The Top 1%

ECON 499: Economics of Inquality

Winter 2018

Four questions:

- What is inequality?
- What causes inequality?
- What are the consequences of inequality?
- What can we do about inequality?

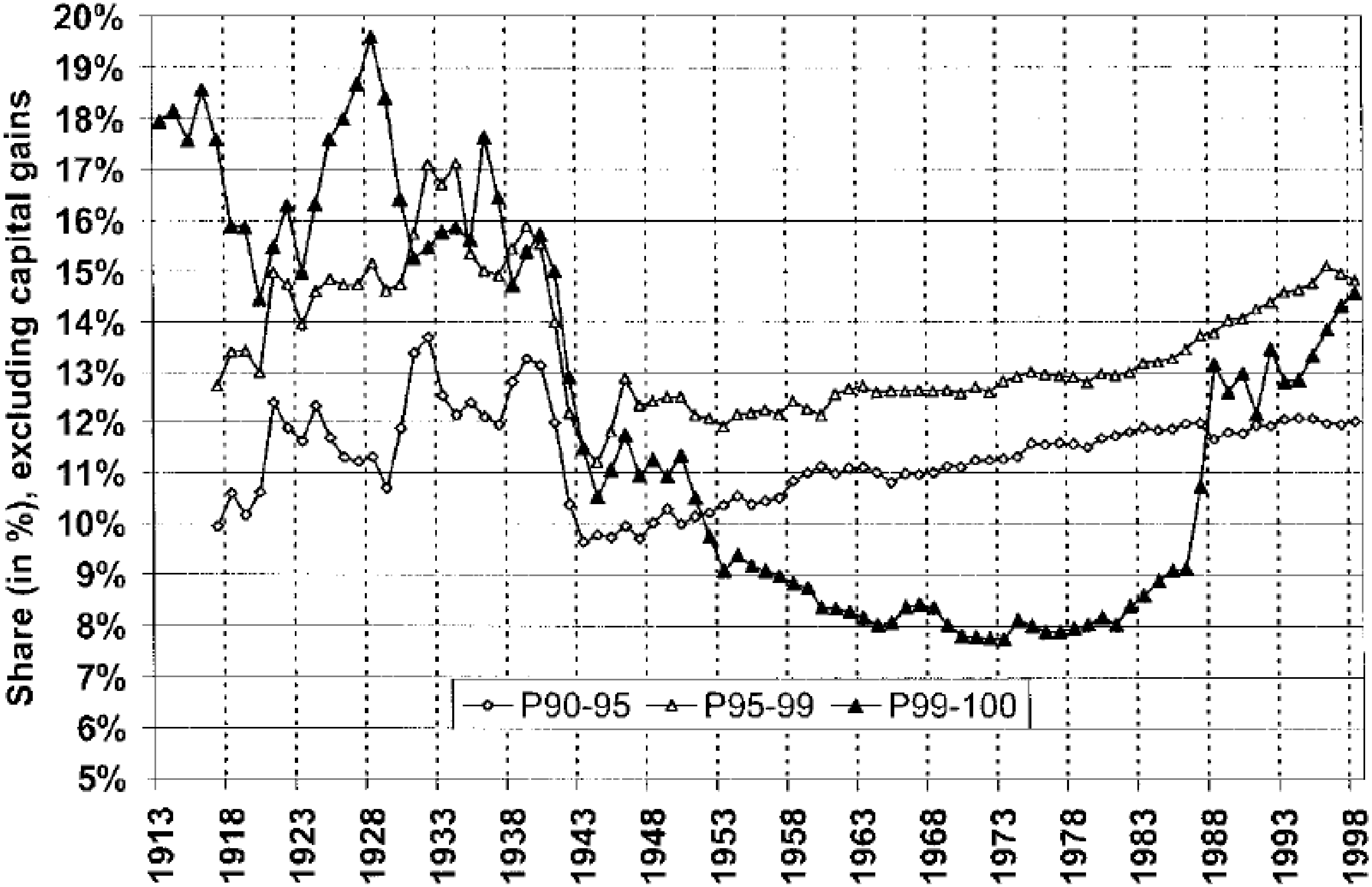


FIGURE II
The Income Shares of P90–95, P95–99, and P99–100, 1913–1998

What's causing top incomes to diverge?

- Piketty and Saez speculate that tax rates and "social attitudes" are responsible
- Do not provide conclusive evidence
- Other explanations: Political "capture," exploitation, fraud, skills, etc
- Matters for policy (LeBron James parable)

Kaplan and Rauh (2013)

- "It's the Market: The Broad-Based Rise in the Return to Top Talent"
- Does the top 1% "earn" their income, or do the get it though other means?

Economic rents

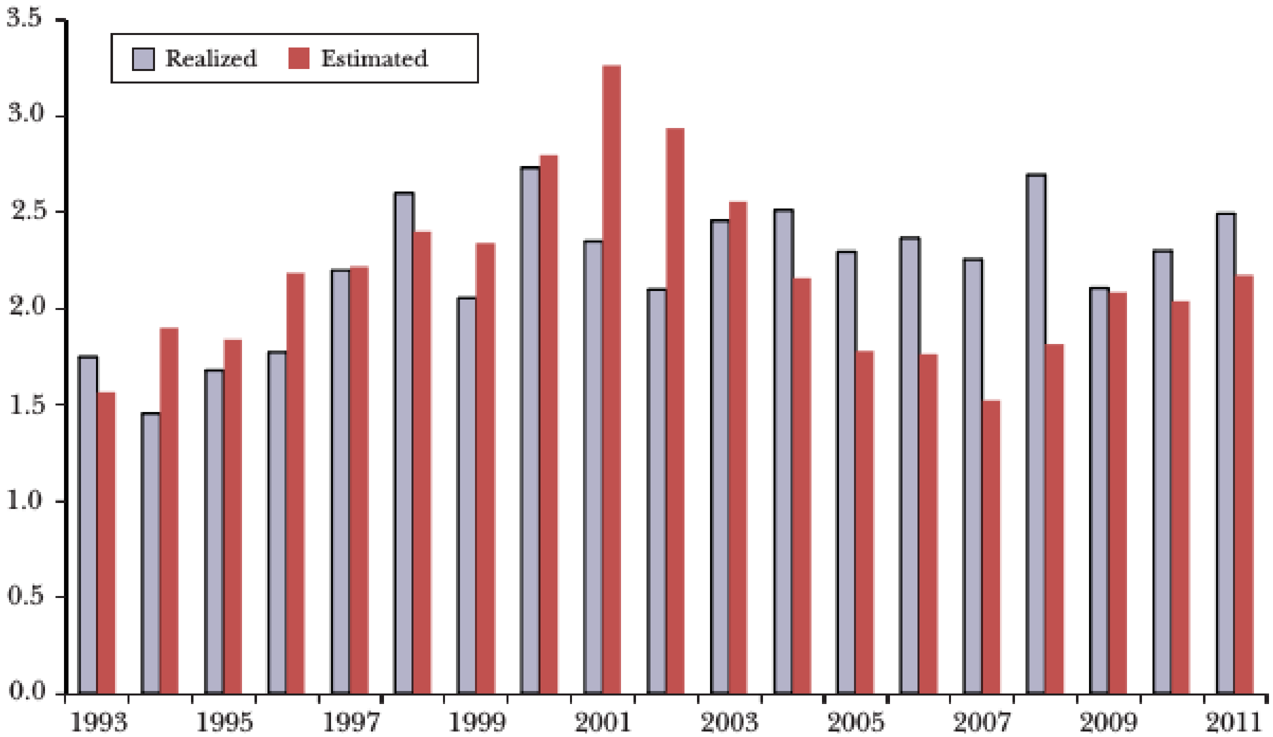
- Things that are used in production of goods and services are called *factors of production* (labor, machines, factories, etc)
- Factors are compensated because they are productive (wages, interest, etc)
- A payment received by a factor beyond what can be explained by their productivity is a **rent**
  - Examples: Occupational licensing, monopolies, patents
- A rent is wealth that is earned through a process that does not itself create wealth
- Are top wage earners very productive, or do they receive rents?

Executive power

- Top CEOs exert power over their companies and boards
- They might be able to use this power to pay themselves more than what they are otherwise worth (extract rents)
- If so, we expect CEO pay to diverge from other top earners
- This is not what we observe

Figure 2

Average Pay (Estimated and Realized) of S&P 500 Chief Executive Officers Relative to Average Adjusted Gross Income of Top 0.1% of Taxpayers from 1993 to 2011



Top CEOs

- It does not appear that executive pay is driving the change in top earnings
- Whatever the cause, it is affecting executives and their non-executive peers equally

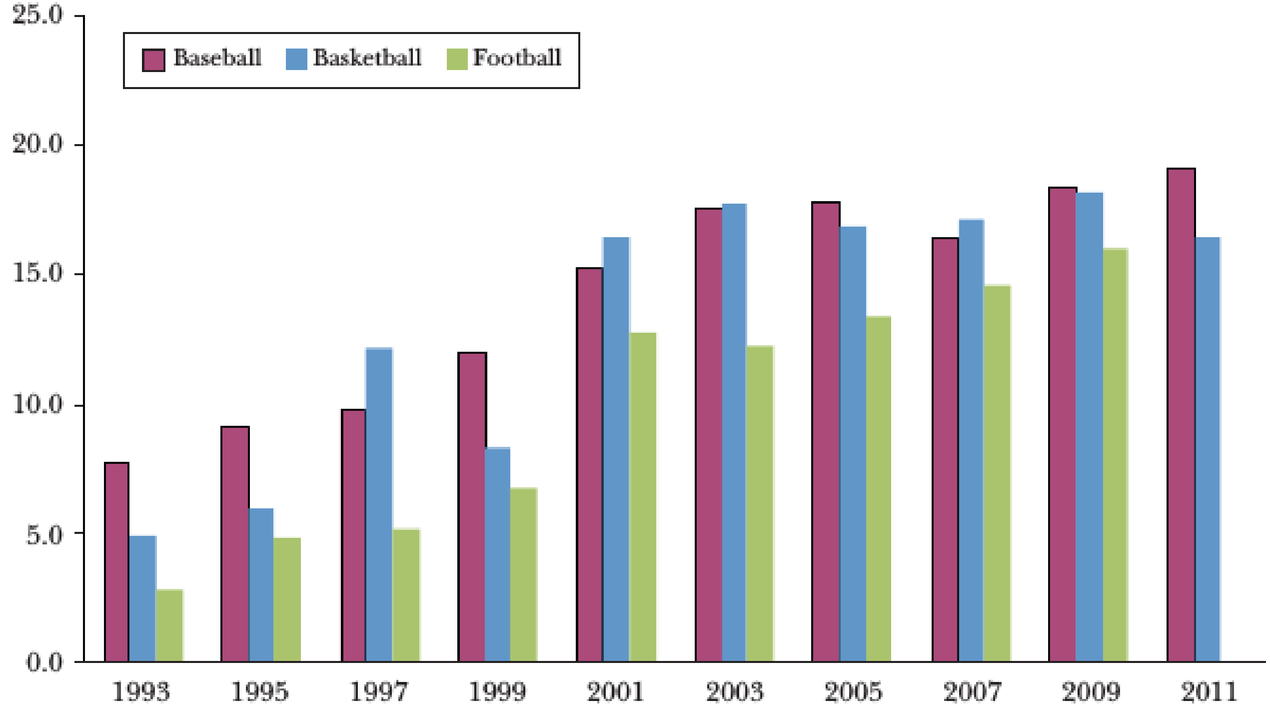
Other industries

- If CEOs are leveraging their power to get higher incomes, then their income should be rising faster than other high-payed workers
- Kaplan and Rauh consider hedge-fund managers, lawyers, and professional athletes
- Managerial power is unlikely to explain rises in all these professions

Table 1
Average Pay of Top Hedge Fund Managers and Law Partners

Year	***Average pay of top 25 hedge fund managers*** *(Millions of $2010 [and relative to average adjusted gross income of top 0.1%])*	***Average profit per partner at top 50 law firms*** *(Millions of $2010 [and relative to average adjusted gross income of top 0.1%])*
1994		$0.704 [0.268]
1996		$0.784 [0.219]
1998		$0.997 [0.200]
2000		$1.084 [0.167]
2002	$133.7 [34.6x]	$1.099 [0.285]
2004	$289.5 [55.7x]	$1.286 [0.247]
2006	$616.2 [90.3x]	$1.491 [0.218]
2008	$469.8 [82.1x]	$1.449 [0.253]
2010	$882.8 [177.6x]	$1.557 [0.313]
2012	$537.2 [115.7x]	

Figure 3
Average Top 25 Salaries in Professional Baseball, Basketball, and Football
(in millions of 2010 dollars)

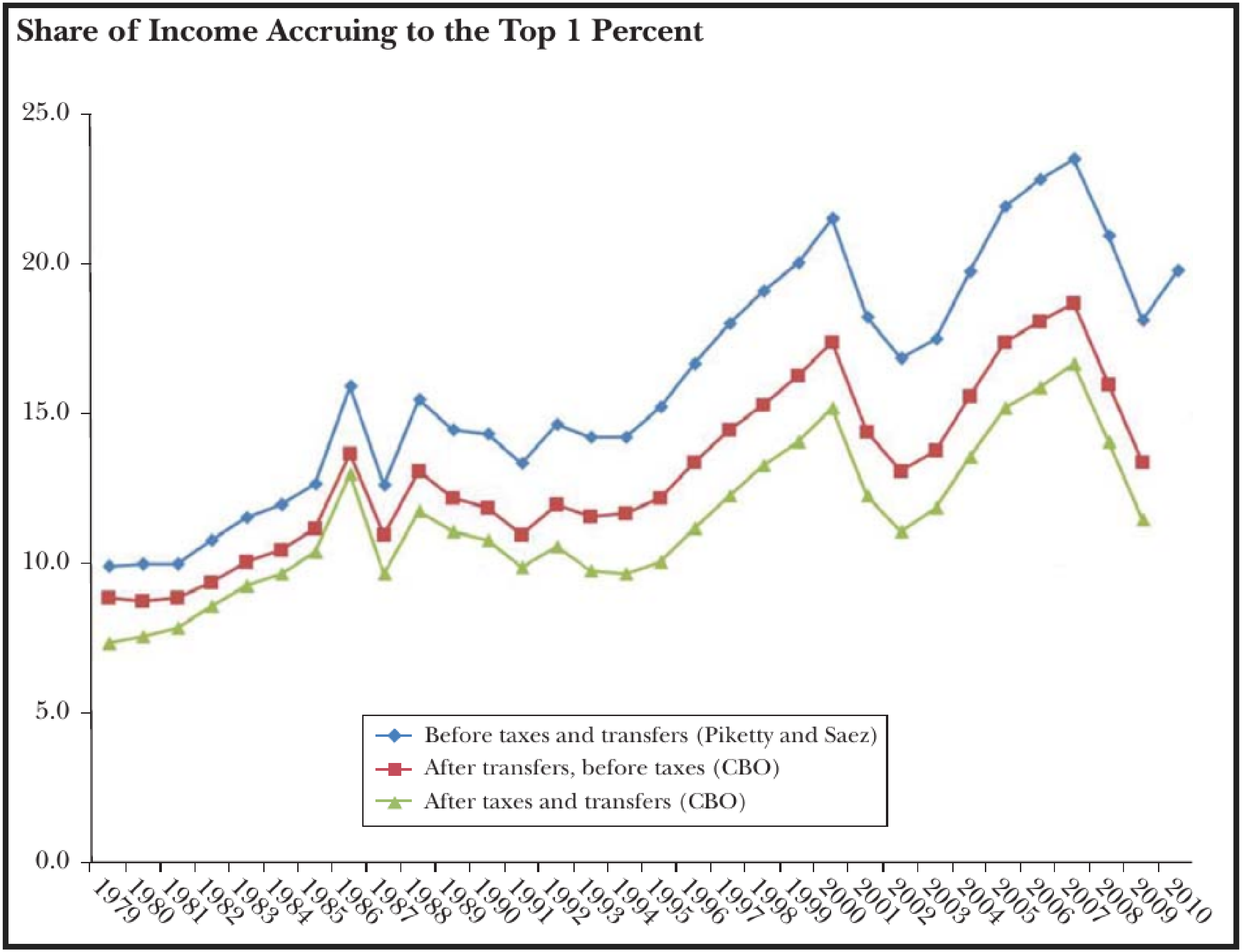


Kaplan and Rauh:

> *…the breadth of the occupations that have seen a rise in top income levels is much more consistent with the argument that the increase in "superstar" pay (or pay at the top) has been driven by the growth of information and communications technology, and the ways this technology allows individuals with particular skills that are in high demand to expand the scale of their performance*

Piketty and Saez top incomes

- Piketty and Saez measure top incomes at a "peak"
- Extended time series more volatile
- While increasing "by any measure," less severe when looking at longer time periods


Share of Income Accruing to the Top 1 Percent
25.0
20.0
15.0
10.0
5.0
0.0
1979
1980
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Before taxes and transfers (Piketty and Saez)
After transfers, before taxes (CBO)
After taxes and transfers (CBO)

Inherited wealth

- Do high income earners have an unfair advantage at birth?
- Can parents "buy" income for their children?
- Do the wealthy create institutions that prevent the non-wealthy from participating?

Figure 5

Generation of the Wealth-Creating Businesses of Forbes 400 Individuals in 1982, 1992, 2001, and 2011

(share among Forbes 400 individuals)

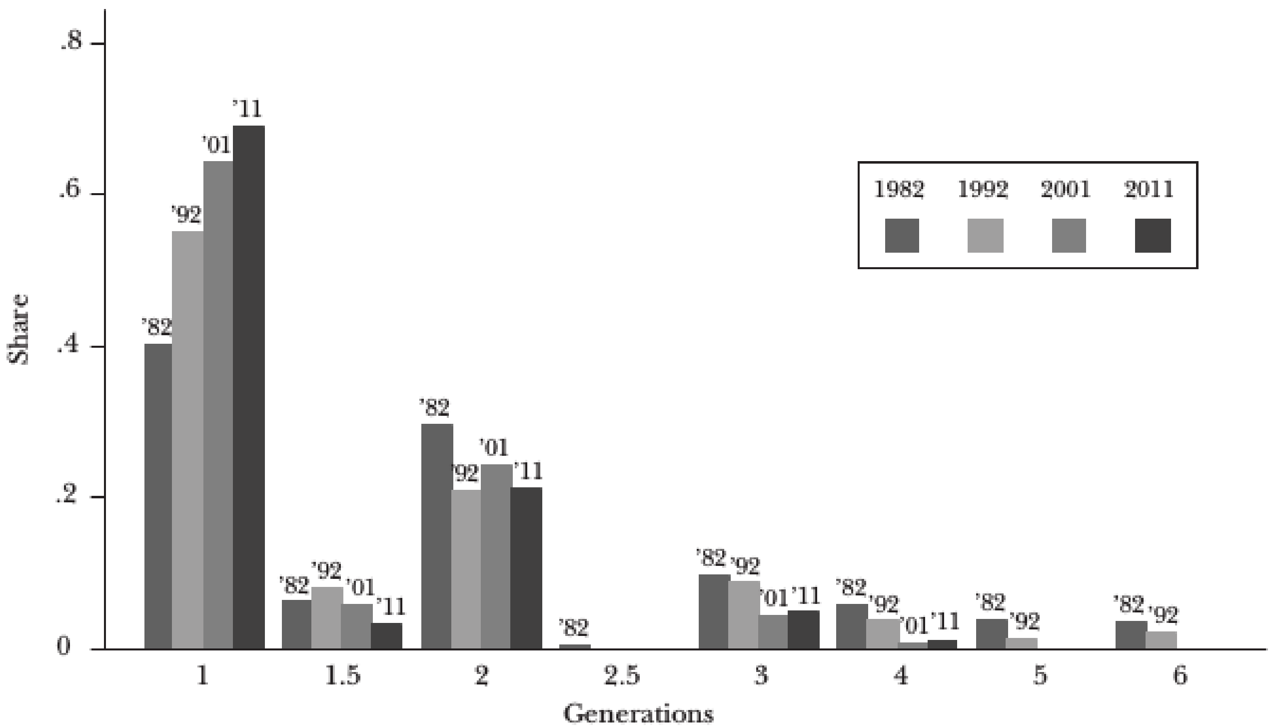


Figure 6

Did the Forbes 400 Grow Up Wealthy?

(share of Forbes 400 individuals for 1982, 1992, 2001, and 2011 with each upbringing)

Inherited wealth

- High income earners today are *less* likely have high-income parents than in the past
- However, they are *more* likely to have upper middle class parents
- No change in the number of top income earners from low-income backgrounds
- Very few of the wealthiest CEOs are from poor families
- High income earners have more education than in the past (much more on this later in the course)

Access to education

- Family wealth allows for parents to invest in education
- If top incomes are the results of skills, then education becomes more important
- Share of Forbes 400 who graduated college increased 77-87% between 1982 and 2011
- Share of those without any college dropped from 17% to 5%

Skills

- Most of the pay increase is in industries that require specialized skills
- Computers and IT require education, finance has become extremely complex
- Executives in these fields must be highly trained, oversee many other highly trained employees

Table 2

Categories of the Wealth-Creating Businesses behind the Forbes 400

(share of Forbes 400 businesses)

	1982	*1992*	*2001*	*2011*	*Change from 1982 to 2011*
Industrial					
Retail/Restaurant	0.053	0.118	0.132	0.150	+0.097
Technology–Computer	0.033	0.053	0.130	0.123	+0.090
Technology–Medical	0.005	0.018	0.021	0.023	+0.017
Consumer	0.131	0.174	0.125	0.108	–0.023
Media	0.136	0.132	0.164	0.100	–0.036
Diversified/Other	0.207	0.205	0.156	0.123	–0.084
Energy	0.214	0.089	0.062	0.098	–0.117
Finance and investments					
Hedge funds	0.005	0.011	0.018	0.075	+0.070
Private equity/leveraged buyout	0.018	0.034	0.039	0.068	+0.050
Money management	0.018	0.055	0.062	0.045	+0.027
Venture capital	0.003	0.005	0.008	0.015	+0.012
Real estate	0.179	0.105	0.081	0.075	–0.104

Family wealth

- Having (some) family wealth seems to be more important in the US than in other countries
- This might be due to education being more expensive, or education more rewarded in US markets

Figure 8

Did the Forbes Non-US Billionaires Grow Up Wealthy?

(share of Forbes non-US billionaires in 1987, 1992, 2001, and 2011 with each upbringing)

Bonica et al (2013)

- "Why Hasn't Democracy Slowed Rising Inequality?"
- Anecdotally, people seem to care as much (or more) about inequality today as in the past
- Why haven't voters demanded redistribution?
- Article written by prominent political scientists (in an economics journal)

Polarization

- Parties have become more extreme politically
- Moderate Republicans have left Congress, more conservative Republicans have entered
- Moderate Democrats have been replaced by Republicans, remaining Democrats move left on average
- Polarization closely correlated with inequality

Figure 1
Party Means on Liberal–Conservative Dimension for the US House of Representatives, 1879–2012

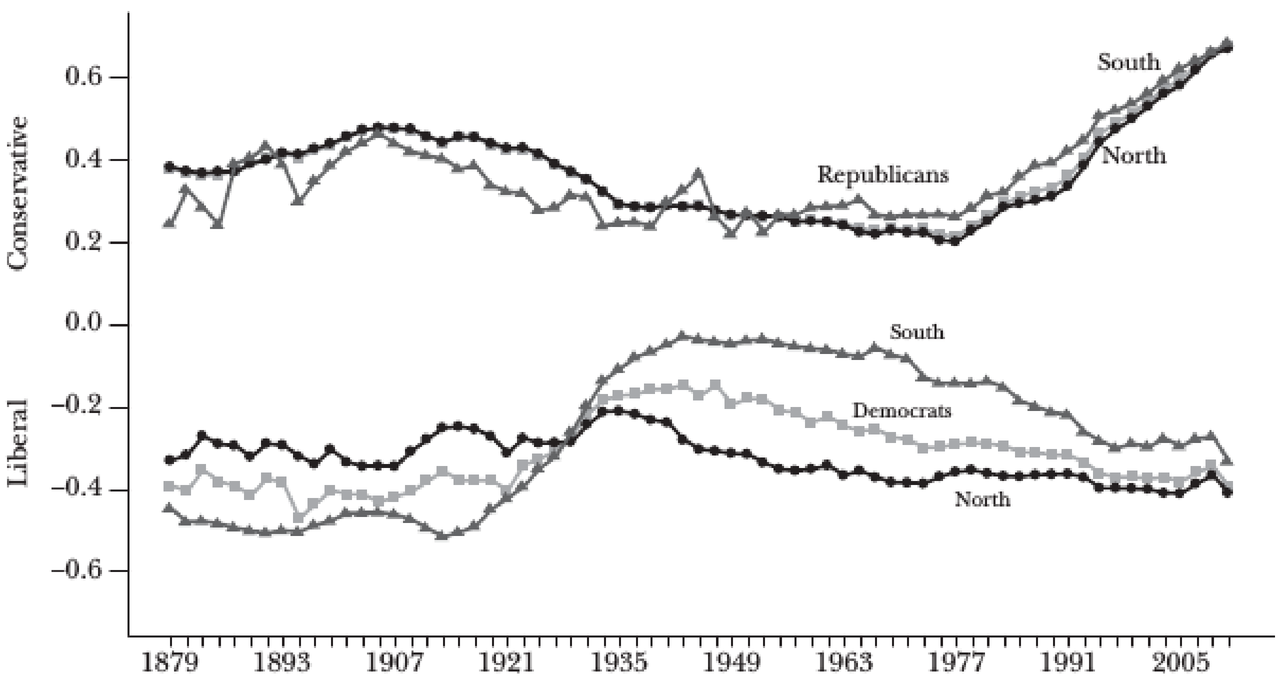
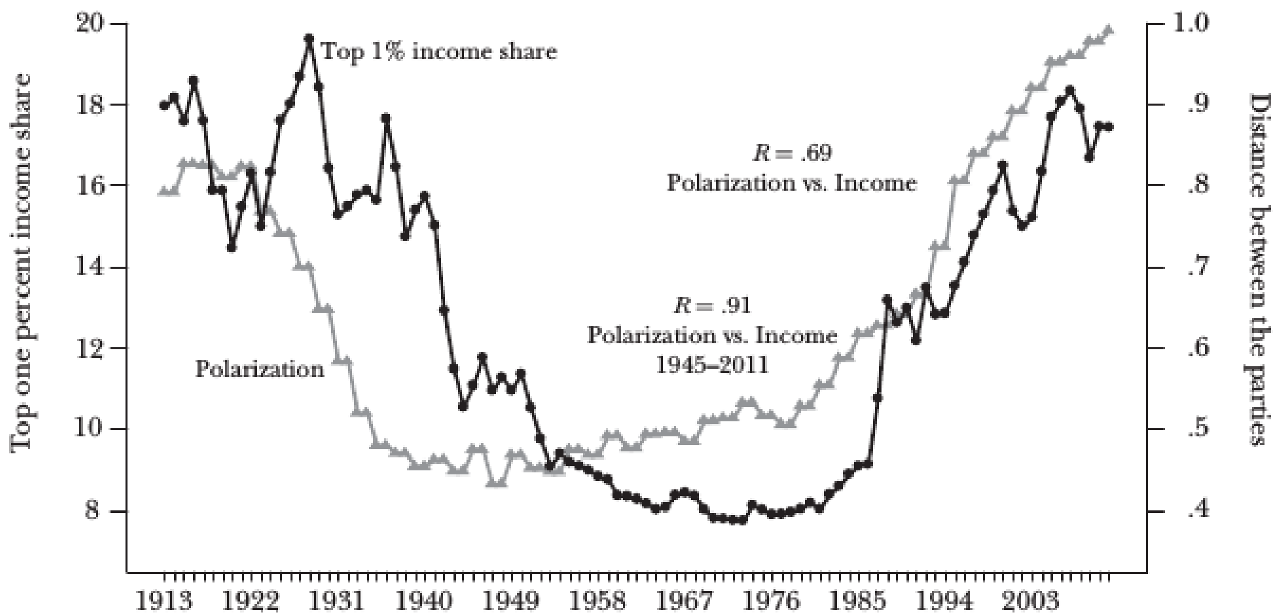


Figure 2

Top 1 Percent Income Share and Polarization in the US House of Representatives, 1913–2008



Causality?

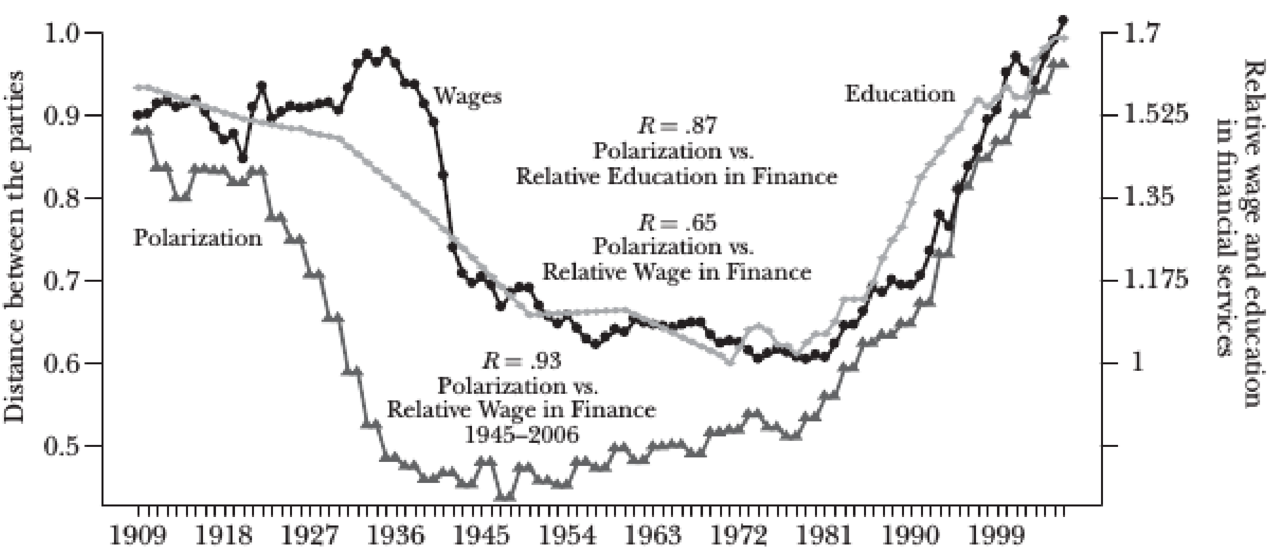
- Inequality could cause polarization to increase — wealthier people may have different political preferences than non-wealthy
- Polarization might cause inequality — more legislative gridlock, government less responsive to market changes that increase inequality
- A third factor might be causing both simultaneously

Deregulation

- Fewer financial regulations encourage highly-educated people to go into finance
- Educated people are more skilled, get higher wages
- Wages and education in finance closely correlated with polarization

Figure 3

Polarization in the House of Representatives, and Relative Wage and Education in Financial Services Sector, 1909–2006



Voting

- Wealthier people more likely to vote
- May be more likely to vote for policies that favor the wealthy
- Top 1% give more of their income to politicians, represent larger share of total political donations

Figure 4

Voter Turnout by Household Income and Citizenship, 2008 and 2010

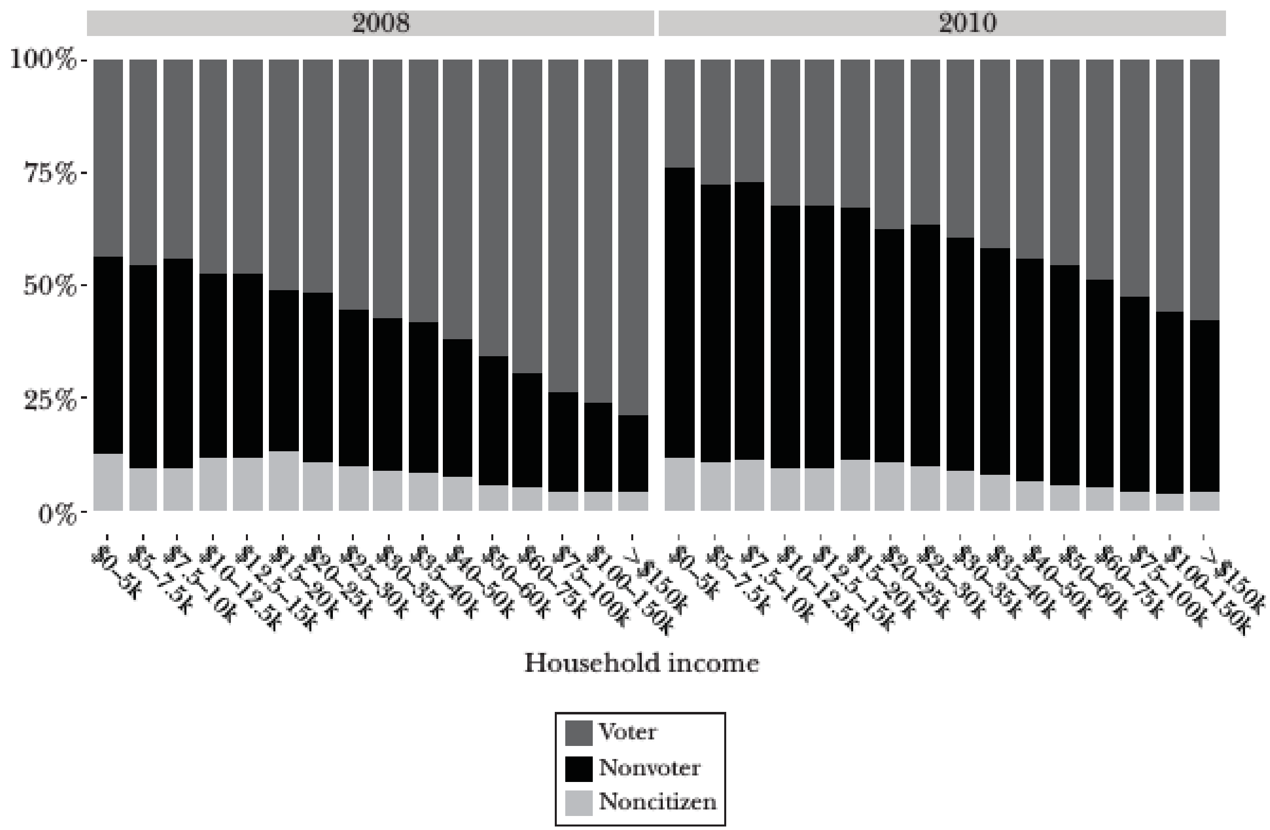
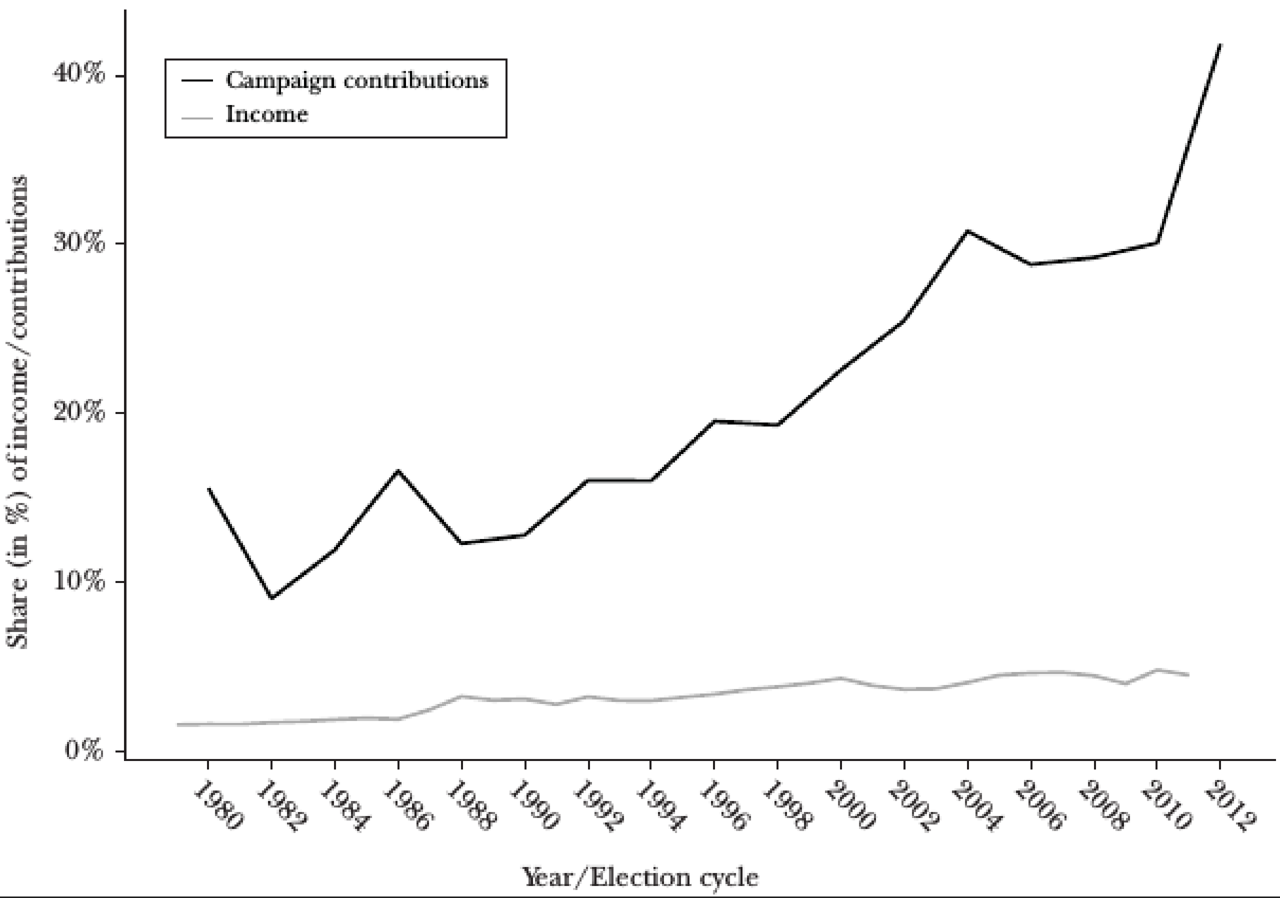


Figure 5

Concentration of Income and Campaign Contributions in the Top 0.01 Percent of Households and Voting Age Population

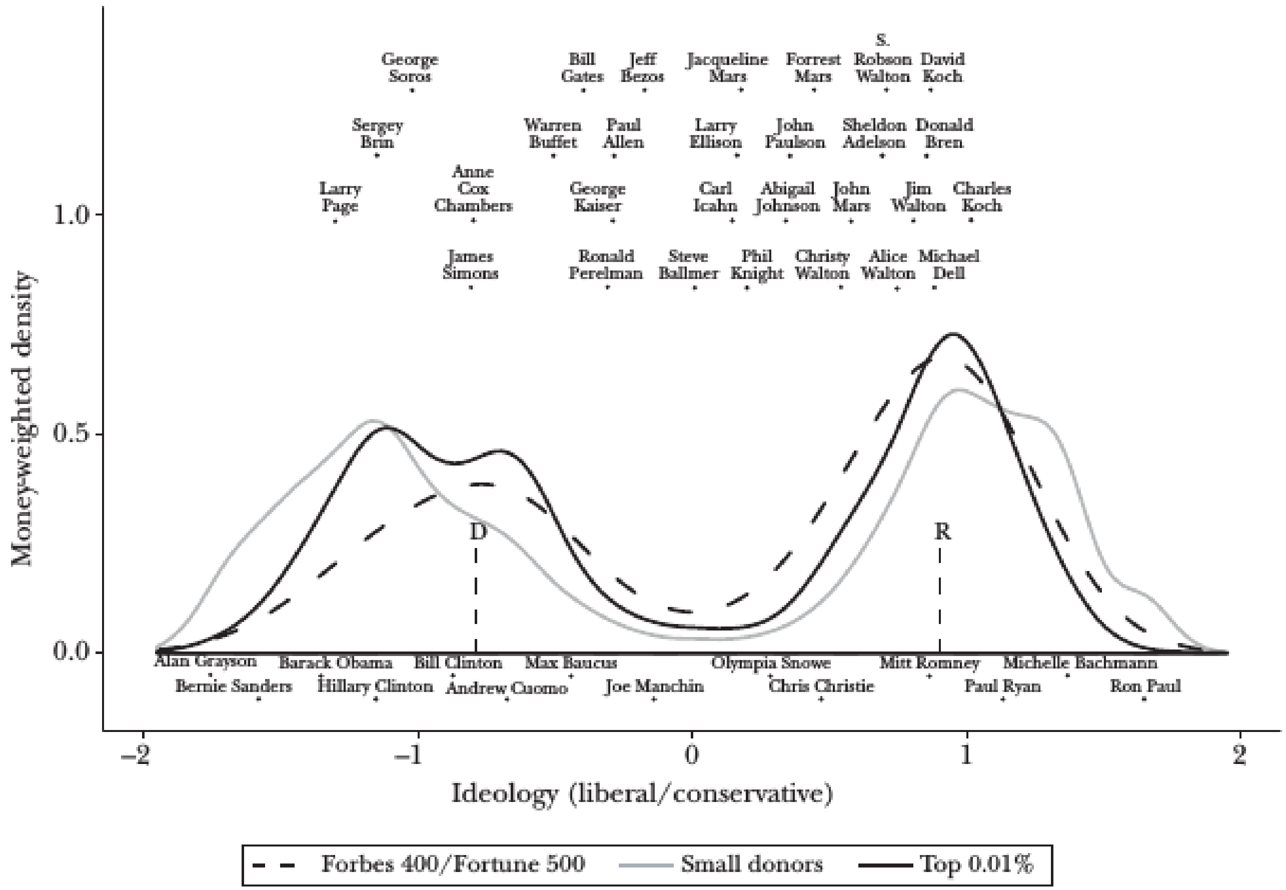


Left vs right?

- US political system is largely "winner-takes-all"
- If wealthy are affiliated with one party, then redistribution policies might be enacted if other party is in power
- If wealthy are in both parties, then neither party will support redistribution

Figure 7

The Ideological Distribution of Dollars from Small Donors and the Top 0.01 Percent



Summary

- Top incomes are largely driven by market forces, return to talent
- Top earners give more money to politicians than anyone else
- Top earners and donations are (for the most part) evenly distributed on the left-right divide
- Gridlock means government cannot respond to changes in market that give rise to inequality