

CLEMENS LECTURE SERIES 2007

19

*How Growing Inequality  
Hurts the Middle Class*

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**Professor of Management and Economics  
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UNIVERSITY



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Robert H. Frank is the Henrietta Johnson Louis Professor of Economics and Professor of Management at the Johnson Graduate School of Management at Cornell University. He holds a B.S. in mathematics from the Georgia Institute of Technology, an M.A. in statistics from the University of California Berkeley and a Ph.D. in economics also from UC Berkeley. Professor Frank is a monthly contributor to the “Economic Scene” column in the New York Times. Until 2001, he was the Goldwin Smith Professor of Economics, Ethics and Public Policy in Cornell’s College of Arts and Sciences. He has also served as a Peace Corps volunteer in rural Nepal, chief economist for the Civil Aeronautics Board, fellow at the Center for Advanced Study in the Behavioral Sciences and was Professor of American Civilization at l’Ecole des Hautes Etudes en Sciences Sociales in Paris. Professor Frank’s books include *Choosing the Right Pond*, *Passions within Reason*, *Microeconomics and Behavior*, *Luxury Fever*, and *What Price the Moral High Ground? The Winner-Take-All Society*, co-authored with Philip Cook, was named a Notable Book of the Year by The New York Times, and was included in Business Week’s list of the ten best books for 1995

# How Growing Inequality Hurts the Middle Class

**Robert H. Frank**

Adam Smith had a really good idea: the invisible hand idea. It is amazing to me that no one thought of this idea before Smith really got it down in such a clear fashion when he wrote it in the 1700s. But for Smith, the invisible hand didn't mean what many of his modern disciples think it does. His modern disciples think he believed that if you just turn people loose and let them pursue their own selfish interest, you always get the best results possible. That is not what Smith believed. He thought if you turn people loose and watch them pursue their own interest you will often get pretty good results. Producers will compete with one another to expand their market share by adopting cost saving innovations that will drive prices down. Consumers will ultimately be the beneficiaries of that. But Smith did not believe that if you turn people loose and tell them to pursue their own selfish interest that you would always get great outcomes.

Charles Darwin did not believe that, either. I think we saw a much sharper description of the conflict between individual and group interests when it came time for Darwin to write one hundred years later. His central insight was that the interests of individuals drive evolution, not the interest of groups or species. Sometimes those two sets of interests coincide, but not always. There are traits that work for the advantage of the individual but are very harmful for the group as a whole.



So here is a question that Darwin might well have posed. Why is it that in most vertebrate species, the male is so much bigger than the female? A bull elephant seal weighs up to 6000 pounds – that is as much as a Lincoln Navigator SUV, 23 feet long – a prodigious, creature. The cow seal weighs 800 – 1200 pounds. They’ve got to mate side by side or she will be crushed. So why are the males so much bigger?

Darwin had a simple answer to this question. These seals are a polygynous species – where males take more than one mate if they can. If some do take more than one mate then others aren’t going to get any mates at all, and remember in the Darwinian scheme this is the only thing that matters. So how do they get multiple mates? They fight tooth and nail for hours on the beach, and finally one of the bulls loses and lumbers off exhausted. As you might guess, the bigger of two bulls tends to win, so from the individual’s point of view, being big is a good thing.

So if some little mutation occurs that makes a bull seal a little bigger than the others, this may cause him to prevail. That mutation is going to be borne by the pups of the 50–100 female seals to which he has a year of exclusive sexual access. The next generation of males will be larger, but a similar struggle will take place among them. And then if there is another mutation, it will be passed along to the next set of offspring and ultimately we reach an equilibrium where the males weigh 6000 pounds.

However, this is a horrible equilibrium for the males as a group. It makes their work day longer, since they have to eat a great amount of fish just to sustain that body mass. They are so big they are very unmaneuverable, and their principle predator, the great white shark, can catch 6000 pound males much more easily

than if they weighed 3000 pounds. If they could just push a button and cut the weight of all males in half, so all weigh around 3000 pounds, that would be a win-win option for all bulls. The fights would still be settled the same way and the same largest bulls would win, but without the problems caused by the extra 3000 pounds. But, they can't do that – and any male who might unilaterally slim down would be sure to lose and wouldn't leave any of his DNA behind. So that is the conflict between what is rational for the individual –to be bigger than your rivals – and what is rational for the group – to not be so big.

It is a very general phenomenon in animal species. Why are elk antlers so big? It seems like a bad idea. Take the elk into the woods and he is quickly surrounded by wolves, his huge antlers get caught in the trees and he's killed – what a counterproductive appendage to have on top of your head.

But if you don't have very large antlers, you won't win the fight with other males for access to females. To win access to females you want a big rack of antlers. Big antlers: smart for the individual animal, but dumb for the group as a whole.

To begin to apply all this to humans, consider the following thought experiment. Which of the following two worlds would you prefer to live in? There is *World A* where you and your family live in a neighborhood with 4000-square-foot houses. Even by today's standards in the U.S., that is a pretty good size house. All the houses in other neighborhoods have 6000 square feet. Or you could live in *World B*, where you and your family would live in a 3000-square-foot house –still a pretty big house today—but the houses in other neighborhoods have only 2000 square feet. Which would you choose? According to the standard economic model, this is a no-brainer. Of course, everyone will choose World A. You have a bigger house there, an absolute consumption advantage. However, most people actually need to ponder this question before making a choice, and when the tallies are counted in most groups the majority pick World B. Why do they pick World B? It is because they feel insecure and they want to lord their big houses over other people in that world? I don't think that is a plausible account. Yes, there are people like that, but not most people.

I lived in Nepal for a few years in a two-room house that had no electricity and no plumbing. It had a grass roof that leaked when it rained hard. Yet at no time did that house feel inadequate. It was a totally satisfactory house in that country. So if I live in World B, I am going to be pretty satisfied with my house. My kids will go to decent schools; it's going to be a good package for me there. If I go to World A, I'll be behind the curve there, and maybe that won't be such a good choice. As long as you see why some reasonable person would choose World B, that is all the information you'll need for the point I am trying to make.

Now think about this experiment – it has a very similar structure. In world C you have two weeks of vacation each year while everybody else has only one week. In world D you have four weeks while everybody else has six weeks. You can get more absolute vacation in world D at the expense of lower relative vacation. This time most people pick World D. It's not that they won't notice they have less vacation time than others. But rather than go from four weeks to two weeks, they say "yes, I'll pick the second world. Absolute vacation time seems to trump relative vacation time in this context.

Building on these two examples, I am going to define two types of goods. A positional good is one whose value to us depends quite heavily on context; in particular on how much of the good I have relative to others. A non-positional good is one that depends on context too, but less so than for positional goods. So considering our examples, housing is a positional good and leisure time is non-positional. What you think of your house depends more heavily on where it stands in the distribution of housing than what you think about the amount of leisure time you have.

I will try to make these four points. First, people care more about relative consumption in some domains than others – that was the point illustrated by the experiment. Housing is a domain where position matters more than for leisure. Second, when positional concerns vary in this way, we get expenditure "arms races" focused on positional goods – those goods for which relative position matters most. Third, these arms races suck resources out of the non-positional goods category. So with the example we just considered, people find it attractive to work longer hours to earn more money to be able to buy a bigger house, because then their kids would go to better schools. But if everybody worked longer hours and everybody spent more on housing, still half the kids would go to bottom-half schools, the same as before.

It's like the familiar stadium metaphor: Standing up helps you see better, but only if others stay seated. When we all stand up, we see no better than before, but we're all more uncomfortable. It is an arms race and it's welfare reducing. The last point I will try to make is that these kinds of welfare losses are made more pronounced when income inequality is rising.

Here is another way to talk about the tradeoff between positional and non-positional goods – the familiar choice of bombs versus toasters. I am talking about the military arms race now. There are two kinds of goods societies can build – armaments or consumption goods. I am going to use toasters as a stand-in for consumption goods – more generally, schools, hospitals, good diets, and so on. We would like to have more consumption goods. But we are understandably worried that if we do



not have enough armaments, our political independence could be threatened by aggressive actions of other nations. And so rather than risk losing our independence we build more armaments. But other nations have these same fears and also build more armaments, and the military balance returns to a stalemate. In the process, resources are taken away from consumption in both countries that would have been better left there if everyone had spent less on bombs. You don't get an arms race unless the dependence of your well-being on the number of bombs you have is more context sensitive (more positional) than the link between your well-being and the number of consumption goods you have. If the other nation had more toasters than we do, that would not be fun but we could get over it. If they had more bombs, then sooner or later they could control us and we'd pay taxes to their government. It is way more important not to fall behind on the bomb distribution than to fall behind on toasters.

If the two distributions mattered the same, there would be no arms race, since if you built more bombs and fell behind in the toaster distribution – and if the two were equally important – then you would say “hey we have to quit building bombs and start catching up on toasters.” It would be a stand-off; there would be no distortion.

But everybody agrees there is a distortion in the international weapons race. Everybody thinks it makes sense when equally matched rival nations sign agreements to limit the number of bombs they make. These are called military arms control agreements and they are non-controversial. It is a way for each side to spend less and save resources for better uses.

Note that it would make no sense to argue against the military arms control agreement on the grounds that it limits your freedom to do what you want to do. Of course it limits your freedom – that is the whole point! If you are free to do what you will want to do without an agreement, you will build too many bombs. That is the story I am going to tell you in multiple forms tonight. If you walk out tonight and you are not sure what you heard, think about the big antlers, think about the big seals and think about the arms-control metaphor.

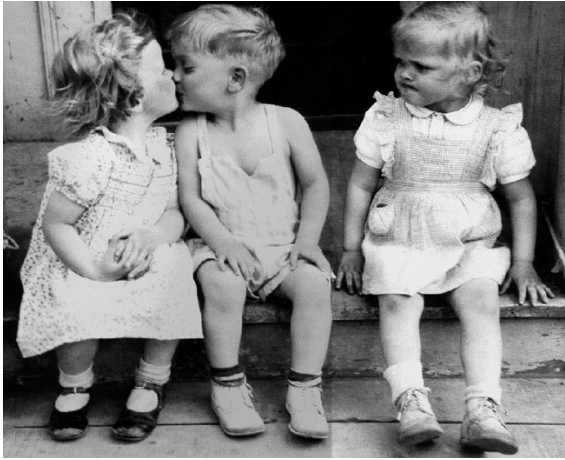
Okay. Let's look at the question of inequality and the well-being of the middle class another way. I am going to ask, “Does rising inequality have any effect on the happiness of people?” This is not a question economists normally ask, but psychologists have been asking questions like this, and economists are starting to get interested. We can actually measure well-being now. And the evidence says that when income is rising rapidly in a country – think of Japan going from the early 60's to the late 80's, when they went from essentially a third-world level of income to a developed country level of income – happiness levels stay flat as a

pancake. Everyone had more stuff, everyone's stuff was growing in tandem, yet no one was happier. Subjective well-being is the technical term psychologists use. What is going on here? It sounds like bad news for economists if people aren't happier when they get more money. Why do they take so much trouble to get more money?

It turns out that getting more money does matter if you examine it a second way. Consider the relation of income and satisfaction in a single country at a single moment of time. Here we have lots of empirical evidence that rich people, on average, report being a lot happier than poor people do. It is much easier to make your way in the world if you are not under financial pressure all of the time. And the evidence indicates that when income matters, it is relative income that matters, much more than absolute income. Relative income clearly seems to matter and so to the extent that middle-class families have fallen behind – I will say more about that later – the world has become more like World A than World B. They used to have a relatively better position than they have today, and so by this evidence they are less happy than they would have been.

Is it strange that people might care about *relative* income? The best model that anyone has offered about why people care about what they care about is the Darwinian model of natural selection. Why does the nervous system point us to the things it points us to? Basically the theory says that we care about the things that assist us in survival and reproduction. And relative income was always a huge predictor of who would survive and succeed in evolutionary history. You care about relative income because relative income indicates so strongly whether you are going to succeed. In a famine there is always some food – so who gets it? It is not the rich but the poor who go without food in a famine. So the farther forward you move in the queue, the less likely you would be to die in the famine.

Most early humans in society were polygynous, like the seals that have more than one mate. Anybody want to guess that the winners were the males with low relative income? That would be wrong – it was the males with high relative income. Mate access was the key driver of this. Are these positional concerns hard wired in humans?



Here is another way to think about the question: Do you teach kids to care about relative position or do they just discover it on their own? Consider the photograph of the girl on the right. We can't ask what is on her mind but she is clearly upset about something. It is a plausible conjecture that she wouldn't be so upset if it wasn't for the fact that she sees someone getting something that would be nice to have that she is not getting at that moment. That is how most of us intuitively read this picture, and the question is, "why did she react that way?" Did her parents teach her to react that way? "Whenever you see something that would be nice to have and you don't have it, you should throw a fit? Make sure you express your anger clearly in that situation." That is not the way I taught my kids. I don't imagine there are too many people in the auditorium that taught their kids that way, either.

But I was curious and did an experiment with my two older boys when they were young. David was seven and Jason was five, and it was a three day experiment. I gave them each a full glass of orange juice on the first day. I watched them each day. What did they do? Nothing on the first day! I cut them back to a half glass on day 2. Did they complain? "Why did we get only half a glass?" No, they again drank their orange juice without comment. The pay-off was day 3. David got  $\frac{7}{8}$  of a glass, Jason  $\frac{3}{4}$ —what psychologists call a "just noticeable difference," where you need to carefully make sure there is a difference. Sure enough – I could see Jason's eyes go back and forth between the two glasses. He could tell it wasn't going to play out well if he complained, but he just couldn't bottle it up any longer. He finally blurted out "That's not fair. He *always* gets more than me." We don't teach them to do that, they just do it. It is a good thing probably that they pay

attention to how they are doing. You *should* ask “how am I doing?” Young people have to choose an arena to work in. If they don’t care about how they’re doing, they are not going to be attentive to the right feedback that is going to guide them to what they are going to do in the world.

There seems to be, in fact, some bio-chemicals that nature structures specifically for this. Serotonin is a neurotransmitter implicated in social behavior and feelings of well-being. In the world of the monkey, the alpha male has concentration of about twice the serotonin of the other, subordinate animals. If you take the dominant animal out, one of the other animals becomes dominant after a struggle, and then his serotonin levels double over the course of weeks. You could think about these animals trying to climb to serotonin ratings that feel good. Animals with low levels of serotonin feel irritable and are less likely to be successful in social situations. The drug Prozac stimulates production of this nerve transmitter.

The testosterone system also seems to focus attention on rank. For example, if you play a close match with a tennis partner regularly and you win decisively one day and analysts take a sample of blood from each of your arms a couple hours later, the winner will have an elevated level serum testosterone, the loser will have a depressed level.

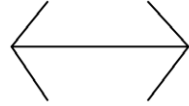
Should I be assertive, or should I be deferential? Well, it depends on what group I am in. So if you have some feedback loops that are telling you what to do, according to the context, you are going to be a more effective person no matter which group you find yourself in.

So whose income should you care about – people on Mars, people on another continent? The general finding is that local rank is what people seem most focused on. David Neumark and Andrew Postlewaite did a study of sisters – three thousand pairs of sisters. In each pair, sister B didn’t work outside the home and the question was “what factors would explain whether her sister looked for a job outside the home?” The usual economic suspects didn’t seem to matter much – wage rates, the unemployment rate, vacancy listings in local job market, etc. If, however, sister B’s husband earned more money than sister A’s husband, then sister A was from 16 to 25 percent more likely to look for a job outside the home. It’s the only variable that really had much impact.

Whose income matters? Some people’s income matters more to others. H. L. Menkin defined a wealthy man as someone who earned \$100.00 a year more than his wife’s sister’s husband. I asked Neumark and Postlewaite whether they were inspired by Menkin’s definition, and they said they had never heard of it. But their study confirmed it.

Context is more important than we often think. Start by considering a standard

optical illusion – that the two horizontal lines on this page *appear* to be different lengths. They are not, but their contexts lead us to judge them differently. A related, conceptual illusion is our belief that many judgments we regularly make are “objective,” in the sense that they are unaffected by context, when in reality they are fundamentally contextual.



Context matters in every domain we have been able to measure. So, which horizontal line is longer? You know it is a trick, so you are not going to say what you think. But most people, if they say what they think, say that the one below is longer. And you ask them “Are you sure?” They say “Yes I am sure.” Why? Because it *looks* longer. In truth, they are the same length. If you think they look the same length, you might want to get an eye check-up. They are not supposed to look the same lengths because of the context in which they sit – they are doing different jobs in those two contexts.

Is it cold out? Well you won’t be surprised – context matters here too. I grew up in Miami. Is it cold out on a 60-degree day in November? Absolutely! You wear every piece of warm clothing you have to go to an event in Miami on a day like that. What if you asked the question here in Minnesota in February on a 60-degree day – they would think you are stupid. Is it cold out? Of course it isn’t! Look at everyone celebrating. There’s no need to apologize for context mattering in these ways – it is totally okay.

Let’s get to the punch line here. Does context matter for you? What a strange world this would be if context mattered for everyone except you. Think about that. What a weird, odd exception you would be. Of course it matters to you. Let’s say you own a 1959 Chevy Nova? Is your car okay? What if you lived in Havana, Cuba? You’d have one of the nicest cars on the island not owned by a bureaucrat. It’s a huge asset to own a car like that. If you show up at a gathering driving that car, it’s like having a huge placard around your neck that says “I am a player here.” That’s what this car says in Havana. But suppose you’re trying to make deals in Bel Air, California, to put a film project together – the same car says you are *not* a player – others will think “if this guy’s a player, what’s he doing driving a ’59 Chevy Nova?” So if you feel a little worried driving that car in California – that is normal. You are not a bad person. This is a totally normal reaction. The critical thing to see is that it isn’t just nasty people who have these reactions based on context.

I'd like to describe the experience I had that I think crystallized the rhetoric that you need to get over in order to see what is really going on. I went to give a talk at the University of Chicago. I was taken out to dinner by three professors at the law school. One of them drove up in a brand new Lexus sedan. He gave it to the valet and we all went in. Before we sat down he told me (I didn't ask him about the car) "I don't know or care what kind of car my colleagues drive." He wanted me to know that. I've known this gentleman for a long time, and his claim was totally plausible. If you asked him what kind of car a specific colleague drives, he wouldn't know. I asked him, "so why did you buy the Lexus instead of the equally reliable but much less expensive Toyota model from the same manufacturer?" He said it was palpable quality of the vehicle that attracted him. He mentioned the leather seats, the sound the door makes when it closes. And he really liked that red letter warning in the owner's manual: "Don't start the car up when it is already running." The engine is so quiet you might not hear it, a real risk with a Lexus.

So, what was he driving before the Lexus? I forget, but let's say it was a 5-year-old Saab. What if we sent that car back to 1935 in a time capsule? What would people think? Well he is a smart guy – he knew immediately that car would seem wonderful in their eyes. So then we all had a nice animated discussion about how we might actually measure quality in constructing an economic model of consumer behavior. We agreed that we would have a list of the features of the car and how they compared with the same features on other cars in the same local environment. And if your car's feature exceeded the norms, that would count towards a plus on the quality of the car. If it had high quality, as with a Lexus, you would be willing to pay more for it.

Then I pointed out that if we wanted to model the behavior of someone whose goal was to make his neighbors feel bad because he had a better car than theirs, we would use exactly the same mathematical model! Context is important, and it's not just jerks out there trying to one up everybody, nor is it just insecure people who need to prove their worth. Normal people are affected by this.

Richard Layard has this great line in a paper in 1980 – "In a poor country a man proves to his wife that he loves her by giving her a rose; in a rich country he must give a dozen roses." It's all context. The middle-class family is having a harder time now because the context has shifted. That makes things tougher for them psychologically. The same things that would have been pleasing to them before now seem not so pleasing. My first car, I think it would have accelerated to 60 miles per hour in 9 or 10 seconds, but at the time we all thought it was a blistering fast car. Now a car like that would not thrill anybody. Context is important.

Now let's consider the change in inequality that has caused a lot of the diffi-

culties for the middle class. From World War II up to the mid '70s, everybody's income was growing at about 3% a year--rich and poor, and middle class. After that we saw a total change in the pattern. It was fractal. Every market group that anyone has been able to collect data for – has shown the same pattern. The bottom quintile lost ground in real terms. This is very unusual over a three-decade period. The middle quintile has been treading water; maybe gaining a little bit but the median income is only about 15% higher than the median earned thirty years ago. The top quintile is where you first see substantial growth, and within that group, most income growth is among the top 1%. For college graduates, it is just the same pattern. And within the top 1% the biggest gains have been in the top 1/10<sup>th</sup> of 1 percent. No matter what group you belong to, you have probably fallen behind the top people in your group. That is what has happened over the last thirty years.

We have good data on CEOs – we can track their salaries over the years. In 1980 we saw them earning as much 42 times as much as the average worker. By 2000 that had exploded up to 531 times – more than 10 times the earlier ratio. Middle earners 15% percent ahead, top earnings 10 times as much. We call this the “winner take all” effect. If you think about traditional textbook labor markets – if you make 110 bricks and another guy makes 100, you would get 10% more than the other guy. But today there are a lot of markets – sports and entertainment markets in particular – where if you are just a little better than the next person you can earn many times more.

Consider Steffi Graf. She was at the top of her game all throughout the mid-nineties. Yet even though her quality of play did not improve between 1993 and 1994, her earnings doubled. Why was that? Anybody remember? That was the year that Monica Seles was off the tour because a deranged man had stabbed her in the back at a tournament in Hamburg. Graf was playing at the same absolute level, but relative to the field she was playing at a higher level and her prize money doubled. Small differences in performance translate into huge differences on the bottom line.

Some presidents of elite universities now get \$1 million a year. This has prompted cries of outrage. What are members of the Board of Trustees doing? Have they lost their moral moorings? We just hired a new president at Cornell. His name is David Skorton. I don't know how much he makes, but I bet he is well paid. Our university has just launched a \$4 billion capital campaign. I think the committee that hired him – our Board of Trustees - thought he would be way better than the next best candidate at raising money. But suppose he was only a little bit better than the next best candidate. I have seen him in action in this role over the past year and

I think he is way better than anybody else I could imagine. He is a distinguished research cardiologist. He is a very accomplished jazz musician. He is cunning, he is charming, and he is warm and wonderful. Donors love him. They are going to write big checks when he articulates his vision of what the university is going to be doing over the next decade. And what's the bottom line if he is better by even 3%? That is a \$120 million difference. That is where the inequality is coming from. Everything is more competitive. If you have a good performer in highly leveraged position, that person delivers a much bigger difference on the bottom line, and competition means you have to pay accordingly. That's what's happening.

There are psychological costs for middle class families that are caused by this pulling away of top earners. But there are some concrete costs that you should be worrying about even if you think psychological costs would be best ignored. Many economists think we shouldn't worry about psychological costs. That has always been a puzzle to me. Life is lived inside the brain. Why shouldn't we worry about the stress experienced inside the brain? If your daughter feels bad because you can't afford to get braces for her teeth and they make fun of her in school, that is a psychological cost. Why isn't that a real cost? That seems to me a totally valid cost.

If economists don't want to consider that – here are some other costs. Maybe they will like these. Try this thought experiment. You are the median earner. Which option do you choose to do for yourself? You could save enough to support a comfortable living for your retirement. If you do that you won't have enough money to buy a house in a good school district. Your kids will go to a school where the other kids scored in the 20<sup>th</sup> percentile in reading and math tests. Or you can forget about your retirement and worry about it later, and if you do that you can buy a house in the better school district – one that matches your position in the income distribution. Is there any parent that doesn't have at least that ambition for his or her kids? You wouldn't judge a parent harshly for making a sacrifice to bid for the best school within reach, and most parents have shown that they are willing to stretch their budgets to the breaking point to do that. But even if we all spend more for a house in a better school district, 50% of the kids will still go to bottom-half schools. This is where the expenditure pressure has been mounting on the middle class.

If you look at the cost of sending your child to a school of average quality, the way it works is that school quality closely tracks neighborhood house prices. I think that is one reason behind the intuition that drove some people to choose World B in the earlier thought experiment. In 1980, the median new house had 1600 square feet. The first quarter this year the median new house was more than



2300 square feet. More than a 40% increase. The price of land has gone up too. To send your kids to a school of average quality, you must buy the median priced house for your area. The median family doesn't have the money to comfortably afford a house that much more expensive and so they are working every conceivable margin—working longer hours, saving less, borrowing more, commuting longer distances.

We have seen basically an expenditure cascade launched by higher incomes at the top. The wealthy spend more because they have more. That is not an indictment of them in any moral sense. Everybody spends more when they have more. The top earners do, too. The middle earners don't envy them, but the people just below the top are influenced by the top spenders. Maybe that shifts their frame of reference in some subtle way. Maybe now it is the custom in the top echelon to have your daughter's wedding reception in the home, not in a club or a hotel. And then people just below this group build bigger. The cascade continues all the way down the income level. Why is the median house bigger? Not because they have more income in the middle but because of this cascade.

The cascade really got going in earnest when the inequality started growing in earnest, and this has influenced savings rates year by year. In the last two years we have had negative savings rates in the United States for the first time since The Great Depression! Spending more than we earn! Obviously, this is a blueprint for economic failure in the future. We can't continue doing that.

There is also an expenditure cascade in interview suits. Top people spend more money on clothes because they have more money, and that has raised the bar for others just below them, and so on. If you don't spend as much on an interview suit as others who have the same income as you, you'll be less likely to get that second interview. So, of course, you will try to keep up. But, when everyone spends more to get the better suit, the second interview goes to the same people as before. Again, the stadium metaphor: if everybody stands to get a better view, nobody sees better than before.

The bottom line is that the invisible hand isn't doing the job here; it's making things worse. When you are competing for scarce slots in a rank ordering, there should never be any presumption that the invisible hand will produce good results. This goes back to the military arms race and the Darwinian example of the competition for mates. And there is some indirect evidence that inequality is driving it.

My former students and I did some studies. We looked at census data from the 100 most populous countries. We found that countries in which income inequality grew the most also experienced the biggest growth in bankruptcy rates, in long commute times, and divorce rates. These are all symptoms of increased financial

distress. More growth in inequality, more growth in symptoms of distress! If you look at school districts, controlling for the median income, the median house price is higher in the districts with more income inequality. The spending at the top seems to be driving this. People work longer hours when there is more inequality, both across countries and over time.

It affects ordinary spending decisions. I was faced with replacing my broken down old gas grill – it was a cheapee. It was falling apart in multiple ways. Finally I said “I have published a textbook that has begun to sell. I am going to get myself a new grill.” I was astonished at what was on offer, quite a change since the time, ten years ago, when I bought that grill. There was one with two ancillary range top burners, each one with 15,000 BTUs, the salesman told me. Is that a lot? It must be or the salesman wouldn’t have said that. It was twice the capacity of burners on an ordinary kitchen range. Why would you need that? Just start boiling the water a little earlier, I thought. I was told the reason is that if you are doing ethnic stir fry, you need the high heat to sear the flavor in. There is a wood chip smoker down below. You have room to grill 40 hamburgers at one time. You have an infrared bar that will broil two twenty pounds turkeys on the rotisserie. The price was \$5000 – a pretty cool grill but way too much for me. Then the salesman showed me “the value model.” It had only one range top burner – 15,000 BTUs. No rotisserie, no smoker, but the same stainless steel construction. \$1160.00! I didn’t buy that either. But I thought to myself I could have bought it and thought “Wow I have been a careful shopper today.” The prices of things we consider as prudent purchases drift up. Winner-take-all markets have been steering more money to the top earners through no moral culpability on their part. They have been spending more on bigger mansions, more elaborate gas grills, more expensive jewels, bigger yachts, and so on. And the response from our national government over the last seven years has been to give them tax cuts.

The tax cuts have had consequences. There have been delayed investments on infrastructure. Half our bridges are overdue for important maintenance. There are huge potholes in a lot of the roads we drive on. Forty million households get drinking water that has manganese in it, leeching from antiquated pipes. We cut the Energy Department’s budget for rounding up loosely guarded nuclear materials in the Soviet Union last year because we didn’t have enough money for that. These are materials that terrorists want to get. It is not out of the question that someone could figure out a bribe that would be attractive to some of the underpaid soldiers who guard them. It is easy to smuggle this material out of the country. We don’t inspect the cargo containers that come into the country, we can’t afford that. But we can afford to build extra wings on the mansions.

So it seems that this is a bad deal not only for the middle class but for the rich. Why? The evidence is very clear on this. When the rich all build larger mansions, there is no gain. It just shifts the bar that defines how big a mansion they are expected to have. When everybody buys a big mansion, that is probably even worse for rich. Think of all the extra staff they have to deal with. It would be a sacrifice that would be totally painless for the rich not to build the extra wing. But how might you get the rich to do that?

Well, you can't just ask the elk to voluntarily have narrower antlers. That would be suicide. You can't ask the rich to voluntarily not keep up with what others are doing. Actually, you can ask them, and some of them might do it, but I think this strategy is destined to fail for the whole group. It's not going to work. So how can you get the rich to divert some of that spending at the top into more productive uses?

Here is my proposal. It is built on the idea that some behaviors are smart for one, dumb for all. Scrap the income tax completely – throw it out the window. In its place adopt a progressive consumption tax. It sounds scary, but it is easy. We know that all you can do with your income is spend it or save it. So if we know how much your income is and we know how much you saved this year – we already measure those numbers for the IRS reporting for income tax purposes and 401K reporting for retirement savings. We could measure how much you consume this year by the simple difference between these two numbers. So it's a one-line calculation, basically. And then knock off a big standard deduction – you don't need complicated itemized deductions for this or for that. Just have a standard deduction of, say, \$7500 per person, or \$30,000 for a family of four. Your taxable consumption is then your income minus your savings minus the standard deduction. The more you consume, the more the tax rate rises. Thus, I propose a 50% tax on consumption for people who are consuming a quarter of a million dollars. We used to have a tax on *income* that was that high. But my proposal is only for that portion of income used for consumption. Most countries around the world still do tax income that much, so we could too. But better not to tax income because that taxes both consumption and savings (the only two things you can do with income). This discourages savings. You don't want to tax savings; tax the thing we have too much of. What do we have too much of? Wings being built on mansions! So let the tax rate on consumption keep going up.

Consider a family that is currently spending \$4 million a year and considering a \$1 million wing for its mansion. With a top marginal tax rate of 200% on consumption, this family would have to come up with \$1 million for the contractor, plus \$2 million for the tax authorities.

Think about that. That is a pretty powerful incentive to say, well, on second thought, let's build a smaller wing. And in the end when the dust settles, they will not be too disappointed with the results because that is what everyone else is going to do, too. If they want to go ahead, let them go ahead. They will be coughing up a lot of extra revenue that is going to be spent on inspecting containers, rounding up terrorists and fixing the bridges we drive across. Sure if they want to make me feel like my business is doing poorly because my mansion is not as big as theirs, fine! Let them pay the tax.

This is the kind of tax that a rich person, if he were shopping for a country, would like. If I am rich and choose a country with a tax structure like the U.S. currently has, then I will have to spend \$10 million on my daughter's 16<sup>th</sup> birthday party or she will be disappointed. I have to hire "50 Cent" or she will be disappointed, and while I am at it, I will hire "Aerosmith" because my friends will be coming too. This is actually a real "coming of age" party I am describing and it cost \$10 million. The executive who threw this party invited 300 of his daughter's closest friends, each of whom got video iPods and all kinds of other party favors. Wealthy people who lived in a country with a steeply progressive consumption tax would feel much less pressure to spend in these ways. They would be better off.

So that's the bottom line message: What is smart for one; can be dumb for all . . . A progressive consumption tax can help us be smart for all of us.





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