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On the Issues

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The Wealth Trajectory: Rewards for the Few

By N. Gregory Mankiw

Income inequality is rising, and in this article, AEI visiting scholar N. Gregory Mankiw looks at the statistical evidence and causes. Government policy, he says, is unlikely to be the culprit because inequality has risen in Democratic and Republican administrations—we need to look instead at skills-based technological change and educational attainment. Education, Mankiw says, is key to understanding the broader trends, but it cannot fully explain the incomes of the super-rich.

If there is one thing about the U.S. economy in recent years that is beyond dispute, it is this: it is a great time to be rich. Yes, I know, being rich has never exactly been a downer. But today it is all the more sweet.

You see it in the daily headlines: The financial pages tell us that Lloyd C. Blankfein, CEO of Goldman Sachs, took home $68.5 million last year. The political pages tell us that during the last eight years, Bill and Hillary Clinton raked in $109 million. These stories are not mere aberrations. According to the economists who crunch the numbers, they reflect a long-term trend of increasing economic inequality.

The best data on the super-rich come from Thomas Piketty of the Paris School of Economics and Emmanuel Saez of the University of California, Berkeley. Piketty and Saez have been studying historical data from tax returns and recently updated their work to 2006.

They report that one out of every ten thousand American families has income in excess of $10.7 million. These lucky duckies number less than fifteen thousand. Put together, they could all fit into a modest-size town. (We could call it Aspen or Nantucket.)

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What is more, the super-rich have been getting an increasing slice of the economic pie. In 1980, the top 0.01 percent of the population had 0.87 percent of total income. By 2006, their share had more than quadrupled to 3.89 percent—a level not seen since 1916.

Critics of the Piketty-Saez data argue, with some justification, that tax return data are unreliable. Tax rules are constantly changing, and the rich have ways to manipulate the system. It is impossible to be sure whether a change in reported income is merely a change in tax strategy or a true change in circumstance.

It is hard to escape the conclusion, however, that Piketty and Saez are finding something real. Other data sources lack much information on the super-rich, who are simply too rare to show up in significant numbers. But when we compare the merely affluent with those at the low end of the pay scale, these other sources show similar, if less extreme, trends.

Take the government's Current Population Survey (CPS), which covers about fifty thousand households and is best known for producing the monthly unemployment rate. Like the tax return data, the CPS also shows rising inequality. From 1980 to 2005, the earnings of the ninetieth percentile full-time male worker increased 49 percent more than the earnings of the tenth percentile worker. Among full-time female workers,

there has been a similar divergence between high and low earners.

Offsetting this trend to some degree is the shrinking gender gap. Female workers started well below their male counterparts and have been catching up. But despite this equalizing force, the earnings ratio of the ninetieth to tenth percentiles—men and women combined—has risen 30 percent.

What accounts for rising inequality? Some pundits are tempted to look inside the Beltway for a cause, but the case is hard to make. Policymakers do not have the tools to exert such a strong influence over pretax earnings, even if they wanted to do so. Also, the trend toward increasing inequality has been fairly steady, despite changing political winds. The income share of the richest families increased substantially both during Ronald Reagan's eight years in office and during Bill Clinton's.

The best diagnosis so far comes from two of my Harvard colleagues, Claudia Goldin and Lawrence F. Katz, in their forthcoming book *The Race between Education and Technology* (Harvard University Press). Goldin is an economic historian, and Katz is a labor economist who briefly worked in the Clinton administration. Their bottom line: "the sharp rise in inequality was largely due to an educational slowdown."

According to Goldin and Katz, for the past century, technological progress has been a steady force, not only increasing average living standards, but also increasing the demand for skilled workers relative to unskilled workers. Skilled workers are needed to apply and manage new technologies, while less-skilled workers are more likely to become obsolete.

For much of the twentieth century, however, skill-based technological change was outpaced by advances in educational attainment. In other words, while technological progress increased the demand for skilled workers, our educational system increased the supply of them even faster. As a result, skilled workers did not benefit disproportionately from economic growth.

But recently things have changed. Over the last several decades, technology has kept up its pace, while educational advancement has slowed down. The numbers are striking. The cohort of workers born in 1950 had an average of 4.67 more years of schooling than the cohort born in 1900, representing an increase of 0.93 years in each decade. By contrast, the cohort born in 1975 had only 0.74 more years of schooling than that born in 1950, an increase of only 0.30 years a decade.

Because growth in the supply of skilled workers has slowed, their wages have grown relative to those of the unskilled. This shows up in the estimates of the financial return to education made by Goldin and Katz. In 1980, each year of college raised a person's wage by 7.6 percent. In 2005, each year of college yielded an additional 12.9 percent. The rate of return from each year of graduate school has risen even more—from 7.3 to 14.2 percent.

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While education is the key to understanding broad inequality trends, it is less obvious whether it can explain the incomes of the super-rich. Simply going to college and graduate school is hardly enough to join the top echelons with Blankfein and the Clintons. But neither is education irrelevant. If Blankfein had left the New York public school system and gone directly to work, instead of attending Harvard College and Law School, most likely he would not be the head of a major investment bank today.

If the Clintons had been content with high school diplomas and not attended Georgetown, Wellesley, Oxford, and Yale, they most likely would not have reached the White House and Senate, and it is a good bet that they would not now be getting multimillion-dollar book deals and $100,000 speaking dates. A top education is no guarantee of great riches, but it often helps.

Maybe educational levels are like Willy Wonka's chocolate bars. A few of them come with golden tickets that give you opportunities almost beyond imagination. But even if you are not lucky enough to get a golden ticket, you can still enjoy the chocolate, which by itself is well worth the price.