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# MISUNDERSTANDING DISTRIBUTION*

By Young Back Choi

## I. Introduction

Inequality in income and wealth distribution in society is said to be a great concern to many social critics. Rarely is the issue of inequality in income or wealth distribution, as such, a concern for the majority of Americans as individuals, however. The Nobel laureate James Tobin, an economist, has expressed his amazement at Americans' general lack of concern for the issues of unequal distribution of income and wealth:

> American attitudes toward economic inequality are complex. The egalitarian sentiments of contemporary college campuses are not necessarily shared by the not-so-silent majority. Our society, I believe, accepts and approves a large measure of inequality, even of inherited inequality. Americans commonly perceive differences of wealth and income as earned and regard the differential earnings of effort, skill, foresight, and enterprise as deserved. Even the prizes of sheer luck cause very little resentment. People are much more concerned with the legitimacy, legality, and fairness of large gains than with their sheer size.[1]

The concern about inequality is a political concern especially pronounced among intellectuals or social critics rather than among the general population. For many social critics, inequality in income or wealth distribution is a sign of something gone wrong. For them, the presumptive ideal is equality. Consequently, an increase in inequality is usually viewed negatively and vocally, and a decrease in inequality is often met by silence, indicating an implicit approval. For example, when growing inequality in the late 1980s and the early 1990s was noted, the trend was nearly universally denounced as an evil outcome of the market

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[1] James Tobin, "On Limiting the Domain of Inequality," *Journal of Law and Economics* 13, no. 2 (1970): 263–64.

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system.[2] Many predicted that it would become worse. Documenting growing inequality and proposing remedial measures became a growth industry in academia. Unfortunately for the industry, the pattern of distribution has stabilized since the mid-1990s.

Why do many social critics single out individual differences in income or wealth as a special public concern? Not all inequalities command such critical attention. Few show similar concerns about the unequal distribution of other valued attributes, such as height, good looks, intelligence, and athletic ability. Nor do many think it appropriate to demand their equalization. Most people appear to regard the individual differences in these attributes as natural (in the sense that no one can be blamed for the differential outcomes). Why, then, do the critics regard the existing inequality in income or wealth distribution as bad, when they know that the bulk of individual income and wealth in the United States is generated from voluntary exchanges and is a product of individual conduct? What is wrong with unequal distribution of income or wealth?

I believe that there are, broadly speaking, three problems that critics associate with inequality in income and wealth distribution: (a) that the existing inequality is excessive; (b) that inequality leads to increasing polarization because the rich have an inherent advantage over the poor;[3] and (c) that inequality is a sign (or product) of injustice. I believe that each of these views is based on a certain misunderstanding of both facts and the economic processes that generate the income and wealth distribution. It is not that I am proposing some original insights, but that many critics act as if they are oblivious to some elemental facts. In the remainder of this essay, I will try to explain how this is the case.

The outline of the essay is as follows: In the next two sections, I analyze the view that the existing inequality is excessive. Though income and wealth are related and one can be converted into the other, I find it convenient for expository purposes to consider them separately—first income, and then wealth. Sections IV and V will examine, respectively, the views that the rich have an inherent advantage over the poor and that inequality is unjust. I end the essay with some concluding remarks.

[2] For example, see Peter Passell, "Economic Scene: The Rich Are Getting Richer, Etc., and It's Likely to Remain That Way," *New York Times*, March 28, 1996, D2; Paul Krugman, "The Right, the Rich, and the Facts: Deconstructing the Income Distribution Debate," *American Prospect* 3, no. 11 (1992): 19–31; Paul Krugman, "The Income Distribution Disparity," *Challenge* 33, no. 4 (1990): 4–6; and Edward N. Wolff, *Top Heavy: A Study of the Increasing Inequality of Wealth in America* (New York: Twentieth Century Fund Press, 1995).

[3] An associated view is that the rich have disproportionate political influence that undercuts the general welfare. While I do not explicitly examine this view in this essay, I do not believe that it is correct, especially in a democracy with universal adult suffrage and where the rich have a hard time fending off confiscatory taxes. For example, the highest statutory marginal tax rate in the United States was 94 percent in 1954. After several decreases, the rate was reduced to 28 percent in the Tax Reform Act of 1986, but raised again to 39.6 percent in the Taxpayer Relief Act of 1997—over this period, an increasing proportion of national income was collected as taxes.

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TABLE 1. *Shares of household income of quintiles*

| | Lowest (%) | Second (%) | Third (%) | Fourth (%) | Highest (%) |
|---|---|---|---|---|---|
| 1998 | 3.6 | 9.0 | 15.0 | 23.2 | 49.2 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998* (Washington, DC: U.S. Government Printing Office, 1999), xv, table C.

## II. EXCESSIVE INEQUALITY: INCOME

Many critics try to show that the existing inequality in income distribution is excessive, in the sense that collective action is needed to reduce it. Of course, in the absence of an acceptable standard, any such judgment is purely arbitrary. Therefore, in arguing that the perception of excessive inequality is a mistake, I do not intend to introduce an arbitrary standard of my own. That would be futile. All that I wish to argue is that critics often convey the impression that inequality is greater than it actually is.

The most commonly used data on American income distribution is from the Current Population Survey (CPS), conducted each year by the U.S. Census Bureau. In trying to demonstrate the extent of inequality, critics commonly use the CPS data to show how the highest-earning segment of the population compares with the lowest-earning segment. For example, Table 1 shows that in 1998 the share of national income that went to the highest quintile was 49.2 percent, nearly 14 times as large as the lowest quintile's 3.6 percent.

Presenting data in this manner, however, conveys an impression of the degree of inequality that is greater than is actually warranted. CPS data measures the money income of households in a year, before taxes and excluding capital gains. Given the specific definition adopted by the Census Bureau to measure income, the failure to net out taxes that higher-earning households pay from income, or to add in the values of noncash transfers that low-income households receive, leads to an overstatement of the degree of inequality.[4] There are also other factors (such as differences in household size, the age of the primary earner, costs of living, etc.) that, if not taken into consideration, tend to overstate the degree of inequality. Let us briefly consider all of these factors in turn.

### *A. Adjusting income*

Since the early 1980s, the Census Bureau has provided estimates of the effects on income distribution of various adjustments such as (realized)

[4] Noncash transfers include food stamps, rent subsidies, free and reduced-price school lunches, and the value of Medicare and Medicaid.

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TABLE 2. *Shares of household income of quintiles, 1998*

| | Lowest (%) | Second (%) | Third (%) | Fourth (%) | Highest (%) |
|---|---|---|---|---|---|
| Official Census data | 3.6 | 9.0 | 15.0 | 23.2 | 49.2 |
| After all adjustments by the Census | 4.9 | 10.7 | 16.0 | 23.0 | 45.4 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998*, xix, table F and 48–53, table 12.

capital gains (or losses), the imputed return on home equity net of property taxes, the value of employer-paid health benefits, federal and state income taxes, Social Security and Medicare taxes, the earned income credit (a refund of Social Security taxes for qualifying low-income people), and the values of noncash transfers.[5] Not all adjustments are in one direction, but the dominant factors are the taxes higher earners pay and the noncash subsidies lower earners receive.[6] The overall result of the adjustments, accounted for in Table 2, clearly shows that the official measure of income overstates the degree of inequality. After the adjustments are made, the highest quintile's income share in 1998 falls from 49.2 percent to 45.4 percent, while the lowest quintile's share rises from 3.6 percent to 4.9 percent. The ratio of the share of the richest quintile to that of the poorest falls from almost 14 to slightly above 9.

### *B. Household size*

The CPS reports *household* income, and in the survey household size ranges from one to seven or more. To the extent that household size is not randomly distributed across quintiles—it is not—it must be taken into consideration in any judgments about inequality. As shown in Table 3, in 1998, the average size of households with annual income between $5,000 and $9,999 was 1.74. The average size of households with annual income over $100,000 was 3.25. That is, the size of the households with annual income over $100,000 was almost 90 percent larger than the average size of households with annual income between $5,000 and $9,999. Moreover, there is a positive relationship between household income and household

[5] I would argue that the Census Bureau's analysis is still insufficient, even given these adjustments, because it leaves out the value of tuition assistance, especially at the college level; this is increasingly provided on the basis of need, as many middle-class and upper-middle-class families with college-bound children are acutely aware.

[6] In 1996, noncash transfers accounted for 75 percent of welfare expenditures in the United States. See Vee Burke, *Cash and Noncash Benefits for Persons with Limited Income: Eligibility Rules, Recipient and Expenditure Data, FY 1994–96* (Washington, DC: Congressional Research Service, 1997), 16, 18.

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TABLE 3. *Average size (in people) of households at different income levels, 1998*

| | Less than $5,000 | $5,000 to $9,999 | $10,000 to $14,999 | $15,000 to $24,999 | $25,000 to $34,999 | $35,000 to $49,999 | $50,000 to $74,999 | $75,000 to $99,999 | $100,000 and Over |
|---|---|---|---|---|---|---|---|---|---|
| Size | 2.06 | 1.74 | 1.98 | 2.23 | 2.45 | 2.72 | 2.97 | 3.18 | 3.25 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998*, 5, table 2. The average size of all households is 2.61 people.

size.[7] Therefore, drawing inferences about inequality without making an adjustment for the differences in the size of households clearly exaggerates inequality.

How should we make an adjustment? The simplest way is to count one person as one person. Policy analysts Robert Rector and Rea Hederman report that, when adjustments are made on 1997 Census data so that each quintile contains approximately the same number of persons, the income share of the lowest quintile rises from 5.6 percent to 9.4 percent, and that of the highest quintile falls from 45.3 percent to 39.7 percent; see Table 4.[8] Accordingly, the ratio of the income share of the highest quintile to that of the lowest falls from almost 14, in the official data, to a little over 4.

Alternately, one may use an "equivalence scale," a scheme of discounting multiperson households, as is done in the federal government's calculation of the poverty guidelines.[9] With the use of an equivalence scale, the reduction in the measured degree of inequality should be less than that implied by Rector and Hederman. But the question of the specific nature of adjustment regarding household size is not important for our purpose, for the point is made clear: if one does not adjust for differences in household size, income data overstates the degree of inequality.

[7] The only exception is the class of households with less than $5,000 annual income; most of this class's income is government cash transfers. I would guess that single moms disproportionately head these households.

[8] Robert Rector and Rea Hederman, *Income Inequality: How Census Data Misrepresent Income Distribution* (Washington, DC: Heritage Foundation, 1999), 4–5.

[9] Paul Ryscavage, *Income Inequality in America: An Analysis of Trends* (Armonk, NY: M. E. Sharpe, 1999), 30–33. The equivalence scale implicit in the federal government's poverty-line calculation in 1996 is as follows:

| Size of family | 1 person | 2 persons | 3 persons | 4 persons | 5 persons | 6 persons | 7 persons |
|---|---|---|---|---|---|---|---|
| Equivalence scale | 1.000 | 1.279 | 1.565 | 2.010 | 2.370 | 2.680 | 3.040 |

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TABLE 4. *Shares of household income of quintiles, 1997*

| | Lowest (%) | Second (%) | Third (%) | Fourth (%) | Highest (%) |
|---|---|---|---|---|---|
| Official Census data | 3.6 | 8.9 | 15.0 | 23.2 | 49.4 |
| After all adjustments by the Census | 5.6 | 10.8 | 15.8 | 22.5 | 45.3 |
| After quintiles are also adjusted to hold same number of persons | 9.4 | 13.3 | 16.5 | 21.2 | 39.7 |

*Source:* Rector and Hederman, *Income Inequality*. Due to rounding, not all rows in this table sum to 100.0. Figures in Table 4 are based on 1997 CPS data. All other income figures in this essay are based on 1998 CPS data. There are slight discrepancies between the 1997 and 1998 figures.

### *C. Income fluctuation and age differences*

The Census data measures yearly income. There are two reasons why using yearly-income data overstates the degree of inequality. One is that household income fluctuates from year to year—through occasional unemployment and business failure.[10] It is easy to see how three people with identical lifetime income may nevertheless have unequal distributions of yearly income, depending on who has good fortune and who has a bad break.

The other reason is as follows: an individual goes through different phases of life—young, middle-aged, and aged—and a young person's income tends to increase as time passes (and as he or she gains in experience and skill) and then fall off upon retirement. A population of three people at different phases in life, but otherwise identical, may, therefore, be portrayed as having a high degree of inequality, even though their incomes are equal over their lifetimes. It would be unacceptable in this case to infer from the data that income distribution is highly unequal.

Indeed, higher-income households tend to be headed by individuals in their prime working age, say 35–54; see Table 5. Poorer households tend to be headed by older or younger people. Therefore, if we are to draw a fair inference about the degree of inequality in income distribution, we must also adjust the data for differences in the age of householders (assuming that they are primary earners).

The fact that using yearly-income data leads to overstatement of inequality, due to yearly fluctuation of income and differences in the age of earners, can be addressed if income is measured over a longer period of

[10] Boarding schools, for example, know this—they grant financial assistance yearly because family income fluctuates from year to year.

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TABLE 5. *Age of householder at different income levels, 1998*

| | Less than $5,000 (%) | $5,000 to $9,999 (%) | $10,000 to $14,999 (%) | $15,000 to $24,999 (%) | $25,000 to $34,999 (%) | $35,000 to $49,999 (%) | $50,000 to $74,999 (%) | $75,000 to $99,999 (%) | $100,000 and Over (%) |
|---|---|---|---|---|---|---|---|---|---|
| 15–24 | 14.6 | 7.9 | 8.3 | 9.1 | 6.9 | 5.6 | 2.9 | 1.5 | 1.1 |
| 25–34 | 20.0 | 11.4 | 14.7 | 17.3 | 21.4 | 21.0 | 21.8 | 17.2 | 11.5 |
| 35–54 | 32.1 | 23.2 | 23.8 | 29.2 | 37.0 | 45.0 | 52.7 | 57.6 | 61.4 |
| 55–64 | 14.6 | 13.8 | 10.7 | 10.9 | 12.3 | 12.5 | 12.9 | 15.3 | 16.8 |
| Over 65 | 18.7 | 43.7 | 42.5 | 33.5 | 22.4 | 15.9 | 9.7 | 8.4 | 9.2 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998*, 5, table 2.

time. Indeed, a study shows that considering income over a seventeen-year period reduces inequality by about 30 percent.[11]

### *D. Differences in costs of living*

The judgment on the present degree of inequality must be further modified by the fact that different localities have different costs of living. There are fifty different states in the United States, and they differ considerably in average income and costs of living. For example, according to the Census Bureau, the median household incomes in New Jersey and Arkansas are $49,297 and $27,117, respectively. Therefore, the median-income household in New Jersey is placed in the fourth income quintile, and its Arkansas counterpart, in the second. To conclude that the median-income-earning New Jersey household earns some 80 percent more than its Arkansas counterpart would be rash, however, for the costs of living are much higher in New Jersey than in Arkansas.

From our discussions thus far, it should be clear that if all these factors (i.e., taxes, noncash transfers, capital gains, size of household, age of primary earner, and costs of living) were properly accounted for in income data, the degree of measured inequality would be much lower than people commonly infer from careless presentations of the data. It is hoped that at least some people who think that the existing inequality is "excessive" might change their minds after discovering how their judgments are based on an overestimation. However, there are additional factors that must be taken into consideration if the discussion of inequality in income

[11] Peter Gottschalk, "Inequality, Income Growth, and Mobility: The Basic Facts," *Journal of Economic Perspectives* 11, no. 2 (1997): 37. His estimate is based on the University of Michigan's Panel Survey of Income Dynamics.

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TABLE 6. *Characteristics of families at different income levels, 1998*

| | Less than $5,000 | $5,000 to $9,999 | $10,000 to $14,999 | $15,000 to $24,999 | $25,000 to $34,999 | $35,000 to $49,999 | $50,000 to $74,999 | $75,000 to $99,999 | $100,000 and Over |
|---|---|---|---|---|---|---|---|---|---|
| Family size | 3.00 | 2.97 | 3.00 | 2.91 | 3.02 | 3.18 | 3.27 | 3.39 | 3.39 |
| Mean number of earners | 0.58 | 0.69 | 0.86 | 1.02 | 1.34 | 1.67 | 1.98 | 2.19 | 2.22 |
| % of family earning | 19.3 | 23.2 | 28.7 | 35.1 | 44.4 | 52.5 | 60.6 | 64.6 | 65.5 |
| % of earners working full-time[a] | 8.0 | 9.9 | 27.7 | 35.7 | 48.9 | 59.2 | 70.1 | 75.6 | 75.6 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998*, 17–18, table 5.
[a] Percentages in bottom row refer to those working full-time for more than fifty weeks a year.

distribution is to go beyond strictly statistical issues and into the issue of equalization through redistribution.

### *E. Differences in the amount of work and skills*

Once we adjust for the factors of the previous subsections, a good part of the remaining inequality is likely to be accounted for by differences in the amount of work families perform and the skills they offer. First of all, families differ in the number of people working and the amount of hours they work. Indeed, higher-income families tend to have more people working, and working longer hours, than do lower-income households. For example, compare households in two different income levels—say $5,000 to $9,999 and $100,000 and over. Families in the latter level have over three times as many people working than families in the former do, and earners in the latter level are over seven times as likely to work full-time; see Table 6.

Also important is the fact that a worker with more highly valued skills tends to generate a higher income. A person's skills have definite relationships with age and education. The impact of age on income distribution was briefly addressed in Subsection C. Now consider the impact of the differences in educational attainment (standing in part for skills). The relationship between family income and the educational attainment of families is obvious from Table 7. Counting only people 25 and over, more than 60 percent of the families with yearly income over $100,000 have a member with a bachelor's degree or better. Only 4 percent of such families do not contain at least one individual with a high school diploma. In contrast, almost 40 percent of the families with less than $15,000 in yearly income lack any individuals having a high school diploma.

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TABLE 7. *Educational attainment of peak individuals in families at different income levels, 1998*

| | Less than $5,000 (%) | $5,000 to $9,999 (%) | $10,000 to $14,999 (%) | $15,000 to $24,999 (%) | $25,000 to $34,999 (%) | $35,000 to $49,999 (%) | $50,000 to $74,999 (%) | $75,000 to $99,999 (%) | $100,000 and Over (%) |
|---|---|---|---|---|---|---|---|---|---|
| Less than 9th grade | 12 | 21 | 20 | 14 | 9 | 5 | 2 | 1 | 1 |
| 9th to 12th grade[a] | 24 | 23 | 19 | 17 | 12 | 10 | 5 | 3 | 2 |
| High school graduate[b] | 37 | 32 | 35 | 37 | 40 | 38 | 33 | 25 | 14 |
| Some college | 20 | 18 | 20 | 23 | 26 | 30 | 31 | 29 | 22 |
| Bachelor's degree or more | 7 | 6 | 6 | 9 | 13 | 17 | 29 | 42 | 61 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998*, 17–18, table 5. Measure of educational attainment is restricted to people 25 years old and over.
[a] No diploma.
[b] Including equivalency.

Given the relationship between income on the one hand and the amount of work and education (standing in part for skills) on the other hand, our inference about inequality should therefore be even further modified, especially if the inference is being used to motivate a redistribution scheme. (One must also consider the possibility that the remaining inequality may be largely attributable to differences in energy, risk-taking, prudence, and ingenuity.)

What I have argued thus far is that regardless of what critics think the appropriate level of inequality is, the inferences based on unadjusted official data overstate the actual degree of inequality. Critics often do not take necessary care in presenting and interpreting the data. I will not speculate unduly on cause. Perhaps these critics are careless about numbers (even though the critics include some well-known economists); perhaps they run with numbers that seemingly conform to what they want to believe.

### *F. Inequality without redistribution*

Before we discuss wealth distribution in Section III, it is important to address one more issue: how much worse the distribution of income would be without the redistribution schemes currently in place. I am not about to propose a specific figure, but I am inclined to observe that the extent of inequality that might prevail is commonly overestimated.

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TABLE 8. *Shares of household income of quintiles, 1998*

| | Lowest (%) | Second (%) | Third (%) | Fourth (%) | Highest (%) | Gini Coefficient |
|---|---|---|---|---|---|---|
| Official Census data (1) | 3.6 | 9.2 | 14.9 | 23.3 | 49.0 | .446 |
| (1) – cash transfers + capital gains + employee health benefits | 1.0 | 7.1 | 14.2 | 23.4 | 54.1 | .509 |
| After all adjustments by the Census[a] | 4.9 | 10.7 | 16.0 | 23.0 | 45.4 | .399 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998*, xix, table F. Due to rounding, the percentages in this table's rows do not always sum to 100.0.
[a] See Subsection A of Section II above.

To see this, consider Table 8. The Gini coefficient for the 1998 official data is .446.[12] By excluding cash transfers from the official data, and adding capital gains and the value of employee health benefits, Census Bureau analysts estimate the Gini coefficient would have been .509 if there had been no government-sponsored redistribution. They then compare this to the Gini coefficient one gets after all the Census adjustments are made, including those for capital gains, employee benefits, taxes, and both cash and noncash transfers: the result is a Gini coefficient of .399. The Census Bureau analysts conclude that the Gini coefficient with redistribution is .399, and .509 without it.

Unfortunately, the analysts seem to ignore a basic lesson of economics—namely, that when a tax on a good is increased or a subsidy on it reduced, the price of the good neither increases by as much as the tax does, nor decreases by as much as the subsidy does.[13] Accordingly, if existing taxes were eliminated, a taxpayer's income would not go up by the amount of the taxes that he used to pay. By the same token, if existing government transfers were eliminated, a transfer recipient's income would not decrease by the amount of transfers that he used to receive. Therefore, it seems that

[12] The Gini coefficient measures the degree to which income distribution departs from perfect equality. If income distribution is perfectly equal, the Gini coefficient is 0. On the other extreme, if no household except one had any income, the Gini coefficient would be 1. It should be noted that since the Gini coefficient summarizes an entire distribution with one value, a Gini coefficient is compatible with any number of distributions. Consequently, an income distribution with a lower Gini coefficient may not necessarily be preferable to one with a higher Gini coefficient.

[13] For example, if the taxes on cigarettes (say, $2 a pack) are eliminated, the out-of-pocket cost of cigarettes (the price of cigarettes plus any taxes) will decline by less than $2. The reason is that at the no-tax price, there would be an excess demand for cigarettes, causing the price to rise. Similarly, if college tuition subsidies are eliminated, college tuitions will not decline by the amount of the subsidies eliminated.

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estimating what the Gini coefficient would be without redistribution by simply eliminating taxes and subsidies results in an overestimation of the inequality that might prevail in the absence of government-sponsored redistribution.

## III. Excessive Inequality: Wealth

Critics commonly observe that wealth is even more unequally distributed than income. Again, I have no intention of disputing the fact that distribution of wealth is unequal. I merely wish to suggest that careless inferences from commonly available data overstate the degree of inequality. The reason is that the Federal Reserve Board's triennial Surveys of Consumer Finances (SCFs), the best-known data source on household wealth in the United States, exclude from wealth consideration such important items as the value of expected Social Security benefits, the future tax liabilities on unrealized capital gains, and the value of human capital.

### *A. Value of Social Security and other entitlements*

The SCFs define household wealth as net worth (NW), current marketable or fungible assets minus the current value of debts. By focusing on marketable assets, the definition excludes such nonmarketable assets as expected Social Security benefits. However, including the value of retirement benefits from private sources—for example, corporate and union pensions, and individual retirement provisions such as 401(k)s—as a part of one's wealth while excluding the equivalent from Uncle Sam introduces a bias to the extent that Social Security benefits are a more important part of the wealth of the less well-off.[14] The extent of this overstatement is clear from Table 9, which compares the 1992 median net worth of different income classes with and without the estimated present value of Social Security benefits as a part of household wealth. Excluding Social Security benefits, the ratio of the net worths of the median household with more than $100,000 in income and that with less than $10,000 in income is 493 to 1. Including the values of Social Security benefits reduces the ratio to 19 to 1.[15] Appropriate inclusion of the values of other social entitlements—for example, the present value of expected disability benefits—should further reduce the degree of inequality.

[14] Some may try to justify the exclusion of "Social Security wealth" on the ground that the Social Security system, as a pay-as-you-go system, is unfunded. This ignores the fact that not all pensions are fully funded. More importantly, the majority of Americans organize their lives based on the belief that Social Security wealth is real. One should ask politicians whether any of them would be willing to argue that such wealth is not real.

[15] Estimates of the values of expected Social Security benefits are based on algorithms supplied by the Social Security Administration.

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TABLE 9. *Median household wealth at different income levels, 1992*

| Household Income | NW without Social Security Wealth ($1000) | NW with Social Security Wealth ($1000) |
|---|---|---|
| $9,999 or less | 1.7 | 56.4 |
| $24,999 to $10,000 | 28.3 | 108.6 |
| $49,999 to $25,000 | 117.9 | 231.5 |
| $99,999 to $50,000 | 279.3 | 444.6 |
| $100,000 or more | 837.8 | 1,052.3 |

*Source:* Arthur B. Kennickell and Annika E. Sunden, "Pensions, Social Security, and the Distribution of Wealth" (working paper, Federal Reserve Board—SCF, 1997), table 3; document available on-line at http://www.federalreserve.gov/pubs/feds/1997/199755/199755abs.html.

Instead of modifying the data to get a more accurate picture, some seem to modify the data to further accentuate the degree of inequality. For example, consider economist Edward Wolff's study of wealth distribution in the United States.[16] He proposes to modify the definition of wealth from NW to the even more narrow measure of financial wealth (FW): "NW minus net equity in owner-occupied housing."[17] He justifies the exclusion of an important American asset on the ground that "it is somewhat difficult to liquidate one's housing wealth in the short term."[18] But there is a certain inconsistency here: FW excludes the value of owner-occupied housing, but not the value of other real estate properties. Is there any evidence that the latter is more liquid than the former? Wolff does not say. But Wolff's definition of wealth in terms of FW results in a further overstatement of inequality in that owner-occupied housing is a more significant part of the wealth of middle-class households, while other real estate properties are a more significant part of the wealth of more well-off households.

*B. Tax liabilities on unrealized gains*

Also significant is the exclusion of the future tax liabilities on unrealized capital gains, especially during booming asset markets. The effect is to grossly overstate the net worth of more well-off households. For example, suppose that Mr. A bought a vacation house for $10,000 in cash in 1970. He now learns that the property can be sold for $500,000. In the

[16] Edward N. Wolff, "Recent Trends in the Size Distribution of Household Wealth," *Journal of Economic Perspectives* 12, no. 3 (1998): 131–50.
[17] Ibid., 133.
[18] Ibid.

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SCFs, the full half-million will be counted toward his household wealth. But were he to sell his property, the proceeds would be subject to taxes for ordinary income under the current tax laws. He may end up paying almost 50 percent taxes on his nominal net gain of $490,000.[19] Therefore, on the day of the survey, the real value of the vacation house—net of the tax liabilities—should be something like half that reported in the SCFs.

This reasoning should generally apply to all unrealized gains that are counted as part of one's wealth. For example, suppose 50 percent of the value of the financial assets of the very well-off is unrealized capital gains. The future tax liabilities on these appreciated assets (supposing that all future gains are subject to preferential long-term capital gains tax rates) add up to about 40 percent—say, the 28 percent alternative minimum tax and about 12 percent in state and local taxes (as in New York City).[20] The result is that if one disregards these future liabilities, one overstates the financial wealth of the very well-off by about 25 percent. This is, of course, just one example, and there is no simple way to estimate the extent of overstatement. But the direction of overstatement is clear. The larger the proportion of unrealized capital gains in the very well-off's NW, the greater the exaggeration.

### *C. Value of human capital*

Failure to include in household wealth the value of "human capital," which is the source of most future earnings (especially for professionals), understates the wealth of the young and the middle class. Consider the example of a newly minted surgeon. The SCFs would record his or her net worth as negative, given the large debt incurred to finance medical training. Compare this young surgeon with a 30-year-old invalid with an annuity valued at $500,000 thanks to a generous uncle. (The annuity pays the invalid, say, $45,000 a year until he dies.) The SCFs would record the invalid's net worth at $500,000. Careless inference would lead one to count the invalid as rich and the young surgeon as poor, even though the young surgeon expects to earn, say, $300,000 a year for the next thirty years, based on his human capital.[21]

[19] Under the current tax codes, capital gains on a vacation home are treated as ordinary income. The highest federal marginal income tax rate, which applies to a joint return above $278,450, is 39.6 percent. For a New York City couple, the state and local marginal income tax rates add up to 11.785 percent. Even if the state and local taxes were fully deductible against federal income tax, which is doubtful, the effective state and local marginal tax rates in this case would be roughly 7 percent. The combined marginal tax rates would thus be over 46 percent. This of course does not include the sales tax on the property.

[20] I am using here the example of the very well-off, who would easily become subject to the alternative minimum tax, which is basically a 28 percent flat tax with virtually no deductions. (The only exceptions are mortgage interest and investment expenses.)

[21] In divorce courts, the value of human capital is often recognized for what it is.

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*D. Fluctuation of net worth*

An additional point to consider is that household wealth is customarily measured at a moment in time. To the extent that the net worth of households fluctuates through time and changes through the life-cycle (for reasons similar to those presented in Subsection C of Section II above), this convention significantly overstates the degree of inequality.

*E. Consumption vs. savings and investment*

There is one more factor that should be considered if one is to draw inferences about the degree of inequality in wealth distribution. The net worth of an individual at a point in time depends much on his or her income stream, consumption (and savings) pattern, and investment strategies. That is, two individuals who are identical in many respects—such as income, years worked, inheritance, and so on—may end up with vastly different net worths at a particular moment.

For example, consider two retired middle managers, X and Y, with identical salary histories. Suppose X's net worth is $2,000,000 and Y's is zero. Are we to conclude that X is infinitely richer than Y and that wealth distribution is very unequal? Not necessarily. Upon a closer look, one may discover that X is an elderly miser who never got married out of fear of spending money on a wife or children. He has had coarse meals all his life, and has methodically saved and invested with a moderate rate of return. On the other hand, Y, with zero net worth, may have had an enjoyable life, supported his wife, and raised his many children well, by prudently spending all his income. To observe that X is infinitely richer than Y, and therefore to recommend that X's wealth be redistributed, would be a very strange and unjust suggestion. Most of X's wealth may be merely postponed consumption, with him getting token rewards (that is, interest payments) for his discipline in saving. Who knows what kind of future consumption plans X has up his sleeve?[22]

I have thus far discussed some misunderstandings about "facts" of income and wealth distribution, misunderstandings that—through careless uses of data—make the distributions look much more unequal than they really are. Let us now turn to analyze social critics' other views about the economic processes that generate income and wealth distribution. In the following section, I will address the view that inequality leads to

[22] In 1995, Oseola McCarty, an 87-year-old black woman from Hattiesburg, Mississippi, donated $150,000 to a local college for a scholarship fund for black youths. She spent all her life as a seamstress earning minimal wages; in her youth, she earned nickels and dimes a day. Nevertheless, she managed to amass a fortune. Her lifetime accumulation was $250,000, as the donation represented 60 percent of her wealth; the rest was distributed among her relatives and her church. It is incredible, but it happened. See Sharon Wertz, "Oseola McCarty Donates $150,000 to USM" (article from the University of Southern Mississippi's Office of University Relations, July 1995), available on-line at http://www.pr.usm.edu/oola1.htm.

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TABLE 10. *Gini coefficient of income inequality over time*

| Year | 1967 | 1970[a] | 1975 | 1980[a] | 1985 | 1990 | 1995[b] | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|---|---|---|---|
| Gini coefficient | .399 | .394 | .397 | .403 | .419 | .428 | .450 | .455 | .459 | .456 |

*Source:* U.S. Census Bureau, *Money Income in the U.S.—1998*, xiv–xv.
[a] The method of data collection changed in 1970 and 1980.
[b] Increases in 1993 in the limits applied by the Census Bureau when counting some income sources resulted in measured income for the highest-income households rising by considerably more than did their actual income. That is, the method of income-data collection used since 1993 is different from that used prior to 1993.

increasing polarization because the rich have an inherent advantage over the poor. The view that inequality is a sign (or product) of injustice shall be analyzed in Section V.

## IV. The Inherent Advantage of the Rich

Many critics appear to have the strong suspicion that the rich have an inherent (and unfair) advantage over the poor, and that this advantage is accentuated by cutthroat competition in the market. They feel that the rich are bound to get richer and that the poor are condemned to increasing misery.

This deeply held suspicion was rekindled by reports suggesting that inequality in income distribution increased in the 1980s and the early 1990s. For example, Table 10 shows that the Gini coefficient of income inequality increased from .397 in 1975 to .419 in 1985, .428 in 1990, and .450 in 1995.[23] Many social critics were convinced by the reports of increasing inequality that their view of the inherent advantage of the rich and the inherent disadvantage of the poor was validated, and that the United States was becoming a polarized society of the haves and the have-nots.[24]

Of course, this was not the only possible interpretation of the reports of growing inequality in measured income or wealth. Volumes have al-

[23] Many people regarded this trend as real enough despite those shortcomings of income and wealth measurements that I noted in Sections II and III. They felt that even a faulty measure, if used *consistently*, could still give a fair sense of change. Even so, one should be mindful that the measurement of income changes over time for various reasons. For example, in Table 10, the big increase in the Gini coefficient between 1990 and 1995, from .428 to .450, is more a reflection of changes in the ways in which income is measured than of changes in income distribution; see Table 10, note b. As noted in the table, there were changes in income measurement in 1970 and 1980 as well.

[24] Economist Paul Krugman, one of the most vocal critics of the trend toward income inequality, was so sure of its causes that he suspected that any individuals who proposed to examine the validity of the thesis of the disappearing middle class had to be "hired guns of the Right." Paul Krugman, "The Spiral of Inequality," *Mother Jones*, November 1996, 47. See also Paul Krugman, "What the Public Doesn't Know Can't Hurt Us," *Washington Monthly*, October 1995, 8–12.

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ready been written to explain the reasons for the trend toward growing inequality.[25] The main aim of this section, therefore, is not to add another explanation for the trend, nor to attempt to deny that the trend is real. The main aim of the section, rather, is to analyze the validity of the social critics' understanding of the way the economy works, the understanding that led the critics to believe that they (or their views) were vindicated by the reported trend of growing inequality.

Surely, one can easily think of many advantages the rich have over the poor. For example, the rich have a higher savings rate than the poor, with the poorest saving virtually nothing. Even if the rich and the poor earned the same rate of return on their savings, it is inevitable that the wealth of the rich will grow at a higher rate. Accordingly, the gap between the rich and the poor may grow over time.[26] Another possibility is what economists Robert Frank and Philip Cook regard as the modern tendency of small differences in ability (and resources) to translate into large differences in income (and wealth).[27] They call the process "winner-take-all," and see the real source of rising inequality in its spread.

But is the putative advantage of the rich truly the dominant feature of the process of generating income and wealth in a market economy? I do not think so. The advantage of the rich is more pronounced in the short run. In the longer run, however, it becomes less clear. The reason is that there are other, more important factors in determining income and wealth in the future than the ownership of currently valued assets. The most important of these is entrepreneurship.[28]

However, it is not easy to argue in the abstract. A better way to see that the critics' claim that the rich have an advantage is mistaken is to see whether its implications are consistent with our experience. If it were true that the rich have an inherent advantage, then (a) the distribution of income and wealth should become increasingly polarized over time, and (b) we should observe little mobility. But we observe the contrary. Let me explain.

### *A. Relative stability of distribution*

The first implication, that of an ever-increasing polarization of income and wealth distribution, is not consistent with the evidence. According to economic historians, the pattern of the distribution of earnings among American males in the last 150 years is "marked by long periods of

[25] For a good survey of the literature, see Frank Levy and Richard J. Murnane, "U.S. Earnings Levels and Earnings Inequality: A Review of Recent Trends and Proposed Explanations," *Journal of Economic Literature* 30, no. 3 (1992): 1333–81.

[26] Herbert Inhaber and Sidney Carroll, *How Rich Is Too Rich?: Income and Wealth in America* (New York: Praeger, 1992), 82–89.

[27] Robert H. Frank and Philip J. Cook, *The Winner-Take-All Society* (New York: Free Press, 1995).

[28] For a more detailed discussion, see Young Back Choi, "On the Rich Getting Richer and the Poor Getting Poorer," *Kyklos* 52, no. 2 (1999): 239–58.

relative stability and shorter periods of substantial change."[29] In fact, the pattern of income distribution does not vary much across ages or different economic systems.[30]

What about the recent much-discussed trend of growing inequality in income distribution?[31] Though the increasing inequality in the 1980s has drawn much attention, many economists believe that much of it had to do with changes in demography, labor-market conditions, and industrial structure.[32] The supply of young and less-educated males increased (relative to that of the more educated), reflecting a low premium on education during the preceding decades. At the same time, the relative demand for the labor of less-educated males declined in the 1980s, when the strengthening of the dollar accelerated the restructuring of industries and increased both the industrial migration to high-tech/service sectors and the relocation of manufacturing overseas. Another factor was the increased competition in the labor market brought about by women, who had marked gains during the period under consideration. Changes in the characteristics of families (the proportion of single-head households increased, as did the proportion of the elderly in the population) and of

[29] Levy and Murnane, "U.S. Earnings Levels and Earnings Inequality," 1340. One should note that the periodic changes have not all been in the direction of increasing inequality, and that the overall stability is in the very long run.

[30] International (as well as intertemporal) comparison of income dispersion is difficult because of data incompatibility. Still, economist A. B. Atkinson ventures to say that "within the group of industrialized countries the degree of dispersion is broadly the same," despite differences in economic structures. A. B. Atkinson, *The Economics of Inequality* (Oxford: Clarendon Press, 1975), 27.

[31] The alleged increase in wealth inequality rests on a shakier ground than does the trend of income inequality, in that comparability of data over time with respect to wealth is even more questionable than it is with respect to income. For example, in Wolff, "Recent Trends in the Size Distribution of Household Wealth," Wolff shows that wealth distribution in the United States worsened between 1983 and 1995 (and shows how unfavorably it compares with wealth distribution in European countries and Japan). However, A. B. Kennickell and R. L. Woodburn show that using different weights meant to correct sampling biases can alter the survey results dramatically, especially for the wealthiest segment of the population. A. B. Kennickell and R. L. Woodburn, "Consistent Weight Design for the 1989, 1992, and 1995 SCFs, and the Distribution of Wealth" (working paper, Federal Reserve Board—SCF, 1997), available on-line at http://www.federalreserve.gov/pubs/oss/oss2/method.html. For example, using the revised weights, "the share of the top $\frac{1}{2}$ percent in 1989 is *lower* than that in 1983"; using the original weights "showed a dramatic increase" during the same period (ibid., 2). Kennickell and Woodburn therefore caution against drawing inferences about the trend in wealth distribution by comparing the 1983 and 1989 surveys, which used the original weights, and the 1989 and subsequent surveys using the revised weights. They explicitly cite Wolff's earlier attempts to make cross-country comparisons as strongly inadvisable, given the sensitivity of data to weights and the inconsistency of weights used in different countries.

[32] Levy and Murnane, "U.S. Earnings Levels and Earnings Inequality," 1340–41; Finis Welch, "In Defense of Inequality," *AEA Papers and Proceedings* 89, no. 2 (1999): 1–17. It should be noted that much of the significance of the reported increase in inequality in the 1980s and the early 1990s arises from a common mistake people make: thinking that people in the lowest quintile (and other quintiles) in 1980 are the very same people in the lowest quintile (and other quintiles) in 1990. This is certainly not the case. Somehow, the discussion of the "shares" of certain classes of people seems to conjure up the image of identifiable groups of people.

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immigrants (over three-quarters of whom now have less than a high school education) also contributed to the increased statistical dispersion of income distribution. Whatever the cause was, there is no good ground to project the recent trend into the future. Indeed, since the mid-1990s, the income distribution has become stable; see Table 10.

### *B. Mobility*

The implied lack of economic mobility is also contrary to the evidence. Relatively few remain chronically poor, within a lifetime or across generations.[33] Intragenerational mobility deals with the degree to which the income status of an individual at a moment in time is determined by his or her economic status at another moment in time. Much of intragenerational mobility has to do with the life-cycle of the individual—the fact that, given a career path, the income of the young increases over time as they gain experience and skills, and falls off upon retirement, as discussed in Subsection C of Section II above. Another source of intragenerational mobility is changes in one's career path.

A study based on the University of Michigan's Panel Survey of Income Dynamics (PSID) shows much intragenerational mobility; see Table 11. The chance that one in the poorest quintile in 1974 improved one's situation by 1991 is 58 percent, and that person's chance of being in the top two quintiles is 21 percent. Given that we are considering intragenerational mobility, mobility is substantial.[34] Noting that there is a good deal

[33] Greg J. Duncan, *Years of Poverty, Years of Plenty* (Ann Arbor: University of Michigan Press, 1984), 41–43, 91. Duncan found substantial mobility and observed that only about 2.6 percent of the population appeared to be chronically poor.

[34] A study based on U.S. income tax returns shows even greater intragenerational mobility. Table A shows that over 85 percent of those in the poorest quintile in 1979 improved their situation by 1988, and 40 percent found themselves in the top two quintiles. Indeed, the chance of someone in the poorest quintile in 1979 remaining there after nine years is the same as him or her joining the highest quintile.

TABLE A. *Percent of each 1979 income quintile in 1988 income quintiles*

| 1979 Quintile | Lowest (%) | Second (%) | Third (%) | Fourth (%) | Highest (%) |
|---|---|---|---|---|---|
| Lowest | 14.2 | 20.7 | 25.0 | 25.3 | 14.7 |
| Second | 10.9 | 29.0 | 29.6 | 19.5 | 11.1 |
| Third | 5.7 | 14.0 | 33.0 | 32.3 | 15.0 |
| Fourth | 3.1 | 9.3 | 14.8 | 37.5 | 35.4 |
| Highest | 1.1 | 4.4 | 9.4 | 20.3 | 64.7 |

*Source:* Chris Frenze, "Income Mobility and Economic Opportunity," in Edwin Mansfield, ed., *Leading Economic Controversies of 1996* (New York: W. W. Norton, 1996), 10–45. Due to rounding, not all rows in this table sum to 100.0.

This study has been criticized for suffering from certain sampling biases, as it includes only individuals who filed income taxes both in 1979 and 1988.

TABLE 11. *Percent of each 1974 income quintile in 1991 income quintiles*

| 1974 Quintile | Lowest (%) | Second (%) | Third (%) | Fourth (%) | Highest (%) |
|---|---|---|---|---|---|
| Lowest | 42.1 | 22.8 | 14.3 | 13.0 | 7.8 |
| Second | 28.7 | 36.0 | 19.3 | 9.2 | 6.7 |
| Third | 14.7 | 20.6 | 32.1 | 20.5 | 12.0 |
| Fourth | 9.7 | 12.0 | 24.2 | 32.4 | 21.7 |
| Highest | 3.1 | 7.3 | 10.2 | 25.4 | 53.9 |

*Source:* Peter Gottschalk, "Inequality, Income Growth, and Mobility." Due to rounding, not all rows in this table sum to 100.0.

of mobility in the United States, economist Alan Blinder says, "While ghetto dwellers rarely trade places with Rockefellers, ours is not a stratified society."[35]

Intergenerational mobility, which is perhaps of greater interest to many concerned with the unfair advantages of the rich, deals with the degree to which income status is transmitted from one generation to another. Many economists have found evidence for high intergenerational mobility, that is, little correlation between the incomes of fathers and sons.[36] Gary Becker, a Nobel laureate in economics, observes that in rich countries, including the United States, "low earnings as well as high earnings are not strongly transmitted from fathers to sons."[37]

Economist Gary Solon, however, argues that the impression of a highly mobile America is based on flawed studies overestimating intergenerational mobility. According to a study by Solon based on the PSID, the intergenerational income correlation is .4 or higher, "indicating dramatically less mobility than suggested by earlier research."[38] Solon's estimate certainly implies a higher degree of transmission of earnings status across generations than do earlier estimates (for example, William Sewell and Robert Hauser's estimate that the correlation is .18).

But what does it mean? Does the father/son earnings correlation of .4 represent a lack of mobility? Hardly. Consider the following: Given the

[35] Alan S. Blinder, "The Level and Distribution of Economic Well-Being," in Martin Feldstein, ed., *The American Economy in Transition* (Chicago: University of Chicago Press, 1980), 454.

[36] William H. Sewell and Robert M. Hauser, *Education, Occupation, and Earnings: Achievement in the Early Career* (New York: Academic Press, 1975), 72.

[37] Gary S. Becker, "Family Economics and Macro Behavior," *American Economic Review* 78, no. 1 (1988): 10.

[38] Gary Solon, "Intergenerational Income Mobility in the United States," *American Economic Review* 82, no. 3 (1992): 393–408.

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father/son earnings correlation of .4, the expected differences in earnings among sons will be only 40 percent of the differences in earnings among their fathers, and the expected differences among grandsons will be only 16 percent of the differences among their grandfathers. Alternately, consider two individuals, X and Y, with earnings such that roughly 15.8 percent of the population earns less than X and 15.8 percent earns more than Y—that is, X is in the lowest quintile, and Y is in the highest.[39] Assuming a standard normal distribution, the chance of Y's son doing better than X's son is 78.8 percent, compared to a 21.2 percent chance of X's son doing better than Y's son. The respective chances are 62.6 percent and 37.4 percent in the grandsons' generation, and 55.1 percent and 44.9 percent in the great-grandsons' generation.[40] Even with a father/son earnings correlation of .4, the economic prospects of the third-generation descendants of someone in the lowest quintile are not much inferior to those of descendants of one in the highest quintile. The degree of mobility in the United States is rather striking.[41] Some people might argue that anything short of equality between the probability of the poor becoming rich and the probability of the rich becoming poor is insufficient. Millions of prospective immigrants wish to vote to the contrary with their feet.

What about mobility among the richest in America? Since one of the major difficulties of using large-scale data is its underrepresentation of those at the highest level of income or wealth, it would be of great interest to get a glimpse of the degree of mobility at the very top of the wealth scale. Mobility among the richest is of added interest in the context of my discussion; if the alleged advantage of the rich really exists, it should be more pronounced among the richest. Table 12 presents the ten richest Americans in 1995 and their prior and subsequent rankings. It should be noted that all, save the Waltons, are self-made. (In 1999, thirty-seven out of the top fifty richest Americans were self-made.) In 1983, only twelve years before, five out of the ten were not even ranked among the richest four hundred. By 1999, only four years later, some of them were already elbowed out by newcomers. Mobility among the richest is high, indeed.

Of course, there are Rockefellers, DuPonts, and Mellons who have carefully husbanded their inheritances and remain among the richest. However, their fortunes pale compared to the newly found fortunes of

[39] Assuming a normal distribution, the positions of X and Y are such that their incomes are one standard deviation away from the mean on either side.

[40] This may be an underestimate of intergenerational mobility, as Solon admits that his model ignores the possibility of differential intergenerational transmission across income strata. The possibility is not idle. Solon discusses the fact that it is possible that the earnings correlation is higher for the highest quintile (.48) and lower for the lowest quintile (.34). If that is the case, "'riches to rags' may occur less frequently than 'rags to riches.'" Solon, "Intergenerational Income Mobility in the United States," 404.

[41] Peter Bauer notes a high degree of mobility in the supposedly stratified Great Britain. Peter Bauer, *From Subsistence to Exchange* (Princeton, NJ: Princeton University Press, 2000), 125–38.

TABLE 12. *The ten richest Americans in 1995 and their prior and subsequent rankings*

| Name | Source of Wealth | 1983 Rank | 1989 Rank | 1995 Rank | 1999 Rank |
|---|---|---|---|---|---|
| W. H. Gates III | Microsoft | n/a | 43 | 1 | 1 |
| W. E. Buffett | Investments | 31 | 2 | 2 | 3 |
| J. W. Kluge | Metromedia | 100 | 1 | 3 | 14 |
| P. G. Allen | Microsoft | n/a | 86 | 4 | 2 |
| S. M. Redstone | Viacom | n/a | 3 | 5 | 19 |
| R. M. DeVos and J. Van Andel | Amway | 102 | 268 | 6 | 152 |
| S. I. and D. E. Newhouse | Media holdings | 19 | 6 | 7 | 42 |
| Waltons | Wal-Mart (inheritance) | 2 | 17 | 8 | 6 |
| R. O. Perelman | Investments | n/a | 5 | 9 | 61 |
| L. J. Ellison | Oracle | n/a | 98 | 10 | 18 |

*Source: Forbes* lists of wealthiest Americans, various years.

Bill Gates (Microsoft), Larry Ellison (Oracle), Warren Buffett (Berkshire Hathaway), Michael Dell (Dell Computer), Jerry Yang (Yahoo!), and the like. Moreover, few heirs of great fortunes from the Roaring Twenties are still counted among the richest.[42] Obviously, the rich do not always stay on top.

Evidence considered thus far contradicts critics' claims that the rich have inherent advantages over the poor and that, as a consequence, income and wealth distribution will become increasingly unequal. Instead of finding increasing polarization of income distribution and little or no mobility, we see both long-term stability in the pattern of income distribution and much mobility. Other forces—the most important of which is entrepreneurship—counter the putative advantage of the rich, allowing some of the poor, with all their disadvantages in resources (e.g., poor manpower, difficulty in raising capital, lack of connections, etc.) somehow to supplant the rich, while causing many of the rich, with all their putative advantages, to fall from their dominance. To believe that the advantages of the rich are predominant in competitive economic pro-

[42] Some may remain skeptical, believing that old fortunes are skillfully hidden from the probing eyes of *Forbes* researchers (and, more importantly, from those of the IRS). Of course, there are limitations to the "Forbes 400," as there are with most data. But the suspicion is an unfalsifiable speculation. For what evidence (that can stick in court) is there, when solid evidence would enable an ambitious politico to build an outstanding career?

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cesses is to display a profound misunderstanding of economic processes that generate income and wealth distribution.[43]

## V. Inequality Is Unjust

Many critics seem to think that inequality in income and wealth distribution is a sign of (or a product of) injustice. They hold onto this belief even when there is no evidence of wrongdoing that is punishable under the law. I believe that the idea of the injustice of inequality in the absence of such evidence is ill considered and largely based on a misunderstanding of the process of income and wealth generation.

If there is evidence that someone gained through unjust acts, our grievance should be against the unjust acts and should have little to do with the gain. Someone either committed injustice or not. The fact that someone is poor should not exonerate him or her from charges of wrongdoing. Otherwise, we exempt all unjust acts that failed to be lucrative. Therefore, the distinction between rich and poor (or the issue of inequality) is tangential to the issue of injustice.

When there is no evidence of injustice, what can be the grounds for the suspicion that inequality is a sign of injustice? If we lived in a country that was lawless (or had unjust laws), the suspicion might well be justified. In that country, few things would be regarded as legitimate. The extant distribution there would hang delicately on the distribution of naked force. But in a country where the law is tolerably upheld, so that whenever evidence of wrongdoing surfaces, the legal system is mobilized to address the wrong, the basis for suspicion is less clear.

The belief that inequality signifies injustice, even when there is no evidence to this effect, seems to be grounded on four kinds of views about economic processes: (a) that one man's gain is necessarily at the expense of others; (b) that voluntary exchanges may be mutually beneficial, but the gains from exchanges are unfairly distributed; (c) that all above-average gains are undeserved; and (d) that there are negative pecuniary externalities. Let us briefly consider these claims in turn.

### *A. One man's gain is at the expense of another*

The belief that one man's gain is necessarily at the expense of another—as is the case when dividing a pie—is deeply rooted in the human psyche. Whatever the origin of the belief, it is not valid when applied to voluntary exchanges, which is what a market economy is largely about. One of the most valuable insights of economics suggests that voluntary exchanges are value-creating and mutually beneficial—otherwise, the exchanges would not have taken place. Nevertheless, the erroneous perception of

[43] See Choi, "On the Rich Getting Richer and the Poor Getting Poorer."

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economic processes as a zero-sum game has found expression through the ages in denouncements of trade as unproductive and parasitic. Even today, in the age of universal commerce, the suspicion persists against gains, especially large gains.

Not all large gains are held in suspicion, of course. For example, I have not heard social critics charging that the baseball slugger Mark McGwire's decamillion-dollar income is at someone else's expense. The critics can see that McGwire can hit the ball over the fence better than anyone else alive and that his fans gladly pay to see him play. The same point applies to star entertainers such as singers, actors and actresses, and other sports players. The fantastic gains of inventors also seem to be easily understood and excused.

But when a nondescript businessman or an entrepreneur makes big gains, critics wonder whether someone else is not cheated, exploited, or even robbed. The suspicion has a lot to do with misunderstanding the nature of profit. Profit in the competitive market does not arise from routine practices, but from discovering and exploiting opportunities overlooked by others. The source of profit, in other words, lies in superior knowledge and hunches about market conditions. Social critics, not being privy to the sources of profit, generally see no ground for profit.[44] Since the sources of profit are obscure, the critics suspect some sort of injustice—if not illegal actions, then perhaps highly immoral ones.[45]

Even when the critics come to learn, ex post, about the sources of profits, they often feel that the sources are too trivial to merit the gains—ignoring the fact that the whole informational advantage lies in having these sources before others. (Timing is a crucial factor here. Aren't we all smart in hindsight?) Critics, who usually view themselves as intellectually capable, cannot see how so much profit can be justified by such trivialities.[46] Since the critics fail to see justifiable causes for profits, they do what is "logical," suspecting wrongdoing on the part of entrepreneurs, however unproven. Once they convince themselves that the rich have gained unjustly, they have few qualms about demanding redistribution, which is really only demanding justice as far as they are concerned.

[44] Otherwise, they might have taken an action and captured the profit themselves. Of course, if they valued other things (such as academic pursuits) more highly than the profit, and ignored the profitable opportunity that they were certain of, it was their choice. In this case, they paid the implicit price of the expected profit to engage in their nobler pursuits. The blaming of others for taking profit that the critics themselves could have, then, amounts to the critics blaming others for not sharing the critics' interests.

[45] Young Back Choi, "Entrepreneurship and Envy," *Constitutional Political Economy* 4, no. 3 (1993): 331–47. See also F. A. Hayek, *The Fatal Conceit: The Errors of Socialism* (Chicago: University of Chicago Press, 1989), 89–105.

[46] Furthermore, the source of much American wealth is mundane as well. Many American millionaires own small, nonglamorous businesses, including junkyards, insurance agencies, and small manufacturing concerns. See Thomas J. Stanley, *The Millionaire Mind* (Kansas City, MO: Andrews McMeel, 2000); and Thomas J. Stanley and William D. Danko, *The Millionaire Next Door* (Atlanta, GA: Longstreet Press, 1996). See also Andrew Hacker, *Money: Who Has How Much and Why* (New York: Scribner, 1997), 76–77.

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Those critics who suspect injustice in the extant distribution of income, without probable cause, merely because it is unequal, fail to see that the race to discover neglected opportunities—however trivial they may seem in retrospect—is what drives entrepreneurs constantly to bring out new and better products at lower prices. It is a race from which mankind has benefited immeasurably. These critics also fail to see that whatever gains entrepreneurs have, they are what the entrepreneurs' customers voluntarily gave them, because they too benefit in the process.

### *B. Gains from trade are disproportionately captured by the rich*

Critics who would accept in principle the proposition that voluntary exchanges are mutually beneficial may still argue that the gains from trade are not equally or fairly shared if one party—usually the rich and powerful one—has superior knowledge or bargaining power. In Section IV, I argued that the idea of the inherent advantage of the rich is more apparent than real. The key issue here, however, is who should decide what division of gains is fair, if not the parties to the transaction themselves at the time of the transaction. Parties to a potential transaction consider all options available to them at the moment, and the transaction will only be agreed to if both parties believe that the terms of the transaction are superior to any other alternative available to them. The desire of the rich and powerful to dictate their terms to get a lion's share of the gains from trade in a transaction will be frustrated, for if the terms offered by the rich and powerful are indeed lopsided, then there should be offers of superior terms by bargain hunters.

I acknowledge that individuals make mistakes occasionally or even often. But to err is to be human. I assert that society would have a much greater problem if all transactions were made open for renegotiations, in the corrective light of added information and changed circumstances (or at the urging of bystanders), at some time in the future. For then gains from trade would become completely uncertain. Few, if any, would try to trade at all. The consequence would be a reversion to barbarism and meager living for everyone.

### *C. Inequality is unjustified*

Many critics also seem to hold that inequality as such is unjustified, in the sense that there is no good justification for someone having more than others do. This argument comes in two flavors—that above-average income (or wealth) is unearned, and that it is undeserved.

1. *The unearned*. Many critics feel that only income from labor is earned. Income from other sources—rent, interest, and profit—is often regarded

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as unearned.[47] This distinction is taken to mean that what is unearned is unjustified. Since the rich are viewed as deriving the bulk of their income from nonlabor sources, their income is seen as unjustified.

But a view such as this is based on much ignorance and confusion. First of all, even if only labor income is earned, the earned income would be distributed unequally, as some people work more, harder, smarter, and with more skills than others. Second, the critics ignore the fact that the majority of households in the United States derive their income from various nonlabor sources—through their pension funds invested in stocks and bonds, through their savings (from past earnings) that earn interest, through the appreciation of the value of their homes, and so on. Under these circumstances, the question is not whose income is earned and whose is not, but who has proportionally more or less "unearned" income.

The answer to this question, however, is not necessarily directly correlated with one's income or wealth. For example, a retired couple that relies on pensions and rents out a couple of rooms in their house, though not rich, would have nearly all of their income coming from nonlabor sources. On the other hand, Chrysler once paid Lee Iacocca a few hundred million dollars a year, which put him as one of the top earners in the world at the time; that income should be classified as earned. Chrysler had hired him to turn around the troubled firm, so the compensation was mostly for his labor, though very highly priced.

But more importantly, why regard income from sources other than labor as unearned in the first place? The view is based on the belief that only labor creates value, and that other factors of production, or rather, their owners, merely partake in the value created by labor. This view ignores the fact that labor alone, without other factors of production, is not very productive. Consider the productivity of millions of souls in Uganda, Somalia, or the Sudan, each of whom could create much value, and earn accordingly, if he or she could relocate to industrialized countries where other factors of production are abundant; this disproves the claim that only labor is productive. The view also ignores the question of how the current owners of other factors of production came to their ownership. Upon consideration, it should become clear that the bulk of the ownership comes from savings and investment, which take much labor, ingenuity, and discipline.

The same critics would regard inherited wealth as also unearned. But there are other inheritances—genetic makeup, upbringing, and so forth. Why single out inheritance of money (or near-money) assets as unearned? What about other inheritances such as intelligence, talents, temperament, disposition, upbringing, looks, and strength, each of which is a valuable asset and in due time can be turned into money or near

[47] Even the U.S. government adopts this sort of terminology when it uses the category "earned income credit."

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money? There is no good reason. As if to be consistent, however, some critics have chosen to question the legitimacy of the above-average inheritance of nonmoney assets as well, as we shall see below.

2. *The undeserved*. Even "earned income" is not all justified or deserving in the eyes of discerning critics. Much of the individual differences in income and wealth has to do with differences in endowments (e.g., skills, talents, drive, etc.). But what did the individuals who enjoy above-average income do to *deserve* the valuable assets denied to others? Critics cannot think of any good justification for the good fortune of having the valuable resources (money or otherwise) that are responsible for some individuals doing better than others. Put in another manner, who can justify what they have as merited? All that most reasonable people can say is that it happens to be that way. For critics, then, the inequality in income and wealth distribution is largely a matter of luck, in the sense that one has little control over the outcome.[48] And no one deserves to be lucky, or luckier than others.

It is perverse reasoning to say that to keep what one has, one must be able to explicitly justify one's possession. I wonder whether many can explicitly justify their existence (or longevity or health) so as to satisfy the standard demanded by the critics for the ownership of one's own intelligence, talent, drive, will to excel, and so on. Would the critics dare to suggest that those who fail to justify their existence must forfeit their lives or health?[49] Why must the burden of justification be placed on inequality? I believe that the burden should rather fall on those who, against all things natural, hold equality as the ideal.

The critics' argument that, unless the "luck" of having more than others can be justified (to the satisfaction of the critics), no one deserves to have more than others (that is, everything must be shared equally), is perverse in another way. According to social psychologist Helmut Schoeck, the concept of luck was invented as a means of diverting the envy of others (i.e., their suspicion that you gained unfairly and that therefore you should be sanctioned) by declaring your innocence.[50] Schoeck argues that the origin of the word "happiness" reveals the role of luck in mitigating the envy of others. "Happiness" derives from the Old English word "hap," meaning accident or luck. Earlier people tried to lessen others' envy by describing an extraordinary success as a fluke or as fortuitous (i.e., by disclaiming any unfair action on their part).[51] The fact that over time

[48] Viewing matters in this way, the critics assume a simple form of materialism, denying any efficacy of human agency.

[49] The logic may run as follows: "I am dying of kidney disease. But you have two. What did you do to deserve two sound kidneys when I am doomed? Since you did not do anything to deserve your good fortune, we should equalize. It is only fair that you give me one of your kidneys."

[50] Helmut Schoeck, *Envy: A Theory of Social Behaviour* (Indianapolis, IN: Liberty Press, 1987).

[51] Interestingly, the word for happiness in Chinese, *hsing fu*, with the literal meaning of "good luck," must have a similar origin.

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people have come to express the state of being well as being happy indicates that the means of mitigating envy have been more formally institutionalized.[52]

Now, critics propose that luck is unfair. In the hands of the critics, this concept of luck has itself become an instrument of envy, justifying redistribution. The matter has become implicitly one of negative pecuniary externalities.

### *D. Negative pecuniary externalities*

In economics, "negative externalities" are by-products of economic transactions that harm individuals who are not parties to the transactions. Air pollution is a prime example. "Negative pecuniary externalities" occur when some individuals gain from their own economic activities, but others who have nothing to do with these activities feel harmed by the sight of the participants' relative gains. In this mind-set, how well off you are in absolute terms matters not. All that matters is whether anyone is better off than you are. If others are relatively better off than you, then you are injured. In this mind-set, people would be content, even if everyone had meager living conditions, as long as no one were better off.

This is a pure expression of envy. Envy is man's desire to eliminate others' relative gains even if he would become absolutely worse off in the process. Envy is appeased only at equality, regardless of the absolute level of consumption. Only those societies that have been able to develop sufficient means to mitigate the destructive forces of envy have been able to build civilizations and prosper. Anthropologists have documented that two of the most distinguishing features of poor societies are the relative free expression of envy and the universal fear of envy on the part of those who come to have above-average gains.[53]

[52] Leda Cosmides and John Tooby, "Cognitive Adaptations for Social Exchange," in Jerome H. Barkow, Leda Cosmides, and John Tooby, eds., *The Adapted Mind: Evolutionary Psychology and the Generation of Culture* (New York: Oxford University Press, 1992), 212–20. Evolutionary psychologists argue that the human brain is hardwired to invoke a sharing norm in circumstances where the variability of individual success (e.g., successful hunting) is greater than that of the collective, the connection between individual success and individual merit is uncertain, and there is no means of storing food. This description applied to the sort of hunter-gatherer society from which human beings have emerged only relatively recently. But the norm became less compelling as human beings went through successive stages of economic development—agriculture, handicraft, manufacturing, and so on, with an ever-expanding network of exchanges—where the connection between individual success and merit is more direct, individual gains can be stored, and people can pool risks through various insurances.

[53] See Eric R. Wolf, "Types of Latin American Peasantry: A Preliminary Discussion," *American Anthropologist* 57, no. 3 (1955): 452–57; Y. A. Cohen, "Four Categories of Interpersonal Relationships in the Family and Community of a Jamaican Village," *Anthropological Quarterly* 28, no. 3 (1955): 121–47; and Audrey I. Richards, *Land, Labour, and Diet in Northern Rhodesia* (London: Oxford University Press, 1939).

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## VI. Conclusion

In the United States, social critics are much more concerned about unequal distribution of income and wealth than the general public is. To these critics, inequality is wrong and undesirable; collective actions are needed to reduce it. I have discussed the critics' concerns on three broad topics—that inequality is excessive, that market competition is rigged in favor of the rich, and that inequality is unjust—and tried to argue that each is based on a misunderstanding of the facts. First, when official statistics are properly adjusted (for such missing items as taxes, noncash transfers, the value of Social Security benefits, the size of households, the age of primary earners, differences in costs of living, etc.), inequality in income and wealth distribution is much lower than the critics portray. The remaining inequality of income is largely attributable to differences among workers in their amounts of labor and skill; in the case of wealth, inequality reflects differences in consumption behavior and success of investment, as well as differences in income over time.

Second, the idea of the rich having an inherent advantage over the poor is more apparent than real. Its implications—increasing polarization of income and wealth, and lack of mobility—are not supported by the facts. The idea itself reflects a profound misunderstanding of the process of market competition.

Third, the attitude of regarding inequality in income and wealth distribution as a sign of injustice arises in a large measure from the critics' inability to understand the sources of profit. The sources of profit are often obscure and the critics cannot imagine its justifiable causes. Unjustified gains, it is reasoned, must be a sign of injustice, even when there is no evidence. If the critics understood the nature of profit, and how the race for profit has brought forth many of the good things in life, they would not regard profit and inequality as signs of injustice.

The association between income (or wealth) distribution and justice (or fairness) may be triggered by the word "distribution." Distribution (or, more formally, "frequency distribution") is a method of organizing and summarizing data whereby individual observations are distributed in accordance with the few distinct values that the variable can take. Hence, we speak of (frequency) distributions of income, wealth, height, weight, age, and so on. Even so, the word "distribution," in connection with income and wealth, tends to conjure up in the minds of many an image of someone apportioning a set of resources, as in a family. This tendency reflects the habits of mind the bulk of humanity acquires in being brought up in families. The strength of the appeal of equality as the ideal rests largely on these habits of mind. Unfortunately, it is the wrong imagery for modern economic processes that operate beyond family, beyond one's own local community, and even beyond national boundaries. The mistaken imagery of a "national family" conjures up

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obligations and entitlements that are only appropriate within a *real* family.[54]

Though many people have a vague longing for equality, once it is stated explicitly they easily recognize its absurdity as a practicable goal. Equality is impossible to achieve, and attempts to achieve it would produce many undesirable results. Incentives are perverted if in the name of reducing inequality money is taken away from those who work and given to those who do not, or if money is taken away from those who make available the goods that consumers want (when and how they want them) and given to those who do not render any service to others. If a society tries to redistribute constantly (as it will be bound to do if it is to keep inequality at a low level), not only will that society become much poorer through the perversion of incentives, but it will become increasingly arbitrary and oppressive as well.

Nevertheless, critics maintain that it is necessary and desirable that the opportunities that individuals face be equalized, especially for the young. Many social programs are motivated by such a belief. However, equalization of opportunities is not any easier than equalization of income or wealth. People, as bundles of characteristics, differ along many dimensions. Trying to equalize along only one dimension (measurable income or wealth, for example), disregarding all others, is arbitrary and reckless if we do not know individuals' values along that dimension and how those values might change in the near or distant future. A poor farm boy may grow up to be a millionaire sports star or a businessman, while another boy born with a silver spoon in his mouth may grow into an imbecile, squandering a fortune and becoming penniless. A redistribution to equalize the recorded income or wealth during these individuals' boyhoods would in fact be transferring wealth from the poor (the imbecile, poor in human capital) to the rich (the farm boy, rich in human capital). One can go on and on.

The real problem with the attempt to equalize income or wealth distribution stems from failing to realize that the vast majority of income or wealth is obtained as a result of voluntary transactions among individuals. Income and wealth are typically the cumulative result of market prices received for certain services rendered (to someone). Income and wealth both support and result from the role of the price signals that most economists readily recognize as crucial in the working of the market, channeling resources to those activities that benefit consumers. To become indignant that income or wealth is unevenly distributed is akin to becoming incensed that a car fetches a higher price than a banana. Demanding that inequality in income or wealth distribution be reduced

[54] Note also that many who hold equality as the ideal have a peculiar view of equality that stops well within a national boundary. The fact that the poorest in a given critic's own country may be far better off than the rich in another country is often viewed with surprising detachment.

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substantially is like demanding that the price difference between a student violin and a Stradivarius be reduced substantially.[55]

The politics of equalization would entail severe restrictions on what individuals can or cannot do, beyond the general rules of conduct, as economic processes would have to be fitted to conform to some acceptable level of equality. Consequently, if redistributive measures are at all successful, they will produce a stagnant economy through regulations and discouragement of economic activities, and a society with more rigid class distinctions through a diminution of mobility. The end result will be far from what the social critics imagine.

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[55] If this demand were put into practice, Stradivarius violins would disappear in no time.

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