

# Defending the One Percent

N. Gregory Mankiw

**I**magine a society with perfect economic equality. Perhaps out of sheer coincidence, the supply and demand for different types of labor happen to produce an equilibrium in which everyone earns exactly the same income. As a result, no one worries about the gap between the rich and poor, and no one debates to what extent public policy should make income redistribution a priority. Because people earn the value of their marginal product, everyone has the appropriate incentive to provide the efficient amount of effort. The government is still needed to provide public goods, such as national defense, but those are financed with a lump-sum tax. There is no need for taxes that would distort incentives, such as an income tax, because they would be strictly worse for everyone. The society enjoys not only perfect equality but also perfect efficiency.

Then, one day, this egalitarian utopia is disturbed by an entrepreneur with an idea for a new product. Think of the entrepreneur as Steve Jobs as he develops the iPod, J. K. Rowling as she writes her Harry Potter books, or Steven Spielberg as he directs his blockbuster movies. When the entrepreneur's product is introduced, everyone in society wants to buy it. They each part with, say, \$100. The transaction is a voluntary exchange, so it must make both the buyer and the seller better off. But because there are many buyers and only one seller, the distribution of economic well-being is now vastly unequal. The new product makes the entrepreneur much richer than everyone else.

The society now faces a new set of questions: How should the entrepreneurial disturbance in this formerly egalitarian outcome alter public policy? Should public policy remain the same, because the situation was initially acceptable and

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the entrepreneur improved it for everyone?<sup>2</sup> Or should government policymakers deplore the resulting inequality and use their powers to tax and transfer to spread the gains more equally?

In my view, this thought experiment captures, in an extreme and stylized way, what has happened to US society over the past several decades. Since the 1970s, average incomes have grown, but the growth has not been uniform across the income distribution. The incomes at the top, especially in the top 1 percent, have grown much faster than average. These high earners have made significant economic contributions, but they have also reaped large gains. The question for public policy is what, if anything, to do about it.

This development is one of the largest challenges facing the body politic. A few numbers illustrate the magnitude of the issue. The best data we have on the upper tail of the income distribution come from Piketty and Saez's (2003, with updates) tabulations of individual tax returns. (Even these numbers, though, are subject to some controversy: the tax code changes over time, altering the incentives to receive and report compensation in alternative forms.) According to their numbers, the share of income, excluding capital gains, earned by the top 1 percent rose from 7.7 percent in 1973 to 17.4 percent in 2010. Even more striking is the share earned by the top 0.01 percent—an elite group that, in 2010, had a membership requirement of annual income exceeding \$5.9 million. This group's share of total income rose from 0.5 percent in 1973 to 3.3 percent in 2010. These numbers are not easily ignored. Indeed, they in no small part motivated the Occupy movement, and they have led to calls from policymakers on the left to make the tax code more progressive.

At the outset, it is worth noting that addressing the issue of rising inequality necessarily involves not just economics but also a healthy dose of political philosophy. We economists must recognize not only the limits of what we know about inequality's causes, but also the limits on the ability of our discipline to prescribe policy responses. Economists who discuss policy responses to increasing inequality are often playing the role of amateur political philosopher (and, admittedly, I will do so in this essay). Given the topic, that is perhaps inevitable. But it is useful to keep in mind when we are writing as economists and when we are venturing beyond the boundaries of our professional expertise.

## **Is Inequality Inefficient?**

It is tempting for economists who abhor inequality to suggest that the issue involves not just inequality per se, but also economic inefficiency. Discussion of inequality necessarily involves our social and political values, but if inequality also entails inefficiency, those normative judgments are more easily agreed upon. The Pareto criterion is the clearest case: if we can make some people better off without making anyone worse off, who could possibly object? Yet for the question at hand, this criterion does not take us very far. As far as I know, no one has proposed any

credible policy intervention to deal with rising inequality that will make everyone, including those at the very top, better off.

More common is the claim that inequality is inefficient in the sense of shrinking the size of the economic pie. (That is, inefficiency is being viewed through the lens of the Kaldor–Hicks criterion.) If the top 1 percent is earning an extra \$1 in some way that reduces the incomes of the middle class and the poor by \$2, then many people will see that as a social problem worth addressing. For example, suppose the rising income share of the top 1 percent were largely attributable to successful rent-seeking. Imagine that the government were to favor its political allies by granting them monopoly power over certain products, favorable regulations, or restrictions on trade. Such a policy would likely lead to both inequality and inefficiency. Economists of all stripes would deplore it. I certainly would.

Joseph Stiglitz's (2012) book, *The Price of Inequality*, spends many pages trying to convince the reader that such rent-seeking is a primary driving force behind the growing incomes of the rich. This essay is not the place for a book review, but I can report that I was not convinced. Stiglitz's narrative relies more on exhortation and anecdote than on systematic evidence. There is no good reason to believe that rent-seeking by the rich is more pervasive today than it was in the 1970s, when the income share of the top 1 percent was much lower than it is today.

I am more persuaded by the thesis advanced by Claudia Goldin and Lawrence Katz (2008) in their book *The Race between Education and Technology*. Goldin and Katz argue that skill-biased technological change continually increases the demand for skilled labor. By itself, this force tends to increase the earnings gap between skilled and unskilled workers, thereby increasing inequality. Society can offset the effect of this demand shift by increasing the supply of skilled labor at an even faster pace, as it did in the 1950s and 1960s. In this case, the earnings gap need not rise and, indeed, can even decline, as in fact occurred. But when the pace of educational advance slows down, as it did in the 1970s, the increasing demand for skilled labor will naturally cause inequality to rise. The story of rising inequality, therefore, is not primarily about politics and rent-seeking, but rather about supply and demand.

To be sure, Goldin and Katz focus their work on the broad changes in inequality, not on the incomes of the top 1 percent in particular. But it is natural to suspect that similar forces are at work. The income share of the top 1 percent exhibits a U-shaped pattern: falling from the 1950s to the 1970s, and rising from the 1970s to the present. The earnings differentials between skilled and unskilled workers studied by Goldin and Katz follow a similar U-shaped pattern. If Goldin and Katz are right that the broad changes in inequality have been driven by the interaction between technology and education, rather than changes in rent-seeking through the political process, then it would seem an unlikely coincidence that the parallel changes at the top have been driven by something entirely different. Rather, it seems that changes in technology have allowed a small number of highly educated and exceptionally talented individuals to command superstar incomes in ways that were not possible a generation ago. Erik Brynjolfsson and Andrew McAfee (2011) advance this thesis forcefully in their book *Race Against the Machine*. They write,

“Aided by digital technologies, entrepreneurs, CEOs, entertainment stars, and financial executives have been able to leverage their talents across global markets and capture reward that would have been unimaginable in earlier times (p. 44).”

Nonetheless, to the extent that Stiglitz is right that inefficient rent-seeking is a driving force behind rising inequality, the appropriate policy response is to address the root cause. It is at best incomplete and at worst misleading to describe the situation as simply “rising inequality,” because inequality here is a symptom of a deeper problem. A progressive system of taxes and transfers might make the outcome more equal, but it would not address the underlying inefficiency. For example, if domestic firms are enriching themselves at the expense of consumers through quotas on imports (as is the case with some agribusinesses), the solution to the problem entails not a revision of the tax code, but rather a change in trade policy. I am skeptical that such rent-seeking activities are the reason why inequality has risen in recent decades, but I would support attempts to reduce whatever rent-seeking does occur.

An especially important and particularly difficult case is the finance industry, where many hefty compensation packages can be found. On the one hand, there is no doubt that this sector plays a crucial role. Those who work in commercial banks, investment banks, hedge funds, and other financial firms are in charge of allocating capital and risk, as well as providing liquidity. They decide, in a decentralized and competitive way, which firms and industries need to shrink and which will be encouraged to grow. It makes sense that a nation would allocate many of its most talented and thus highly compensated individuals to this activity. On the other hand, some of what occurs in financial firms does smack of rent-seeking: when a high-frequency trader figures out a way to respond to news a fraction of a second faster than a competitor, the vast personal reward may well exceed the social value of what is produced. Devising a legal and regulatory framework to ensure that we get the right kind and amount of financial activity is a difficult task. While the solution may well affect the degree of equality and the incomes of the 1 percent, the issue is primarily one of efficiency. A well-functioning economy needs the correct allocation of talent. The last thing we need is for the next Steve Jobs to forgo Silicon Valley in order to join the high-frequency traders on Wall Street. That is, we shouldn’t be concerned about the next Steve Jobs striking it rich, but we want to make sure he strikes it rich in a socially productive way.

## **Equality of Opportunity as a Desideratum**

Closely related to the claim of inefficiency is concern about inequality of opportunity. Equality of opportunity is often viewed as a social goal in itself, but economists recognize that the failure to achieve such equality would normally lead to inefficiency as well. If some individuals are precluded from pursuing certain paths in life, then they might be unable to contribute fully to growing the economic pie. To be specific, if children from poor families are unable to continue their education because of financial constraints, they do not accumulate the optimal amount of

human capital. The outcome from underinvestment in education is both unequal and inefficient.

Measuring the degree of equality of opportunity is difficult. In his book, Stiglitz (2012) proposes a metric: the intergenerational transmission of income. He writes (p. 18), “If America were really a land of opportunity, the life chances of success—of, say, winding up in the top 10 percent—of someone born to a poor or less educated family would be the same as those of someone born to a rich, well-educated, and well-connected family.” In other words, under this definition of equality of opportunity, people’s earnings would be uncorrelated with those of their parents. Needless to say, in the data, that is not at all the case, which leads Stiglitz to conclude that we are falling short of providing equal opportunity.

Yet the issue cannot be settled so easily, because the intergenerational transmission of income has many causes beyond unequal opportunity. In particular, parents and children share genes, a fact that would lead to intergenerational persistence in income even in a world of equal opportunities. IQ, for example, has been widely studied, and it has a large degree of heritability. Smart parents are more likely to have smart children, and their greater intelligence will be reflected, on average, in higher incomes. Of course, IQ is only one dimension of talent, but it is easy to believe that other dimensions, such as self-control, ability to focus, and interpersonal skills, have a degree of genetic heritability as well.

This is not to say that we live in a world of genetic determinism, for surely we do not. But it would be a mistake to go to the other extreme and presume no genetic transmission of economic outcomes. A recent survey of the small but growing field of genoconomics by Benjamin et al. (2012) reports, “Twin studies suggest that economic outcomes and preferences, once corrected for measurement error, appear to be about as heritable as many medical conditions and personality traits.” Similarly, in his study of the life outcomes of adopted children, Sacerdote (2007) writes, “While educational attainment and income are frequently the focus of economic studies, these are among the outcomes least affected by differences in family environment.” (He reports that family background exerts a stronger influence on social variables, such as drinking behavior.) This evidence suggests that it is implausible to interpret generational persistence in income as simply a failure of society to provide equal opportunities. Indeed, Sacerdote estimates (in his table 5) that while 33 percent of the variance of family income is explained by genetic heritability, only 11 percent is explained by the family environment. The remaining 56 percent includes environmental factors unrelated to family. If this 11 percent figure is approximately correct, it suggests that we are not far from a plausible definition of equality of opportunity—that is, being raised by the right family does give a person a leg up in life, but family environment accounts for only a small percentage of the variation in economic outcomes compared with genetic inheritance and environmental factors unrelated to family.

To the extent that our society deviates from the ideal of equality of opportunity, it is probably best to focus our attention on the left tail of the income distribution rather than on the right tail. Poverty entails a variety of socioeconomic maladies,

and it is easy to believe that children raised in such circumstances do not receive the right investments in human capital. By contrast, the educational and career opportunities available to children of the top 1 percent are, I believe, not very different from those available to the middle class. My view here is shaped by personal experience. I was raised in a middle-class family; neither of my parents were college graduates. My own children are being raised by parents with both more money and more education. Yet I do not see my children as having significantly better opportunities than I had at their age.

In the end, I am led to conclude that concern about income inequality, and especially growth in incomes of the top 1 percent, cannot be founded primarily on concern about inefficiency and inequality of opportunity. If the growing incomes of the rich are to be a focus of public policy, it must be because income inequality is a problem in and of itself.

## The Big Tradeoff

In the title of his celebrated book, Arthur Okun (1975) told us that the “big tradeoff” that society faces is between equality and efficiency. We can use the government’s system of taxes and transfers to move income from the rich to the poor, but that system is a “leaky bucket.” Some of the money is lost as it is moved. This leak should not stop us from trying to redistribute, Okun argued, because we value equality. But because we are also concerned about efficiency, the leak will stop us before we fully equalize economic resources.

The formal framework that modern economists use to address this issue is that proposed by Mirrlees (1971). In the standard Mirrlees model, individuals get utility from consumption  $C$  and disutility from providing work effort  $L$ . They differ only according to their productivity  $W$ . In the absence of government redistribution, each person’s consumption would be  $WL$ . Those with higher productivity would have higher consumption, higher utility, and lower marginal utility.

The government is then introduced as a benevolent social planner with the goal of maximizing total utility in society (or, sometimes, a more general social welfare function that could depend nonlinearly on individual utilities). The social planner wants to move economic resources from those with high productivity and low marginal utility to those with lower productivity and higher marginal utility. Yet this redistribution is hard to accomplish, because the government is assumed to be unable to observe productivity  $W$ ; instead, it observes only income  $WL$ , the product of productivity and effort. If it redistributes income too much, high-productivity individuals will start to act as if they are low-productivity individuals. Public policymakers are thus forced to forgo the first-best egalitarian outcome for a second-best incentive-compatible solution. Like a government armed with Okun’s leaky bucket, the Mirrleesian social planner redistributes to some degree but also allows some inequality to remain.

If this framework is adopted, then the debate over redistribution turns to questions about key parameters. In particular, optimal redistribution depends on the

degree to which work effort responds to incentives. If the supply of effort is completely inelastic, then the bucket has no leak, and the social planner can reach the egalitarian outcome. If the elasticity is small, the social planner can come close. But if work effort responds substantially to incentives, then the bucket is more like a sieve, and the social planner should attempt little or no redistribution. Thus, much debate among economists about optimal redistribution centers on the elasticity of labor supply.

Even if one is willing to accept the utilitarian premise of this framework, there is good reason to be suspicious of particular numerical results that follow from it. When researchers implement the Mirrlees model, they typically assume, as Mirrlees did, that all individuals have the same preferences. People are assumed to differ only in their productivity. For purposes of illustrative theory, that assumption is fine, but it is also false. Incomes differ in part because people have different tastes regarding consumption, leisure, and job attributes. Acknowledging variation in preferences weakens the case for redistribution (Lockwood and Weinzierl 2012). For example, many economics professors could have pursued higher-income career paths as business economists, software engineers, or corporate lawyers. That they chose to take some of their compensation in the form of personal and intellectual freedom rather than cold cash is a personal lifestyle choice, not a reflection of innate productivity. Those who made the opposite choice may have done so because they get greater utility from income. A utilitarian social planner will want to allocate greater income to these individuals, even apart from any incentive effects.

Another problem with the Mirrlees framework as typically implemented is that it takes a simplistic approach to tax incidence. Any good introductory student of economics knows that when a good or service is taxed, the buyer and seller share the burden. Yet in the Mirrlees framework, when an individual's labor income is taxed, only the seller of the services is worse off. In essence, the demand for labor services is assumed to be infinitely elastic. A more general set of assumptions would acknowledge that the burden of the tax is spread more broadly to buyers of those services (and perhaps to sellers of complementary inputs as well). In this more realistic setting, tax policy would be a less well-targeted tool for redistributing economic well-being.

The harder and perhaps deeper question is whether the government's policy toward redistribution is best viewed as being based on a benevolent social planner with utilitarian preferences. That is, did Okun and Mirrlees provide economists with the right starting point for thinking about this issue? I believe there are good reasons to doubt this model from the get-go.

## The Uneasy Case for Utilitarianism

For economists, the utilitarian approach to income distribution comes naturally. After all, utilitarians and economists share an intellectual tradition: early utilitarians, such as John Stuart Mill, were also among the early economists. Also, utilitarianism seems to extend the economist's model of individual decision making



to the societal level. Indeed, once one adopts the political philosophy of utilitarianism, running a society becomes yet another problem of constrained optimization. Despite its natural appeal (to economists, at least), the utilitarian approach is fraught with problems.

One classic problem is the interpersonal comparability of utility. We can infer an individual's utility function from the choices that individual makes when facing varying prices and levels of income. But from this revealed-preference perspective, utility is not inherently measurable, and it is impossible to compare utilities across people. Perhaps advances in neuroscience will someday lead to an objective measure of happiness, but as of now, there is no scientific way to establish whether the marginal dollar consumed by one person produces more or less utility than the marginal dollar consumed by a neighbor.

Another more concrete problem is the geographic scope of the analysis. Usually, analyses of optimal income redistribution are conducted at the national level. But there is nothing inherent in utilitarianism that suggests such a limitation. Some of the largest income disparities are observed between nations. If a national system of taxes and transfers is designed to move resources from Palm Beach, Florida, to Detroit, Michigan, shouldn't a similar international system move resources from the United States and Western Europe to sub-Saharan Africa? Many economists do support increased foreign aid, but as far as I know, no one has proposed marginal tax rates on rich nations as high as the marginal tax rates imposed on rich individuals. Our reluctance to apply utilitarianism at the global level should give us pause when applying it at the national level.

In a 2010 paper, Matthew Weinzierl and I emphasized another reason to be wary of utilitarianism: it recommends a greater use of "tags" than most people feel comfortable with. As Akerlof (1978) pointed out, if the social planner can observe individual characteristics that are correlated with productivity, then an optimal tax system should use that information, in addition to income, in determining an individual's tax liability. The more the tax system is based on such fixed characteristics rather than income, the less it will distort incentives. Weinzierl and I showed that one such tag is height. Indeed, the correlation between height and wages is sufficiently strong that the optimal tax on height is quite large. Similarly, according to the utilitarian calculus, the tax system should also make a person's tax liability a function of race, gender, and perhaps many other exogenous characteristics. Of course, few people would embrace the idea of a height tax, and Weinzierl and I did not offer it as a serious policy proposal. Even fewer people would be comfortable with a race-based income tax (although Alesina, Ichin, and Karabarbounis, 2011, propose in earnest a gender-based tax). Yet these implications cannot just be ignored. If you take from a theory only the conclusions you like and discard the rest, you are using the theory as a drunkard uses a lamp post—for support rather than illumination. If utilitarianism takes policy in directions that most people don't like, then perhaps it is not a sound foundation for thinking about redistribution and public policy.

Finally, in thinking about whether the utilitarian model really captures our moral intuitions, it is worth thinking for a moment about the first-best outcome for



a utilitarian social planner. Suppose, in contrast to the Mirrlees model, the social planner could directly observe productivity. In this case, the planner would not need to worry about incentives, but could set taxes and transfers based directly on productivity. The optimal policy would equalize the marginal utility of consumption across individuals; if the utility function is assumed to be additively separable in consumption and leisure, this means everyone consumes the same amount. But because some people are more productive than others, equalizing leisure would not be optimal. Instead, the social planner would require more-productive individuals to work more. Thus, in the utilitarian first-best allocation, the more-productive members of society would work more and consume the same as everyone else. In other words, in the allocation that maximizes society's total utility, the less-productive individuals would enjoy a higher utility than the more productive.

Is this really the outcome we would want society to achieve if it could? A true utilitarian would follow the logic of the model and say "yes." Yet this outcome does not strike me as the ideal toward which we should aspire, and I suspect most people would agree. Even young children have an innate sense that merit should be rewarded (Kanngiesser and Warneken 2012)—and I doubt it is only because they are worried about the incentive effects of not doing so. If I am right, then we need a model of optimal government taxes and transfers that departs significantly from conventional utilitarian social planning.

## **Listening to the Left**

In recent years, the left side of the political spectrum has focused much attention on the rising incomes of the top 1 percent. This includes President Obama's proposals to raise taxes on higher incomes, the Occupy Wall Street movement, and a rash of books about economic inequality. Even though I don't share the Left's policy conclusions, I find it is worthwhile to listen carefully to their arguments to discern what set of philosophical principles and empirical claims underlie their concerns.

It is, I believe, hard to square the rhetoric of the Left with the economist's standard framework. Someone favoring greater redistribution along the lines of Okun and Mirrlees would argue as follows: "The rich earn higher incomes because they contribute more to society than others do. However, because of diminishing marginal utility, they don't get much value from their last few dollars of consumption. So we should take some of their income away and give it to less-productive members of society. While this policy would cause the most productive members to work less, shrinking the size of the economic pie, that is a cost we should bear, to some degree, to increase utility for society's less-productive citizens."

Surely, that phrasing of the argument would not animate the Occupy crowd! So let's consider the case that the Left makes in favor of greater income redistribution. There are three broad classes of arguments.

The first is the suggestion that the tax system we now have is regressive. Most famously, during the presidential campaign of 2008, at a fund-raiser for Hillary

Clinton, the billionaire investor Warren E. Buffett said that the rich were not paying enough. Mr. Buffett used himself as an example. He asserted that his taxes in the previous year equaled only 17.7 percent of his taxable income, while his receptionist paid about 30 percent of her income in taxes (Tse 2007). In 2011, President Obama proposed the “Buffett rule,” which would require taxpayers with income over a million dollars to pay at least 30 percent of their income in federal income taxes.

There are, however, good reasons to be skeptical of Buffett’s calculations. If his receptionist was truly a middle-income taxpayer, then to get her tax rate to 30 percent, he most likely added the payroll tax to the income tax. Fair enough. But for Buffett’s tax rate to be only 17.7 percent, most of his income was likely dividends and capital gains, and his calculation had to ignore the fact that this capital income was already taxed at the corporate level. A complete accounting requires aggregating not only all taxes on labor income but also all taxes on capital income.

The Congressional Budget Office (2012) does precisely that when it calculates the distribution of the federal tax burden—and it paints a very different picture than did Buffett’s anecdote. In 2009, the most recent year available, the poorest fifth of the population, with average annual income of \$23,500, paid only 1.0 percent of its income in federal taxes. The middle fifth, with income of \$64,300, paid 11.1 percent. And the top fifth, with income of \$223,500, paid 23.2 percent. The richest 1 percent, with an average income of \$1,219,700, paid 28.9 percent of its income to the federal government. To be sure, some taxpayers aggressively plan to minimize taxes, and this may result in some individual cases where those with high incomes pay relatively little in federal taxes. But the CBO data make clear that these cases are the exceptions. As a general rule, the existing federal tax code is highly progressive.

A second type of argument from the Left is that the incomes of the rich do not reflect their contributions to society. In the standard competitive labor market, a person’s earnings equal the value of his or her marginal productivity. But there are various reasons that real life might deviate from this classical benchmark. If, for example, a person’s high income results from political rent-seeking rather than producing a valuable product, the outcome is likely to be both inefficient and widely viewed as inequitable. Steve Jobs getting rich from producing the iPod and Pixar movies does not produce much ire among the public. A Wall Street executive benefiting from a taxpayer-financed bailout does.

The key issue is the extent to which the high incomes of the top 1 percent reflect high productivity rather than some market imperfection. This question is one of positive economics, but unfortunately not one that is easily answered. My own reading of the evidence is that most of the very wealthy get that way by making substantial economic contributions, not by gaming the system or taking advantage of some market failure or the political process. Take the example of pay for chief executive officers. Without doubt, CEOs are paid handsomely, and their pay has grown over time relative to that of the average worker. Commentators on this phenomenon sometimes suggest that this high pay reflects the failure of corporate boards of directors to do their job. Rather than representing shareholders, the argument goes, boards are too cozy with the CEOs and pay them more than they are worth to their organizations.

Yet this argument fails to explain the behavior of closely-held corporations. A private equity group with a controlling interest in a firm does not face the alleged principal-agent problem between shareholders and boards, and yet these closely-held firms also pay their CEOs handsomely. Indeed, Kaplan (2012) reports that over the past three decades, executive pay in closely-held firms has outpaced that in public companies. Cronqvist and Fahlenbrach (2013) find that when public companies go private, the CEOs tend to get paid more rather than less in both base salaries and bonuses. In light of these facts, the most natural explanation of high CEO pay is that the value of a good CEO is extraordinarily high (a conclusion that, incidentally, is consistent with the model of CEO pay proposed by Gabaix and Landier 2008).

A third argument that the Left uses to advocate greater taxation of those with higher incomes is that the rich benefit from the physical, legal, and social infrastructure that government provides and, therefore, should contribute to supporting it. As one prominent example, President Obama (2012) said in a speech, “If you were successful, somebody along the line gave you some help. There was a great teacher somewhere in your life. Somebody helped to create this unbelievable American system that we have that allowed you to thrive. Somebody invested in roads and bridges. If you’ve got a business—you didn’t build that. Somebody else made that happen. The Internet didn’t get invented on its own. Government research created the Internet so that all the companies could make money off the Internet. The point is that when we succeed, we succeed because of our individual initiative, but also because we do things together.”

In the language of traditional public finance, President Obama was relying less on the ability-to-pay principle and more on the benefits principle. That is, higher taxation of the rich is not being justified by the argument that their marginal utility of consumption is low, as it is in the frameworks of Okun and Mirrlees. Rather, higher taxation is being justified by the claim that the rich achieved their wealth in large measure because of the goods and services the government provides and therefore have a responsibility to finance those goods and services.

This line of argument raises the empirical question of how large the benefit of government infrastructure is. The average value is surely very high, as lawless anarchy would leave the rich (as well as most everyone else) much worse off. But like other inputs into the production process, government infrastructure should be valued at the margin, where the valuation is harder to discern. As I pointed out earlier, the average person in the top 1 percent pays more than one-quarter of income in federal taxes, and about one-third if state and local taxes are included. Why isn’t that enough to compensate for the value of government infrastructure?

A relevant fact here is that, over time, an increasing share of government spending has been for transfer payments, rather than for purchases of goods and services. Government has grown as a percentage of the economy not because it is providing more and better roads, more and better legal institutions, and more and better educational systems. Rather, government has increasingly used its power to tax to take from Peter to pay Paul. Discussions of the benefits of government services should not distract from this fundamental truth.

In the end, the Left's arguments for increased redistribution are valid in principle but dubious in practice. If the current tax system were regressive, or if the incomes of the top 1 percent were much greater than their economic contributions, or if the rich enjoyed government services in excess of what they pay in taxes, then the case for increasing the top tax rate would indeed be strong. But there is no compelling reason to believe that any of these premises holds true.

## **The Need for an Alternative Philosophical Framework**

A common thought experiment used to motivate income redistribution is to imagine a situation in which individuals are in an "original position" behind a "veil of ignorance" (as in Rawls 1971). This original position occurs in a hypothetical time before we are born, without the knowledge of whether we will be lucky or unlucky, talented or less talented, rich or poor. A risk-averse person in such a position would want to buy insurance against the possibility of being born into a less-fortunate station in life. In this view, governmental income redistribution is an enforcement of the social insurance contract to which people would have voluntarily agreed in this original position.

Yet take this logic a bit further. In this original position, people would be concerned about more than being born rich or poor. They would also be concerned about health outcomes. Consider kidneys, for example. Most people walk around with two healthy kidneys, one of which they do not need. A few people get kidney disease that leaves them without a functioning kidney, a condition that often cuts life short. A person in the original position would surely sign an insurance contract that guarantees him at least one working kidney. That is, he would be willing to risk being a kidney donor if he is lucky, in exchange for the assurance of being a transplant recipient if he is unlucky. Thus, the same logic of social insurance that justifies income redistribution similarly justifies government-mandated kidney donation.

No doubt, if such a policy were ever seriously considered, most people would oppose it. A person has a right to his own organs, they would argue, and a thought experiment about an original position behind a veil of ignorance does not vitiate that right. But if that is the case, and I believe it is, it undermines the thought experiment more generally. If imagining a hypothetical social insurance contract signed in an original position does not supersede the right of a person to his own organs, why should it supersede the right of a person to the fruits of his own labor?

An alternative to the social insurance view of the income distribution is what, in Mankiw (2010), I called a "just deserts" perspective. According to this view, people should receive compensation congruent with their contributions. If the economy were described by a classical competitive equilibrium without any externalities or public goods, then every individual would earn the value of his or her own marginal product, and there would be no need for government to alter the resulting income distribution. The role of government arises as the economy departs from this classical benchmark. Pigovian taxes and subsidies are necessary to correct externalities,

and progressive income taxes can be justified to finance public goods based on the benefits principle. Transfer payments to the poor have a role as well, because fighting poverty can be viewed as a public good (Thurow 1971).

This alternative perspective on the income distribution is a radical departure from the utilitarian perspective that has long influenced economists, including Okun and Mirrlees. But it is not entirely new. It harkens back about a century to the tradition of “just taxation” suggested by Knut Wicksell (1896, translated 1958) and Erik Lindahl (1919, translated 1958). More important, I believe it is more consistent with our innate moral intuitions. Indeed, many of the arguments of the Left discussed earlier are easier to reconcile with the just-deserts theory than they are with utilitarianism. My disagreement with the Left lies not in the nature of their arguments, but rather in the factual basis for their conclusions.

The political philosophy one adopts naturally influences the kind of economic questions that are relevant for determining optimal policy. The utilitarian perspective leads to questions such as: How rapidly does marginal utility of consumption decline? What is the distribution of productivity? How much do taxes influence work effort? The just-deserts perspective focuses instead on other questions: Do the high incomes of the top 1 percent reflect extraordinary productivity, or some type of market failure? How are the benefits of public goods distributed across the income distribution? I have my own conjectures about the answers to these latter questions, and I have suggested them throughout this essay, but I am the first to admit that they are tentative. Fortunately, these are positive questions to which future economic research may provide more definitive answers.

To highlight the difference between these approaches, consider how each would address the issue of the top tax rate. In particular, why shouldn’t we raise the rate on high incomes to 75 percent, as France’s President Hollande has recently proposed, or to 91 percent, where it was through much of the 1950s in the United States? A utilitarian social planner would say that perhaps we should and would refrain from doing so only if the adverse incentive effects were too great. From the just-deserts perspective, such confiscatory tax rates are wrong, even ignoring any incentive effects. By this view, using the force of government to seize such a large share of the fruits of someone else’s labor is unjust, even if the taking is sanctioned by a majority of the citizenry.

In the final analysis, we should not be surprised when opinions about income redistribution vary. Economists can turn to empirical methods to estimate key parameters, but no amount of applied econometrics can bridge this philosophical divide. I hope my ruminations in this essay have convinced some readers to see the situation from a new angle. But at the very least, I trust that these thoughts offer a vivid reminder that fundamentally normative conclusions cannot rest on positive economics alone.

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