

Income and Wealth Concentration in a Historical and International Perspective

by

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Discussion

This paper describes an intriguing body of evidence on how the fraction of income accruing to the richest individuals in various countries has changed over time. At this point, Saez, Piketty, Atkinson, and others have compiled almost a century's worth of data not only from the U.S. and the U.K., but also from Canada, France, Switzerland, and the Netherlands. These data report not only the distribution of total income but also some information on the sources of this income.

The objective of the paper is to lay out a set of stylized facts that stand out immediately from these data, and then to speculate about possible explanations for the patterns observed in the data. Among the stylized facts for the U.S., U.K., and Canada are the following:

- 1) There was a sharp drop in income inequality during the Great Depression and World War II.
- 2) This drop largely represented a fall in the fraction of capital income accruing to the very rich.
- 3) Unlike after WWI, following a similar drop, the fraction of capital income accruing to the very rich did not recover after WWII.
- 4) Starting in the late 1970's, the fraction of labor income and business income accruing to the very rich steadily increased, though there was no comparable change in capital income or wealth.

Intriguingly, the data for Switzerland differ sharply: the fraction of capital income accruing to the very rich there recovered after WWII to about the levels seen before the War. In addition, while the data for France and the Netherlands look broadly the same as those for the Anglo-Saxon countries up through the 1970's, these continental countries do not experience any sharp growth in the share of labor income accruing to the rich in recent years.

Such striking facts beg for an explanation. Emmanuel argues that these patterns over time and across countries are quite consistent with incentives created under the income tax. In particular, income tax rates became important in these countries only during and after WWII. With high tax rates on the return to savings in particular, Emmanuel speculates that rich individuals were no longer in a position to reaccumulate the large wealth holdings that they had before the Depression. Switzerland did not adopt such high tax rates after WWII, and there we did see a recovery of the capital income of the rich.

Certainly, the top statutory tax rates in these countries were extremely high following World War II. The hypothesis that high tax rates made wealth accumulation particularly hard for the top 1% strikes me as questionable. The increase in the corporate tax rate should have lowered the return to savings for all individuals, but this would not affect the rich differentially. A large fraction of the capital income of the rich would take tax-favored forms, e.g. municipal bond interest, capital gains on corporate equity, deferred compensation, as well as pension accumulation, so that the extremely high statutory tax rates in the law at the very top end should not have been relevant to their rates of capital accumulation.¹ Their capital income, however, would shift to forms not included in the personal income tax base, so would no longer be observed in Emmanuel's data.

In addition to such portfolio adjustments, we would also expect to see changes in the organizational form decisions of firms, again changing what income is reported on personal tax returns. During the war, for example, the corporate tax rate was particularly high, encouraging firms to shift to noncorporate status, consistent with the observed jump in business income. Following WWII, the top personal tax rates went up much more than the corporate tax rate. As a result, high-bracket individuals would gain for tax purposes from having their income reported as corporate rather than personal income, e.g. doctors could incorporate their medical practices.² Such income shifting affects not just capital income but also the reported labor income of owners of closely held firms, and even to some degree the income of those in publicly traded firms (through use of incentive stock options). While the reported share of capital income going to the rich falls more, their share of labor income falls as well during and after WWII.

If such income shifting were the explanation, there should be no comparable movements in the wealth share of these individuals. At least for the U.S., Figure 5 does show a very stable wealth share for the top 1% since the early 1930's, whereas the sharp drop in capital income occurred during WWII and later. The same is not true in the U.K. or France, however, where the wealth share of the top 1% continued to decline steadily.

It is certainly suggestive that the expansion in the share of labor income going to the top 1% in the U.S. and U.K. starting in the 1970's and particularly the 1980's largely

¹ While the very rich still pay an "implicit" tax on some of these assets, through a lower pretax rate of return, this lower rate of return would be shared with a far broader group of taxpayers, given that a sizeable fraction of taxpayers face statutory tax rates above plausible implicit tax rates on these assets.

² When these individuals wanted access to these funds, they could either sell shares generating capital gains which are ignored in Emmanuel's figures, or perhaps borrow from the corporation, reducing their reported capital income.

coincided with a sequence of cuts in marginal tax rates,³ inspired by Reagan and Thatcher and perhaps by Mirrlees (1971). The tax cuts could be responsible for the observed growth in the labor income of the very rich if the very rich faced a larger cut in tax rates or responded more to any given tax cut.⁴ Perhaps the cuts were still not sufficient to enable a recovery of the share of capital income accruing to these individuals, or at least not quickly enough to show up in the data to date.⁵ France and the Netherlands did not enact equivalent drops in tax rates, and did not experience an equivalent growth in the share of labor income accruing to the rich.

The key question, though, is what behavior exactly is changing to generate such patterns in the data. This question arose as well in response to comparable observations about the jump in reported labor income following the tax reforms in the U.S. during the 1980's, as documented in Lindsey (1987) and Feldstein (1995). Moffitt and Wilhelm (1998) find that hours of work did not change noticeably. While skill-biased technical change would generate a growth in the relative wage rates of the high skilled, such growth should have been shared with France and the Netherlands,⁶ so Emmanuel infers that this cannot be the main explanation for the observed patterns.

A drop in tax evasion rates, or a shift from nonmonetary to cash compensation (e.g. a shift from university teaching to Wall Street) might also be part of the explanation. Saez, I think appropriately, argues that these changes should be too small to explain the magnitude of the observed changes, even if they would likely be occurring.

There might also have been a change in the timing of income, with greater use of nonqualified stock options and pension type savings plans rather than straight wages. Any shift towards these alternative forms of compensation would result in an immediate drop in reported wages, and in a compensating increase at some point in the future when the options are exercised or the pension income is received. Given the rapid growth in stock markets during the 1990's, the compensating increase in the future could have been particularly large *ex post*. It is difficult, though, to explain a large increase in the use of options or pensions, due to the drop in tax rates. That options were not recorded as an expense for accounting purposes might provide an explanation for their growth in the U.S., though I do not know whether the same is true elsewhere.

Among other possible explanations that Saez notes are: 1) a shift in income from the corporate to the personal tax base in response to the sequence of cuts in personal relative to corporate tax rates, 2) an increase in real productivity (and pay) due to increased effort or increased risk taking, or 3) an increase in pay *per se*. Let me focus on each explanation in turn.

³ In the U.S., there was a cap imposed on the marginal tax rate on labor income starting in the early 1970's. There were further cuts in 1981-3, and then in 1986, again both affecting mainly those in the very top brackets. However, there was a partially offsetting jump in the top personal tax rate in 1993.

⁴ Gruber and Saez (2002) report evidence in support of the latter hypothesis.

⁵ Note, though, that the share of capital income accruing to the rich recovered very quickly following WWI.

⁶ Given the strong evidence for skill-biased technical change, it is in fact puzzling that there is not clearer evidence for it in the data from France and the Netherlands, or in the data for the Anglo-Saxon countries below the top 1% of the population.

Regarding income shifting, past papers have certainly documented a sizeable shift from C-corporate form to S-corporate form in the U.S. following the 1986 tax reform.⁷ The resulting jump in reported business income clearly shows up in Figure 4B in the paper, though this jump still explains only a moderate fraction of the overall growth in the fraction of labor income received by the rich.⁸

Income shifting can occur in forms other than a shift in capital between organizational forms. There is considerable flexibility to shift reported taxable income, holding the allocation of capital fixed, particularly within closely held firms, e.g. by shifting from stock compensation to wage and salary income.

To the extent that income shifting explains the observed patterns in the data, there need be no accompanying increase in productivity or in efficiency. In fact, if the effective corporate tax rate exceeds that on personal income of these individuals, then any shift of income from the corporate to the personal tax base results in a drop in tax revenue, and a drop in efficiency.

The second explanation, increased effort of the rich relative to everyone else, should also occur in response to a larger drop in their relative tax rates. Such productivity responses would be hard to document, though the Anglo-Saxon countries did experience unusually rapid growth during this time period. Cullen and Gordon (2002) report evidence that rates of entrepreneurship increased during this period. If the explanation for the observed jump in reported earnings of the very rich during this period is in fact due to a jump in their real productivity, this would provide strong support on efficiency grounds for the observed drop in marginal tax rates.

Saez emphasizes, though that an increase in relative pay of the very richest individuals need not necessarily reflect an increase in their relative productivity. There could have been a breakdown in corporate governance during the 1980's and 1990's in the Anglo Saxon countries, in response for example to the pressures created by greater use of options as compensation. Such a breakdown would suggest that these executives became overpaid. Alternatively, social norms that previously discouraged too high salaries for top executives may have broken down during this time period, so that these executives were no longer underpaid relative to their true productivity. The wage compression during World War II may also have reflected pressures for shared sacrifice during the War. In this case, a better match of pay and marginal productivity should improve efficiency. Regardless, there need be no causal link between these changes in corporate governance or social norms and changes in the tax law. The three different explanations

⁷ See, e.g., Gordon and MacKie-Mason (1990). While the transaction costs of shifting from C-corporate to S-corporate are particularly low, activity can also easily shift between partnership and corporate status, as occurred with the use of equipment-leasing and real-estate partnerships taking on ownership of capital used in the corporate sector.

⁸ That future entrants are more likely to choose to be noncorporate (or S-corporate), however, could represent part of the subsequent growth in labor income of the rich.

therefore have sharply different implications for the efficiency consequences of the cuts in tax rates in the top brackets that occurred in recent years.

There are two further observations from these data that to a degree help differentiate among these alternative explanations. First, it is striking that the fraction of total wealth held by the rich did not change noticeably among the Anglo-Saxon countries during this time period. A jump in reported wage income with no change in wealth is consistent with the income-shifting explanation, since all that is changing is *where* income is reported, not how much income is earned.⁹ If the increased productivity arises from the rapid entry of new entrepreneurial firms, in contrast, wealth should have increased since the value of these firms would reflect the present value of the future profits generated by past entrepreneurial ideas. Even an increase in pay *per se* should have generated some changes in wealth over this long a time period – observe, for example, the quick rebound in the wealth share of the rich following the first World War.

The second additional observation that Saez notes is the increase in the labor income share of the very rich in Canada, in spite of relatively stable personal tax rates there. His explanation is that at least Anglophone Canadians would have been attracted by the now higher wage rates in the U.S., forcing firms in Canada to increase their pay comparably in order to keep these individuals in Canada. It is certainly very plausible that top executives are very mobile from Canada to the U.S. Note, however, that the cut in the top marginal tax rates in the U.S. *per se*, with no comparable drop in the progressivity of the Canadian tax system, is sufficient to explain mobility to the U.S. and a forced increase in the top wage rates in Canada, even without any changes in pretax pay in the U.S. The Canadian evidence then cannot rule out any of these possible explanations.

The lack of response in the U.S. to the increase in the top marginal tax rate to 39.6% in 1993 presents a puzzle for the two tax-based stories, however. This increase brought the top marginal tax rate about half way back to where it had been prior to the 1986 tax reform. If individuals are responding strongly to their marginal tax rate, then one should have expected to see a drop in the fraction of labor income reported by the rich roughly halfway back towards the figures from prior to 1986. This tax increase in 1993 also arguably brought the top personal rate above the top corporate tax rate, so should have recreated the incentives faced prior to 1986 to favor corporate over personal taxable income.¹⁰ This tax change plausibly would not have affected corporate governance or social norms affecting executive compensation, however.

While the evidence reported in this paper cannot in itself provide clear support for one explanation or another, it raises some fascinating and important questions. I hope and

⁹ The drop in personal relative to corporate tax rates, however, could have generated a shift in portfolio choice, with the very rich shifting towards more heavily taxed assets as tax rates fell. Dividend and interest income remained heavily penalized, though, for the very rich. Rebalancing portfolios among other assets would have had little effect on reported personal taxable income.

¹⁰ This reverse incentive is present, however, only if the overall tax rate on corporate income, including future capital gains tax liabilities, is below the top personal tax rate, which is less clear.

expect that it will stimulus much future research about the role of taxes on economic behavior.

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