What Thomas Piketty and Larry Summers Don't Tell You About Income Inequality

Interview of Lance Taylor by Lynn Parramore

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In a new paper for the Institute For New Economic Thinking's Working Group on the Political Economy of Distribution, economist Lance Taylor and his colleagues examine income inequality using new tools and models that give us a more nuanced — and frightening —picture than we've had before. Their simulation models show how so-called "reasonable" modifications like modest tax increases on the wealthy and boosting low wages are not going to be enough to stem the disproportionate tide of income rushing toward the rich. Taylor's research challenges the approaches of American policy makers, the assumptions of traditional economists, and some of the conclusions drawn by Thomas Piketty and Larry Summers. Bottom line: We're not yet talking about the kinds of major changes needed to keep us from becoming a Downton Abbey society.

Lynn Parramore: In America, the top 1 percent has steadily increased its income share while the rest are either treading water or sinking. Let's talk first about how you're measuring the problem of inequality.

Lance Taylor: I think we need some detail to really understand what's going on. So I look at inequality across low, middle and top groups. How does the share of income of the richest group compare to the others? Where do these groups get their income and what do they do with it? Is the middle getting squeezed? What's driving income towards the rich?

In the U.S., if you are in the bottom 50-60 percent group of households, your main sources of income are wages and, especially for the very bottom, government transfers like Medicaid and Social Security. In the reported data, this group has a negative savings rate, meaning that people spend more than they receive. Their average wealth is close to zero.

If you're in the "middle class" — households between the 61st and 99th percentiles — wages are your main income source, though you may get some capital income from interest and dividends. In recent decades, people in this group have been getting squeezed as income flows shift toward profits for business owners rather than wages for employees. The variation in wages has been increasing among this group as well. The middle class has positive saving rates and visible net worth, largely concentrated in housing.

If you're in the top one percent group, you get income from wages, with a lot of variability among individuals. But bigger chunks come from interest and dividends along with proprietors' incomes, like lawyers' fees and big farmers' subsidies and sales. These people have high saving rates and substantial wealth, including equity. The top group holds one-third of total equity in the U.S. and receives large capital gains. Their share of total disposable income (not including capital gains) has jumped by around ten percentage points since the mid-1980s. This is an enormous change in shares, very unusual in historical terms. The top group's income now exceeds three trillion dollars, one-fifth of the total.

The picture we get from making these comparisons can be captured in a ratio named for Gabriel Palma of the University of Cambridge, the "Palma ratio" which draws a contrast between the rich and poor. It tells us that in the U.S., the income per household of the top one percent compared to the bottom 40 percent has more than doubled since the 1980s, while incomes at the bottom were virtually flat. Compared to other rich countries, the ratio here is very high.

LP: Your research suggests that it's not just some natural process that's causing more wealth to flow towards the rich than the other two groups. How is it happening?

LT: There are three things happening that seem especially important to me: stratospheric CEO and executive pay, shrinkage in the wage slice of the total income pie due to various social and political forces, and a trend of higher capital gains or rising asset prices which benefits the rich. None of these factors is inevitable.

First, salaries at the very top shot up after 1980, as Thomas Piketty emphasizes. This was mostly among CEOs (along with other top executives) who get paid in eight figures with salaries and stock options. It's hard to explain skyrocketing executive pay on purely economic grounds. There is no reason to believe that top managers circa 2015 are more or less essential than, say, in 1975 when comparable pay was ten times lower. The best explanation I can come up with is that a social contract or unwritten law against exorbitant executive income has disappeared in the U.S. We'll only get it back by social consensus and/or seriously progressive taxation.

Second, people are working more productively, but they aren't getting paid for it. Since World War II, there have been predictable cycles in America (in a pattern for rich capitalist economies noted by Karl Marx 150 years ago). When we come out of a recession, productivity rises as firms make more use of labor already on the payroll. Wages, on the other hand, are stable. So business owners end up with more profits, and business activity picks up. The labor market gets tighter and eventually wages begin to catch up, cutting into profits, capital investment, and eventually, the total demand for goods and services in the economy.

In keeping with this cycle, real wages now may finally be creeping up after the Great Recession. But the bad news is that the overall wage share has been trending downward – another huge inequality jump. The reasons again are social and political. Three of the most obvious explanations of why real wage growth (adjusted for inflation) is failing to keep up with productivity are the impact of globalization, repression of labor activism and a stagnant minimum wage. Servaas Storm and C.W.M. Naastepad of the Delft University of Technology document how the U.S. ranks low on employment protection, expenditure on active labor market policy, and collective bargaining. Social attitudes and political decisions are the reasons why.

The third factor has to do with capital gains, or rising asset prices, a trend that mainly benefits people with high incomes. Asset prices are rising for a lot of reasons, like corporate share buybacks, which tend to pump up the price of shares in a way that benefits executives and others who hold a lot of company stock, low interest rates pegged by the Federal Reserve, and speculation. Equity price increases reduce business net worth on paper or increase debt for buybacks. But they are a visible income flow like interest and dividends for their recipients who also benefit because the U.S. tax rate on capital gains is low.

LP: Let's take a look at a couple of ideas that are popular right now, like raising the minimum wage and increasing taxes on the highest income brackets. How might these measures impact income inequality in America?

LT: How much could the top one percent "reasonably" be taxed? If we wanted to tax them as much as rich European countries do, we'd have to double their tax burden. The Obama administration is now floating an increase of about one percent of the top group's income. That's not going to do a lot for income inequality given how much richer the rich have gotten since 1980. A marginal tax rate around 60 percent, the Scandinavian norm, could do the trick, but putting it into place here seems highly unlikely. The same observation applies to higher capital gains taxation and Piketty's recommendation of a tax on wealth. It won't be enough.

Of course taxes could also be raised on less affluent households, but the prospects are not much better. Our models show that unless the U.S. tax/transfer system is made dramatically more progressive, adjustments around the edges will not have much impact on income inequality.

On the wage front, we looked at what would happen if you raised the wages 10 percent for the poorest 20 percent, and 5 percent for the next 20 percent. That would sound like a pretty big proposal if an American politician floated it. But our models show that it hardly moves the Palma ratio. It does very little to change income inequality.

Also, you have to keep in mind that the U.S. transfer system effectively "taxes" you at a steep rate if you're low income and get a higher wage because your benefits, like Medicaid, will be reduced. When you factor in these kinds of mechanisms, you see that policy initiatives within the range now be being discussed will not strongly affect income inequality in the U.S. economy.

LP: Thomas Piketty's work on inequality has generated enormous interest. How does your analysis of how the rich grow richer differ from his?

LT: To judge from his writing, Piketty is well aware that social relations and power strongly influence income inequality. But there are problems with the way he thinks economies work in the long run. He's using the standard supply-driven growth model, assuming that there is always full employment and investment is determined by saving.

But there's another way of looking at growth, with less than full employment and investment driving demand. From this view, economies grow when people spend their money on goods and services.

Luigi Pasinetti, a Cambridge economist, has looked at the economy in terms of two classes – "capitalists" who collect profits on the capital they own and "workers" who get the rest of income. Extending his work shows that when the wage share falls over time, workers will not only have less wealth, but economic growth will slow because people don't have as much money to buy goods and services. In other words, wage repression (and excess capital gains, too) create stagnation in the long run. You can think of the top one percent as Pasinetti's capitalists and the middle class as his workers. (Poor households don't figure into the story of wealth because they don't have any, although they do have an impact on the economy when they spend money on goods and services).

Our preliminary simulations show that the top one percent's share of wealth might stabilize in the range of fifty percent (half the total pie), and the growth rate might settle down at less than two percent per year, which would be a less vibrant economy than we're used to. One bit of good news for middle class families is that in the long run, they do retain the power to save from wages, which to an extent protects their wealth. Piketty does not take this linkage into account. But overall, a falling wage share will hurt the entire economy and hold back everyone, even, eventually, those at the top.

LP: Larry Summers, former Treasury Secretary and advisor to President Obama, is now co-chairing a commission on inequality sponsored by Center for American Progress (CAP). The commission has a new report that looks at how to increase wages and living standards for working families. Do you think their suggestions could work?

LT: Summers is the bellwether of mainstream macroeconomics. When he changes his mind others follow, so his recognition of the problem of income inequality is all to the good. But the mainstream's basic supply-driven growth model is the same as Piketty's, which is reflected in the CAP report. The report does mention the problem of deficient demand — how the economy suffers when regular people don't have enough money to spend on goods and services, and it advocates policies to boost income. But the basic analysis looks at potential economic growth from the supply side. Its recommendations such as improved education (or more "human capital"), modest tax reform, and provision of public jobs, tailored to perceived political limitations, are mostly supply-oriented and of the same magnitude as the ones I've mentioned. I doubt that they would much impact on American inequality.

LP: In your view, is there anybody in the U.S. offering meaningful approaches to income inequality?

LT: Not in the general political debate.

LP: So what's to stop us from becoming a Downton Abbey society?

LT: We've got to have a real social consensus that the way things are going is dangerous and unacceptable, and an understanding that it will take seriously progressive taxation to make a dent in the problem. But I am not optimistic about the prospects. Through various channels ten percent of national income has been transferred to an über class. Without the political will, that sort of change is difficult to undo.