lose. A second perspective is that banks are sufficiently chastened for the time being but that economic turmoil in Europe and China has not yet played itself out, so perhaps we still have seen only the early stages of what will prove to be an even bigger international financial crisis. Adherents of this view often analogize 2009–10 to 1929–32, when many people thought that negative economic shocks had stopped and recovery was underway. In 2006, banks were gambling on the housing market, and maybe today they are, as the result of earlier decisions, gambling on China and Europe staying in one economic piece.

A third view is perhaps most likely. We probably don't have any solution to the hazards created by our financial sector, not because plutocrats are preventing our political system from adopting appropriate remedies, but because we don't know what those remedies are. Yet neither is another crisis immediately upon us. The underlying dynamic favors excess risk-taking, but banks at the current moment fear the scrutiny of regulators and the public and so are playing it fairly safe. They are sitting on money rather than lending it out. The biggest risk today is how *few* parties will take risks, and, in part, the caution of banks is driving our current protracted economic slowdown. According to this view, the long run will bring another financial crisis once moods pick up and external scrutiny weakens, but that day of reckoning is still some ways off.

Is the overall picture a shame? Yes. Is it distorting resource distribution and productivity in the meantime? Yes. Will it again bring our economy to its knees? Probably. Maybe that's simply the price of modern society. Income inequality will likely continue to rise and we will search in vain for the appropriate political remedies for our underlying problems.

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[1]See Jacob S. Hacker and Paul Pierson, "Winner-Take-All Politics: Public Policy, Political Organization, and the Precipitous Rise of Top Incomes in the United States", *Politics & Society* (June 2010). For one criticism of those numbers, see Scott Winship, "Hacker-mania!", ScottWinshipWeb, September 19, 2010.

[2]Lemieux, "Increasing Residual Wage Inequality: Composition Effects, Noisy Data, or Rising Demand for Skill?" *American Economic Review*, June 2006.

[3]See Christian Broda and John Romalis, "Shattering the Conventional Wisdom on Growing Inequality", *New York Times* Freakonomics blog, May 19, 2008.

[4]Gordon, "Misperceptions About the Magnitude and Timing of Changes in American Income Inequality", National Bureau of Economic Research, NBER Working Paper No. 15351 (September 2009).

[5]See Thomas Lemieux, W. Bentley Macleod and Daniel Parent, "Performance Pay and Wage Inequality", *Quarterly Journal of Economics* (February 2009).

[6]Kaplan and Rauh, "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?" *Review of Financial Studies* (March 2010).

[7]Johnson, "The Quiet Coup", *The Atlantic* (May 2009).

[8]See "Wages and Human Capital in the U.S. Financial Industry", Thomas Philippon and Ariell

Reshef, National Bureau of Economic Research, NBER Working Paper No. 14644 (January 2009).