

How can one defend the 1%?

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In a forthcoming article in the *Journal of Economic Perspectives*¹, Harvard Professor and bestselling textbook author Greg Mankiw defends the income earned by the richest 1%, as opposed to the movement of the 99% that attacks the explosion of inequality and the concentration of income and wealth. Mankiw cites the study by Thomas Piketty and Emmanuel Saez (2003, updated 2011)², which shows that in the United States the share of income earned by the richest 1% rose from 7.7% in 1973 to 17.4% in 2010. Mankiw argues that the income received by the 1% is fair and denounces the idea of taxing them at what he considers confiscatory rates. He criticizes in particular the proposal of French President François Hollande to tax high income at a marginal rate of 75%, in the following terms: “using the force of government to seize such a large share of the fruits of someone else’s labor is unjust, even if the taking is sanctioned by a majority of the citizenry”. To defend this position, Mankiw uses a theory of justice based on “just deserts”. According to this perspective, people should receive compensation in proportion to their contributions. If the economy were described by a classical competitive equilibrium without externalities or public goods, then every individual would earn the value of his or her own marginal product, and there would be no need for government to redistribute. In this perspective, equity is perfectly aligned with the right incentives.

To illustrate his point, Mankiw uses the famous “Wilt Chamberlain” argument developed by Robert Nozick in *Anarchy, State and Utopia*³, as summarized below:

Imagine a society with perfect economic equality. Perhaps out of sheer coincidence, the supply and demand for different types of labor produce an equilibrium in which everyone earns the same income. There is no need for redistribution and because people earn their marginal contribution, everyone is perfectly incentivized. The society enjoys not only perfect equality but also perfect efficiency.

1. G. Mankiw, 2013, “Defending the one percent”, forthcoming *Journal of Economic Perspective*. http://scholar.harvard.edu/files/mankiw/files/defending_the_one_percent_0.pdf

2. T. Piketty and E. Saez, 2003, “Income Inequality in the United States, 1913-1998” *Quarterly Journal of Economics*, 118(1), 2003, 1-39, [Data updated in 2011 \(xls\)](#).

3. R. Nozick, 1974, *Anarchy, State and Utopia*, Basic Books, New York.

Then one day, this egalitarian utopia is disturbed by an entrepreneur with an idea for a new product. This might be Steve Jobs as he develops the iPod or JK Rowling as she writes Harry Potter or Steven Spielberg as he directs his blockbuster movies [in 1974, Nozick used the example of the basketball superstar, Wilt Chamberlain]. Everyone in society wants to buy the new product for say \$100. Following voluntary exchanges, the resulting distribution of economic well-being is now vastly unequal.

Mankiw and Nozick both conclude that the new distribution is fair, but for different reasons. Nozick used a procedural justice perspective: since the initial distribution is fair and the exchanges are voluntary and to the mutual benefit of both parties, and therefore fair, then the final distribution is necessarily fair. Mankiw uses a distributive justice perspective: the new distribution is fair because it respects the marginal contributions of each individual. Under this approach, assessing the fairness of the income distribution involves checking whether the final state of the income distribution actually satisfies the principle of marginal contribution.

I focus here on a limit in Mankiw's demonstration: the economy in which the 1% live is not a classic competitive equilibrium in ways that the author does not discuss, and therefore income does not reflect marginal contributions. One could also argue that marginal productivity is not the only way to apply the contribution principle, especially in the presence of a cooperative surplus⁴, or that other principles of distributive justice (equality, needs) could compete with the principle of contribution, which implies a compromise between these principles. We must say here that, in Mankiw's text, and by extension in this response, the term "one percent" should not be taken too literally: the incomes discussed by Mankiw (of CEOs, traders and entertainment superstars) concern rather the one per one thousand or even the one per ten thousand⁵.

Do the 1% really live in an economy with classical competitive equilibrium?

Mankiw's demonstration against redistribution is based on the idea that market prices (wages, compensation of contractors) reflect the marginal productivity of individuals. He then explains the rising income share of the top 1% by skill-biased technological change: "Aided by digital technologies, entrepreneurs, CEOs, entertainment stars, and financial executives have been able to leverage their talents across global markets and capture reward that would have been unimaginable in earlier times" (McAfee, 2011, cited in the text). Mankiw nevertheless recognizes that the

4. There is a cooperative surplus when the division of labor improves total production. The competitive market equilibrium divides the cooperative surplus proportionally to marginal productivities. For some, including Mankiw, this principle is fair, but one can imagine other equitable ways to share the surplus, including equal sharing, especially when it is difficult to distinguish individual marginal contributions. One can also note that an individual's marginal productivity depends on the state of society and therefore on the work of other members of society (think of Bill Gates' productivity in the United States or in a Papuan tribe). In this perspective, individuals are not fully responsible for their marginal productivity and do not necessarily "deserve" it entirely.

5. Moreover, the issue of capital income, donations and inheritances is not discussed in the text. To say the least, it appears difficult to defend in a single text merit measured by marginal contribution and the repeal of the Estate tax. See Mankiw, "The Estate Tax Is One Death Penalty Too Many," *Fortune*, 4 September 2000.

http://money.cnn.com/magazines/fortune/fortune_archive/2000/09/04/286818/index.htm

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economy can move away from the traditional competitive equilibrium because of externalities, public goods or rent-seeking. In the presence of externalities, the market price does not reflect the social marginal contribution, but Mankiw argues that in this case we need public policies that correct externalities through Pigovian taxes. This is right, for example, in the case of a polluting activity. But Mankiw neglects the fact that economic inequality itself can be a negative externality, directly if equality is included in social welfare or indirectly if it reduces social mobility or social cohesion.

Unlike Joseph Stiglitz in his book *The Price of Inequality*⁶, Mankiw does not believe that the rising income share of the top 1 percent is largely attributable to successful rent-seeking. Rent-seeking can be defined as the manipulation of the economic and social policy environment – rather than the creation of new economic wealth – in order to obtain a larger share of the economic wealth produced. Mankiw recognizes that there are elements of rent-seeking in financial industries, and especially in certain speculative activities such as high-frequency trading, but denies that the increase in the income of the 1% is mainly due to this phenomenon⁷. Above all, he stresses that the right response in terms of public policy is to reduce the phenomenon with better regulations and institutions, rather than to address it through taxation. While we cannot agree more with Mankiw on this point, it should be noted that the author implicitly recognizes that income is not only the consequence of market equilibrium, but also depends on the regulations and institutions in which the market is embedded.

To make his point, Mankiw uses only examples of perfectly competitive markets where contributory equity and efficiency are perfectly aligned. But what happens if the market intrinsically cannot be made competitive?

Financial markets, for example, are known to be imperfectly competitive markets. In these markets, the prices do not necessarily reflect all available information. The classic law of supply and demand does not work: an increase in the price of a financial asset may result in an increase in its demand. In that case, it is illusory to think that the market-based income of people operating in the financial markets may reflect something approaching marginal social contribution, especially if informational rents are important and give rise to “heist phenomena” as described by Olivier Godechot⁸. Financiers do not operate in a classic competitive economy, which does not mean that their social contribution is null, but rather that the market is unable to measure this contribution. Moreover, as shown by Godechot in the case of France, the role of the financial sector in the growth of inequality is particularly important, especially at the top of the ladder⁹.

Jobs, Rowling and Spielberg do not work in the financial sector, but do they live in a classical competitive economy? It is significant that two of the three examples of Mankiw (as well as Nozick’s example, Chamberlain) are superstars of the entertain-

6. J. Stiglitz, 2012, *The Price of Inequality*, W.W. Norton, New York.

7. Neither Stiglitz nor Mankiw provide compelling evidence in one sense or the other. On the question of rent-seeking by the top 1% income earners, see Alvarado *et al.* (2013) for a literature review and some empirical evidence: F. Alvarado, A. Atkinson, T. Piketty and E. Saez, 2013, “The top 1 percent in international and historical perspective”, *NBER Working Paper*, no. 19075.

8. O. Godechot, 2006, “‘Hold-up’ in finance: the conditions of possibility for high bonuses in the financial industry”, *Revue française de sociologie*, vol. 49, Supplement Annual English Edition, pp. 95-123: http://olivier.godechot.free.fr/hopfichiers/Hold-up_in_Finance_Rfs_2008.pdf

9. Godechot Olivier, 2011, “Finance, an Inequality Factor”, Books and ideas.net. URL: http://olivier.godechot.free.fr/hopfichiers/20110415_GodechotEN.pdf

ment industry (including artists and athletes). These are popular personalities who work in what is perceived as a competitive industry: there is no shortage of people wanting to be the next superstar. In this sense, the merit of superstars is difficult to attack, because they are chosen by the public after a fierce competition. However, is the remuneration of superstars congruent with their marginal social contribution, since is the standard that Mankiw chooses for measuring equity? This is highly doubtful. In fact, the entertainment economy is characterized by network effects: the value provided by the consumption of the good depends not only on the intrinsic quality of the good but also on the number of other people using it, *i.e.* when I choose to go to the cinema to see the latest Spielberg movie, not only for the experience the movie procures, but also (especially?) to share that experience with other people (opinion, citation, pastiche, etc.). This explains the winner-take-all aspect of the entertainment industry, especially when the marginal cost of production is low. In a landmark paper on the economics of superstars, Sherwin Rosen (1981) shows that with network effects and low marginal cost, very small differences in talent can lead to astronomical earnings differences¹⁰. Moshe Adler (1985) points out that these large earnings differences do not necessarily arise from differences in talent but also from luck among individuals of equal talent¹¹. This is true because a small initial advantage in terms of exposure can result in large differences in income through a snowball effect: think, for example, of the celebrities of popular culture who are famous for being ... famous.

This superstar phenomenon does not apply just to the entertainment industry but can also concern, for example, authors of economics textbooks, such as Mankiw himself, as a 1995 *New York Times* article illustrates¹². Mankiw is interviewed after the signing of a major publishing contract for an introductory textbook: "The top three or four textbooks, even the top 10, are profitable, wildly profitable". The journalist adds: "The market for introductory economics textbooks, which most publishers peg at \$50 million a year, is a lot like the movie business. Thirty to 40 books are typically on the market, but only a handful of blockbusters, selling more than 50,000 copies a year at around \$55 each, provide a feast of regular profits, leaving crumbs for everybody else." Is this due to major innovations by the bestselling authors? Not according to a study: "Indeed, as a 1990 study by two economists, William Walstad and Michael Watts, found, all the successful textbooks are remarkably similar in content." Mankiw adds: "these things are evolutionary, not revolutionary". This is clearly an industry where a lot of people want the same product not because it is new and innovative and responds to new needs but because they want ... to use the same product as others. In that case, superstars do not operate in a pure competitive market. In the presence of network effects, the conditions for competitive equilibrium are not met. The income of the superstar is thus not equal to their marginal social contribution: he or she receives in addition a winner's bonus that would be captured by another superstar in their absence. Since the earnings of superstars are greater than their marginal social contribution, taxing them can be justified both in terms of equity and efficiency.

10. S. Rosen, 1981, "The Economics of Superstars", *The American Economic Review*, Vol. 71, no. 5. URL: <http://www.ppge.ufrgs.br/GIACOMO/arquivos/ecop72/rosen-1981.pdf>

11. M. Adler, 1995, "Stardom and Talent", *The American Economic Review*, Vol. 75, no. 1. URL: http://www.unc.edu/~fbaum/teaching/articles/Adler_1985_Stardom_and_Talent.pdf

12. "A Hard Act to Follow? Here Goes", by Sylvia Nasar, *The New York Times*, 14 March 1995: <http://www.nytimes.com/1995/03/14/business/a-hard-act-to-follow-here-goes.html?pagewanted=print>

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That leaves us with Steve Jobs. He embodies the creative entrepreneur inventing products to meet new and unexpected needs. But does the market measure his marginal social contribution well? While there is no denying Apple's innovations, one cannot neglect the "star product" aspect. It is also hard to deny the role of conspicuous consumption. Again, there might be network effects, and the market equilibrium does not reflect the marginal contribution. Above all, the example of Apple, especially in its war with Samsung, illustrates the role of patents in the monetization of innovation. Being innovative is not enough to command astronomical income: one must be able to protect one's innovations. Creative entrepreneurs, like superstar performers of the entertainment industry, need a legal environment that recognizes and protects their image and intellectual property rights. In the absence of intellectual property rights, the market fails: companies cannot benefit from their innovations, and there is a risk of under-investment in research and development (especially if the innovations are expensive). Patents attempt to provide the right incentives for innovation, but the corollary is a reduction in competition. Intellectual property laws seek a compromise between protection of intellectual property and competition. Earnings then depend heavily on the details of this compromise (What is covered and what is not? For how long?), which sets us relatively far away from the world of the perfectly competitive market.

The examples chosen by Mankiw do not live in the economy with classical competitive equilibrium that serves as his justification to defend their income. It even seems that it is *because* they do not live in a world of perfect competition that they are part of the 1%. Furthermore, in public policy terms, it is unrealistic to think that it is possible to establish this classic competitive balance. Given their nature, the industries in which top income earners are found (financial markets, entertainment, creative entrepreneurship, etc.) cannot be perfectly competitive by their very nature.

The market does not inform us very well about individual marginal contributions to society. Above all, it tells us nothing about merit¹³: do Hollywood superstars deserve to be paid 10 or 100 times more than the heroes (*e.g.* police or secret agents) they portray? On the contrary, if workers have moral feelings, they will accept lower wages if their work is perceived as having a positive social externality (see Preston, 1989)¹⁴. However, if the market tells us nothing about merit, we still find it fair that people benefit from the wages and salaries they earn. This is out of a sense not of distributive justice but of procedural justice – earnings being the result of the exercise of a right or freedom – the same way we find it fair that the winner of a lottery benefits from his or her gains. It is the role of democracy to set the rules (including the top marginal tax rates) so that the exercise of individual freedom is compatible with the common good.

13. Unlike Mankiw, Hayek and Nozick recognize that market incomes are not congruent to merit. Hayek emphasizes the instrumental character of prices: "their function is not so much to reward people for what they have done as to tell them in their own as well as in general interest what they ought to do. ... it will often be necessary that the return of people's efforts do not correspond to recognizable merit" F. Hayek, 1976, *Law, Legislation and Liberty: The Mirage of Social Justice*

14. A. Preston, 1989, "The Nonprofit Worker in a For-Profit World", *Journal of Labor Economics*, Vol. 7, no. 4.