ONE source of the outsize inequalities in America is the dynamism that made economic activity so rewarding. An economy open to new concepts and novel ventures is bound to generate unequal gains. To tax all of those gains would close off the prospects for success that many entrepreneurs need if they are to undertake ambitious ventures — a big mistake. But it would also be a mistake to misunderstand the relation of inequality and innovation. It is less innovation — not more — that has widened inequality in the United States in recent decades.

America’s peak years of indigenous innovation ran from the 1820s to the 1960s. There were a few financial panics and two depressions, to be sure. But in this period, a frenzy of creative activity, economic competition and rapid growth in national income provided widening economic inclusion, rising wages for all and engaging careers for most. Innovations gave workers better tools to work with and better products to make, thus lifting their wages. Then this innovation began to retreat, most of it to an area of land along the West Coast. In the early 1970s the rate of indigenous innovation (as measured by its estimated contribution to the rate of growth in labor productivity) dropped by about half — to around 1 percent since then, from about 2 percent before then.

The economist Robert J. Gordon has noted this slowdown in innovation, which he lays to the end of big breakthroughs. My view is that innovation has declined in the everyday processes that businesses tinker with incrementally as they try to become more productive over time. This decline of innovation across many fields — with notable exceptions like Silicon Valley, biotechnology and clean energy — has set back much of the earlier gains in productivity in American history.

It forced a broad devaluation of business assets, including employees. Wage restraint and reduced hiring followed, especially in the heavy manufacture of capital goods. As a result, wages of workers on the low rungs of the ladder slowed more than the wages of those in the middle, and the rising gap leveled off only in the 1990s. Unemployment rates tend to rise and fall in roughly equal proportion at all rungs of the ladder, and that happened between 1973 and 1985. (Over that time, the rate for white men went from 4.3 to 6.2 percent, for black men from 9.4 to 15.1 percent.) But the rise in unemployment was of greater consequence to those on the bottom rung, since their economic precariousness had been higher to start with. This is the heart of the inequality story.

The gap between the less advantaged and the more advantaged widened as the gap
between high-school graduates and dropouts and Americans with college and graduate
degrees rose. Many of the more advantaged could opt to retire on their resources, which
fewer of the less advantaged could do. No wonder that between the mid-1970s and the
mid-1990s, the labor force participation rate of white men — who were already relatively
advantaged — drifted down while, in contrast, the participation rates of black and Latino
men did not. (The rise of female participation rates, white and nonwhite, is another
story.)

The inequality gaining attention recently is different in scale but not kind. In my 1997
book “Rewarding Work: How to Restore Participation and Self-Support to Free
Enterprise,” I wrote that wages had declined in the middle of the income distribution —
“approximately at the border between the working class and the middle class” — relative
to the affluent.

In short, there has been a widening between the middle and the top in both employment
and wages. This “decompression,” as some economists call it, began swelling with the
return, around 2004, of the meager innovation and slow growth that had plagued the
economy since the 1970s until the brief respite offered by the Internet boom that began in
the mid-1990s.

The question that confronts policy makers is what steps to take.

There has been a drumbeat for investment in infrastructure. Advocates in business and
government assert that such projects would create more work while they last and leave
productivity higher in the end — though maybe not high enough to earn the revenue to
cover the cost. The impact on jobs is clear over the short run. Economists have been
sifting data for evidence that cities and states have won measurable gains in productivity
from their capital projects. Whatever the answer, the debate has missed the point that the
government will have to keep on finding new projects as old ones are completed. Such an
endless series of projects will run into the law of diminishing returns. And even if returns
hold up, bricks and mortar are not a solution to the decline in dynamism that — largely if
not wholly — lies behind the slowdown in innovation.

Two ideas about how to revive the nation’s dynamism are much in discussion.

Some observers attribute the bulk of the American economy's innovation — new products
and new methods — to commercial applications of recent scientific advances. This pool of
scientific advances, the argument goes, has pretty much run dry, with little
replenishment in recent years, and so American innovation has run out of fuel. These
scientists then say that stepping up government funding for scientific research could refill
the pool, creating new possibilities for innovation into the indefinite future.

But this thesis is based on a mistaken premise. There is no evidence that innovating in
America is or has been tethered to scientific advances. Some historians find that
innovations largely ran ahead of scientific advances in the 19th century. The myriad new
products of recent decades were mostly created by new commercial ideas and tinkering,
not by new scientific advances.
A second approach, advocated by some economists and policy makers, is the explicit adoption of an industrial policy. It is argued that the government can spark innovation in the private sector by providing finance for development and marketing of new products or methods in companies or industries that offer promise, at least in the government’s view, of boosting innovation. President Obama has implicitly endorsed such an approach. In his State of the Union address last month, he vowed to make America “a magnet for new jobs and manufacturing,” favorably cited a “manufacturing innovation institute” in Youngstown, Ohio, that engages in 3-D printing, and announced the start of three more such manufacturing hubs, which will work with the Defense and Energy Departments “to turn regions left behind by globalization into global centers of high-tech jobs.”

But this thesis that the government can adequately make the decisions once made by a well-functioning private sector raises serious doubts. Granted, enterprises in the private sector are prone to making mistakes when deciding to develop new products — since feasibility, cost and market reception are all unknown. The difficulty with a national industrial policy is that it places those decisions in the hands of government officials who are remote from the local expertise and insights that companies draw on for dynamic innovation. It is hard enough for venture capitalists and early-stage investors to make the right choices. It is unimaginable that the government can do it well. Besides, there is a moral hazard. Operating an industrial policy runs the risk that government officials — perhaps unconsciously — will do what is best for their political prospects rather than what they might agree was best if they were not directly involved.

What, then, can be done to address the slowdown in innovation and the attendant rise in inequality? There is no question that effective initiatives can be taken to address particular inequalities. Subsidies for employers to hire low-wage workers is one initiative that could be taken to address a particularly serious inequality. But there is no way to restore the sense of equality that prevailed as late as the 1960s without remedying the ills that caused inequalities to widen: the narrowing of high innovation to a handful of industries and the consequent slowing of economic growth to a snail’s pace.

I am convinced that a return to the productivity growth and broad economic inclusion of the past will require nothing less than a revival of the high dynamism that underpinned that performance.

The needed revival will require a reform of the financial sector and of the business sector. In the financial sector it is necessary to put an end to the short-term thinking that unduly focuses on hitting quarterly earnings targets instead of aiming for long-range profitability and growth. Financial institutions’ addiction to liquidity has made lending to business less attractive, while an addiction to diversified investments has left very few financial institutions willing to make money the old-fashioned way — by lending, or investing in projects for new products and methods.

In the business sector, it is necessary to put an end to infighting in established companies and the shortsightedness of chief executives who know they have only a few years in which to haul in some big bonuses. Better corporate oversight by boards and by
government regulators is also essential.

Little of this will happen, however, and any government reforms will be undermined without a wider embrace of the old ethos of imagination, exploration, experiment and discovery. It is that ethos that laid the foundation for the broad-based prosperity of the American middle class in the postwar years, and without its revival, no amount of government intervention can fully mitigate the widening inequality that the slowdown in innovation has helped create.

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