Recent Evolution of Income and Wealth Inequality: Comments on Piketty’s “Capital in the 21st Century”

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The astounding success of Thomas Piketty’s book (Piketty, 2014) makes it clear that the topic of changing inequality in recent decades is of great interest to the public. There is huge demand for understanding what has happened and, even more so, what are the consequences for the future.

Piketty does three basic things in the book. First, he documents what has happened in the past to the (relative) importance of capital stock, as well as to income and wealth inequality. Second, he provides an economic framework for organizing the historical data and uses this framework to project into the future. Third, having concluded that wealth concentration will increase, he makes policy recommendations.

The book has received tremendous amount of attention and much has been written about strengths and weaknesses of the arguments in each of these parts. I will make a few critical and, given how much has already been written, not always original comments in what follows. That should not detract though from the fact that — whatever one thinks about details or even the whole message — the book is very important. It is based on truly astounding data collection effort of Piketty and coauthors over the last 15 years that allowed for documenting basic facts about the evolution of inequality. It has behind it scholarship at the frontier of economic research on this topic. As with any academic work, it is never the last word but Piketty’s research has already accomplished what everyone in his position would wish to accomplish: it set the agenda and inspired a lot of additional work. The book further cements it and goes beyond it by making all of it accessible to the masses (or at least, masses that are educated, motivated and curious enough to push through a 700-pages long book of academic origin).

I will start by providing a few remarks about why one may be concerned with inequality at all. I will follow with the discussion of explanations for an increase in inequality in recent decades, stressing the importance of technological change and
being skeptical about the importance of institutional changes that play a prominent role in the book. I will then comment on changes in income and wealth inequality in the United States, pointing out measurement problems that make the analysis of wealth inequality (which is central to the book's thesis) difficult. Subsequently, I am going to argue that technological transition helps in understanding the patterns of wealth and income inequality, in particular controversy about whether wealth inequality has increased as much as income inequality has. In the final section, I will comment on the reasons why having the right story for why inequality has increased matters.

1 Do we care about inequality (and of what)?

There are many ways to approach inequality — one may be interested in inequality of well-being or proxies for it such as consumption, earnings, income or wealth. A welfarist with preference for equity would (in an ideal world, with ideal data) focus on inequality of well-being. Consumption is a close second, though perhaps one would like to see it corrected for effort that different people exert to achieve it. Well-being is very hard to measure directly (not withstanding interesting line of research on subjective well-being) and comprehensive consumption data is very hard to come by, so that somewhat easier to measure earnings, income and wealth are of natural focus. Even then, measurement issues abound — tax sources and survey data are the source of information but they all have various problems (and relative benefits). One can think about inequality of individuals, households or families; adjust (or not) for taxes, transfers or fringe benefits; correct (or not) for cross-sectional and over time differences in the cost the of living; consider annual, multi-year or perhaps lifetime measures. Inequality has many aspects to it — understanding the bottom of the
distribution is not the same as understanding its top.

The attractiveness of earnings, income or wealth is not just that the data is somewhat easier to come by than is the case with well-being or consumption. It is also due to the fact that these variables get us closer to the notion of opportunities rather than outcomes. Few people would be upset about inequality in earnings or wealth arising from different decisions about how much to work or save. However, a possible normative rationale for the analysis inequality in earnings or wealth rather than economic well-being is (often implicit) belief that they reflect opportunities rather than tastes. Even then, there are different aspects of opportunities that have very different ramifications. Commanding high salary because of one’s productive skills is different than earning large incomes because of access, connections or corruption. A billionaire hedge fund manager testing the fine line of insider trading is likely to be viewed differently than a billionaire Silicon Valley entrepreneur. Simply measuring inequality does not discriminate between these explanations.

Focusing on the very top of the distribution raises one other issue: beyond preferences for equity in either outcomes or opportunities, one may be concerned about the direct effect that the well to do have on others. The notion that high wealth concentration affects the nature of the society is plausible. Piketty certainly thinks so: “the rentier, enemy of democracy” (Piketty, 2014, page 422) is a sub-title of one of the chapters. Money can buy political influence, perpetuate differences across generations and on a more local level stratify neighborhoods and exclude others. But it can also pay for vaccines in developing countries, museums or education. The net effect is an empirical question.

The reason for the success of the book has probably something to do with all three motivations: redistributive concerns, a sense that growing inequality reflects growing inequality of opportunities and the possibility that changing inequality may
have an adverse effect on the whole society in the future.

2 Why has income inequality increased?

The redistributive concern is the easiest to evaluate. Inequality has increased. Since the book is focused on the very top of the distribution, I will focus on it as well. Income tax data has been used to construct measures of income concentration in the United States. Early work of Feenberg and Poterba (1993) drew attention to changes at the top of the distribution, but it is work of Piketty and Saez (2003) that comprehensively documented the patterns of income concentration since early 20th century and its increase in recent decades. Figure 1 shows the evolution of top 1% of income using their updated series. A lot of subsequent literature probed the importance of various measurement issues (such as changing form of compensation, household composition, robustness to accounting for transfers or fringe benefits, changing demographic structure). The increase in income concentration since the 1970s is very robust to these considerations. The Figure also shows labor earnings (rather than income) concentration based on payroll tax records of commerce and industry workers from the Social Security Administration analyzed by Kopczuk et al. (2009) to illustrate that labor income is the key component of these changes: the same pattern prevails when capital income is ignored completely.

The evidence that the concentration of incomes has grown is overwhelming and it is not limited to the top of the distribution, although the patterns are most spectacular there. Rising earnings differentials by measures of skills (such as education) have been well documented and the literature has probed various explanations for it. There are many pieces to the story, including changing demographics, increasing labor force participation of women, trade, changing labor market institutions (unions,
Figure 1: Top 1% income and earnings share
minimum wage, taxation). There is close to the consensus that the most important explanation in accounting for general patterns of inequality is the changing technology — economists refer to “skill-biased technological progress” — and its interaction with education (e.g Autor, 2014). The idea is that the economy has evolved in a way that favors certain types of skills — “non-routine”, i.e. those that cannot be easily substituted by technology

Piketty has a different explanation than technology for the growth of inequality. On page 20, when summarizing his major conclusions, he states: “the reduction of inequality that took place in most developed countries between 1910 and 1950 was above all a consequence of war and of polices adopted to cope with the shocks of war. Similarly, the resurgence of inequality after 1980 is due largely to the political shifts of the past several decades especially in regard to taxation and finance.” This is a bold hypothesis that rings somewhat true, because it would be hard to argue that wars and redistributive taxation have no effect on the distribution. Indeed, the book is persuasive that they do. Figure 1 shows that the drop in the share of top incomes and earnings did not occur immediately after the Great Depression but instead happened in the 1940s — the exact timing is hard to pin down, but other work also suggests that the 1940s were the period of Great Compression (Goldin and Margo, 1992) in wages. This nicely coincides with wartime wage control and a rapid increase in progressivity occurring around the time. Similarly, large tax reforms of the early- to mid-1980s coincide with the growth in income concentration. In particular, the second massive reduction in marginal tax rates, the Tax Reform Act of 1986, is clearly visible in the data series on Figure 1, though, the onset of inequality growth appears to precede the first large reform — the Economic Recovery Tax Act of 1981.

Having said that, I find explanations for the evolution of inequality in developed countries that highlight as the primary force the role of institutional changes
unattractive for a number of reasons.

First, to my knowledge, no paper has conclusively shown the direction of causality. Instead, it is almost certain that causality runs (also?) in the opposite direction: growing inequality increases opposition to high marginal tax rates, declining inequality makes it easy to adopt nominally progressive policies (interestingly, top marginal tax rates of the 1940s and 1950s were set so high that they applied to very few individuals). Increased size of capital markets and innovation in finance induces pressure to deregulate. Naturally, once adopted, such policies can further affect inequality, but such feedback mechanism does not make them the root cause of inequality growth.

On surface, this is not inconsistent with the narrative of the book. Piketty highlights the evolution of capital stock relative to GDP or incomes as the primary force. Inequality follows and institutions keep it — or not — in check. This way of thinking makes it then natural to talk about “top 1 percent” or “top .1 percent”. There is a group of wealthy individuals and how wealthy they are depends on where the capital stock is and what institutions are in place. What this line of thinking ignores though is the role of technology and analysis of how inequality comes about beyond mechanical following of the path of capital/income ratio. Perhaps this is fine for very long term trends, but ignoring the process of transition is potentially unattractive when inequality is changing rapidly.

The second problem with this approach is precisely the fact that we know that technology is important for understanding the evolution of the rest of the distribution. Occam’s razor approach would suggest that we need not look for a different class of explanations at the top. It is certainly in principle possible that dynamics of the top of the distribution has been driven by different forces (reduced progressivity, deregulation, rent-seeking) than those that shaped the rest of the distribution. It is even more likely that these forces have contributed. However, it is hard to believe
that skill-biased technological progress is primary force necessary for understanding the evolution of education/college premium and relative performance of blue- vs white-collar workers, but that it does not play the important role in explaining the top 1%.

How has technology influenced the very top of the distribution? Some ways are obvious — Apple is the world’s most valuable company, Microsoft’s founder Bill Gates has been the richest person in the United States for years, technology-based fortunes abound in Forbes 400. More subtly, fortunes of companies like Walmart that were the first in their industry to take advantage of information technology (streamlined supply chain) can be traced to the same source as well. Finance is a very different industry than it was 40 years ago — technology allowed for introducing sophisticated new products, analysis and trading strategies. Of course, technology has been improving before the 1970s. However, the argument is that information technology (IT) is a general purpose technology: once it arrives, it changes most sectors of the economy. Smaller inventions do not and hence they generate isolated fortunes, but do not change the whole structure of the economy and hence have relatively small effect on inequality. One has to go back to development of mass transportation or electricity to find similar examples.

None of it says that smaller stories such as rent-seeking, decoupling CEO pay from performance, rigging financial markets and insider trading do not happen, just that they accompany (and perhaps contribute to) rather than drive the evolution of inequality. For all the talk about CEO pay, the Forbes list has few non-founder CEOs on it.
3 Wealth vs income inequality

The book is about wealth but our best evidence is about income. I will focus on the recent decades. The best evidence on wealth and inheritances that is presented in the book and comes from France. In the nutshell, wealth inequality in France has been quite stable since the 1970 and so has been labor income inequality. At the same time Piketty documents that inheritances in France have been increasing (see Piketty, 2011, for the primary source).

The US evidence is less systematic and somewhat more controversial, as I explain below. Figure 2 presents estimates of the shares of wealth held by the top 1% and the top 0.1% of the wealthiest in the US. Until recently, all existing estimates of wealth concentration in the US (based on surveys and estate tax data) suggested that it has not changed much. This is the evidence that is reported in Piketty (2014). However, in a very recent work Saez and Zucman (2014) document an increase in concentration of capital income on individual tax returns and interpret it as reflecting increased wealth concentration (so called “capitalization method”). I will discuss these various sources of data below, I do acknowledge uncertainty of what we know, but personally find the direct measures of wealth concentration (which show little change) more compelling.

3.1 Measurement of wealth inequality

In a very recent paper (Kopczuk, 2015) I discuss in details the existing estimates of wealth concentration, methodological issues that underlie these series and the potential explanations for discrepancies where they exist.

In the nutshell, there are three ways of measuring wealth at the very top of the
distribution. The first one is surveys that oversample high net worth families. The only such a survey in the US is the Survey of Consumer Finances. Second, one can estimate wealth distribution based on estate tax returns by adjusting wealth holdings of decedents to be representative of the whole population. Third, much (though not all) of income that wealth generates (capital income) is taxable and potentially observable. One can attempt to learn from income about the underlying stock and construct estimates of wealth distribution in this fashion — this is known as capitalization method.

The SCF series in Figure 2 was compiled by Roine and Waldenström (2014). The estate tax series is based on Kopczuk and Saez (2004). Capitalization estimates are most recent and based on unpublished work of Saez and Zucman (2014). Availability of data explains why not all series contain estimates for each year. Differences in the wealth accounted for by different sources and in the unit of observation (individual vs household) are behind level differences but probably do not spill over to differences in trends.

Separately, named lists of the wealthiest (such as Forbes 400) provide less systematic supplementary source of information.

This is known as “estate multiplier” approach. The idea is to consider people who died as being sampled from the living population — the sampling rate is the mortality rate \( m_i \). If \( m_i \) is known, the distribution for the living population can be simply obtained by reweighting the data for decedents by inverse sampling weights \( \frac{1}{m_i} \) (“estate multipliers”). Lampman (1962) was the first to provide such estimates for the U.S. (there are earlier estimates for the UK). The key difficulty has to do with selecting the mortality rate appropriate for the group studied. Wealth measured in this way reflects wealth at death and hence is skewed by any tax avoidance and planning in anticipation of death.

As Figure 2 shows, different series produce very different patterns. This is most stark in recent decades.\(^4\) In recent decades, concentration of capital income has increased but that increase does not seem to be reflected by direct ways of measuring wealth in the SCF and estate tax data. Saez and Zucman (2014) have their preferred explanations: they propose that SCF fails to adequately sample the rising top of the wealth distribution and suggest that the estate tax estimates err by assuming that the difference in mortality rates of the wealthy and general public stayed constant when, in fact, it may have diverged.

These are plausible explanations but not without weaknesses. The SCF would have to become progressively worse over time to explain the difference in trends. Significant non-response rate in particular is certainly an issue with the SCF, but as far as we can tell they do not result in systematic bias.\(^5\)

Saez and Zucman (2014) show that people that they classify as very wealthy (say top 1\%) have significantly lower mortality rates than general public and that the differential has increased over time. However, the magnitude of this change is not sufficient for explaining the difference between estate tax estimates and capitalization estimates (see footnote 5 in Kopczuk, 2015). Furthermore, the mortality rates that underlie their evidence are much lower than those based on other sources (such as Social Security data), suggesting that deriving mortality estimates from the tax data is a perilous exercise due to the fact that not everyone files a tax return.\(^6\)

\(^4\)However, even before that, relying on capital incomes produces a much smoother pattern in the decline of wealth concentration in the 1930s and 1940s than does the estate tax series.

\(^5\)See Kennickell (2009a) and more extensive discussion in Kopczuk (2015). This conclusion appears to also hold in most recent surveys — verifying this point is a subject of the ongoing work at the Federal Reserve (personal communication).

\(^6\)Saez and Zucman (2014) also show that using their mortality rates to apply estate multiplier technique on the population of decedents in their data replicates their capitalization estimates, and
The evidence of increasing differentials in mortality rates observed in tax data that they document is, however, points to an interesting possibility. Their evidence pertains not to the people that are classified as wealthy based on their wealth holdings (because those are not observable directly), but rather it is about people with high capital incomes. It is possible and likely that, as income inequality has increased, people with highest capital income are increasingly active rather than passive earners and that capital income increasingly reflects compensation rather than return on wealth. Furthermore, tax incentives discourage realizing capital income shortly before death due to the presence of a step-up in basis at death, so that the population of high capital income earners should be selected on having a longer expected lifespan. A shift to more active earners being represented at the top of the distribution may very well explain why the top of capital income distribution appears much healthier.

The problems with capitalization approach are significant. One needs to assume that the observed capital income reflects normal rate of return on broadly defined asset classes. This presumes that people at the top of the distribution do not earn rents in the form of capital income but, instead, effectively invest like everyone else within each assets classes, so that the sole source of differences are differences in portfolio composition. It also presumes that quantitative importance of the level and/or changes in compensation component of capital income is small, ruling out the increased importance of carried interest, stock option compensation etc. and various other ways of reclassifying labor as capital income. Furthermore, the tax incentives interpret in favor of their approach. This exercise has, however, a tautological element to it: by construction, the mortality rates are sampling rate corresponding to the population of decedents in the same data. Hence, mechanically, the two approaches should produce the same result except for the sampling error and do not provide independent evidence about the performance of estate multiplier approach.
have changed over time in a way that favors capital income and realizing income on individual income tax returns rather than retaining it within a firm. As an illustrative data point, the effect of the 1986 TRA is again visible in the capitalization-based wealth series without similar effects being present using the other two methods.

The most surprising aspect of the estimates presented by Saez and Zucman (2014) is that the growth in wealth concentration since 2000 is fully accounted for by assets generating fixed income, see Figure 3. One possibility is that it is true, although I would like to see some additional corroborating evidence. The alternative explanation is that declining rates of return require adjusting capital income from these types of assets by a large factor and relatively small mistakes in estimating the rate of return translate into very large errors in capitalization factors.

As a final point, the assumption of no extraordinary capital incomes for the wealthy is inconsistent with what Piketty (2014) appears to think. On pages 430-431, he notes that large investors are likely to rely on intermediaries and be both more patient and more willing to take risk resulting in a higher rate of return. In fact, one of the important claims of the book is that large fortunes have been growing faster than average wealth in recent decades. While part of the explanation may be differences in portfolio composition, the rough division into stocks, bonds, housing, entrepreneurial wealth and bank accounts is unlikely to account for it.

4 Changes in the composition of the top wealth holders

At the end of the day, I suspect that estimates that are based on direct observation of wealth (SCF or estate tax method) are more reliable: while they may suffer
Figure 3: Top 1% wealth share

from some sampling issues, it seems unlikely that the bias is sufficient to explain the difference in trends between capitalization and the direct methods; at the same time the assumptions behind the capitalization method are heroic and some of the patterns that emerge from it are quite puzzling. However, I acknowledge uncertainty of what we know, so that which of these approaches provides the right picture of wealth concentration is certainly not a settled question.

The discrepancy between different approaches starts in the early 1980s. If, in fact, there has been no rapid trend in wealth shares as SCF and estate tax approach indicate, how can it be consistent with rapidly growing income inequality? Alternatively, if top wealth have been trending, why did the other two approaches get progressively worse?

I suspect that the difficulty with measurement in this case reflects the changing nature of inequality in the United States and it is not an accident that results start to diverge at the same time that inequality has started growing. Explanations for differences between series have a common theme. Being based on individual income tax data, capitalization method is capturing the changing patterns of capital incomes. Any reporting bias in the SCF that increases over time would probably have its sources in difficulties of capturing new wealth. Mortality assumptions and the perceived massive improvement in mortality of top capital income earners is likely to correspond to changes in the composition of that group. The bottom line is that the top of the wealth distribution has likely been fluid in recent decades.

If the top 1% of income and wealth distribution were the same people, we would expect that the top of wealth and income distribution would behave in a similar way. If these are different people but the composition of the types of individuals making up the two groups is roughly constant over time, we would expect that they would follow different paths reflecting relative trends in capital and labor income.
However, it is extremely unlikely that any of these possibilities is true. The top of the income distribution has been increasingly reflecting labor incomes, the point emphasized by Piketty and Saez (2003). The top of the wealth distribution has changed significantly too.

![Figure 4: Share of women at the very top of wealth distribution](image)

Figure shows the estimate of the number of women at the very top of the wealth distribution based on estate tax data and estate multiplier adjustment. See Edlund and Kopczuk (2009) for details.

In my previous work with Lena Edlund (Edlund and Kopczuk, 2009) we show evidence suggesting that the importance of inheritances as the source of wealth at top of the wealth distribution in the US peaked at the top of the wealth distribution in the 1970s and has declined since. Our main piece of evidence relies on changing gender composition of the wealthiest estate taxpayers. Since the 1970s, the number of
women among those with the highest estates has actually declined. This is during the era when women have been making significant strides in the labor market, including the top groups. We concluded that this change reflects a shift away from inherited wealth and toward self-made wealth — inherited wealth is split roughly equally across genders but self-made wealth is skewed toward men. This is also visible in the Forbes 400 list (Table 1) that shows both a decline in the number of women and the corresponding decline in inheritance as the source of wealth. Kaplan and Rauh (2013) also analyze the Forbes list (including more recent years), reaching similar conclusions.

The decline in the importance of old wealth potentially counterweights an increase that might result from higher wealth concentration due to increasing income inequality. The notion that the top of the wealth distribution has been changing in the direction of self-made wealth is very consistent with the idea that the recent decades have been the period of disruptive technological change that created a lot of possibilities to make extraordinary fortunes. The top of the wealth distribution cannot be explained by excessive CEO salaries (one of the Piketty’s favorite explanations for the growth in income inequality) simply because few non-founder CEOs are at the top of the Forbes list, even though they are well-represented among the highest incomes.

The key point here is that technological explanations have a potential for explaining what has been happening both with income and wealth distribution in the United States. The main objection to this argument has to do with international evidence. If technology is the same everywhere, why has income inequality followed a different path in continental Europe than in the United States? I suspect that this is the place where institutions do in fact start to matter, but in a way that is different than that emphasized by Piketty. Globalization should be viewed as a technological
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development too. Information technology makes it possible to manage businesses elsewhere, outsource in many different ways, optimize supply chains, share information, reach bigger markets etc., thereby resulting in both greater opportunities for economic cooperation and increasing returns to scale in many economic activities. In a global economy, workers (and, especially, highly skilled workers) are mobile. It is not an accident that main financial centers are in London and New York and that Silicon Valley is a mecca for technology entrepreneurs. In each of these places, highly skilled and successful people come from all over the world. The natural explanation is that there are economies of scale from co-locating. Hence, we would not necessarily expect to see every country being able to attract successful workers or entrepreneurs. High taxation, over-regulation and policies that hamper innovation would then affect which countries are winners of this competition. If so, the lack of increase in income inequality in France and some other countries may be evidence of failure rather than success of the policies that are behind it — France may have simply exported its inequality elsewhere.

5 Conclusions

Why does it matter what is the explanation for changes in inequality in recent decades? There are multiple reasons.

The first one is simply to have the right description of who we are talking about when referring to the top of the distribution. CEOs vs entrepreneurs vs highly skilled workers vs inheritors are all very different groups. If the composition of the top income and wealth holders is changing then presumably our view of what is the appropriate policy reaction changes as well.

The second one has to do with merits. I subscribe to Piketty’s view that large
inheritances are not meritocratic and have written on the role of estate taxation in addressing externalities that may result from concentration of inheritances (Kopczuk, 2009). Many members of the new elites are highly educated and entrepreneurial. There is certainly a contribution of family background to being successful based on these characteristics, but nevertheless there is an important meritocratic component to the growth in inequality that stems from favoring skilled labor.

The third one has to do with projecting into the future. If technological change is an explanation for the current transition in inequality, predictions about future changes in inequality become difficult. Clearly, nowadays, we are no longer talking about ownership of capital just as a way of controlling means of production. The nature of information technology based economy does not necessarily favor physical capital. The importance of capital vs labor in the future remains to be seen, but it is not clear at all that patterns from agricultural or industrial economies provide any information about substitutability of labor and capital in the future.

The fourth point is about potential transitional nature of current inequality. The Kuznet’s curve is a useful framework for thinking about the evolution of inequality over the course of economic development: inequality first increases when early adopters benefit, but then technology spreads out, benefits others and ultimately inequality declines. There is no reason why there should be a single Kuznet’s curve and every reason to believe that we are at the stage of technological change in which early adoption is happening. In fact, multiple transitions can be happening at once: evidence of improvements in the standard of living in less developed economies (declining global income inequality, though not necessarily income or wealth concentration) suggests that this process may be happening on the global scale.

The final point has to do with recommended policy prescription. Piketty predicts mechanically increasing role of capital and wealth inequality that will follow and
proposes a global wealth tax as a way of addressing the problem. Implementing a policy like this would yield no benefit but only distortions if the problem that it intends to address ultimately does not materialize. Of course, he is also well aware of administrative issues that make implementation of such a tax difficult. Similar administrative issues that would need to be resolved to implement wealth taxation would also help in improving our ability to tax capital income, so that I find preference for taxing wealth over capital income difficult to justify.

A separate point though that I want to remind of here following Adam et al. (2011) has to do with poor equity properties of such a tax. A tax on wealth is primarily a tax on the normal return to capital — precisely the opposite of what best tax practice would suggest. To see that, imagine a 5% normal rate of return and 1% wealth tax. Such a tax would collect slightly more than 1% of the original principal. A 10% or so income tax would do so as well. However, consider the possibility of extraordinary returns — rents, privileged investments etc. Such extraordinary returns would be taxed lightly (at 1%) by wealth tax but would be taxed highly (at 10%) by an equivalent income tax. A wealth tax provides a tax break for precisely the wrong component of return on capital.

If there is one thing to take from these comments, it is that the last 30 years have been a period of technological transition. We have made progress in documenting and understanding changes in income inequality, although we clearly still do not have the full picture of the forces behind it. The research on wealth inequality is still incomplete — both in terms of reaching consensus about what has happened and understanding how changes in income and wealth concentration are related. Understanding the causes of wealth and income inequality changes is key for informing policy.
References


