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Why the "Rich" Can Get Richer Faster than the "Poor"

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President Barack Obama has tagged the growing inequality of income over the past three or four decades as "the defining challenge of our time," an often-repeated claim recently echoed by economist Thomas Piketty in Capital in the Twenty-First Century. *Numerous social and economic factors explain why the income and wealth gaps have grown, from the rise in family breakdown to the incentives embedded in government welfare programs.*

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Executive Summary

However, there are reasons for the gaps that have gone largely, if not completely, unrecognized. These explanations make the *relative* growth in the income (and wealth) of the rich practically inevitable — at least as officially measured.

According to official measures, the average and total income of people at the top of the income distribution is growing relative to the incomes of lower income groups. From 1979 to 2007, the inflation-adjusted income of the top 1 percent of households grew 275 percent, while the bottom fifth's income grew only 18 percent. However, if the incomes of household members are combined, if household income is adjusted to reflect reductions in tax rates and increases in government transfers and if household income is further adjusted to account for the declining number of people in the average household over nearly three decades, the 3.2 percent increase in median taxpayer earnings over the period rises to nearly 37 percent.

Much of the income inequality debate in the United States has focused on "fifths," "tenths" or "the top 1 percent" of households. Such divisions give the *appearance* of greater inequality than actually exists. There are far more people and workers in the top income brackets than in the lower ones. Indeed, there are 82 percent more people in the top fifth of households than in the bottom fifth. In 2006, 81 percent of households in the top quintile had two or more workers; but only 13 percent of households in the bottom fifth had two or more workers. In nearly 40 percent of these households, no one was working.

Further, people in different income divisions do not remain at those income levels throughout their lives. The Federal Reserve Bank of San Francisco found that absolute mobility — that is, the extent to which children earn more than their parents — is high:

- Of all U.S. adults, 67 percent had higher incomes than their parents; and among those born into the lowest income bracket, 83 percent exceeded their parents' income.

- About 40 percent of people in the lowest fifth of income earners in 1986 moved to a higher income bracket by 1996, and roughly half the people in the lowest income quintile in 1996 had moved to a higher income bracket by 2005.

Indeed, one study found that a majority of Americans reach the upper income brackets at some point during their lives. Over a 44-year period, 12 percent of 25- to 60-year-olds moved into the top 1 percent for at least one year; 39 percent reached the top 5 percent; over half reached the top 10 percent; and nearly three-fourths were in the top fifth of the income distribution.

Moreover, Americans are moving to the top of the income ladder without inheritances. Thus, an investigation into the 2013 *Forbes* list of the 400 wealthiest Americans found:

- More than two-thirds (68 percent) of the billionaires were "self-made," which means they built their fortunes without the help of inheritance.
- Furthermore, according to the Internal Revenue Service, between 1992 and 2009, only 2 percent of the people on the Forbes 400 list were on it for 10 or more consecutive years.

The success of people at the bottom of the income distribution can increase inequality, because their newfound success does not improve the average incomes of the lower income brackets they left behind; rather, their economic gains are treated as gains to the higher income and wealth brackets they reach.

An analysis of portfolio investment over time reveals an unheralded reason the "rich" have become richer absolutely and relative to the "poor." The top 1 percent of households hold over a third of the country's total wealth, while the bottom two quintiles hold a fraction of that wealth. As such, the rich are able to develop and maintain highly diversified portfolios of investments, including stocks, bonds, derivatives, insurance, precious metals, degrees, multiple homes and other real estate holdings. The ability of the rich to safely diversify their portfolios allows them to take on riskier investments that carry higher rates of return, but without incurring the hazards associated with the far less diverse portfolios of lower income individuals.

Moreover, pundits often fail to appreciate the direct and indirect ties between the Federal Reserve's monetary policy and the distribution of wealth and income.

When the Great Recession emerged with force in 2007, the Federal Reserve pushed down interest rates drastically with the expectation of stimulating the economy. The drop in interest rates negatively affected many low-income people who relied on their small amount of interest income earned from bank savings accounts. At the same time, the lower interest rates boosted the discounted present value of firms' future profit streams that has fueled the dramatic rise in their stock prices over recent years. The Fed also padded the pockets of firms deemed "too big to fail," giving the privileged firms a form of government-backed insurance for their future profit streams and adding upward pressure on stock prices. As a consequence, the wealth of rich people has escalated over the last several years.

Finally, family breakdown is a large contributor to poverty. Households in the top income brackets are far more likely to be married, stay married and have children after marriage, while households in the bottom income brackets are far more likely to be single-parent households. Wealth taxes, such as those proposed by Piketty, can retard the future accumulation of wealth, with negative consequences for people down the income ladder who depend on capital accumulation for growth in the number of income-producing jobs.

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Introduction

Left-leaning pundits everywhere harp on the "low-hanging fruit" of social welfare policy: The "rich" are getting richer than the "poor." By "rich" they generally are referring to people in the top fifth, or maybe the top 1 percent, of all households in the country. President Barack Obama has tagged the growing inequality of income over the past three or four decades as "the defining challenge of our time," an often-repeated claim made with the suggestion that the rich are getting richer, in nefarious ways, at the expense of the poor.[1]

A growing chorus of academics, most notably Nobel Laureates in Economics Robert Schiller and Paul Krugman, have also championed the "inequality crisis."[2] Most recently, French economist Thomas Piketty was catapulted into the realm of "international economics celebrity" for his cross-Atlantic best-selling tome, *Capital in the Twenty-First Century* — replete with charts showing that the income and wealth of the rich and poor in the United States (and elsewhere) have been diverging since at least 1980.[3] All three economists believe that combating inequality with higher taxes on the rich will have positive effects, generating more revenues and reducing government deficits. But they also argue that inequality, in and of itself, is a social "bad" worth abating for its own sake.

Numerous social and economic factors explain why the income and wealth gaps have grown:

- Family structures have broken down, limiting the economic progress of many children due to lack of support from both parents.
- Executives have gained control of their own compensation packages, allowing them to push their incomes into the stratosphere.
- Schools, especially those in impoverished neighborhoods, have deteriorated, handicapping low-income children at a time when the value of education in the workplace has risen.
- Government welfare programs have provided many low-income Americans with disincentives to move out of poverty.
- The political system has grown progressively rigged in favor of the economic interests of the already rich.
- The globalization of the economy, along with the downfall of communism in China, has worsened the competitive market position of American assembly-line workers, who now have to compete on wages with the lowest-paid workers around the world.

And the list of explanations goes on.

This paper, however, will focus on reasons for the wealth and income gaps that have gone largely, if not completely, unrecognized. Many policy partisans — Obama, Schiller, Krugman, Piketty and others — view comparative data on income disparity as the source of economic truth, without the need for serious scrutiny. Consequently, they see modern capitalism as fundamentally flawed and believe that the government should place limits on the growth of incomes and wealth of those at the top of the nation's income ladder.

This study will provide a brief and sober look at the trend toward income inequality by considering two explanations for the growing measured income gap that have been overlooked, or simply sidestepped. These explanations make the *relative* growth in the income (and wealth) of the rich over the past several decades practically inevitable — at least as officially measured:

- The way the "income distribution" is stratified into "fifths of households" (quintiles), or "tenths" (deciles) or even smaller fractions, such as the "top 1 percent," gives the appearance that individuals in the bottom brackets are making far less gains than they are.
- The rich have more opportunities to diversify their investment portfolios and to soften the economic consequences of risk taking.

Along the way, this paper will explain how the Federal Reserve's easy money policy and federal government bailouts, intended to stimulate the economy out of the Great Recession, have increased the wealth gap.

Evidence of Growing Inequality

Academics and liberal pundits cite evidence on the growth of inequality that is sometimes stark and, for them, conclusive — but it is ultimately misleading.

Clearly, the average and total income of people at the top of the income distribution is growing relative to the incomes of lower income groups, and at a significantly faster pace, *as officially measured*.

Figure I plots the cumulative average income growth of households in various income groups from 1979 to 2007, as measured in a 2011 study by the Congressional Budget Office. The CBO found that:

- From 1979 to 2007, the real (inflation-adjusted) income of the top 1 percent of households grew 275 percent.
- The top fifth of households' income grew by 65 percent over the period.
- The bottom fifth's income grew only 18 percent. However, the lowest quintile's income has slowly trended upward since the early 1980s, as the figure shows.[4]

Thomas Piketty starts his treatise by pointing to a chart on the share of U.S. national income captured by the top 10 percent of all income earners over the past century, which shows a major U-turn in inequality:

- In the 1920s and 1930s, the top decile took in about 45 percent of national income.
- During World War II, the top decile's share plummeted to the 35 percent range, where it stayed until the very late 1970s.
- At that point, the top cohort's share began a relentless march upward, reaching the 45 percent to 50 percent range in the 2000s.[5]

Scrutinizing the Numbers. What many pundits, as well as the president, fail to acknowledge is that the hard data paint a significantly different picture of what is happening — or not happening — to income inequality. For example, median taxpayer earnings before taxes and government transfers officially rose just 3.2 percent between 1979 and 2007. However, if the incomes of household members are combined, if household income is adjusted to reflect reductions in tax rates and increases in government transfers and if household income is further adjusted to account for the decline in the number of people in the average household over nearly three decades, the 3.2 percent increase in median taxpayer earnings rises to nearly 37 percent.[6]

Overlooking Stagnation. The pundits also fail to recognize research that shows, by measures of real income over time, that the middle and lower income classes have done reasonably well during periods of economic growth but not so well during periods of relative economic stagnation. For example, according to Robert Grady, managing director of the Cheyenne Capital Fund, median family income fell during two periods of sluggish growth, 1974-1982 and 2008-present. However, median family income grew nearly 22 percent in real terms during more than two decades of growth from 1983 to 2007, which suggests that a major force behind the growth in income inequality in recent years has been the Great Recession.[7]

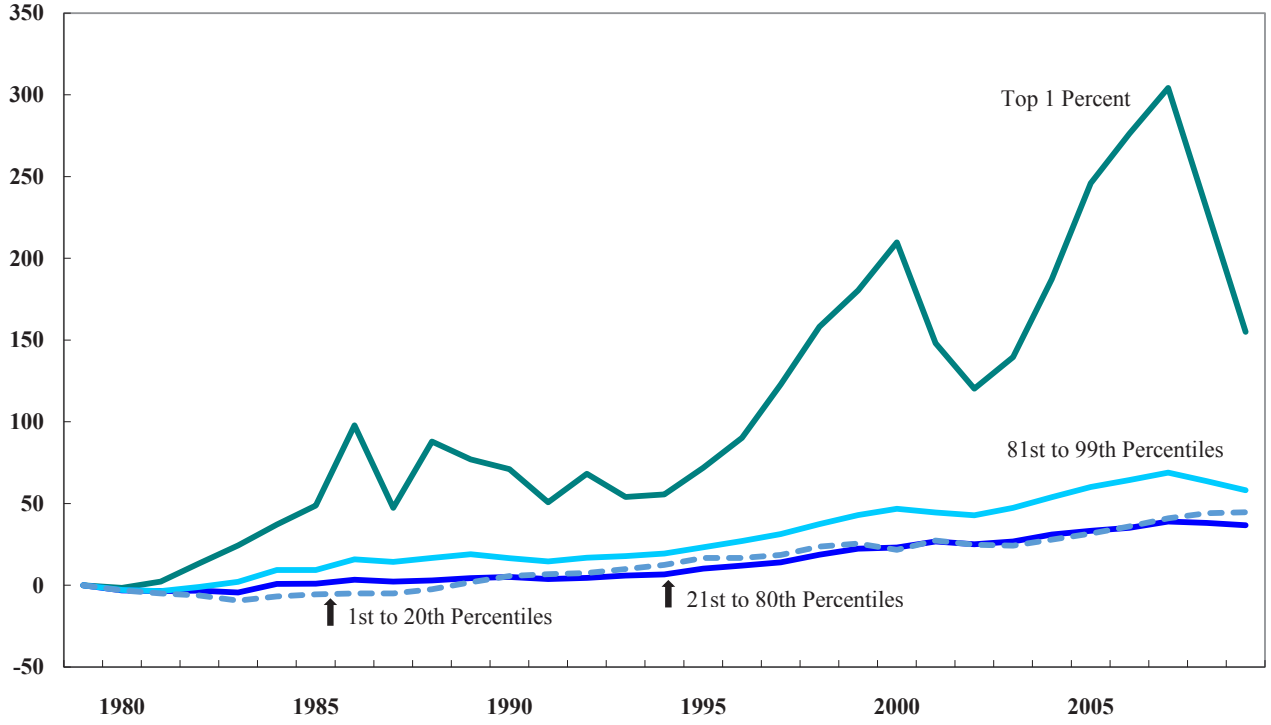
Overstating Inflation. Moreover, pundits often cite data that uses a widely recognized — but flawed and overstated — measure of inflation developed by the Bureau of Labor Statistics for adjusting *current* income to *real* income. This conventional measure of inflation-adjusted income, which inadequately accounts for quality improvements in goods and services over time, suggests that median household income rose 5 percent between 1979 and 2012. An overstated inflation rate can understate real income and income growth. When an improved measure of inflation — one developed by the Bureau of Economic Analysis and preferred by the Congressional Budget Office and the Federal Reserve Board of Governors — is used to make the adjustment, real median income rose 16 percent during the 1979-2012 period. While that rate of growth appears minor, it is growth nonetheless — not stagnant or negative growth, as some inequality pundits claim.[8] Inclusion of growth in fringe benefits, most notably health insurance, raises the rate of growth in people's total real compensation even higher.[9]

Ignoring Non-Money Transfers. Notably, measures of relative income growth often consider only earned money income and do not include growth in non-money, in-kind government transfers in the form of subsidies for health care, housing, day care and food. Additionally, much real income that everyone receives — rich and poor alike — comes in the form of so-called "surplus value," the extent to which the value of the goods people consume exceeds the prices recorded in the consumer price index and, hence, in measures of real income. The value people get from Google searches, for example, is totally excluded from people's real income because there are not market prices for those searches. Tens of millions of iPhone buyers would not pay several hundred dollars for their phones if the value of their calls and texts were not greater than the price of their phones.

Growing income inequality is not restricted to the United States. Over the past three decades, a slight-to-

Figure I

Percentage Growth in Household Income by Income Group, 1979 to 2009



Source: Congressional Budget Office, "Trends in the Distribution of Household Income, 1979-2009."

modest increase in inequality has been measured in most advanced countries by the Organization for Economic Cooperation and Development (OECD).[10] This observation suggests that the growth in inequality can't be attributed singularly to U.S. capitalistic institutions becoming progressively dominated by the economic elites, as Piketty, Schiller and Krugman suggest.[11]

Nevertheless, an observation is clear: No matter how income statistics are viewed, key *official* data series undeniably show that over the last three to five decades, the "rich" have become *relatively* richer than the "poor" — as the "rich" and "poor" income categories are officially defined. The growing income gap is also apparent in daily news reports of the substantial growth in the compensation packages for CEOs of major corporations and presidents of universities and in the fabulous growth in income and wealth of entrepreneurs, athletes and entertainers.[12]

Growing Income and Wealth Inequality

Much of the income inequality debate in the United States has focused on divisions of households (or families) into "fifths" or "tenths" or "1 percent and the lower 99 percent." Readers of reports on inequality might assume that each fifth contains the same number of Americans (63 million) and the same number of households (24 million). That is hardly the case.

There Are More Workers in Upper Income Households. Far more people and workers appear in the top income brackets than in the lower brackets. Indeed, 82 percent more people reside in the top fifth of households than in the bottom fifth.[13]

- There are three times more workers in households in the top quintile than in the bottom quintile.
- In 2006, 81 percent of households in the top quintile had two or more workers; only 13 percent of the bottom fifth had two or more workers, and nearly 40 percent had no one working.[14]
- Top income earners tend to put in more hours of work than workers at the bottom of the income ladder, because single

elderly people and welfare recipients are disproportionately congregated in the lowest income bracket.

With multiple workers, households in the top fifth enjoy a built-in form of social insurance to soften the blow of economic and medical vagaries — including the economic downturn after 2007 — that households in the bottom fifth do not typically have. With only a few low-wage workers, most households in the bottom quintile receive various forms of government-based social insurance, welfare payments and in-kind benefits that do not get counted in their "income."

There Are More Intact Families in Upper Income Households. Furthermore, households in the top income brackets are far more likely to be married, stay married and have children after marriage, while households in the bottom income brackets are far more likely to be single-parent households.

The poverty rate among single mothers is more than four times the poverty rate among married couples, and the growth in single motherhood over the past five decades has increased the long-term poverty rate.[15] Over the last half-century, single-person households have skyrocketed due to:

- The growth in the divorce rate through the early 1980s;
- The increasing number of elderly who live on their own with government-subsidized health care and social security; and
- The rise in the number of single-parent families, attributable both to the divorce rate and the rise in childbirth out of wedlock, especially among African-Americans.

Researchers believe these changing trends in family structure could explain over two-fifths of the change in income inequality between 1976 and 2000, and they believe it could account for the failure of the poverty rate to fall, despite growth in government-based poverty relief. As Piketty stresses, inheritance has been a force for growing inequality since World War II.[16] Indeed, some "idle rich" at the top of the income ladder *are* living off inherited wealth, spending their days drawing unearned incomes from their families' past investments. The OECD estimates that 14.8 percent of young Americans ages 15 to 24 are not actively involved in education, employment or training (nicknamed NEETS).[17] One can assume that many of these young people are living off of their well-to-do parents. However, the NEETS cohort constitutes a relatively small portion of the population.

Income Mobility. People who press their concerns over growing income inequality argue as if the "fifths" or "tenths" of the stratified income structure are static; that is, they assume that people in the different income divisions remain in those divisions through time. But this is not the case. Income distribution is actually very fluid. People move all the time among different income brackets, which are themselves moving targets. The thresholds for the different brackets constantly move up and down (mainly up) as incomes change.

Consider the real upper income limits for the five quintiles and top 5 percent of households for 2012. [See Figure II.] The data confirms that the upper income limit moved very little (less than 4 percent) between 1980 and 2012. It took 44 percent more real income to reach the top 5 percent in 2012 than in 1980; but also note that households can move to the top 5 percent with less than $200,000 in household income, which may come as a surprise to many. These statistics suggest that the "rich" includes Americans with far less lavish income — especially in areas of the country with high living costs — than one might suspect, given all the media attention to billionaires.

Note also, in 2012, two single people with $20,000 in income each could jump two income brackets (fifths) by marrying and combining their income — and will likely have a greater rise in welfare than their $40,000 combined income suggests — because of the scale economies of sharing a living space and expenses. Similarly, a married couple with a combined income of $30,000 is in the middle of the second fifth, but if they divorce and split their income evenly, they push the average and the top limit of the bottom fifth's income downward. This movement feeds the notion that the welfare of people in the bottom fifth has been undermined by some economic "scourge" — say, the capitalistic economic system — when their divorce is likely the fault of personal and social forces.

Similarly, the flow of illegal, low-income immigrants from low-income countries, such as Mexico and points beyond, has been a force holding (and pressing) down the income of households in the bottom half of the income distribution, especially the bottom fifth. The growth in drug addiction and the large numbers

of high school dropouts have also impaired the ability of low-income Americans to move up the income ladder, although the fall in the dropout rate in recent years has very likely improved the welfare of people in the lower fifths.

Inequality in Public Education. Importantly, the poor's economic opportunities have likely been held in check by the sad performances of public schools in poverty-stricken neighborhoods. Poorly performing schools and parents rarely provide students with the general skills they need for employment, which in turn narrows the potential diversity of investments the poor can include in their portfolios. Recent research shows that the poor also face challenges in decision making, with ill-informed and outright bad personal decisions inhibiting their climb up the income ladder. Because the poor face stressful economic problems that come with low-income, if not subsistence-level, living — finding transportation to work and covering incoming bills, for example — they have fewer neuronal resources available to make calculated decisions about investment, personal care and even child care. Thus, even the limitations of the human brain can impose a check on making good economic decisions.

Indeed, many poor people remain poor over time, trapped by their circumstances and personal and family decisions. However, many people also move up and out of the bottom fifth. How far they move up the ladder depends on their work, personal and investment decisions, and good fortune. Others will move up the income ladder briefly, only to fall back down after a downturn in the economy, or a work or medical crisis.

In short, many people who were in lower income brackets decades ago have stayed put, but many others have moved up the income ladder. It must be strongly emphasized that their new and higher incomes do not improve the measured income of the lower income brackets they leave behind; rather, they raise the income levels of the higher income brackets they join.

Many graduate students, for example, are considered "poor" by official income standards. But after they matriculate and begin to establish research and academic careers, their incomes will rise, and they will add to the measured success of their future income brackets, not to the brackets where they currently subsist.

> *"Two-thirds of Americans earn more real income than their parents."*

The fantastic economic success of hundreds of thousands (if not millions) of highly successful Americans — Morgan Freeman and Oprah Winfrey, for example, are renowned black actors who grew up in the South near the poverty threshold — does not improve the average incomes of the lower income brackets they left behind. Rather, their success is reflected in the average income of the top income bracket they entered (after years of hard work, dedication and a substantial measure of risk taking).

Intergenerational Upward Mobility. Upward mobility toward the American Dream remains a very real goal for many Americans. The Federal Reserve Bank of San Francisco found that, based on absolute mobility — that is, the extent to which children are likely to earn more than their parents — the United States remains highly mobile:

- Of all U.S. adults, 67 percent have higher incomes than their parents, and 83 percent of adults born into the lowest income bracket exceed their parents' income as adults.[18]
- About 40 percent of people in the lowest fifth of income earners in 1986 moved to a higher income bracket by 1996, and roughly half of the people in the lowest income quintile in 1996 moved to a higher income bracket by 2005.[19]

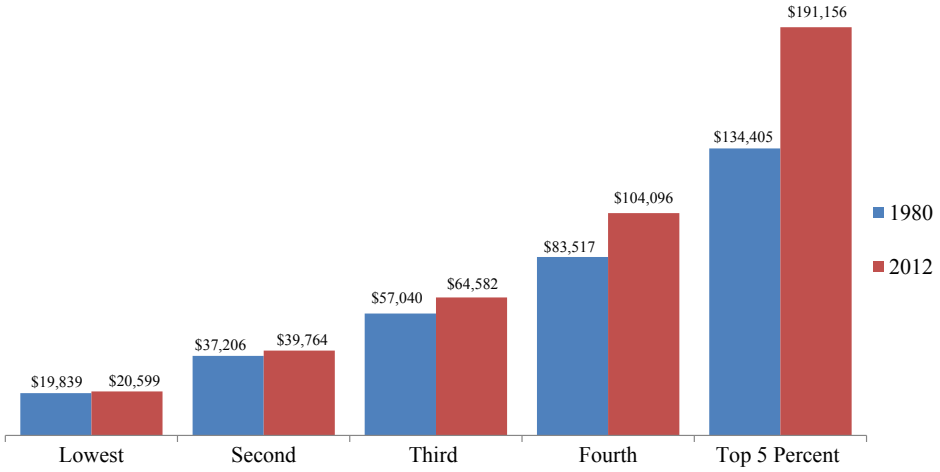
Indeed:

- Of the estimated 65,000-plus North Americans with $30 million or more in net worth, about 49,000 are self-made.
- Only 14 percent obtained their riches through inheritance alone.
- The rest (86 percent) parlayed their inheritance into greater net worth in old-fashioned ways: hard work and smart investments, with a measure of luck at work.[20]

A recent study shows that mobility up and down the income ladder has remained largely unchanged over time. For example:

- In both the 1970s and 1980s, 8 percent of children born in the bottom fifth of the income distribution rose to the top fifth.

Figure II
Upper Income Limits for Each Fifth and Top 5 Percent of All Households in 1980 and 2012



Note: The table depicts households as of March 1980 and March 2012. Income is shown in 2012 inflation-adjusted dollars.

Source: U.S. Census Bureau, Table H-1. Income Limits for Each Fifth and Top 5 Percent of All Households: 1967 to 2012, Historical Income Statistics: Households. Available at https://www.census.gov/hhes/www/income/data/historical/household/.

- About 20 percent of children born in the middle fifth of the income distribution later rose to the top fifth.

Taken together with previous studies on income mobility, intergenerational mobility over the last half-century has remained about the same; thus, upward mobility has continued apace.[21]

In another study, researchers found:

- Over a 44-year period, 12 percent of 25- to 60-year-olds moved into the top 1 percent for at least one year.
- Thirty-nine percent spent at least one year in the top 5 percent; over half spent at least one year in the top 10 percent; and nearly three-fourths spent at least a year in the top fifth.
- Only 0.6 percent of Americans spent 10 consecutive years in the top 1 percent.[22]

The fact that some Americans do move up the income ladder suggests something that the income inequality debate often overlooks: that there are probably many *other* Americans who had opportunities to improve their incomes — by completing a college degree, for example — but chose not to take them. Moreover, some Americans, such as artists and entertainers, have chosen to live in the bottom fifth because they are committed to a lifestyle that happens to afford little economic success, but they anticipate increases in income in future years.

Thus, an investigation into the 2013 *Forbes* list of the 400 wealthiest Americans found:

- More than two-thirds (68 percent) of the billionaires were "self-made," which means they built their fortunes on their own, without the help of inheritance.[23]
- About one in every 10 fortunes on the Forbes 400 list was created by an immigrant.[24]
- The Internal Revenue Service determined that between 1992 and 2009, only 2 percent of the people on the Forbes 400 list were on it for 10 or more consecutive years.[25]

Success Can Increase Inequality. Of course, an untold number of the 12 million undocumented aliens whose numbers have increased dramatically over the past two decades improved their own economic lot when they jumped the fences or swam to shore, managed to evade the border patrols and found work in this country. But many also contributed to the *perceived* lack of improvement of people at the bottom of the country's income distribution because they took jobs paying less than average wages, even among poor Americans.

To reiterate, while both the top income and average real income of the lowest fifth of workers can creep up with time, there will always be an upper limit to the income of the four lower fifths in any designated time frame. But for the top income group, there is no upper income limit; thus, the average income of the top group can rise without limit and at a faster pace than the bounded incomes of the lower income groups.

That the income of the "rich" has risen relative to the "poor" can be chalked up to a measure of *statistical inequality* that is bound to occur when income earners and wealth holders are put into brackets for no higher purpose than statistical convenience. Pundits rarely recognize that the success rate of people at the bottom of the income distribution can increase the growth in inequality, leading to an incorrect deduction that

"only the rich are getting richer" in the country. This misimpression can be expected when the substantial movement of income earners up (and down) the income ladder is never juxtaposed in policy discussions with how people in the different income groups are faring economically. And one should not overlook the fact that the appearance of income inequality has been exaggerated by the substantial growth in (and publicity around) the incomes of successful professional athletes and entertainers, as well as corporate executives, many of whom started out with modest means.

Success Is Not a Zero Sum Game. Moreover, the debate over income inequality is often conducted, to one degree or another, with the presumption that national income is a "zero sum game" for all, meaning there is some fixed or barely growing income that must be divided by people in the different income brackets. If the rich gain income (or get rich faster than the poor), the poor lose. That is, the national "income pie" can only be cut in so many ways, and the bigger one slice of the pie, the smaller the others must be. The inequality critics often fail to realize that the size of the pie can increase with both the rich *and* the poor getting bigger slices, though the rich's slice may grow faster than the poor's slice. In addition, few people concerned with inequality acknowledge that the absolute and/or relative gains of the rich can give rise to economic gains for all, including the poor. Thus, they begin with a blatantly false basis for policy discussions.

The late Steve Jobs — a multibillionaire by his death in 2011 — greatly increased his income and wealth by developing innovative products now used all over the world: the iMac, Mac Air, iPod, iPhone, PowerBook, iPad and more, along with the iTunes and app "stores" that offer a half-million applications for the devices just mentioned. He also stimulated competitors to produce cheaper copycats. Now, 81 percent of Americans living below the poverty-income level have cell phones, often loaded with apps, music and books that enrich their lives in ways not counted by their measured incomes. The overwhelming majority also have appliances in their homes, from big-screen televisions to dishwashers that were outside the reach of the middle-income American little more than a half-century ago.

Similarly, Bill Gates became the richest man on the planet by the early 1990s, but he also created a company that provides billions of dollars of value to people all over the world and all the way down the income ladder. Certainly, some rich Americans obtained their wealth through crimes, shady dealings and politics, but the hard data show that the vast majority of rich people have continued to make their way to the top of the income distribution by perfectly legitimate means, with a combination of work, risk taking and a measure of good fortune thrown in. Another source of their good fortune is easily overlooked: being born in the United States. Americans do not have to earn gigantic incomes to be "1 percenters." A mere $346,000 in combined household income in 2013 makes for a nice standard of living, albeit not allowing for multiple homes and yachts (especially for residents of high-cost of living areas).

Differences in the Diversity of Investment Portfolios of the "Poor" and "Rich"

An analysis of portfolio investment over time reveals another unheralded reason the "rich" have become richer absolutely and relative to the "poor." Because the "rich" are rich, they necessarily have a substantial amount of wealth to invest (from past performance, luck, station in life and/or inheritance). The top 1 percent of households hold over a third of the country's total wealth, while the bottom two quintiles hold a fraction of that wealth.[26] The wealth of the rich enables them to develop and maintain highly diversified portfolios of investments, including stocks, bonds, derivatives, insurance, precious metals, degrees, multiple homes and other real estate holdings. They have the financial means to acquire new businesses and social networks, to explore new and untried ventures. They have acquired the skills — and maybe bravado — to negotiate trades and establish investment strategies.

Portfolio Diversity Problems Facing the "Poor." By contrast, the poor's potential "portfolios" are necessarily limited to narrowly focused, work-related skills and family connections, which are more frequently single-parent and dysfunctional than in wealthy families.[27] The "portfolio" of a low-income household may include little more than a car, furniture and a small home. And even home ownership, in certain markets, can reduce the poor's liquidity and mobility. Single parents and the elderly poor often face impaired abilities and incentives to build diversified investment portfolios.

When the poor actually do take the financial step of making, say, a single investment in a stock or business, they take on the enormous risk that comes with exposure to the uncertainty of concentrated investments. While a collection of investments might turn a profit, even the smartest fund managers and venture capitalists cannot identify which single investment, or small percentage of investments, will cover the losses on all the others. With the poor's constricted ability to invest, they are far more likely to lose on a limited array of investments (as the law of large numbers teaches), which compounds their reasons for "playing it safe" with investments that have value in use, such as homes and household furnishings.

A new study in the journal *Science* found that the poor are also much more likely to focus on short-term investment strategies while ignoring long-term consequences. The researchers found across various experiments that being in a state of poverty itself can foster perpetually poor financial decisions; those decisions are not necessarily made from a lack of knowledge or skills (although many poor lack those attributes).[28]

When the poor (and others in the lower part of income distribution) acquire few and narrowly defined workplace skills, they leave themselves open to labor market risks. Any job-specific skills they acquire with their own unpaid time and limited funds can easily and rapidly lose value both in economic downturns and in times of rapid technological improvements in products and production processes. The economic value of a low-income worker's specific work-related skills can erode relatively rapidly in the face of competitive national and global labor markets. The market risks inherent in the development of narrowly defined skills can cause poor people to shy away from acquiring new skills. Instead, they rely on general skills transferable to many job markets, as is the case for servers and clerks. When job-specific skills are required for work, the poor rely on their employers for training, with the employers' training costs cutting into their workers' compensation.

"Low-income individuals have fewer investment options than the rich."

Note, however, that opportunities for investment diversification have grown for everyone on the income ladder. Investors at every income level no longer have to invest in a single or a few stocks. For the past several decades, all income earners could increase their equity diversification by buying into stock funds through a 401(k) or an Individual Retirement Account (IRA) (Vanguard 500, Fidelity Spartan 500 and so forth) or buying SPDRs (Standard and Poor's Depository Receipts, or exchange-traded funds) and Diamonds (which are shares in trusts), with each share covering the S&P 500 or the 30 stocks in the Dow Jones Industrial Average. These new investment options for those on the lower and middle ranks of the income ladder may have also decreased (albeit in a minor way) the desire (or need) to move up the income ladder. However, because the country's progressive income tax does not tax many poor people at the federal or state level, the rich have a greater tax incentive to take advantage of job-related plans for retirement investments.

Of course, many rich people today rose above their initially low incomes by concentrating their investments in a single business venture — a novel restaurant concept, an innovative software application, a brand new search engine or even a well-located retail business — good ideas that paid off. Other entrepreneurs of yesteryear gambled on narrowly defined business portfolios only to fail in large numbers. These many cases of failure have tended to hold in check, if not pull down, the incomes of low-income groups.

The Diversity Portfolio Advantages of the Rich. The ability of the rich to safely diversify their portfolios allows them to take on riskier investments without incurring the hazards associated with the far less diverse portfolios of lower income individuals. Christopher Carroll, an economist at Johns Hopkins University, found that the rich hold a much higher proportion of risky assets than the rest of the population. They are also much more likely to conduct entrepreneurial activities and to hold much of their wealth in their own ventures.[29] Again, this is partially the case because risk-taking, low-income entrepreneurs who throw the dice and win will move to the ranks of the rich.

Moreover, because of their wealth and diversified portfolios, the rich can acquire loans at privileged interest rates not available to people in lower income brackets, which enables them

to further expand their investments and lower the risk they endure from any given collection of business ventures. This "easy credit" allows for a shifting of investment risk and enables the rich to take on even more risky investments.

Unsurprisingly, in 2007 the Federal Reserve Board reported to Congress that individuals in high-income census tracts carry significantly higher credit scores than those in low-income census tracts.[30] Much has been made of the "cycle of poverty," but something needs to be said for the "cycle of richness." Many low-income workers strive to break the poverty chain and climb the income ladder, but they must work especially hard to overcome their initial disadvantages.

Pundits have often missed the fact that risky investments generally carry higher rewards, which is necessary if people are going to assume the greater chances of failure and absorb the economic losses that go with failures. Again, because investors cannot identify the success or failure of an investment beforehand, they mitigate that risk by developing an array of investments — which lower-wealth people cannot fully emulate.

With their higher incomes and diversified investments, the rich can grow their incomes, on balance, at a pace unavailable to the poor. The rich can also join with other rich people, pooling their wealth with the intent of increasing the array of new ventures in which they spread their stakes. New ventures carry inherent risks, but also opportunities for high rewards on those few projects that do succeed. Indeed, coalitions of rich people — such as California's Orange Tech Coast Angels — pool their competence for choosing winning ventures, decreasing the likelihood of failures in the process and increasing the diversity of their portfolios while they take on more risky (and potentially more lucrative) investments.

Members of investment consortiums might experience any number of failed investments, but they can absorb those losses with the profits on their "winners." As higher returns increase their wealth, the rich can continue to diversify their portfolios and assume even higher risks on a wider range of investments with higher payoffs which, in turn, make for relatively higher growth in incomes. Thus, wealth can generate even more wealth, although the process rarely escalates by itself, without attention and work.

"The rich put their money in riskier, higher yielding investments."

The diversification advantages of the rich allow them to do more with their money: develop new ideas and create new products and improvements in established products, start new businesses, hire more workers and take more risks. And that advantage can lead to economic gains for people farther down the income ladder, as new jobs are created or individuals are able to move up within emerging and growing companies (with many of those gains coming in quality improvements not captured in income statistics). Moreover, the diversification advantages of being rich add to the incentive people down the income ladder have to move up. No one should surmise that portfolio diversity makes the rich safe for all times. The history of entrepreneurship is full of rich Americans who, due to economic downturns or consistently bad investment decisions, lost everything. The economic history of the Great Depression and Great Recession is full of case studies about investors losing everything — and joining the ranks of the poor. Consider the fate of the Lehman Brothers, Solyndra or Word Perfect.

The Role of Federal Reserve Monetary Policy

Growth in stock market prices, which can obviously influence wealth and income distributions over time, is affected by myriad economic forces, not the least of which are companies' current economic financial statements (tied to current economic conditions, which can only be read imperfectly) and expected future growth in market share and profits. But pundits often fail to appreciate the direct and indirect ties between the Federal Reserve's monetary policy and stock prices and, hence, the effect of that policy on the distribution of wealth and income.

When the Great Recession emerged with force in 2007, the Federal Reserve turned on its money machine, pushing down interest rates drastically with the expectation of stimulating the economy. The extent of the stimulus' effect on overall economic activity due to the Fed's easy money policy remains in dispute, but it clearly achieved its goal of lowering interest rates. One-year treasury bills carried an interest rate of 5.78 percent in 2000, 1.63 percent in 2008 and 0.13 percent in 2013. Other market interest

rates for longer-term bonds followed a similar downward path, but at higher levels to accommodate the higher risks of the longer-term investments.

The drop in interest rates negatively affected many low-income people who relied on their small amount of interest income earned from bank savings accounts. However, interest rates affect inversely the present discounted values of businesses' expected income streams: the lower the interest rate used to discount expected future profit streams, the greater the present value of those streams, and vice versa. Also, lower interests rates can stimulate the economy, which can drive up businesses' expected future income streams. Both forces — the elevated expected future profit streams and the greater present discounted value of those streams, attributable to Fed easy money policy — will drive up current stock prices.

The Fed's and the federal government's coordinated anti-recession policy solutions after 2007 were multi-tiered: massive purchases of banks' mortgage-backed securities, corporate bailouts and financing of "shovel-ready" infrastructure projects. These policies padded the pockets of firms deemed "too big to fail," first abating the fall of their stock prices, then adding upward pressure on their stock prices. These companies profited at the expense of other firms and consumers who were not privileged to receive federal largess. Many firms found credit harder to obtain because of the drain on loanable funds from a series of federal budget deficits that reached above $1 trillion a year.

As a consequence of the anti-recession monetary and fiscal policies, the wealth of rich people has escalated

"Diverse investment portfolios are more secure than any single investment."

over the last several years as the Dow-Jones Industrial Average, an index of share prices for 30 large corporations, traveled from its recession depth of 6,547 in 2008 to over 17,000 in early July 2014, a more than two-and-a-half fold increase (and more than 20 percent above its 2013 high of 14,165).[31] The greater wealth of the rich has certainly increased their spending power relative to those who had not developed stock portfolios before the run-up in stock prices. In addition, the stock-market surge has also boosted the market value of executives' compensation packages, which have been heavily weighted with stock options and stock grants since the 1990s. A significant number of top corporations' CEOs have realized compensation packages in the millions and tens of millions of dollars in recent years (with some thanks to the federal government's corporate bailouts and the Fed's easy money policy that drove up stock prices).

The resulting rebound in housing prices, attributable in good measure to Fed policy, also disproportionately benefited the rich (and other households in the upper half of the income and wealth distribution) because they own a larger share of the country's housing stock (especially high-priced homes). The rebound in housing prices has enabled the rich to add even greater diversity to their portfolios.

This line of argument suggests that at least some of the relative economic growth of the rich in recent years has resulted directly from the Fed's long-lasting easy money policy and the federal government's fiscal policies. Many advocates of redistributing income toward the poor have avidly supported these monetary and fiscal stimulus policies, perhaps without realizing how they would differentially benefit well-off Americans, leading to demands for government to counter the growth in inequality.

What Is the Solution?

Some of those who view wealth or income inequality as a problem in and of itself think the solution is to tax away the "excess" of the rich and give it to the government, presumably to be redistributed to the poor. But would doing so actually help the poor, or hurt them?

Tax the Rich More? Thomas Piketty ends his book *Capital* by arguing that his proposed global progressive wealth tax could only *improve* economic efficiency and national income. It would have no disincentive effect on the exorbitantly wealthy, he says, because they cannot now spend the vast amounts of wealth they have. Moreover, he argues a wealth tax would have a *positive* incentive on lazy investors who are content to receive low rates of return, say 1 percent to 2 percent a year. His tax would cause those investors to seek more profitable deployment of their investments, just to cover the added wealth tax. If wealthy investors are as unconcerned with taxes on their wealth as Piketty suggests, we have to wonder why he favors a *global* wealth tax. Obviously, he is concerned that even wealthy investors can be

expected to move their wealth from high-tax countries to lower (or no-) tax countries. Fortunately, his proposal is a policy nonstarter, given how difficult it is for countries to coordinate their tax policies.

Both Robert Schiller and Thomas Piketty assume their proposed wealth taxes would only have financial effects, namely to reduce the financial wealth of the truly wealthy and thus reduce inequality of wealth. Maybe so. But they do not consider the fact that such taxes can retard, albeit marginally, the accumulation of wealth — and thereby real capital assets in production — into the future, especially when risky investments are involved. Such a retardation in the accumulation of capital can have negative consequences for people down the income ladder who depend on capital accumulation for growth in the number of income-producing jobs. In addition, when financial wealth is transferred from the wealthy to the government under wealth-tax schemes, the government claims real resources that might be used *less* productively than they would have been had they remained with the wealthy and remained invested in real businesses.

Raise the Poor? Few would dispute that some people at the bottom of the income distribution need improved economic opportunities, and the more the better. Policymakers should begin with three major strategies:

- First, reform the dysfunctional educational systems in low-income neighborhoods. Improved educational opportunities for low-income Americans will allow them to achieve greater diversity in their job opportunities, which can lead to greater diversification in their wealth portfolios.
- Secondly, reform those public policies, including family and welfare policies, which set up disincentives for advancements among the least advantaged.
- Finally, release the energies of charitable groups to help the least fortunate in our midst.

Admittedly, these are widely recognized strategies that are more easily outlined than made operational, given political dynamics.

"Transferring wealth from the rich to the government hurts the poor."

Consider the Moral Dimension? Many inequality commentators often appeal to "morality" as a foundation for their concern about the fabulous incomes and wealth of the few, as if they all achieved their economic positions through nefarious means. Certainly, some unknown number have cheated the system — Bernie Madoff, the infamous financial Ponzi-scheme swindler of the 2010s, is the poster child for ill-gotten fortunes. But another moral issue lies embedded in the debate over whether to modify inequality through taxes and regulations: When wealthy people become rich by playing by the rules, is it moral or fair to take their wealth when they achieved their considerable fortune legitimately? In the process of achieving their fortunes, they took considerable risks of losing everything and, at the same time, benefited many others down the income ladder. Bill Gates and Oprah Winfrey, for example, took enormous risks and slaved away for many unpaid hours as they built the business foundations of their eventual substantial fortunes.

Is it moral to take away the wealth of such people *after* they have earned it, after they have played the game fairly? Would it be considered fair to take the grade points of hard working students at the end of a course to boost the grades of students who were not so diligent in their studies? Granted, many truly wealthy people had a measure of luck along their trek to the top of the income and wealth scales, but luck can come to people who operate in uncertain worlds and who work hard at practically everything they do.

Morality is hardly the exclusive province of the redistributionists, who seem to have little interest in how the truly wealthy achieved their wealth.

Conclusion

We have focused on the problems poor people face in elevating, absolutely and relatively, their incomes vis-à-vis the rich. Obviously, many poor people make it on their own and move up the income ladder, in spite of the odds against their income and wealth improvement. Poor people are not doomed to stay in poverty. If all poor people were forever trapped by their bad economic and social circumstances, many low-income individuals today would not be far richer than the middle class at the start of the 20th century. The poor today enjoy amenities that were only available to the very rich in 1959 (when the Census started defining the poverty threshold). The majority of

the poor have air conditioning, cable TV, cell phones and other modern comforts.[32]

Economic improvement can be tougher for the poor than for the rich, due to the poor's socioeconomic circumstances. That is no big revelation, admittedly. A number of studies have shown that considerable upward mobility remains a reality in the United States, even from the bottom of the income ladder.

We have stressed two modest points not widely recognized in the debate over income and wealth inequality. First, when low-income Americans become richer, their gains are not added to the income and wealth of their initial income and wealth stratum. Rather, their economic gains are treated as gains to the higher income and wealth groups they reach.

Second, Americans who make their way up the income and wealth ladders have an unheralded, undeniable economic advantage — the power of diversification, which can allow for higher rates of return on risky investments. This advantage of rich and other well-off Americans, in and of itself, in no way undercuts the welfare of the poor (except in cases of theft and government favoritism). On the contrary, the welfare of the poor can be enhanced by the greater variety of risky ventures undertaken by the well-to-do. We should therefore ignore calls by Robert Shiller and other progressive economists for an "inequality tax," which would only serve as a disincentive to those trying to move up the income ladder, reducing overall income and wealth.[33]

In discussions of the "rich versus the poor," we need to face the fact that the people who succeeded without being born into wealth have sometimes benefited from a measure of luck in their choice of specific investments (no matter how narrow their portfolios). Other people become and remain rich because they have revealed a level of business and professional sagacity that the poor, who are left behind, do not have. Otherwise, many poor people would not be as poor as they are.

"There is still a high degree of income mobility in the U.S. economy."

One must also acknowledge that some people have deliberately chosen to work and live their lives in occupations and locations of the country where their earning opportunities are restricted, but where their "non-money" opportunities more than make up for their lost incomes. Literally millions of artists, actors and high- and low-tech entrepreneurs often live close to subsistence because they are determined to live their life passions. Undergraduate and graduate students choose a low-income existence while they gain the education that will further their future growth. Many would-be CEOs deliberately jump off corporate treadmills in order to enjoy more peaceful and satisfying lives, even when they end up living in cabins in the wilderness. And still others measure their lives by how many waves they've caught on a daily basis, not the size of their paychecks. Nevertheless, their numbers add to the apparent inequality gap, even as they enjoy the low-income life courses they choose to follow. Indeed, an unknown number of poor people have the business sagacity to get ahead economically as rapidly as their counterparts in the upper ranges of the income distribution, but choose not to do so. Nevertheless, it is important to note that many poor people are hardly poor by choice. Any number of people in the bottom of the income distribution simply do not have (with the same frequency) the ability to diversify their skills and investments as those in the upper income levels. Ultimately though, many poor people are able to improve their situations in life and move up the income ladder. As they move upward, they can, through product and service development, contribute to the real incomes (that which is measured in dollars and that which cannot be measured because it comes in an ephemeral form, "surplus value") of their former cohorts down the income ladder, and even at the bottom. Nonetheless, their upward movement on the ladder adds to the officially measured growth in the income and wealth gaps between the "rich" and the "poor."

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