Economic Inequality

January 2016

Since the 1970s, economic inequality in the US has increased dramatically. And in particular, the rich have gotten a lot richer. Nearly everyone who writes about the topic says that economic inequality should be decreased.

I'm interested in this question because I was one of the founders of a company called Y Combinator that helps people start startups. Almost by definition, if a startup succeeds, its founders become rich. Which means by helping startup founders I've been helping to increase economic inequality. If economic inequality should be decreased, I shouldn't be helping founders. No one should be.

But that doesn't sound right. What's going on here? What's going on is that while economic inequality is a single measure (or more precisely, two: variation in income, and variation in wealth), it has multiple causes. Many of these causes are bad, like tax loopholes and drug addiction. But some are good, like Larry Page and Sergey Brin starting the company you use to find things online.

If you want to understand economic inequality — and more importantly, if you actually want to fix the bad aspects of it — you have to tease apart the components. And yet the trend in nearly everything written about the subject is to do the opposite: to squash together all the aspects of economic inequality as if it were a single phenomenon.

Sometimes this is done for ideological reasons. Sometimes it's because the writer only has very high-level data and so draws conclusions from that, like the proverbial drunk who looks for his keys under the lamppost, instead of where he dropped them, because the light is better there. Sometimes it's because the writer doesn't understand critical aspects of inequality, like the role of technology in wealth creation. Much of the time, perhaps most of the time, writing about economic inequality combines all three.

The most common mistake people make about economic inequality is to treat it as a single phenomenon. The most naive version of which is the one based on the pie fallacy: that the rich get rich by taking money from the poor.

Usually this is an assumption people start from rather than a conclusion they arrive at by examining the evidence. Sometimes the pie fallacy is stated explicitly:

> ...those at the top are grabbing an increasing fraction of the nation's income — so much of a larger share that what's left over for the rest is diminished.... [1]

Other times it's more unconscious. But the unconscious form is very widespread. I think because we grow up in a world where the pie fallacy is actually true. To kids, wealth *is* a fixed pie that's shared out, and if one person gets more, it's at the expense of another. It takes a conscious effort to remind oneself that the real world doesn't work that way.

In the real world you can create wealth as well as taking it from others. A woodworker creates wealth. He makes a chair, and you willingly give him money in return for it. A high-frequency trader does not. He makes a dollar only when someone on the other end of a trade loses a dollar.

If the rich people in a society got that way by taking wealth from the poor, then you have the degenerate case of economic inequality, where the cause of poverty is the same as the cause of wealth. But instances of inequality don't have to be instances of the degenerate case. If one woodworker makes 5 chairs and another makes none, the second woodworker will have less money, but not because anyone took anything from him.

Even people sophisticated enough to know about the pie fallacy are led toward it by the custom of describing economic inequality as a ratio of one quantile's income or wealth to another's. It's so easy to slip from talking about income shifting from one quantile to another, as a figure of speech, into believing that is literally what's happening.

Except in the degenerate case, economic inequality can't be described by a ratio or even a curve. In the general case it consists of multiple ways people become poor, and multiple ways people become rich. Which means to understand economic inequality in a country, you have to go find individual people who are poor or rich and figure out why. [2]

If you want to understand *change* in economic inequality, you should ask what those people would have done when it was different. This is one way I know the rich aren't all getting richer simply from some new system for transferring wealth to them from everyone else. When you use the would-have method with startup founders, you find what most would have done back in 1960, when economic inequality was lower, was to join big companies or become professors. Before Mark Zuckerberg started Facebook, his default expectation was that he'd end up working at Microsoft. The reason he and most other startup founders are richer than they would have been in the mid 20th century is not because of some right turn the country took during the Reagan administration, but because progress in technology has made it much easier to start a new company that grows fast.

Traditional economists seem strangely averse to studying individual humans. It seems to be a rule with them that everything has to start with statistics. So they give you very precise numbers about variation in wealth and income, then follow it with the most naive speculation about the underlying causes.

But while there are a lot of people who get rich through rent-seeking of various forms, and a lot who get rich by playing zero-sum games, there are also a significant number who get rich by creating wealth. And creating wealth, as a source of economic inequality, is different from taking it — not just morally, but also practically, in the sense that it is harder to eradicate. One reason is that variation in productivity is accelerating. The rate at which individuals can create wealth depends on the technology available to them, and that grows exponentially. The other reason creating wealth is such a tenacious source of inequality is that it can expand to accommodate a lot of people.

I'm all for shutting down the crooked ways to get rich. But that won't eliminate great variations in wealth, because as long as you leave open the option of getting rich by creating wealth, people who want to get rich will do that instead.

Most people who get rich tend to be fairly driven. Whatever their other flaws, laziness is usually not one of them. Suppose new policies make it hard to make a fortune in finance. Does it seem plausible that the people who currently go into finance to make their fortunes will continue to do so, but be content to work for ordinary salaries? The reason they go into finance is not because they love finance but because they want to get rich. If the only way left to get rich is to start startups, they'll start startups. They'll do well at it too, because determination is the main factor in the success of a startup. [3] And while it would probably be a good thing for the world if people who wanted to get rich switched from playing zero-sum games to creating wealth, that would not only not eliminate great variations in wealth, but might even exacerbate them. In a zero-sum game there is at least a limit to the upside. Plus a lot of the new startups would create new technology that further accelerated variation in productivity.

Variation in productivity is far from the only source of economic inequality, but it is the irreducible core of it, in the sense that you'll have that left when you eliminate all other sources. And if you do, that core will be big, because it will have expanded to include the efforts of all the refugees. Plus it will have a large Baumol penumbra around it: anyone who could get rich by creating wealth on their own account will have to be paid enough to prevent them from doing it.

You can't prevent great variations in wealth without preventing people from getting rich, and you can't do that without preventing them from starting startups.

So let's be clear about that. Eliminating great variations in wealth would mean eliminating startups. And that doesn't seem a wise move. Especially since it would only mean you eliminated startups in your own country. Ambitious people already move halfway around the world to further their careers, and startups can operate from anywhere nowadays. So if you made it impossible to get rich by creating wealth in your country, people who wanted to do that would just leave and do it somewhere else. Which would certainly get you a lower Gini coefficient, along with a lesson in being careful what you ask for. [4]

I think rising economic inequality is the inevitable fate of countries that don't choose something worse. We had a 40 year stretch in the middle of the 20th century that convinced some people otherwise. But as I explained in The Refragmentation, that was an anomaly — a unique combination of circumstances that compressed American society not just economically but culturally too. [5]

And while some of the growth in economic inequality we've seen since then has been due to bad behavior of various kinds, there has simultaneously been a huge increase in individuals' ability to create wealth. Startups are almost entirely a product of this period. And even within the startup world, there has been a qualitative change in the last 10 years. Technology has decreased the cost of starting a startup so much that founders now have the upper hand over investors. Founders get less diluted, and it is now common for them to retain board control as well. Both further increase economic inequality, the former because founders own more stock, and the latter because, as investors have learned, founders tend to be better at running their companies than investors.

While the surface manifestations change, the underlying forces are very, very old. The acceleration of productivity we see in Silicon Valley has been happening for thousands of years. If you look at the history of stone tools, technology was already accelerating in the Mesolithic. The acceleration would have been too slow to perceive in one lifetime. Such is the nature of the leftmost part of an exponential curve. But it was the same curve.

You do not want to design your society in a way that's incompatible with this curve. The evolution of technology is one of the most powerful forces in history.

Louis Brandeis said "We may have democracy, or we may have wealth concentrated in the hands of a few, but we can't have both." That sounds plausible. But if I have to choose between ignoring him and ignoring an exponential curve that has been operating for thousands of years, I'll bet on the curve. Ignoring any trend that has been operating for thousands of years is dangerous. But exponential growth, especially, tends to bite you.

If accelerating variation in productivity is always going to produce some baseline growth in economic inequality, it would be a good idea to spend some time thinking about that future. Can you have a healthy society with great variation in wealth? What would it look like?

Notice how novel it feels to think about that. The public conversation so far has been exclusively about the need to decrease economic inequality. We've barely given a thought to how to live with it.

I'm hopeful we'll be able to. Brandeis was a product of the Gilded Age, and things have changed since then. It's harder to hide wrongdoing now. And to get rich now you don't have to buy politicians the way railroad or oil magnates did. [6] The great concentrations of wealth I see around me in Silicon Valley don't seem to be destroying democracy.

There are lots of things wrong with the US that have economic inequality as a symptom. We should fix those things. In the process we may decrease economic inequality. But we can't start from the symptom and hope to fix the underlying causes. [7]

The most obvious is poverty. I'm sure most of those who want to decrease economic inequality want to do it mainly to help the poor, not to hurt the rich. [8] Indeed, a good number are merely being sloppy by speaking of decreasing economic inequality when what they mean is decreasing poverty. But this is a situation where it would be good to be precise about what we want. Poverty and economic inequality are not identical. When the city is turning off your water because you can't pay the bill, it doesn't make any difference what Larry Page's net worth is compared to yours. He might only be a few times richer than you, and it would still be just as much of a problem that your water was getting turned off.

Closely related to poverty is lack of social mobility. I've seen this myself: you don't have to grow up rich or even upper middle class to get rich as a startup founder, but few successful founders grew up desperately poor. But again, the problem here is not simply economic inequality. There is an enormous difference in wealth between the household Larry Page grew up in and that of a successful startup founder, but that didn't prevent him from joining their ranks. It's not economic inequality per se that's blocking social mobility, but some specific combination of things that go wrong when kids grow up sufficiently poor.

One of the most important principles in Silicon Valley is that "you make what you measure." It means that if you pick some number to focus on, it will tend to improve, but that you have to choose the right number, because only the one you choose will improve; another that seems conceptually adjacent might not. For example, if you're a university president and you decide to focus on graduation rates, then you'll improve graduation rates. But only graduation rates, not how much students learn. Students could learn less, if to improve graduation rates you made classes easier.

Economic inequality is sufficiently far from identical with the various problems that have it as a symptom that we'll probably only hit whichever of the two we aim at. If we aim at economic inequality, we won't fix these problems. So I say let's aim at the problems.

For example, let's attack poverty, and if necessary damage wealth in the process. That's much more likely to work than attacking wealth in the hope that you will thereby fix poverty. [9] And if there are people getting rich by tricking consumers or lobbying the government for anti-competitive regulations or tax loopholes, then let's stop them. Not because it's causing economic inequality, but because it's stealing. [10]

If all you have is statistics, it seems like that's what you need to fix. But behind a broad statistical measure like economic inequality there are some things that are good and some that are bad, some that are historical trends with immense momentum and others that are random accidents. If we want to fix the world behind the statistics, we have to understand it, and focus our efforts where they'll do the most good.

Notes

[1] Stiglitz, Joseph. *The Price of Inequality*. Norton, 2012. p. 32.

[2] Particularly since economic inequality is a matter of outliers, and outliers are disproportionately likely to have gotten where they are by ways that have little do with the sort of things economists usually think about, like wages and productivity, but rather by, say, ending up on the wrong side of the "War on Drugs."

[3] Determination is the most important factor in deciding between success and failure, which in startups tend to be sharply differentiated. But it takes more than determination to create one of the hugely successful startups. Though most founders start out excited about the idea of getting rich, purely mercenary founders will usually take one of the big acquisition offers most successful startups get on the way up. The founders who go on to the next stage tend to be driven by a sense of mission. They have the same attachment to their companies that an artist or writer has to their work. But it is very hard to predict at the outset which founders will do that. It's not simply a function of their initial attitude. Starting a company changes people.

[4] After reading a draft of this essay, Richard Florida told me how he had once talked to a group of Europeans "who said they wanted to make Europe more entrepreneurial and more like Silicon Valley. I said by definition this will give you more inequality. They thought I was insane — they could not process it."

[5] Economic inequality has been decreasing globally. But this is mainly due to the erosion of the kleptocracies that formerly dominated all the poorer countries. Once the playing field is leveler politically, we'll see economic inequality start to rise again. The US is the bellwether. The situation we face here, the rest of the world will sooner or later.

[6] Some people still get rich by buying politicians. My point is that it's no longer a precondition.

[7] As well as problems that have economic inequality as a symptom, there are those that have it as a cause. But in most if not all, economic inequality is not the primary cause. There is usually some injustice that is allowing economic inequality to turn into other forms of inequality, and that injustice is what we need to fix. For example, the police in the US treat the poor worse than the rich. But the solution is not to make people richer. It's to make the police treat people more equitably. Otherwise they'll continue to maltreat people who are weak in other ways.

[8] Some who read this essay will say that I'm clueless or even being deliberately misleading by focusing so much on the richer end of economic inequality — that economic inequality is really about poverty. But that is exactly the point I'm making, though sloppier language than I'd use to make it. The real problem is poverty, not economic inequality. And if you conflate them you're aiming at the wrong target.

Others will say I'm clueless or being misleading by focusing on people who get rich by creating wealth — that startups aren't the problem, but corrupt practices in finance, healthcare, and so on. Once again, that is exactly my point. The problem is not economic inequality, but those specific abuses.

It's a strange task to write an essay about why something isn't the problem, but that's the situation you find yourself in when so many people mistakenly think it is.

[9] Particularly since many causes of poverty are only partially driven by people trying to make money from them. For example, America's abnormally high incarceration rate is a major cause of poverty. But although for-profit prison companies and prison guard unions both spend a lot lobbying for harsh sentencing laws, they are not the original source of them.

[10] Incidentally, tax loopholes are definitely not a product of some power shift due to recent increases in economic inequality. The golden age of economic equality in the mid 20th century was also the golden age of tax avoidance. Indeed, it was so widespread and so effective that I'm skeptical whether economic inequality was really so low then as we think. In a period when people are trying to hide wealth from the government, it will tend to be hidden from statistics too. One sign of the potential magnitude of the problem is the discrepancy between government receipts as a percentage of GDP, which have remained more or less constant during the entire period from the

end of World War II to the present, and tax rates, which have varied dramatically.

Thanks to Sam Altman, Tiffani Ashley Bell, Patrick Collison, Ron Conway, Richard Florida, Ben Horowitz, Jessica Livingston, Robert Morris, Tim O'Reilly, Max Roser, and Alexia Tsotsis for reading drafts of this.

Note: This is a new version from which I removed a pair of metaphors that made a lot of people mad, essentially by macroexpanding them. If anyone wants to see the old version, I put it here.

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