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Boston Review Gets Serious About Tackling Income Inequality

Shikha Dalmia | March 22, 2012

The *Boston Review* just hosted a forum titled "What to do about income inequality" featuring a lead essay by Stanford University's David Grusky and a number of responses including one from yours truly. Grusky is a big name with big credentials and he argues that progressives make a big mistake when they tackle inequality by focusing exclusively on redistributive taxation. He is no foe of such policies, mind you. He just believes that they misdiagnose the true cause of income inequality, which lies in the pre-tax income generated in the market. He explains:

As important as tax-based redistribution is, we need to supplement it with policies that address *market* inequality. We would do well to look to OWS for inspiration here. Although OWS hardly sings with a single voice, one line in the polyphony implies an institutional critique of inequality and a market-based remedy for it. The institutional critique is not about the tax system but about the ways in which American labor and capital markets generate extreme pre-tax inequality. The core idea is that powerful players have built self-serving and inequality-generating institutions that are often codified in law and come to be represented—through an ingenious sleight of hand—as laissez-faire capitalism.

We all are familiar with the argument that extreme inequality is the inevitable outcome of a highly competitive market. The institutional critique turns this idea on its head and implies that extreme inequality comes from a lack of competition and associated market failure. Put simply, we'd have far less inequality if our labor market and other institutions were *more*competitive—if our commitment to competition weren't mere lip service but were honored even when the rich and powerful would lose out.

In other words, the root cause of the income inequality malady lies in how rich people acquire their pre-tax income—by rigging the rules of the market to extract illicit "rents." Therefore redistributive taxation targets the symptom not the cause.

There is much here to warm the heart of free market libertarians (myself included) and progressives, both of whom are easily worked up about crony capitalism, corporate welfare and what have you. But my issue with Grusky is that his claims about rising income inequality are seriously overblown. And even if they weren't, it wouldn't automatically follow that we should care. I note:

Any indictment of capitalism worth its salt has to show not just that the rich are getting richer, but that they do so by making the poor poorer. There is no evidence of that. Facebook recently floated an IPO making Mark Zuckerberg the richest 27-year-old in America. I didn't notice my bank balance dip…

America remains a highly income-mobile society where poverty is a stage of life, not a way of life. There is no permanent underclass here. A study by Thomas Garrett of the St. Louis Federal Reserve recently found that between 1996 and 2005—nine short years—roughly half of taxpayers who began in the bottom income quintile moved up to a higher one.

This doesn't mean that Grusky's suggestions to eradicate economy-distorting rents are not worth pursuing. It is just that we should do so in the name of creating a level playing field and maximizing economic opportunities, not reducing income inequality.

All the responses are worth checking out, including one by the chief peddlers of income inequality gloom-and-doom, Thomas Piketty and Emmanuel Saez. They disagree with Grusky that progressives shouldn't get fixated on redistributive taxation and trot out their research showing that:

Countries that made large cuts in top tax rates, such as the United Kingdom and the United States, have not grown significantly faster than countries that did not, such as Germany and Denmark. Hence, a substantial fraction of the response of pre-tax top incomes to top tax may in fact be due to increased rent-seeking at the top rather than increased productive effort.

The bottom line is that rich countries have all grown at roughly the same rate over the past 30 years, in spite of huge variations in tax policies. Using a model in which the response of top earners to top tax rate cuts is due in part to increased rent-seeking behavior and in part to increased productive work, ***we find that the top tax rate could be as high as 83 percent—as opposed to 57 percent in the pure supply-side model—without harming economic growth.*** (Emphasis added.)

Oooo….kay!

Also useful is the contribution of Cato Institute's Neal McCluskey who takes Grusky to task for completely misunderstanding the concept of market failure. Grusky irritatingly refers to the scarcity of college seats created by the higher ed cartel as "market failure." But market failure, technically speaking, occurs when the market can't find a way to cost-effectively provide goods that consumers want. The classic examples are roads and highways. But a market that doesn't deliver the desired results because government regulations and policies prevent it from functioning efficiently, as is the case with the higher ed industry, is an example of government not market failure. Notes McCluskey:

[T]here are significant problems in American education… They cannot, however, be pinned on market failure. In higher ed, government intervention is central to creating bottlenecks. Foremost, college prices rise even more quickly than health care costs largely because the federal government, through student aid, ensures that students can pay them. But aid programs generally favor middle- or upper-class parents who have the personal or accountant savvy to take full advantage of loans and tax credits through effective long-term planning. A 1999 study reported by the National Center for Education Statistics shows that poor parents are dramatically less likely than wealthy ones to estimate the costs of college.

But arguably the most comprehensive account of the problems with Grusky's essay is by Brown University's Glenn Loury. He says:

I find much of the detail in Grusky's argument to be unpersuasive or just plain wrong.

The wage premium for college graduates over those with a high school education is not due mainly to non-competitive behavior by elite colleges artificially limiting their enrollments. Nor is it mainly due to the shortage of highly skilled workers that comes about because of abysmal public schooling for the poor. Neither is excessive executive compensation—as unseemly and infuriating as it can be—an important source of economic inequality at the top of the income distribution. (There are too many high-earning lawyers, doctors, athletes, financial analysts, entertainers, entrepreneurs, small-business owners, scientists, and engineers for this to be so).

In Grusky's rush to adopt a language of "market failure" so as to criticize unequal market outcomes, he gives short shrift to the larger structural forces that are at play here, over which no one has much control: forces such as globalization, technological change, social segregation, and middle class–oriented interest group politics. What economists call skill-biased technological change is not a market failure—it's a fact of life. Likewise, the impact of competition from low-paid offshore labor is an effect that won't yield to marginal policy change or the obvious "progressive" (i.e., trade-restricting) legislation.

Couldn't have said it better myself. The whole forum is well worth perusing.