Overstating Income Inequality

September 21st, 2010 at 10:48 am Scott Winship | 2 Comments |

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Today, the D.C. progressive/new media promotional machine launches Jacob Hacker and Paul Pierson's new inequality tract, *Winner-Take-All Politics*, with an event at the New America Foundation. I don't want to tell you not to buy the book or that it is likely to be wrong—I've bought it myself, but only just started it. What I do want to tell you is that since Hacker has been making grand statistics-based arguments—beginning with his and Pierson's *Off Center*, and continuing with his *Great Risk Shift*—his books have been provocatively and cogently argued, have told progressives exactly what they want to hear, and have been based on statistical evidence that I have found to be completely wrong.

First, in *Off Center*, Hacker and Pierson argued that Republican success in the aughts invalidated the "median voter hypothesis" that argues that the parties will tend to take policy positions oriented toward the preferences of moderate voters. They claimed that in recent decades, the Republican caucus had moved steadily rightward (true) while the Democratic caucus had, if anything moved rightward too (ehhh…OK). But because the ideological distribution of the electorate hadn't changed, that meant that Republicans had somehow pulled policy "off center", which Hacker and Pierson say was accomplished through various dirty tricks and hard-knuckled tactics.

What actually happened is that at the start of the 1970s, the Democratic Congress was "off center"—to the left of voters—and so the rightward shift of Congress and the Republicans reflected a move that produced a Congress more consistent with the views of voters. In other words, the median voter hypothesis explains the changes rather well.

In *The Great Risk Shift*, Hacker argued that economic volatility had skyrocketed—more than doubling between 1974 and 2002 and nearly quadrupling between 1974 and 1994 alone. Oops—these results turned out to hinge on an arcane methodological issue that Hacker should have caught. When I uncovered this problem, Hacker was forced to revise his book for the paperback edition (no, you won't find documentation that my discovery was the reason behind the revision, but it's in my in-box archives). When I produced my own estimates of income swings, I found that they had increased over time, but rather modestly, so that if a household's typical income swings were 15 to 16 percent of their income in the early 1970s, they were probably about 17 to 18 percent in the early 2000s.

I also found that, contrary to Hacker's assertions, the evidence on economic risk in other aspects of life also implied fairly modest changes in recent decades.

(Incidentally, I will present evidence in a month at a Census Bureau conference that Hacker's latest effort, an "economic security index" for the Rockefeller Foundation, is also botched. Full details once I have the green light to circulate them after the conference.)

I hope to blog over the next two or three weeks on the new book as I get further into it, but today, let me just provide some commentary on two central claims about what has happened to inequality.

Claim #1: The share of income going to the top 1 percent increased from 8 to 18 percent from 1974 to 2007—from 9 to 24 percent including capital gains.

A strong case can be made that the increase over time was just four percentage points or less, not 10 or 15. In a post I did a year ago, I showed that much of this increase could be explained by two phenomena: (1) a steady rise in tax filing as "subchapter S" corporations (with income reported on individual tax returns) instead of "subchapter C" corporations (with income not included on individual tax returns and thus missing from the IRS data Thomas Piketty and Emmanuel Saez use, whose work Hacker and Pierson rely on); and (2) a jump from 1986 to 1988 in wealthy taxpayers shifting to income and stock options reported on individual tax returns from fringe benefits and stock options not reported on individual tax returns in response to the tax cuts of 1986. These insights are not mine—they come from Cato's Alan Reynolds, who has been making the points for several years now. By adjusting the trend line for these changes (using data from Saez), I showed that the change in the top's share of income probably rose only 4 percentage points rather than 10 from 1974 to 2006 (the increase from 1974 to 2008 would be similar—Saez just released his 2008 estimates).

Are these adjustments warranted? Well, doing so ends up producing estimates that match the trend found by Richard Burkhauser and his colleagues using the Current Population Survey. The adjusted estimates also raise doubts about the claim that the top income share has not been higher since 1928 (since they put the top share when capital gains are excluded lower than every year between 1928 and 1941).

Furthermore, while I have not seen any research examining the question, I am pretty sure that these levels—and the increase over time—would be lower with ideal data. Piketty and Saez identify the top 1 percent in their data by estimating the number of single adults and married households in the population and using that as their baseline. From there, they simply look at the richest people in the tax returns until they have a group equal to one percent of this baseline. But as Steve Rose notes in his new book, *Rebound*, their baseline is almost 30 percent higher than the number of households in the U.S., primarily due to multiple tax returns in households with roommates, non-married romantic partners, and adult and teenage children. Inflating the overall baseline by nearly 30 percent means inflating the number of people in the top one percent by 30 percent too, which would not be problematic except that we can presume that essentially all of the inflation in the IRS data occurs

in the bottom 90 percent.

Let's talk concrete numbers to give a sense of why this is an issue. In 2007, Piketty and Saez use 150 million "tax units" as their baseline population, meaning that to look at the top one percent, they need to focus on the 1.5 million richest tax returns in the IRS data. Rather than look at households, as Rose does, let's just distinguish families and unrelated individuals from each other and look at them (a more conservative approach than looking at households, since there are fewer households). The Current Population Survey indicates that there were just 134 million of these, ten percent fewer than the number of tax units. So the top one percent of families/unrelated individuals included 1.3 million people rather than 1.5 million. To know what share of income the "top one percent" received, one should look at the 1.3 million richest tax returns, not the 1.5 million richest. By looking at the richest 1.5 million, the "true" top one percent is exaggerated by about 15 percent.

To back into the more meaningful figure, we can assign incomes to 200,000 people and subtract them out from the aggregate received by the top 1.5 million. A rough way to do this is to give them the average income received by people in the top five percent of income, which in 2007 was $364,000 according to the IRS data (in 2008 inflation-adjusted dollars).

One other adjustment should be made—because those 16 million additional tax returns in the IRS data represent people with relatively low incomes (think teenagers and college kids), the aggregate amount of income in the bottom 90 percent is lower than in the CPS. The difference should be added to what the IRS shows as total aggregate income (the denominator when computing income shares).

Making these adjustments, the top one percent received 15.5 percent of income in 2007 rather than the 18.3 percent indicated by the Piketty/Saez results. And that doesn't include the adjustments I outlined above due to tax law changes. For 1974, the figures are 7.0 versus 8.1 percent. For the change over time, I show a change of 8.5 percentage points rather than 10.2. Combine this adjustment with the analysis I conducted around the effect of tax law changes, and the increase in the top share since 1974 gets awfully small—probably less than a four-point rise over 35 years.

Claim #2: The nation has moved steadily from "Broadland"—typified by the expansion of the 1960s, when most of the income gains went to the bottom 90 percent—to "Richistan", where over half the gains go to the top one percent.

These numbers are actually pretty solid and robust to shortcomings of the IRS data. However, focusing on changes in the income share is actually a pretty uninformative way of looking at things. Consider the last expansion, from 2002 to 2007. Something like 60 percent of the income gains went to the top one percent. It's only slightly an oversimplification to say that what happened was that Greenspan and Bernanke juiced the economy by keeping interest rates low, which had the unfortunate side effect of sparking all sorts of crazy in the financial sector (including pay increases almost surely out of line with the value these geniuses added to the economy). This is Raghuram Rajan talking, but I think he's completely right. When businesses failed to invest, the result was a weak recovery, small income gains for most Americans, and enormous gains to a bunch of 12-year-olds on Wall St.

For the median family/unrelated individual in the bottom 90 percent, the increase in income according to the CPS was from $37,000 in 2002 to only $38,000 in 2007. Of course, health insurance costs were rising rapidly during this period, so the increase in total compensation was greater. But still, warm beer.

Consider the counterfactual, however. What if the Fed hadn't goosed the economy? Or what if Congress had taxed the income of financial "wizards" until the gains to the top were much smaller? Either might have mitigated the share of gains that went to the top. But neither would have helped the bottom 90 percent much, and without the monetary stimulus (and the tax stimulus from the Bush Administration), the expansion of 2002 to 2007 might instead have been the expansion of *2004* to 2007, with a prolonged recession dragging into the mid-2000s. Of course, the bursting of the bubble in 2008 would not have happened either in that case, but it's

not at all clear (to me) that the bottom 90 percent would be in a better place in this counterfactual scenario, despite having successfully limited gains to the top.

On the other hand, had the expansion been broad and robust, producing solid gains for the bottom 90 percent and the twelve-year-old Wall Streeters *still* received 60 percent of the gains, I don't know that there would be reason to be *equally* frustrated as many are today. Hacker and Pierson's story is about us versus them, but it seems to me that they don't persuasively defend this view. If we can have a bigger pie, but only if we let the rich have a bigger piece of it, then the whole question gets a lot more complicated. Research by my former advisor, Christopher Jencks, indicates that higher inequality doesn't seem to increase a country's growth, but nor does it hurt it. I'm with Dalton Conley—we should care less about inequality and more about living standards at the bottom.

More soon….

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2 Comments so far ↓

- **Oldskool** // Sep 21, 2010 at 11:05 am

  Off the top of my head:

  It takes two incomes today to provide what one income used to. Fewer people have health insurance. CEOs make many times more money today than their workers (approx 30 vs 300). Millions of manufacturing jobs have been shipped overseas. The poverty rate is the highest since LBJ began the War On Poverty. Our physical health is no better than 30-some other countries. Taxes on the wealthy are the lowest in decades. Real wages are unchanged since the early 1970's.

- **Posting From Fake America** // Sep 21, 2010 at 12:49 pm

  Winship,

  I imagine the income swings are much higher now given the recent recession. Also, studies which have asked workers from the 70's to present, whether they believe that they will hold their current job in the future, indicate eroding confidence in economic security. I remember last reviewing this data a few years before the current recession. I'm pretty sure the numbers paint an even uglier picture now.

  While your critique of Hacker may be accurate, you fail to mention how America's inequality (even under your revised numbers) measures up to the levels of inequality found in other OECD countries. Again last time I checked (admittedly a few years ago) the US gini coefficient (a measure of income inequality) had been well above that of European and East Asian economies for a long time, and was close to that of Latin