

Background Facts

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Our subject is the inequality crisis, so called. I somewhat regret the title of my book, *The Inequality Hoax*. If you've published anything lately, you know that your publishers want an attention-drawing title on your book or article. I could not call the book "The Inequality Dilemma" or "The Inequality Challenge"; those titles are too equivocal. That's more or less what it is: a challenge or a dilemma, and one that will be difficult to address. My view is that inequality is real, however you want to measure it. But the subject is being used in ways that are not helpful and could do a great deal of harm if we're not careful. I'll elaborate on that view.

We've experienced a series of crises over our lifetimes. I think back to the poverty crisis of the 1960s, the urban crisis of the 1960s, the energy crisis of the 1970s, the inflation crisis, later the homeless crisis, the health care crisis, and the global warming crisis today. Many people find it helpful politically to talk in terms of crisis, perhaps as a way of stampeding voters into doing things they might not otherwise do. If we look back over these crises, it's not clear that we've responded to them in ways that have always been helpful.

Today we have what some have called "the new inequality." The old inequality was all about helping the poor move up into the middle class: think about the poverty programs in the 1960s or

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spending on education. Federal programs of all sorts were designed to allow the poor to rise. The inequality crisis today is from the other end. It's about the top 1 percent of the income distribution, and finding ways to redistribute that income down through the population to raise the living standards of the other 99 percent. We've been talking about this for a number of years, but it surged into public consciousness last spring with the publication of Thomas Piketty's book, *Capital in the Twenty-First Century*. It was a monumental bestseller, and was widely read and reviewed. Piketty became an overnight celebrity. It is a carefully researched and closely argued book. I encourage everybody to read it. It's an impressive work. It's very insightful in a lot of ways and it makes a case that puts inequality in a historical and intellectual context. In a certain sense, he's done for inequality what Marx did for capitalism. In the nineteenth century, intellectuals and radicals complained about the factory system, the movement of people into the cities, the exploitation of labor, and other developments associated with the rise of industry. But it was Marx who placed it into a theoretical and historical context.

In the 1920s and 1930s, many people were talking about public spending and public works as a way to deal with unemployment. It was John Maynard Keynes who put that into a broader theoretical context to explain how public spending could be used to manipulate or jumpstart the economy during the Depression. In a certain sense, Piketty (along with his colleague, Emmanuel Saez) has done something similar for inequality. They've placed it into a broad intellectual context. It's the strongest statement we have of what we might call "the redistributionist thesis." They have done an impressive job of collecting a great deal of data on wealth and income extending back into the 1800s in the case of a few countries. With respect to the United States, they have collected data on wealth and income going back to 1900. These data are not perfect in every

respect. The wealth data in particular were arrived at via some sophisticated statistical estimation. Governments collect income data because they tax income. They don't collect data on wealth. For this reason, Piketty and his associates had to piece together the data on wealth using estimation techniques from estate tax filings. People have criticized their data. I do not, because I expect that they will improve the data over time. In addition, no one else, to this point, has done a better job.

Piketty makes the theoretical case that inequality is built into the fabric of the capitalist order. It's not accidental but fundamental: inequality will inevitably explode unless it is counteracted by active governmental measures. Their remedy to redistribute income is not complex; they call for a return to the high and confiscatory tax rates on the wealthy that were in place in most countries from the 1930s into the 1970s.

The basic theory is that returns to capital always grow more quickly than output in the economy or returns to labor. If that pattern persists over time, then those who own capital grow wealthier over time. In Figure 1.1, taken from Piketty's *Capital in the 21st Century*, one sees that in the middle of the twentieth century returns to capital declined and were overtaken by overall economic output. For that reason, there was a rough equalization of incomes during that period. Later in the century, after about 1980, inequality increased because capital accumulated faster than the output of the world economy.

What we conclude from this is that the modern age of capitalism can be divided up into three periods. The first period, running from roughly 1870 to 1929 in the United States and from 1870 to 1914 in Europe, was the original gilded age of inequality. The middle period, running roughly from 1930 to 1980, might be called the "golden age of social democracy," marked by high marginal tax rates, output growing more rapidly than returns to capital, and

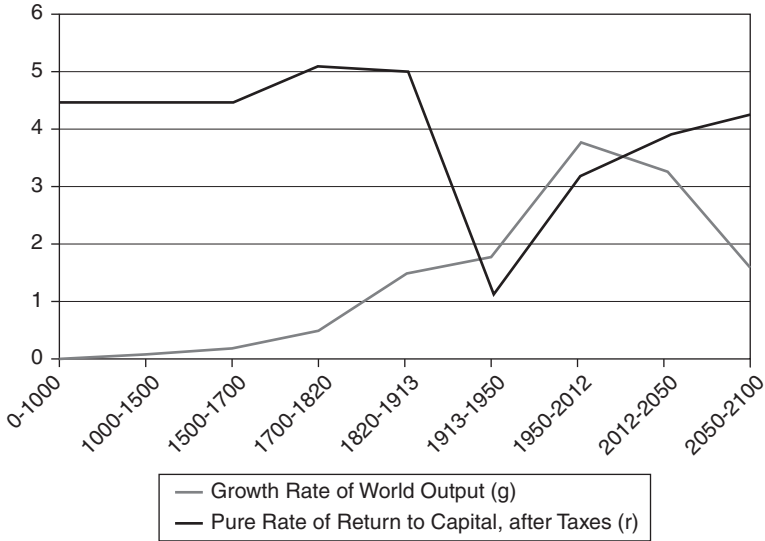


FIGURE 1.1. Rate of return vs. world growth (antiquity to 2100)

Source: Thomas Piketty, *Capital in the 21st Century*, figure 10.10, p. 356

a greater equalization of incomes and wealth. Beginning in 1980 and moving forward to the present time, we have lived through a new gilded age of rising inequality and returns to growth going disproportionately to the wealthy. That is the tripartite division of the history of modern capitalism, which I more or less accept on the basis of the data marshaled by Piketty and his associates.

Figure 1.2 displays a set of data on after-tax income from the Congressional Budget Office. The data cover the period from 1979 to 2010. The top dotted line displays the percentage growth in income from year to year for the top 1 percent of the income distribution; the bottom line displays the same variable for the bottom 99 percent. The line displays the evolution of the median income for the entire population, which tracks closely with the incomes of the bottom 99 percent of the distribution. The basic problem is that the income of the top 1 percent is exploding and the income for the rest is increasing much more slowly, though (importantly)

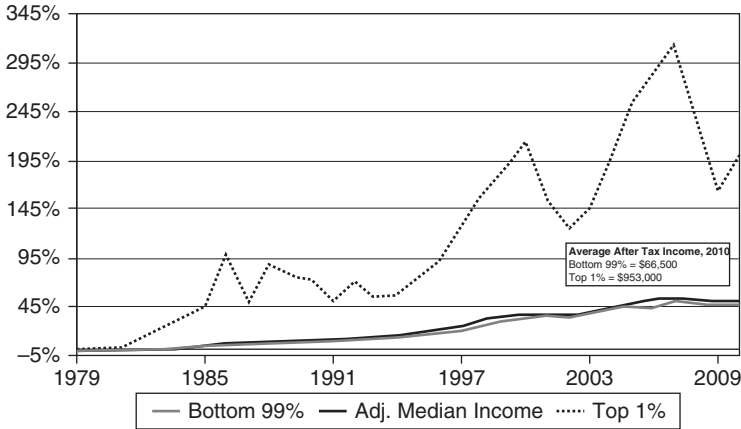


FIGURE 1.2. Average after-tax income growth (1979 to 2010)

Source: Travis Honeyfield, ed., "Distribution of Household Income & Federal Taxes, 2008–2010," tables 3 & 5 (Washington, DC: Congressional Budget Office)

it is not declining. The mean after-tax income for the top 1 percent in 2010 was \$953,000 and for the bottom 99 it was \$66,000. The figures are for after-tax income; the distribution of pre-tax income is slightly more skewed in favor of the wealthy, as there is a mildly redistributive element to the federal tax system.

Placing these figures within a longer historical frame, it is apparent that the great increase in inequality since 1980 represented a departure from the pattern of earlier decades. Figure 1.3, taken from an article by Saez, displays the share of pre-tax income (with and without capital gains) received by the top 1 percent and 0.1 percent in the United States between 1913 and 2010. The data begin in 1913 because that is the year the United States launched the income tax. The lines follow a recognizable U-shaped pattern, with the wealthy reaping higher shares of national income before 1930, then somewhat smaller shares between 1930 and 1980, and once again much higher shares during the three-decade period after 1980. Today the top 1 percent of the income distribution is receiving close to 20 percent of national income, a figure close to what it

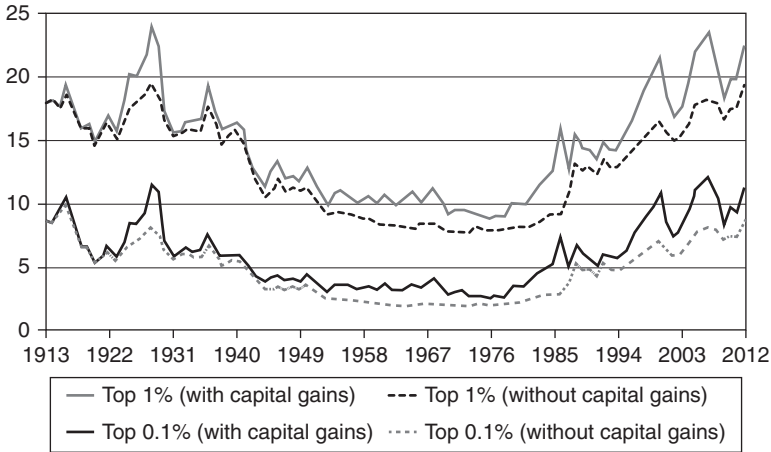


FIGURE 1.3. Share of pre-tax, pre-transfer income for top 1% and 0.1%

Source: Emmanuel Saez, “Income Inequality in the United States, 1913–1998,” with Thomas Piketty, *Quarterly Journal of Economics*, 118(1), 2003, 1–39, updated to 2012, September 2013, tables A1 and A3

was in the 1920s. In the intervening decades—1930 to 1980—those shares dropped by half to around 10 percent of national income. This chart more or less encapsulates Piketty’s historical narrative: the original gilded age broken up by the stock market crash of 1929 and the New Deal, the “golden age” of social democracy from 1930 to 1980, and the return of the gilded age in recent decades.

Piketty also points out that the wealthy in our era earn their incomes from different sources than was the case early in the twentieth century. In the early decades of the century, the wealthy received most of their income from capital gains—that is, by earnings from stocks and bonds rather than from salaries and wages. In the parlance of the day, they were “coupon clippers,” passively receiving income from investments. In the contemporary era, the wealthy are increasingly professionals who earn generous salaries from executive positions. Today, more than half of the total income

of the top 1 percent is received in the form of salaries. These are people who work for a living and depend upon salaries to pay their bills and accumulate wealth.

Piketty focuses a good deal of attention on the so-called “new salaried rich”—those who earn salaries of between \$300,000 and \$1 million per year as executives in businesses, financial firms, colleges and universities, and not-for-profit organizations. He does not believe that they genuinely earn these salaries on the basis of their contributions to the profitability or efficiency of the organizations they run; rather, he suggests, they set their own salaries, or recruit board members who support generous compensation packages, and in general receive high pay packages as members of a “club” with wealthy associates and directors.

The evidence for these claims is thin and impressionistic. Nevertheless, from his point of view, they justify much higher tax rates on members of the new managerial class, particularly since he believes that the lower marginal tax rates of the post-1980 decades have created a permissive environment for boards of directors that set salaries for executives. In the old days, with a 91 percent marginal tax rate, it did not make a lot of sense for boards to approve overly generous salaries, since most of the added increment went to the federal government in the form of taxes. High marginal tax rates thus tended to keep executive salaries down. Today, the logic is different: with low marginal rates, salaried professionals can keep most of their raises.

As one would expect from these figures, there are now significant differences among different segments of the national economy in mean household incomes and net worth. In 2010, as depicted in table 1.1, the mean household income of the top 1 percent was \$1.3 million while the bottom 40 percent received on average about \$17,000. The disparities are even greater for household net worth, measured in terms of ownership of real estate and financial assets.

TABLE 1.1. Income and net worth in the US by percentile (2010 dollars, averages)

Wealth or Income Class	Mean Household Income	Mean Household Net Worth	Mean Household Financial (Non-Home) Wealth
Top 1%	\$1,318,200	\$16,439,400	\$15,171,600
80th to 99th%	107,000	1,295,600	1,010,800
60th to 80th%	72,000	216,900	100,700
40th to 60th%	41,700	61,000	12,200
Bottom 40%	17,300	(10,600)	(14,800)

Note: Only mean figures are available, not medians. Note that income and wealth are separate measures; so, for example, the top 1 percent of income-earners is not exactly the same group of people as the top 1 percent of wealth-holders, although there is considerable overlap.

Source: Edward Wolff, “The Asset Price Meltdown and the Wealth of the Middle Class,” August 26, 2012, table 4

Data source: Survey on Consumer Finances

It is hard to quibble with Piketty and his associates in their claim that inequalities in wealth and income are substantial and growing decade by decade.

Piketty and Saez argue that these patterns justify aggressive national policies to redistribute income through higher taxes on the wealthy. Though the argument is logical, there are several problems with it.

First, though the very wealthy have gained in terms of shares of income and wealth, they have also been paying a larger share of the income tax in the United States. From 1979–2010, the tax liability on the top 1 percent has increased sharply, even as we have reduced marginal tax rates. In 1979, the highest earners paid federal taxes at a marginal rate of 70 percent. Ronald Reagan (and a Democratic Congress) reduced that rate to 50 percent in 1981 and then later to 28 percent. Nevertheless, the share of federal income taxes paid by the top 20 percent of the income distribution increased from 65 percent in 1979 to 93 percent by 2010. The top 1 percent paid 17 percent of income taxes in 1979 but 37 percent in 2010.

Today, then, the top 20 percent of the income distribution pays nearly the whole of our federal income taxes. As we have reduced marginal rates, we have also taken those below the median income completely off the federal income tax rolls (they are still hit with payroll taxes). This, then, points to one of the difficulties in redistributive taxation: there is not a lot of room to raise taxes on “the rich.” They are already paying the lion’s share of the income tax. It also points to the political difficulty in trying to cut taxes: any tax cut will disproportionately favor the wealthy because they are the ones already paying the taxes.

Second, it is not at all clear that we can reduce inequality very much through the income tax system. In theory, taxpayers would send money to Washington, DC, and from there the political authorities would allocate it to those who need it for the purpose of equalizing incomes. But that is not the way the political system actually operates. Money sent to Washington must pass through a gantlet of interest groups seeking concentrated benefits for their members. In the struggle for funds, the politically influential groups usually win out over disorganized voters seeking small and widely dispersed benefits. In addition, the immediate beneficiaries of the national tax system appear to be those living in or around the nation’s capital. Five of the six wealthiest counties in the United States surround Washington. The capital already has the highest per capita income of any metropolitan region in the country. Under current circumstances, a tax increase on the wealthy would merely redistribute income from the top 1 percent to the next 2 percent or 3 percent of the income distribution.

It is true that there is some “real” money in the top income groups. The top 1 percent paid about \$400 billion in federal taxes in 2010, leaving them with about \$1.1 trillion in after-tax income. It might be possible to gain another \$100 billion to \$200 billion by raising their taxes by another 10 percent or 20 percent. That is not

a large sum in relation to a federal budget of close to \$4 trillion, but it would represent a significant proportion of the current federal deficit of \$400 billion to \$500 billion. But, for reasons stated above, it is unlikely that those added revenues would eventually end up where Piketty and his colleagues think they should.

An obvious limitation of the income tax is that it does not get at the extraordinary accumulations of wealth held by individuals like Warren Buffett, Bill Gates, and other members of the Forbes 400. Governments tax incomes, but not wealth. The very wealthy own a disproportionate share of these assets. According to some estimates, the wealthiest 1 percent own close to half of the \$80 trillion to \$90 trillion value of the stock, bond, and residential real estate markets.

As a remedy for this problem, Piketty advocates a global “wealth tax” on the “super-wealthy,” with that tax levied against assets in stocks, bonds, and real estate. He acknowledges that such a tax has little chance of being enacted, though he hopes that at some point it might be enacted to cover the countries in the European Union. The United States has never had a wealth tax; and in fact such a tax may not be allowed under the Constitution (which authorizes taxes on incomes). Several European countries—Germany, Finland, and Sweden among them—have had such a tax in the past, but have discontinued it. France currently has a wealth tax that tops out at a rate of 1.5 percent on assets in excess of ten million Euros (or about \$14 million).

Wealth taxes are notoriously difficult to collect, and they encourage capital flight, hiding of assets, and disputes over pricing of assets. They require individuals to sell assets to pay taxes, thereby causing asset values to fall. Piketty thinks that a capital tax would have to be global in nature to guard against both capital flight and the hiding of assets in foreign accounts. It would also require a new international banking regime under which major banks would be required to disclose account information to

national treasuries. Under his scheme, a tax would be imposed on a sliding scale beginning at 1 percent on modest fortunes (roughly between \$1.5 million and \$7 million) and perhaps reaching as high as 10 percent on “super fortunes” in excess of \$1 billion annually. The purpose of the tax, it should be stressed, is to reduce inequality, not to spend the new revenues on beneficial public purposes.

Professor Piketty argues in the broader message of his book that we are living through a new “gilded age” of extravagant wealth and lavish expenditures enjoyed by a narrow elite at the expense of everyone else. As with the original “gilded age” of the late nineteenth century, the wealth accruing to the few gives the illusion of progress and prosperity, but conceals growing hardships and economic difficulties endured by the rest of the population. Much of his thesis rests upon this proposition: our era is one of faux prosperity, a claim that is manifestly untrue.

This argument makes sense only if one accepts the narrow premise that these multifaceted regimes can be assessed on the basis of the single criterion of wealth and income distribution or that the essence of the capitalist order is found solely in returns to capital and in the distribution of wealth and incomes rather than in rising living standards, innovation, and the spread of modern civilization. In each of these three eras, there was much more going on than simply the rearranging of wealth and incomes.

No less an authority than John Maynard Keynes looked back upon the pre-war era in Europe as a “golden age” of capitalism. “What an extraordinary episode in the economic progress of man that age was which came to an end in August, 1914,” he wrote in 1919 in *The Economic Consequences of the Peace*. He marveled at the economic progress made across the continent after 1870 following the unification of Germany. Industry and population grew steadily as trade across the continent accelerated, widening the sphere of prosperity and the reach of modern comforts. In the United States, rapid growth, stable prices, and high real wages drew millions of

immigrants from Europe to build railroads, work in factories, and industrialize the country. Far-reaching innovations—electricity, the telegraph, mass-produced steel, and motorcars—drove the industrial process forward and made a few people very rich. It was the first era of globalization and open trade. These three factors—innovation, emigration toward emerging centers of wealth, and widening circles of trade—have been key elements of “golden ages” throughout history, and especially in the modern age of capitalism. This particular golden age ended in 1914 in Europe and in 1929 in the United States.

The so-called “golden age” of social democracy has much to commend it; one should not gainsay the genuine economic and social progress achieved in the United States and elsewhere during the middle decades of the century. Nevertheless, the virtues of that era can be overstated. As Piketty acknowledges, much of the accumulated capital of the preceding era was wiped out by war and depression. The confiscatory tax rates of that era, with marginal rates as high as 91 percent in the United States in the 1940s and 1950s, may have equalized incomes to some degree but they also discouraged effort and held back risk-taking and innovation. The impressive growth rates of the 1950s and 1960s developed from a depressed base and built out innovations from the earlier period. Labor unions grew and won impressive wage gains for members, but mainly because (in the United States) they were bargaining with domestic oligopolies in the auto, steel, railroad, aluminum, and other industries. The structure of American industry was highly concentrated which, in the opinion of some, impeded innovation. Economist John Kenneth Galbraith wrote that cartelization was a permanent feature of the US economy. There was little immigration into the United States and Western Europe between 1930 and 1970. Most importantly for the distribution of wealth, the US stock market barely moved in real terms between 1930 and 1980; in 1980,

the Dow Jones Industrial Average was at a lower level (adjusted for inflation) than at its peak in 1929.

The high tax regime of that era collapsed in the 1970s, not because “the rich” dismantled it, but because government spending and regulation brought with them more crime, dependency, and disorder, along with simultaneously growing rates of unemployment and inflation. It was Jimmy Carter who first led the charge to deregulate the airline, railroad, trucking, and communications industries. Democrats and Republicans alike agreed that the US economy was suffering from a shortage of capital—and that tax rates should be reduced to promote capital formation. That approach succeeded, as we have seen. At the same time, US leaders pushed successfully for the elimination of trade barriers and a more open international trading system.

One might echo Keynes’s comments about the pre-war era in Europe in reflecting upon the era through which we have lived from the 1980s to the present. This has been, as some have called it, the “age of Reagan”—an era defined by the tax and regulatory reforms he put in place during the 1980s. Far from being a gilded age, it appears from a broader perspective to have been a new golden age of capitalism, marked by life-changing innovations in technology, globalized markets, and widening circles of trade, unprecedented levels of immigration into centers of prosperity, the absence of major wars, rising living standards around the world, falling inflation and interest rates, and a thirty-year bull market in stocks, bonds, and real estate. At the same time, the boom in financial assets and real estate has also enriched the endowments of colleges, universities, and foundations, along with pension and retirement funds upon which millions of households depend.

These developments broke up the concentrated structure of the US economy, making it more open, competitive, and innovative. At the same time, corporate profits are far higher now than in the age

of industrial concentration and oligopoly. The end of the Cold War and the entrance of China into the world economy similarly broke open the structure of world politics and finance that dominated the middle decades of the century. Meanwhile, levels of poverty and inequality around the world have declined dramatically over the past three decades. Though some have won incredible riches in this new age of capitalism, they have done so by developing new products and technologies of benefit to everyone, or by investing in enterprises that earn profits by satisfying customers.

Keynes once remarked that the challenge in such a situation is to keep “the boom” going, not to bring it to a premature end out of a superstition that those who have prospered must be punished by high taxes and self-defeating regulations. Those errors have been made in the past, most recently in the 1930s. Our golden age is going to end sooner or later, but much sooner if Professor Piketty and his supporters have their way.

This is because our main challenge is not in the area of inequality but in sustaining the economic growth that is the real solution to stagnating middle-class incomes. Economic growth has

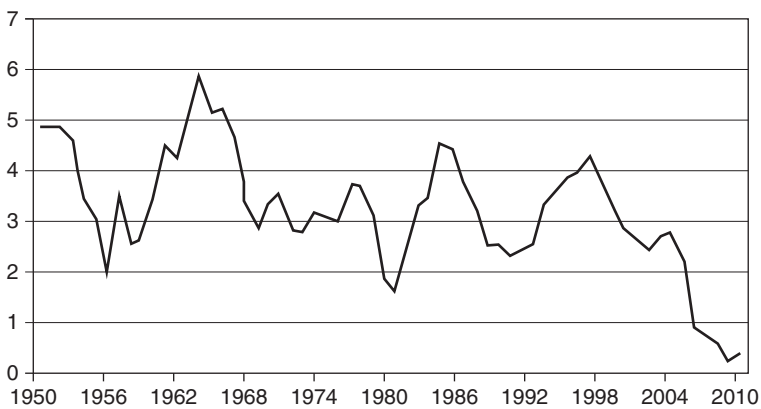


FIGURE 1.4. Annual five-year moving average real GDP growth (%) 1950–2011

Source: Bureau of Economic Activity

been slowing decade by decade in the United States and across the industrial world, and particularly since the year 2000. The stock market boom of recent decades has sustained the wealth and incomes of the top 1 percent, but it has done little for the living standards of the middle and working classes.

This point is illustrated more clearly in figure 1.4, which displays the pattern of real GDP per capita economic growth from 1950 through 2011. The pattern is displayed in five-year moving averages in order to remove the “noise” of year-to-year changes so that the long-term trend can be seen more clearly. As the chart suggests, the US economy has gone through three extended boom periods over the past sixty-plus years: the first in the 1960s, the second in the 1980s, and a third in the 1990s. Yet each recovery has been less robust in GDP growth than its predecessor. In between, the nation has gone through periods of sluggish growth, including an extended one in the 1970s that set the stage for the fairly robust recoveries of the Reagan and Clinton years. From the late 1990s onward, the pattern has been steadily downward, and much more sharply and for much longer than in previous sluggish periods.

The United States may have an inequality problem, but more fundamentally it has a “growth” problem. A stagnant America, lacking growth and broad opportunities for advancement and achievement, would represent something new and dangerous for a nation whose ideals and institutions have been built upon a foundation of growth and prosperity. The emphasis on inequality and redistribution, while not wrong, is nevertheless misplaced, for it may lead us to adopt policies that will disrupt the progress we have made while doing nothing to promote the kind of growth that is essential to national progress.

