INCOME INEQUALITY

A large part of the justification for policies like a federal minimum wage and collective bargaining rests on the supposed ills of income inequality. Income inequality, the argument goes, is harmful for society because it creates winners and losers. And because inequality is an inherent part of the free-market capitalist system, Congress should reduce relative poverty by adopting policies that raise wages. However, such policies do more harm than good.

Congress should:

- Focus on policies that tackle absolute poverty, rather than inequality.
- Reject taxes on capital, including on dividends or capital gains, and reduce those taxes if given the opportunity.
- Refuse to increase, and preferably abolish, the federal minimum wage.

Concerns over income inequality revolve around the idea that the rich are getting richer, while the poor, if not getting poorer, are not getting any richer over time, leading to greater inequality and *relative* poverty. That idea has recently received some intellectual heft following the publication of French economist Thomas Piketty's bestseller *Capital in the Twenty-First Century*. In *Capital*, the broad pattern Piketty traces is that before World War I, income inequality was very high in America but was especially so in Europe. The Gini coefficient, a widely used measure of inequality, ranges from zero at absolute equality to one at absolute inequality. Piketty finds that "Belle Époque Europe exhibited a Gini coefficient of 0.85, not far from absolute inequality."

Piketty argues that the two world wars destroyed accumulated capital in Europe, leading to an era of relative equality in which it appeared that what he perceives as the problem of capitalism had been overcome. Income inequality gradually increased in the postwar decades, with the rise sharpening in the 1970s and 1980s, to the point where today it is nearing prewar levels. America, in particular, has rapidly growing inequality compared with the United Kingdom or France.

The reason for that growing inequality, Piketty argues, is that the rate of return on capital is greater than the growth rate of the economy as a whole, leading to the rich getting richer. As a result, Piketty calls for a global tax on capital, an idea endorsed by leading leftist economists, such as Paul Krugman.

Yet such an argument ignores the problem of *absolute* poverty. Today's poor are in fact much richer in most respects than the richest of a century ago. They have access to faster, safer travel, undreamed-of communications technology, and much better health care, to name but three examples, than the lords of the Belle Époque. That change has come about as a result of global wealth creation.

Taxing capital would reduce the amount of capital formation and investment. Innovators would find it more difficult to find financing for their ideas. More importantly, consumers on all steps of the economic ladder would be denied life-improving inventions, efficiencies, and conveniences. The capital tax would actively harm the poor by slowing the ongoing increase in living standards that began about 200 years ago. That slowdown would make absolute poverty eradication even more difficult than it already is.

It is a moral imperative for public policies to maximize long-run economic growth. Even a few tenths of a percentage point difference in annual economic growth rates can add up to huge differences in living standards over time. Suppose two neighboring countries start with identical per capita annual incomes of $1,000. The first country grows by 2.5 percent per year. After a century, its per capita annual income will have grown nearly twelvefold, to $11,813. Its neighbor, with 2 percent annual growth, after a century will have an annual per capita income of $7,245, barely 60 percent as much. Those extra tenths of a percent in the first country's growth rate have a huge long-run effect on human well-being.

Therefore, Congress should reject any proposals to increase taxes on dividends or capital gains and preferably should reduce them.

Minimum Wage. Another policy favored by those concerned about relative poverty is to increase the federal minimum wage. Again, that policy harms those it is intended to help. A November

2013 Gallup poll found that 76 percent of Americans would vote in favor of a $9-per-hour minimum wage if it were put to a referendum. When Seattle passed a $15-per-hour minimum wage in 2014, to be phased in over seven years, the City Council's website proclaimed, "City Council Approves $15/hour Minimum Wage in Seattle: Historic vote addresses income inequality."

The problem with that thinking is that it ignores tradeoffs. A minimum wage helps some workers but at the cost of hurting other workers. That results in a regressive income transfer and increased inequality. Some of America's least well off workers get a raise precisely as other of America's least well off workers see their hours cut, or even lose their jobs entirely. Other workers will never be hired in the first place. A 2014 Congressional Budget Office study of a proposed $10.10-per-hour minimum wage estimates that "implementing the $10.10 option would reduce employment by roughly 500,000 workers in the second half of 2016, relative to what would happen under current law."

Moreover, even those who seem to benefit from the minimum wage are often harmed in other ways. The minimum wage increase in the SeaTac Airport district near Seattle led to workers losing benefits such as 401(k) accounts, health insurance, paid leave, paid parking, and complimentary meals if they worked at a restaurant. If wage costs increase, employers look for offsetting savings elsewhere, and fringe benefits are usually the first to go. As a result, the extra money in the pay envelope usually ends up going to pay for the lost benefits, often at less favorable tax rates for the employee.

Employers can also lay off some employees or cut employees' hours. Employers will also become more reluctant to hire additional workers, particularly those with low levels of skill, if required to pay them a higher wage. Consumers also lose out. Parking companies in the SeaTac district raised their prices rather than fire workers and replace them with automated kiosks.

The minimum wage's least visible tradeoff is that some workers are never hired in the first place. The individuals who were never hired because of a minimum wage hike are impossible to identify, but the data indicate that those willing would-be workers skew toward young and minority.

Young workers typically have higher unemployment rates than older workers to begin with, as younger people typically have fewer skills and less experience than their elders. And many young people are still in school or have young children, thus limiting their hours and availability. Minimum wages amplify that disparity by pricing some inexperienced and less skilled workers out of the market altogether. Federal minimum wage increases between 2007 and 2009 helped increase the youth unemployment rate by about 3 percent. Indeed, the high minimum wage in European countries such as France helps explain the very large youth unemployment rates there—24 percent as of this writing.

Congress should oppose any increase in the minimum wage and preferably should abolish it by repealing the Fair Minimum Wage Act.

Experts: Ryan Young, Iain Murray, Aloysius Hogan, Ivan Osorio

For Further Reading

Andrew Atkeson, V. V. Chari, and Patrick J. Kehoe, "Taxing Capital Income: A Bad Idea," *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 23, No. 3 (Summer 1999): 3–17, http://www.minneapolisfed.org/research/qr/qr2331.pdf.

Congressional Budget Office, "The Effects of a Minimum-Wage Increase on Employment and Family Income," February 2004, http://www.cbo.gov/sites/default/files/44995-MinimumWage.pdf.

Aspen Gorry, "Minimum Wages and Youth Unemployment," *European Economic Review* 64 (November 2013): 57–75.

Iain Murray and Ryan Young, "Income Inequality: Why Absolute Poverty Matters More than Relative Poverty and What to Do about It," *Issue Analysis*, Competitive Enterprise Institute, forthcoming.