Journal of Economic Perspectives—Volume 28, Number 1—Winter 2014—Pages 243–248

Correspondence

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The One Percent

The cheerful blandness of N. Gregory Mankiw's "Defending the One Percent" (Summer 2013, pp. 21–34) may divert attention from its occasional unstated premises, dubious assumptions, and omitted facts. I have room to point only to a few such weaknesses; but the One Percent are pretty good at defending themselves, so that any assistance they get from the sidelines deserves scrutiny.

First, the paper starts off by invoking an iconic Steve Jobs and, without making an explicit claim, carries on tacitly as if the One Percent consists mainly of entrepreneurs whose innovations generate a lot of consumer surplus for the world. There would be less alarm if that were so. But a large and—before the crisis—increasing part of the income of the One Percent arises in the financial services industry, and a large and increasing part of that has come from trading profits. Much of the income in question must therefore be the payoff to asymmetric information, and generates precious little in the way of aggregate consumer surplus. Consider this history (for details see Murphy 2012, especially pp. 307–8): from 1970 to about 1995, the median realized compensation for chief executive officers in Standard and Poor's 500 broker-dealer firms was essentially indistinguishable from that of Standard and Poor's 500 banks and industrials. Rather suddenly, between 1996 and 2006, the median broker-dealer chief executive officer started to collect anywhere between 7 and 10 times the median compensation of the other two groups. This does not smell like the Goldin and Katz (2008) story. I'll swallow "innovation," but socially productive innovation, no thanks. Extreme inequality is not primarily about useful entrepreneurs. On financial profits and inequality, Mankiw waffles uncomfortably.

Second, Mankiw refers at best tangentially to what may be the most dangerous adverse consequence of extreme inequality at the top: the rich, with a large assist from the *Citizens United v. Federal Election Commission* (558 US 310 [2010]) decision, can buy political influence, and not only influence but power. An immediate example is the millions of dollars spent by the financial services industry to weaken regulation under the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010. Mankiw's partial reference is in connection with the contribution of rent-seeking to inequality. There his response is that the proper remedy is not to attack extreme inequality but to suppress rent-seeking. Presumably he would give the same answer here: if inequality corrupts politics, go after the corruption, not the inequality. But this would be, willfully or not, naive: it is precisely the power of great wealth that makes it difficult or impossible to eradicate corruption.

Third, Mankiw's conception of rents is too narrow; he refers mainly to monopoly rents. But economic rents are pervasive. He mentions the close correlation between height and income. It seems unlikely that height is correlated with true productivity, outside the NBA. More likely height confers an interpersonal advantage, so the return to height is a rent, at the expense of others. (Our culture has produced a song with the line: "Short people got no right to live.") Taxing height would indeed be odd (Greg Mankiw is pretty tall, by the way); but it is too nonchalant to presume that all market incomes reflect true productivity, let alone social productivity.

Fourth, evidence has accumulated that the degree of intergenerational income mobility in the United

States is less than it used to be, less than in some other advanced economies, and less than the American self-image requires. These changes and differences are unlikely to be genetic in origin. (If they were, they would be rents!) Mankiw ignores or skates over this evidence in favor of an anecdote: he thinks his children do not have significantly better opportunities than his own, although they grew up in a much more affluent family than he did. This is a rather small sample, of course. Besides, Professor Mankiw's success came in what must be one of the more meritocratic occupations around. I wonder if he would have had as good a shot at a bank presidency as his children could have.

Fifth, you don't have to be a card-carrying utilitarian to believe that taking a (lump-sum) dollar from a random rich person and giving it to a random poor person would lead to a better social state. Mankiw's attempts to undermine this intuition fall pretty far short: a) Yes, rich countries are pretty cheap with aid to poor countries, and might be so even if they were surer that aid was effective. But this only says something about the limits of human solidarity: greater within a family than outside it, greater within a nation than outside it, etc. So what? b) No, we don't try to equalize the marginal value of kidneys across the population. But this does not deny that some people need a kidney more than others, it merely reflects the fact that most people regard kidneys and other body parts as somehow less fungible than bank accounts. Does it follow from the fact that we do not redistribute spare kidneys that we should not redistribute some spare cash? As for the actual progressiveness of the federal tax code, if we take the group averages given in the paper as points on the tax function, the marginal tax rate between incomes of $223,500 and $1,219,700 appears to be slightly *lower* than that between $64,300 and $223,500.

Sixth, who could be against allowing people their "just deserts?" But there is that matter of what is "just." Most serious ethical thinkers distinguish between deservingness and happenstance. Deservingness has to be rigorously earned. You do not "deserve" that part of your income that comes from your parents' wealth or connections or, for that matter, their DNA. You may be born just plain gorgeous or smart or tall, and those characteristics add to the market value of your marginal product, but not to your just deserts. It may be impractical to separate effort from happenstance numerically, but that is no reason to confound them, especially when you are thinking about taxation and redistribution. That is why we may want to temper the wind to the shorn lamb, and let it blow on the sable coat.

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Response from N. Gregory Mankiw

Robert Solow's scattershot letter offers various gripes about my paper "Defending the One Percent." Let me respond, as blandly and cheerfully as I can, to his points.

First, Solow objects to my invoking the iconic Steve Jobs. Jobs is indeed an extreme case, but he also exemplifies much of what has happened to the US economy in recent years. In the same *JEP* issue as my paper, Kaplan and Rauh (2013) examine alternative hypotheses about increasing inequality. They conclude that "the increase in pay at the highest income levels is broad based" and that "the US evidence on income and wealth shares for the top 1 percent is most consistent with a 'superstar'-style explanation rooted in the importance of scale and skill-biased technological change." Solow says that I waffle on the role of finance, and about that, he is right. The social value of financial activity is hard to measure. When the evidence is inconclusive, honesty requires that we admit it.

Second, Solow is concerned about the political influence of the rich. I am less worried, in part because the wealthy include supporters of both the right (the Koch brothers) and the left (George Soros). Moreover, despite rising inequality, in 2008 and 2012 the United States managed to elect a left-leaning president committed to increasing taxes on the rich. In any event, the absence of such political concerns in my paper is hardly unique. The economics literature on optimal income redistribution, including the celebrated Mirrlees (1971) model, is based largely on utilitarian principles, not on some conjectured link between the income distribution and the electoral process.

Third, Solow thinks I have too narrow a conception of rents. Actually, I am less concerned about rents (incomes paid to factors of production in excess of opportunity cost) than I am about rent-seeking (the attempt to obtain rents by manipulating the political environment). If a person supplies his labor inelastically, his earnings are entirely rent, but that does not mean he is engaged in socially unproductive rent-seeking or that he is earning more than the value of his marginal product. Regarding the narrow, tangential question of

why tall people earn higher wages, the literature has examined various hypotheses; for example, Case and Paxson (2008) report a positive correlation between height and cognitive skills.

Fourth, Solow interprets the evidence on intergenerational mobility as showing that the economy is not very meritocratic. (Oddly, he exempts the economics profession. He seems to believe that lack of success is often the result of bad luck or a rigged system, unless you are an economist, in which case it's your own fault.) Although I noted in my article that those born into extreme poverty face particularly difficult obstacles, I view the rest of the economy as more meritocratic than Solow does. In addition to the Kaplan and Rauh study, I recommend a popular book called *The Millionaire Next Door* (Stanley and Danko 1996). Written by two marketing professors who extensively surveyed high net worth individuals, the book reports that the typical millionaire is not someone who was born into wealth but rather is someone who has worked hard and lived frugally.

Moreover, the fact that higher income inequality is associated with lower intergenerational mobility is not a surprise. Consider the following assumptions: 1) A person's income Y depends on talent T and noise ε:

$$Y = \alpha T + \varepsilon.$$

2) Talent T is partly heritable, while noise ε is uncorrelated across generations. 3) Talent T and noise ε have constant variance but the return to talent α varies over time and across nations. Under these assumptions, higher income inequality goes hand in hand with lower intergenerational mobility. This simple statistical model does not explain why the return to talent varies, but it does explain why inequality and mobility often move in opposite directions.

Fifth, Solow tries to revive utilitarian logic without calling himself a utilitarian by claiming that redistribution leads to a better "social state." But what he means by social state, other than something like total utility, is unclear. In response to my critiques of utilitarianism, he says: a) people don't endorse more foreign aid because they don't feel solidarity with those in other nations, and b) people aren't in favor of kidney redistribution because they don't view kidneys as fungible. I agree. In fact, Solow's arguments seem more like restatements of my observations than refutations of them. If people were maximizing a conventional social welfare function behind a veil of ignorance, they would treat foreigners equally with their fellow citizens and they would treat kidneys as fungible. That they do not do so is evidence that our innate moral intuitions are far from utilitarian.

As for the progressivity of the actual tax system: Progressivity is correctly gauged by average tax rates, which rise strongly with income. Solow's reference to marginal tax rates is perplexing, as these are relevant for measuring incentive effects, not progressivity.

Sixth, and finally, Solow asks, who could be against allowing people their "just deserts"? Actually, much of the economics literature on redistribution takes precisely that stand, albeit without acknowledging doing so. The standard model assumes something like a utilitarian objective function and concludes that the optimal tax code comes from balancing diminishing marginal utility against the adverse incentive effects of redistribution. In this model, what people deserve plays no role in the formulation of optimal policy. I agree with Solow that figuring out what people deserve is hard, and I don't pretend to have the final word on the topic. But if my paper gets economists to focus a bit more on just deserts when thinking about policy, I will feel I have succeeded.

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It is conventional wisdom that income inequality grew almost unabated from the late 1970s up through the start of the Great Recession, with the top 1 percent controlling an increasing share of income in the United States and other English-speaking countries. The intellectual underpinnings of this now dominant view grew out of the tax-record-based research collected by Facundo Alvaredo, Anthony B. Atkinson, Thomas Piketty, and Emmanuel Saez in their world top incomes database and discussed in "The Top 1 Percent in International and Historical Perspective" (Summer 2013, pp. 3–20).

Tax records offer researchers many advantages, but their inherent disadvantages can skew inequality levels and affect their trends. Because the definitions of income are determined administratively, they vary over time within and across countries,

and often differ from how most economists would define income. For example, while most economists agree that Social Security and other public transfers are income for individuals, tax record data largely miss this income in the United States and to a lesser degree in other countries. Similarly, individuals' business income is a real resource, whether reported on their personal income tax form, and thus captured in individual tax return data, or reported on a corporate income tax form and thus missed in the individual tax return data.

In Burkhauser et al. (2012), we raise these measurement concerns as they relate to the unusually large increase in inequality in personal tax data between 1986 and 1988 following the 1986 Tax Reform Act. In Piketty and Saez's top income series excluding capital gains (the series they focus on in Piketty and Saez 2003), the increase in the top 1 percent's income shares during the two years following the implementation of the act represents approximately one-third of the total increase since 1985. This change appears to reflect a reclassification from corporate to individual income in response to top individual tax rates falling below the corporate rate, rather than a true inequality change. Similarly, Burkhauser, Hahn, and Wilkins (2013) note that a short-term spike in Australian top incomes in tax-record data between 1986 and 1989 appears to be driven by a change in the treatment of company profits and dividends that more fully captured company profits in the personal income tax base. The longer-term growth in inequality in tax record data since 1989 seems to arise because Australia started taxing longer-term realized capital gains in 1989—but only on property purchased after September 19, 1985.

Alvaredo, Atkinson, Piketty, and Saez acknowledge that tax changes may affect income measures over time. But in the US case, they dismiss this concern by referencing their data series that includes realized taxable capital gains. They claim doing so eliminates a major part of the tax avoidance channel, because corporate income still appears as capital gains. This rebuttal would be a stronger if realized taxable capital gains had a close relationship to current income. They do not. Because the United States only taxes capital gains when the asset is sold, individuals can defer realizing them indefinitely. Thus, capital gains may not appear on individual tax forms until years or decades after being generated, if at all. This also means corporate income before the 1986 Act may appear as realized capital gains in the 1990s or 2000s. Hence, including taxable realized capital gains as a measure of current market returns to capital can importantly affect such trends. The classic Haig–Simons income definition includes capital income, but at the point of accrual, not when such gains are realized.

In Burkhauser et al. (2012), with data from the Current Population Survey, we largely replicate the inequality trends since the 1960s found by Piketty and Saez (2003) for market income. But when we extend our analysis and use a more comprehensive post-tax, post-transfer income measure, including in-kind income and accrued capital gains, we observe different income trends (Armour, Burkhauser, and Larrimore 2013). Current levels of income inequality are still at or near record levels. But inequality has not appreciably increased since the late 1980s or early 1990s.

This finding does not discount Alvaredo and colleagues' insights on the causes of increased market income inequality. In many ways, their explanations still apply when using accrued, rather than realized, capital gains. If increased bargaining by executives and capital owners due to lower tax rates is important, then market income inequality should have increased more in the 1980s, when top income tax rates fell, than in the 1990s, when top income tax rates increased. This pattern is likely to be the case when using accrued capital gains, but is less true when using realized capital gains—which partially shift the timing of these returns to capital into the 1990s and 2000s.

But designing policy recommendations based on pre-tax, pre-transfer market income trends over long periods of time seems misguided. If you compare distributions of market income in the 1920s when taxes and government transfers were low with market income today, you miss the dramatic growth of progressive income taxes and transfers like Social Security and the Earned Income Tax Credit that shifted income to people with less market income in the real world. More subtly, leaving out the real world behavioral consequences of the growth of Social Security and other government transfers obfuscates the impact these policies have on market income. The US labor force participation rate of men aged 65 and over was well over 50 percent in the 1920s and is now under 20 percent. In a market income world, the elderly look much worse off today, but in fact their income has shifted to nonmarket sources. In this sense, social policies may increase measured market income inequality even if they reduce inequality under broader income measures. Thus, while research using tax records contributes greatly to the inequality debate, it should be viewed as an addition to, rather than a replacement for, the extensive research conducted on both US and international inequality trends using broader income measures.

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