Comments on

"Has U.S. Income Inequality *Really* Increased"

by

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COMMENTS

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Alan Reynolds poses a straightforward question: "Has American inequality *really* increased?" Based on my reading of the evidence, including his new paper and the talk we just heard, my answer is "Yes, inequality has increased." I would guess, based on the paper and his talk, this is not the take-away conclusion he hoped to hear.

Reynolds is skeptical there is any clear evidence showing inequality has increased, at least since the late 1980s. He offers a number of reasons for his skepticism. Most of them boil down to this: The many data series that show inequality has gone up are not worthy of our trust, whereas the series that show very little trend should be accepted at face value.

Like many students of the income distribution, I take seriously some of Reynolds's criticisms of the data on income disparities. No single data source is perfect, and a couple of them have serious flaws. An unwary user can draw misleading conclusions if the data problems are ignored. Reynolds points to some serious problems, and in many cases fair-minded experts will agree with him.

The problem is, he is harshly critical of data series that do not support his viewpoint, while he is usually silent about equal or more serious problems with data sets that show little change in inequality.

For example, like many people with conservative inclinations he is enamored of consumption data in the BLS's Consumer Expenditure Survey. That is probably because it shows no overall change in inequality since about 1986. What Reynolds doesn't mention is that the consumption data have gotten much, much worse since the mid-1980s. In 1985, the Consumer Expenditure Survey uncovered 80% of the consumption that is recorded in the U.S. National Income and Product Accounts. By the year 2000, that percentage had fallen to 61%.[1] As far as I know, no statistical series that tries to approximate total income has suffered such a terrible decline in quality as the data from the consumption survey. You'll look long and in vain for any mention of that problem in Reynolds's paper.

Reading his new paper, one is struck by how much it resembles a lawyer's brief rather than an even-handed weighing of evidence. Of course, there's a place for lawyers' briefs. But I'm an economist not an attorney. I'm not terribly interested in whether Alan Reynolds or Emmanuel Saez or Paul Krugman would receive higher scores from a high school debate coach. I'm much more interested to learn about the strengths and weaknesses of different data series and to understand how each of them can shed light on changes in the income distribution.

My reading of the evidence is not terribly complicated, and it seems consistent with most of the reliable data available to us. Income inequality was higher at the end of the 1980s than it was in the beginning of that decade, and it was higher in 2005 than it was in 1989. Reynolds is certainly right when he says inequality did not increase "continuously" between 1979 and the present. It fell in some years, and remained approximately stable in others. On the whole, however, inequality rose in the 1980s, and it also increased after 1989.

There's an important difference between the rise in inequality in the earlier period and in the more recent period, however. Between 1979 and 1989, the percentage gap between the incomes of the middle-class and the poor got bigger, and the percentage gap between the rich and the middle class also got bigger. Inequality widened up and down the U.S. income distribution. Starting at some point in the early or mid-1990s, the proportional gap between low-income and middle-income Americans stopped rising and in fact probably shrank somewhat. After the early 1990s, the main way in which inequality widened is that the incomes of very well off Americans increased much faster than those of *both* the middle class *and* the poor.

Reynolds devotes most of his attention and criticisms to the use of income tax data to measure trends in the income distribution. People who don't know much about income distribution statistics might infer this is because the income tax statistics are the country's main source of information about distributional trends. They aren't. Ever since the income distribution became a hot topic in the 1980s, the main source of information on which people rely comes from an annual Census Bureau survey of American households. The reason most people think inequality has risen since the late 1980s is because the household survey shows it has.

Economists' favorite indicator of inequality is the Gini coefficient. A higher Gini means there's more inequality; a smaller Gini means there's less. In 1989 the Census Bureau reported a Gini coefficient of household money income equal to 0.431. In 2005, the Bureau said the Gini coefficient was 0.469, which incidentally is the highest Gini coefficient ever recorded.[2] By this measure, American inequality was about 9% higher in 2005 than it was in 1989. You can forgive most reporters and ordinary citizens for interpreting this Census statistic to mean that inequality has gone up.

As it happens, there are problems with the Census Bureau's income statistics. One big problem is that the Bureau's standard measure of income

excludes in-kind benefits and capital gains, and ignores the effects of income and payroll taxes. The Bureau recognizes these problems, and it publishes several alternative measures of inequality which use different definitions of income.[3] If you look at some of the most comprehensive definitions of income, it turns out that inequality increased less, possibly much less, after 1989 than indicated by the Census Bureau's headline number.

By the same token, however, inequality increased much *faster* under those alternative definitions during the 1980s than it did as measured by the Census Bureau's headline number. So the Bureau's headline number *understated* the growth in inequality during the 1980s and *overstated* the rise after 1989.

So far, so good. Reynolds could have written a very short paper in which he urged readers to ignore the Census Bureau's headline measure of inequality and turn instead to a much more obscure measure of inequality that is only published with a lag after the poverty and income statistics are first released. But that would have been a very short and uninteresting paper. It would also have been a very misleading one.

The biases in the Census Bureau's standard measure of (cash income) inequality almost certainly tended to exaggerate the upward trend in inequality between 1989 and 2005 – but only for that portion of the income distribution where the Census Bureau's estimates provide more or less accurate tabulations of income. For a number of reasons, which I am happy to discuss, the Census Bureau questionnaire does not provide accurate or consistent assessments of the incomes of the top 2% or 2½ % of income recipients. One reason is that respondents' answers are top-coded, or at least they were in the not-too-distant past. Another is that the sample of high-income recipients is too small to give an accurate or consistent estimate of the incomes of the very top income recipients, say, those with incomes above $750,000 a year. This means the Census Bureau probably gives us an underestimate of true income inequality every single year, no matter which concept of income we choose to measure.

What is worse, the underestimate will get bigger if top income recipients have incomes that grow faster than the incomes of people further down in the income distribution. That is precisely what most experts think has occurred since the late 1980s. And that is the interpretation of the data that Reynolds passionately wants us to reject.

If we cannot rely on the Census surveys to tell us what has happened to incomes at the top of the distribution, where might we turn? My late colleague Joseph Pechman, and the Congressional Budget Office, and scholars like Thomas Piketty, Emmanuel Saez, Ian Dew-Becker, and Robert Gordon have all turned to the income tax records. Another potential source of information is the Social Security Administration's tabulations of the W-2 files, though this data series only covers wage earnings. The advantage of these administrative records is that they are supplied by many taxpayers. The records are so numerous, in fact, that we can develop very accurate estimates of the incomes of people at the very top of the distribution.

Reynolds' problem is that the data from both the 1040 income tax returns and from the W-2 records tell a simple and similar story. The relative incomes and the relative wages of top income recipients have been increasing much faster than the incomes and wages of people further down in the distribution. This was true in the 1980s, and it has also been true since 1990. Back in 1990, the median annual earnings of a full-time, year-round American worker was a little less than $34,400 (in 2005 $). By 2005, that median had increased by 4½%. Now let's consider what happened to the wages of top wage earners according to the W-2 records. At the 98th percentile, real earnings rose 33%; at the 99th percentile they rose 37%; at the 99.99th percentile, they rose 82%.[4] Most people hearing those numbers would conclude – rightly, in my view – that wage inequality has gone up since 1990. That's because 33%, 37%, and 82% are all bigger numbers than 4.5%.

Reynolds criticizes people who tabulate income reported on IRS 1040 forms without making any adjustment for the changing incentives to report income to the tax authorities. He notes, for example, that the 1986 Tax Reform Act made it advantageous to report capital income on 1040 forms rather than to partially shelter it by retaining earnings inside of a corporation that is subject to the corporate income tax. Tax reform in 1986 certainly increased the amount of income that top income recipients directly reported on their 1040s.

Reynolds' problem here is that careful analysts, like Joe Pechman, of Brookings, and the CBO recognize this problem. They try very hard to calculate total tax burdens faced by Americans, taking into account both the personal and the corporate taxes that they pay, directly on their own tax returns and indirectly through the corporations in which they have an ownership share. The CBO, for example, tries to figure out which Americans own the corporations that must pay corporate income taxes, and then assigns them a pro-rata share of both undistributed corporate income and corporate tax liabilities. CBO may not do a perfect job, but at least it is trying hard to measure tax burdens and net incomes in an even-handed and consistent way. Also, the CBO has developed a comprehensive measure of household income, including taxed and untaxed income, in-kind benefits, and corporate income that is assignable to the households which ultimately own the corporations.

On an after-tax basis, the CBO estimates show that the average income of the top 1% of income recipients was 13.7 times the average income of the middle one-fifth of families in 1988-1990. By 2002-2004, this income ratio had risen to 15.9. Because 15.9 is a bigger number than 13.7, most people would plausibly conclude inequality has gone up since the late 1980s.[5] I don't think Alan Reynolds has given us any reason to think this conclusion is wrong.

Let me summarize two very simple points. *Point number one:* Inequality rose in the 1980s because income gaps widened in every part of the income distribution. Poor Americans lost ground or experienced negligible income

growth, middle income people experienced modest income gains, and people above the middle enjoyed faster gains, with the biggest gains going to the people nearest the top of the distribution. After the early 1990s, inequality in the bottom 85% or 90% of the distribution stopped increasing and possibly started falling, depending on the income measure you choose to emphasize. However, the gap between the very rich and everyone else continued to widen after 1989. The increasing gap was driven partly, no doubt, by a soaring stock market.

Point number two: It is very hard to track top income recipients' wages or capital incomes using standard Census surveys. Analysts have to turn to administrative records and make plausible adjustments for the factors that affect the income reports in these records. This is how we track much of the rise in inequality we have seen since the early 1990s.

Reynolds is harshly critical of the adjustments that other people have made, and some of his criticisms are valid. However, it's hard to see how his criticisms can have a big impact on our interpretation of the W-2 records. These clearly show a rise in wage inequality at the very top. In 1990 the ratio of the wage received by an earner at the 99.99th percentile to the median wage was 46. In 2005 that same ratio was 81. Yes, part of this increase was because of stock options, bonuses, and other nifty elements of the modern compensation package, but so what? In the old days, highly compensated wage earners did not receive these kinds of benefits or received a much smaller allotment of them. Their total compensation was much, much nearer to that of ordinary wage slaves, like your cousin who earned $37,500 last year.

Reynolds has nothing but scorn for the calculations of Professors Pikkety and Saez. Many of his criticisms are misguided or unfair given the goals of the Pikkety-Saez project. Setting aside the findings of Pikkety and Saez, what about the results published by the CBO? The CBO handles almost all the problems Reynolds mentions, and its calculations show a sizeable rise in both pre-tax and after-tax inequality since the late 1980s. You can argue, as Reynolds sometimes

does, that much of the increase in incomes at the top is due to turbo-charged stock prices or other special circumstances. Using the same line of reasoning you could also argue that, adjusting for the weather and the season, no homeowner in New Orleans ended up with a wet basement in August 2005. It might be true, but it's not much comfort to the residents who had to leave a flooded home.

Most people who think inequality is going up are not making a sophisticated adjustment for the level of stock market prices in 1989, 1999, or 2006. They're reading newspaper stories that tell them how Robert Nardelli received \$40–\$45 million a year for failing to serve effectively as CEO of Home Depot. They read how Hank McKinnell may have received even more generous compensation for doing an even worse job at Pfizer. Yes, these are horror stories; they are not data. But when careful economists go sifting through SEC filings, they find that the data match the horror stories. Top corporate officers' pay rose faster than most people's wages in the 1980s, and the growth differential was even bigger after 1990 than it was in the 1980s.[6] If you think the average U.S. worker got annual pay increases of 9½% a year, after adjusting for inflation, as top corporate officers did in the 1990s, you move in different circles than I do.

- Gary Burtless
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Endnotes

[1] Orazio P. Attanasio, Erich Battistin, and Andrew Leicester, "From Micro to Macro, from Poor to Rich: Consumption and Income in the UK and the US," Paper presented at the National Poverty Center conference on "The Well Being of Families and Children as Measured by Consumption Behavior," May 4-5, 2006 at the Capital Hill- Hyatt Regency, Washington, D.C. Conference sponsored by the National Poverty Center, Gerald R. Ford School of Public Policy, University of Michigan, Ann Arbor, MI. (p. 33)

[2] U.S. Census Bureau, http://www.census.gov/hhes/income/histinc/h04.html and "Income, Poverty, and Health Insurance Coverage in the United States: 2005," p. 7.

[3] See, for example, U.S. Census Bureau, http://www.census.gov/hhes/www/income/income05.html .

[4] The estimates of the median annual earnings are based on my own tabulations of labor earnings reported for full-time, year-round workers in the Census Bureau's Annual Social and Economic Supplement, formerly called the March Supplement, covering 1990 and 2005 annual incomes. The estimates of W-2 reported wage and salary income are derived from my estimates based on Social Security Administration tabulations (see http://www.ssa.gov/ OACT/COLA/ awidevelop.html).

[5] U.S. Congressional Budget Office, "Historical Effective Federal Tax Rates:1979 to 2004," Washington, D.C., December 2006, Table 1C. http://www.cbo.gov/ftpdoc.cfm?index=7718&type=1 .

[6] Carola Frydman and Raven E. Saks, "Historical Trends in Executive Compensation: 1936-2003," MIT Economics Department (web.mit.edu/frydman/www/frydmansaks-trends.pdf), p. 44.