Income Inequality and Social Mobility

By John Mauldin | March 16, 2014

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> "Nothing is more dangerous than a dogmatic worldview – nothing more constraining, more blinding to innovation, more destructive of openness to novelty."
> – Stephen Jay Gould

My letters the last few weeks on income inequality (here and here) brought more response from readers than any topic I've written on in the history of this letter. And there was certainly no unanimity of viewpoints. Some of you strongly agree with me; some of you aggressively disagree and think I'm full of it; and others see the issue in an entirely different light. Many of you offered links to other research, which I have spent a great deal of time reading. Today we will continue our thinking about income inequality, and I will respond to some of your letters, as they make good launching points for further discussion of the topic.

Income inequality is going to be a central theme in political campaigns for the rest of the decade, so what I want to try to do is simply get some facts on the table so that at least we know what the research says and doesn't say. A lot of emotional content is offered under the guise of economic research in order to support various political positions. The data suggest that the problem is both worse than we might think when viewed through one lens, and not that big a problem – or at least a very different problem – when viewed through another. I suggest that we look as objectively as possible at all of the data and not just cherry-pick the data that supports our views.

But before we jump back in, I am really pleased to announce that I've persuaded George Gilder, one of the finest thinkers and philosophers I know, and Stephen Moore, contributing editor to the *Wall Street Journal,* along with Grant Williams of Things That Make You Go Hmmm fame to speak at the 11th annual Strategic Investment Conference in San Diego May 13-16. They will join Niall Ferguson, Kyle Bass, Newt Gingrich, Ian Bremmer, David Rosenberg, Dr. Lacy Hunt, Anatole Kaletsky, Patrick Cox, Dylan Grice, David Rosenberg, David Zervos, Rich Yamarone, my *Code Red* coauthor Jonathan Tepper, Jeff Gundlach, and Paul McCulley. Nothing but headliners, one after the other, for 2½ days. Plus some of the best money managers around, some names I hope to confirm within the next few weeks, and one or two people who are trying to figure out how to

change their schedules in order to get there and who will be fabulous surprises for the attendees. By the way, many of the speakers are planning to hang around and listen to the other speakers. This means you will have chances to engage them at the lunches, dinners, and breaks. Most speakers simply fly into a conference and fly out, but my conference is little different.

This is an annual gathering you simply don't want to miss. I can't think of any conference anywhere that has a lineup this strong. When I first broached the idea of our conference to Jon Sundt, the founder of cosponsor Altegris, the one rule I had was that I wanted the conference to be one I would want to attend. The usual conference boasts a few headliners, and then the sponsors fill out the lineup. I wanted to do a conference where no speaker could buy his or her way onto the platform. That means we often lose money on the conference (hard as that may be to imagine, at the price, I acknowledge); however, the purpose is not to make money but to learn with – and maybe have some fun with – great people. We do put on a great show, and my partners make sure it is run well. But the best part will be your fellow attendees. A lot of long-term friendships are forged at this conference. You can learn more and sign up at http://www.mauldineconomics.com/landing/sic-2014 .

At the close of the letter, I also want to tell you about an exclusive interview with Janet Yellen – but first, let's think about income inequality.

No Serious Economist Would Bother

As noted above, the previous two letters on income inequality evoked more responses than any other topic I've written about. Some rather heated debate ensued between readers, which I actually think is a good thing. For the record, I read every comment posted on our website and many that are sent to me directly. I typically don't answer, simply because I could spend all day answering, although I certainly get tempted when there's a comment like the one in which a reader asserted that because I predicted a continuation of the Muddle Through Economy in January 2005, I completely missed the recession that came along three years later! I was clearly predicting recession in late 2006 and a collapse in subprime debt. If anything, I was way too early, and subprime was worse than the $400 billion in losses I suggested at the time.

Let me note that every letter I've written since January 2000 is online. Some of them have aged quite well, and a few are simply embarrassing, but I think it would be disingenuous to pull them down. The record is what the record is. But the letters all generally focus on a single topic in a single week. If I make a forecast, it is typically for a discrete period of time. Further, in total agreement with John Maynard Keynes, when the facts change, I will change my mind. (My less-than-sainted Dad would often remark, when I challenged him over his frequent changes of mind, "A wise man changes his mind. A fool never does." There were times in my youth when I really got tired of hearing that, but now I would love to hear it just one more time if I could.)

But to the point of last week's letter, retired economics professor Dr. John Seater of North Carolina State University took me to task (yet again). John is courteous and a real scholar and was gracious enough to talk me through some of his thoughts. Basically, he felt the paper that had me so thoroughly aroused was not worth the time and effort. But I'll let his words speak for themselves and then reply.

I am sorry to be the bearer of bad news, but John's column is a waste of time. Most of what John has to say is right, but the article that he uses as a launch pad (Cynamon and Fazzari) is simply silly. No serious economist would bother with it. The authors don't understand economic theory at all, and they certainly propose nothing coherent in their paper. Their citations are almost entirely from fringe outlets that most serious economists never heard of. They also do not understand general equilibrium, which is amazing for macroeconomists because macroeconomics is nothing but dynamic general equilibrium. In any case, because they ignore general equilibrium and its requirements, they say foolish things. A big whopper, for example, is their assertion that a shift in income from the poor to the rich will reduce total spending.

Complete nonsense. What it *may* do is shift the *composition* of spending away from consumption a little toward investment. The permanent income/life cycle theory of consumption, developed independently by Modigliani and Friedman in the 1950s questions even that conclusion. All serious economists know these things, even though Cynamon and Fazzari, who apparently live in the mindset of the 1930s, do not. Also, their paper indeed *is* just a paper. It's not even published. I can pretty much guarantee that it will not appear in any respectable journal, not because of any intellectual snobbery (the authors are at places that, until now at any rate, I thought were pretty good) but because the paper is terrible. I can assure John and his readers that mainstream economics is far less confused and ridiculous than the pathetic paper that got John started.

I can add a few more constructive comments. First, the Wikipedia definition of Keynesian economics that John cites misses the most important element of the Keynesian approach, which is the assumption that in periods of recession markets do not clear. Keynesians assume that prices are "sticky" at least downward, leading to excess supply during periods of recession. Downward price stickiness is and always has been the central tenet of the Keynesian approach. There is very little direct evidence to support it. Mark Bils and Pete Klenow, for example, have shown that prices move around far too much to be consistent with the Keynesian assumption of "sticky" prices. However, there is a strong indirect piece of evidence, which motivated Keynes himself, that in recessions there are idle productive resources, both capital and labor, willing to work at the going price and that therefore should be employed but that nevertheless remain idle. That strongly suggests that prices are not moving fast enough to clear the market, as Keynes assumed.

So, although I am very skeptical of Keynesianism, I have to concede that the problem that motivated Keynes remains a problem today – how to explain the presence of persistently idle resources. Furthermore, it also is true that *if* resources are idle because prices really are sticky, then it also is true that an increase in government demand will stimulate the economy by getting those resources back to work. It is *not* a crazy theory. I don't have much regard for Keynesian theory because there is in fact little or no theory there. Keynesians have utterly failed to produce a microeconomic foundation for their macroeconomic model that is both internally coherent and also consistent with the facts. Unfortunately, no one else has a convincing theory for recessions, either. After spending several decades trying to understand recessions, economists still don't understand them.

> Second, John says most academics accept the view that inequality hinders growth. I don't know how he knows that. I certainly don't know that to be true. I am an academic economist, and I am unaware of any such consensus. I also know for sure that few and probably no economists who actually study economic growth (which happens to be my own current field of research) believe such a thing. I note that Cynamon and Fazzari propose no theory of economic growth. They just make a bunch of assertions. They cite literally no works on economic growth. I doubt they know much if anything about it. In any case, they are not at all representative of what other economists think about economic growth.

First of all, Dr. Seater makes very good points. Cynamon and Fazzari are to some degree straw men who don't put forth the best of arguments. But the problem from my point of view is that the arguments they make are becoming more mainstream. Last week the IMF published a paper extolling the virtues of income redistribution to address income inequality. Then this week we got a paper from the Federal Reserve Bank of Richmond suggesting that income redistribution is in fact one of the appropriate tools for dealing with income inequality, although that particular paper is far more nuanced, and caveat-rich. And I would call Paul Krugman a more or less mainstream economist (tongue firmly wedged in cheek here), and he is certainly espousing income redistribution. He has just announced that he is leaving Princeton University and will be joining the Graduate Center at CUNY, where he will focus on issues of income inequality.

The use of income inequality as a justification for income redistribution is popping up more and more in mainstream economic journals and thinking. Everyone is writing about it, which is why it is such a hot topic among my readers when I write about it. Hot, as in, some of you get hot and bothered about it.

In a rather wide-ranging discussion this morning, Prof. Seater began to cite studies which demonstrate that 75% of income inequality is actually due to age distribution. The older you are, the more likely you are to be in the top 20% of whatever category you're looking at. (I "assigned" John the task of producing a paper on this theme for *Outside the Box*. I will publish it when he turns his homework in.) There other factors besides age (education, the status of your parents, etc.) that also help explain income inequality, and we'll get to those later in the letter. This is not to say that income inequality is not real, but you have to know what you mean by the term and then decide whether income redistribution will actually fix what you think is the problem.

Using academic economic studies on income inequality as a Trojan horse to argue for higher taxation on the rich when higher taxes may or may not solve the problem of income inequality is a canard. Especially when those studies, which may issue from prestigious organizations, do not address the problem in totality. This is a very complex topic, and producing a paper in which it is demonstrated that one or two sets of data correlate with your data on income inequality can be very misleading. ***Correlation is not causation,*** and to think that it is proves to be one of the most pernicious problems in economic analysis as well as investment analysis.

And despite Dr Seater's counsel, I want to address at least one other point the Cynamon and Fazzari paper makes, as that point keeps showing up in articles and opinion editorials everywhere. They say:

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> We argue that demand drag caused by inequality is now constraining the U.S. economy. The result is aggregate consumption substantially below comparable trends for past U.S. recoveries. We consider several alternatives that might restore a healthy demand generation process, but we conclude that a robust recovery is unlikely without policy or other institutional change that at least stops, or even reverses, the trend toward greater income inequality. Without such changes, we question whether the U.S. economy can generate the demand growth necessary to maintain stable full employment….
>
> In this simple framework, it is evident that stagnating income growth for any group of households need not create demand drag immediately, but the choice to keep consumption growth above declining income growth will lower the saving rate and increase the fragility of the group's collective balance sheet.
>
> Net worth cannot decline indefinitely, nor can debt rise indefinitely relative to income. While households may initially choose to respond to lower income growth by reducing saving growth rather than reducing consumption growth this choice is not sustainable over some horizon: eventually rising debt forces households with lower income growth to cut back consumption to satisfy their intertemporal [basically, relative-value choices] budget constraint.

What Cynamon and Fazzari argue is that – because a significant percentage of the US population borrowed too much money prior to 2008 and used that money to increase their consumption – unless a way is found to increase the income of the bottom 95%, a recovery is not possible. They don't see the problem as one of people borrowing too much money and getting into debt and now having to pay that money back (irrespective of whether such borrowing was encouraged by unscrupulous banks and given the blessing of regulatory authorities). Not having ongoing access to ever-increasing debt will in fact reduce people's consumption. Especially when some of that consumption was financed by debt to begin with, and must now be paid for.

Adam Smith argued that housing is not a source of wealth, but simply shelter. In the US, housing has come to be seen as a form of wealth and particularly as the foundation for increasing leverage and debt. The increasing use of leverage to finance consumption is precisely what Minsky, Kindleburger, and Fisher would predict, as stability sets the stage for capital misallocation and eventually gives way to instability across the economy. Now, Cynamon and Fazzari, along with many other researchers, want government solutions (notably forced income redistribution) to solve what is essentially a government-created problem. Hold that thought.

Who Are the Rich?

Back in 2006 it took $382,000 to be in the top 1% of all US taxpayers. The latest data from 2011 tax returns shows that it now takes an adjusted gross income of $389,000. There are 1.37 million Americans make this amount or more, and they report almost 19% of total taxable income.

And while many people think of the top 1% as Wall Street bankers, hedge fund and other money managers, Fortune 500 company executives who make 500 times the salary of their lowest-

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paid workers, and so on, the fact is that there are really only a few such people (10,000 perhaps). Throw in a few well-paid athletes and movie and rock stars, and you might get to 10K. The vast, vast majority of this top-income group are small businesspeople, farmers, doctors, and other professionals. These are not people that we tend to think of as people who don't deserve what they make.

And while the share of income of the top 1% has risen in the past decades in the US, the shares of the immediate 9% just below them hasn't moved all that much. There is some upward bias for the top 2-10%, but it is nowhere near significant. For confirmation we can look at the latest research paper offered by Prof. Emmanuel Saez of UC Berkeley. The chart below shows the top decile's US income share for the last 99 years. The chart following it breaks that share up into three different classes, and we can note that the top 1% made almost half the total income of the top-10% group.

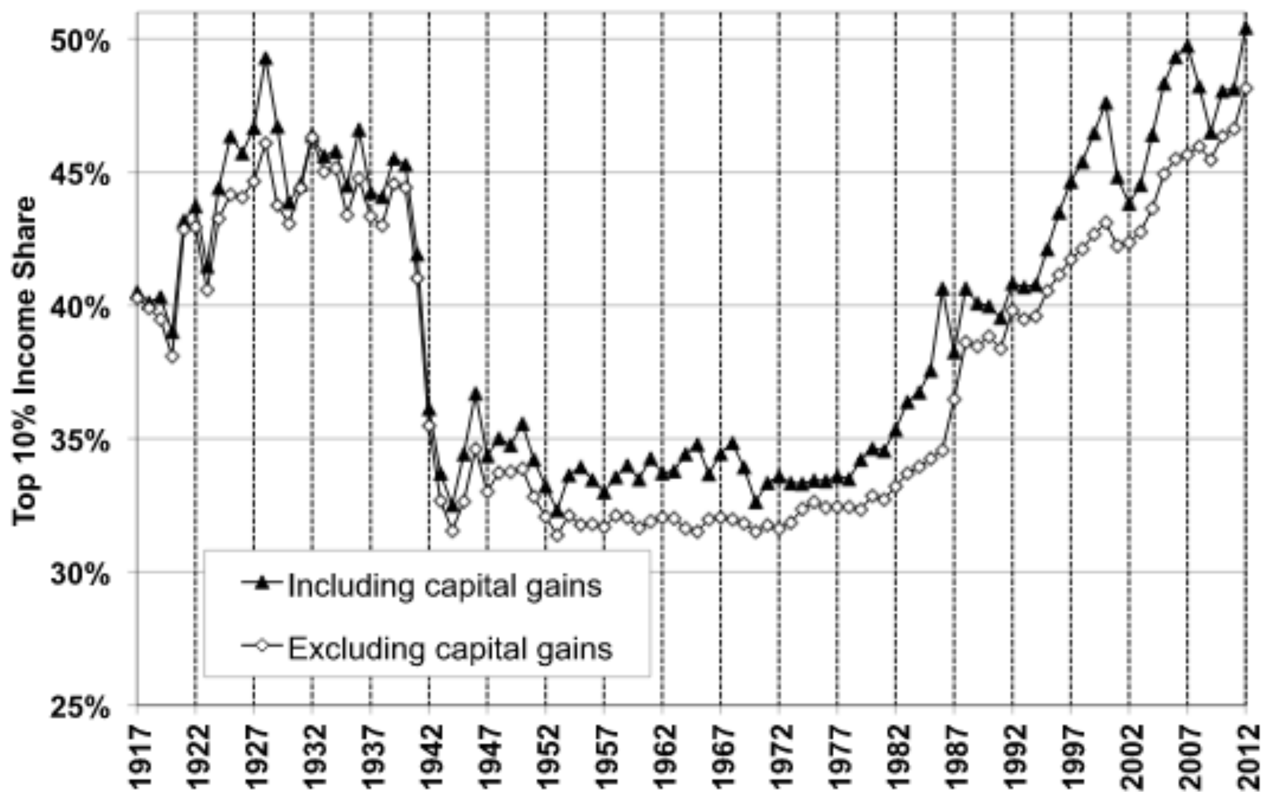

FIGURE 1
The Top Decile Income Share, 1917-2012

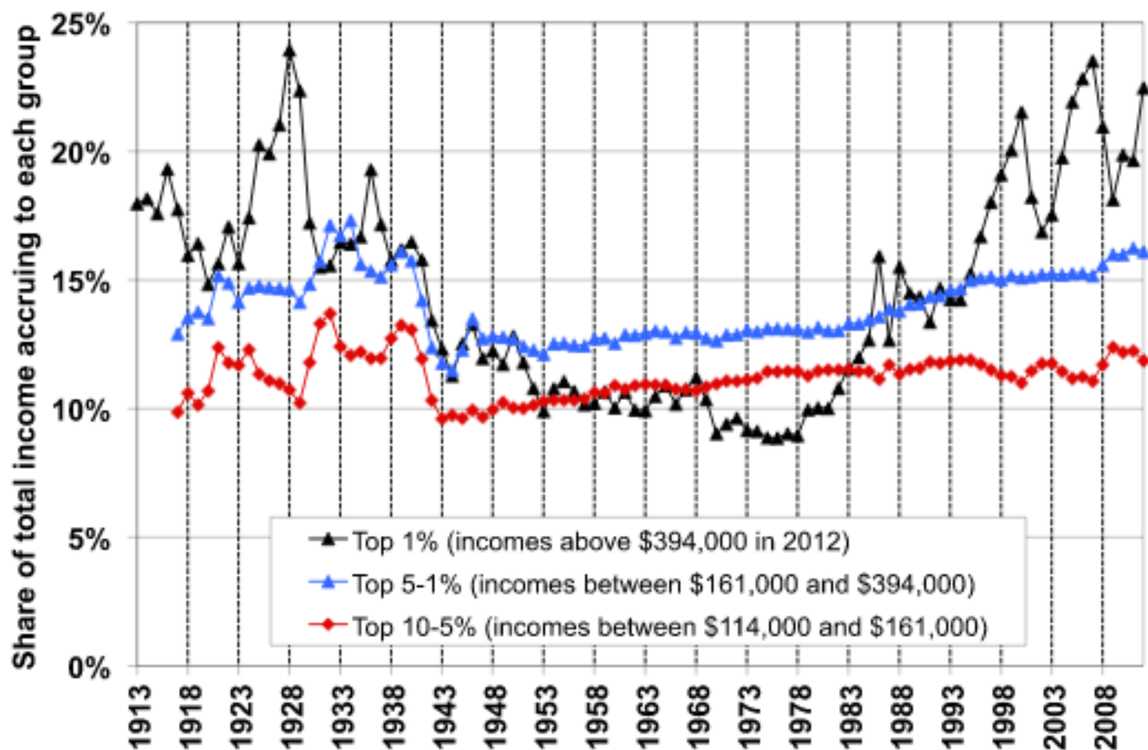

FIGURE 2

Decomposing the Top Decile US Income Share into 3 Groups, 1913-2012

To get into the top 10% of income earners in the United States, a family needed to make $114,000 in 2012. As it turns out, the national share of people reporting over $100,000 in income has much more than doubled since 1975. Quoting from a recent op-ed by Professor Don Boudreaux of George Mason University and Liya Palagashvili in the *Wall Street Journal:*

> The Census Bureau in 2012 compiled data on the percentage of U.S. households earning annual incomes, measured in 2009 dollars, in different income categories (for example, annual incomes between $25,000 and $35,000). These data reveal that between 1975 and 2009, the percentage of households in the low- and middle-income categories fell. The only two categories that saw an increase were households earning between $75,000 and $100,000 annually, and households earning more than $100,000 annually. Remarkably, the share of American households earning annual incomes in excess of $100,000 went to 20.1% in 2009 from 8.4% in 1975. Over these same years, households earning annual incomes of $50,000 or less fell to 50.1% from 58.4%.

They show that when you add in benefits to pay and use the same measure of inflation for both pay and productivity, the disconnect between worker pay and productivity goes away, both in the US and Britain.

Their conclusion? "Middle-class stagnation and the 'decoupling' of pay and productivity are illusions. Yes, the U.S. economy is in the doldrums, thanks to a variety of factors... But by any sensible measure, most Americans are today better paid and more prosperous than in the past."

Equality of Opportunity

In one of the most far-reaching studies I've seen, a group of Harvard economists have compared upward mobility – the ability to rise from lower to higher income groups – among US metropolitan areas, as well as among developed nations. Their rather remarkable website and database can be found here. Their one-paragraph summary is:

> In two recent studies, we find that: (1) Upward income mobility varies substantially within the U.S. [summary][paper] Areas with greater mobility tend to have five characteristics: less segregation, less income inequality, better schools, greater social capital, and more stable families. (2) Contrary to popular perception, economic mobility has not changed significantly over time; however, it is consistently lower in the U.S. than in most developed countries. [summary][paper].

The map below from the Harvard study shows upward mobility in the United States. The patterns are a little complicated, but the lighter the color, the greater the upward mobility in the population. The *New York Times* did a rather remarkable job of making the map interactive, and you can play with that here.

In looking at the map I find a lot of the research counterintuitive. Why does Houston show more upward mobility than Dallas? And upward mobility is higher in the Northeast than it is in the industrial Midwest.

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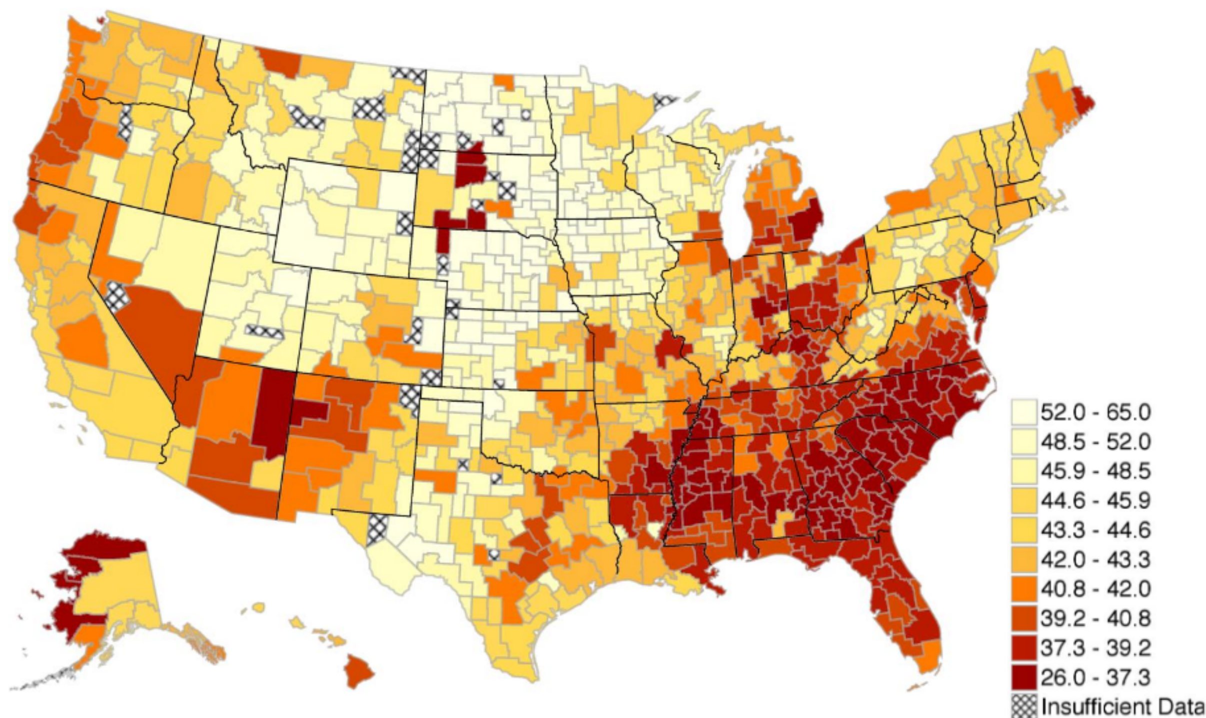


Note: Lighter Color = More Absolute Upward Mobility

From the *New York Times* article (which is interesting):

"Where you grow up matters," said Nathaniel Hendren, a Harvard economist and one of the study's authors. "There is tremendous variation across the U.S. in the extent to which kids can rise out of poverty."

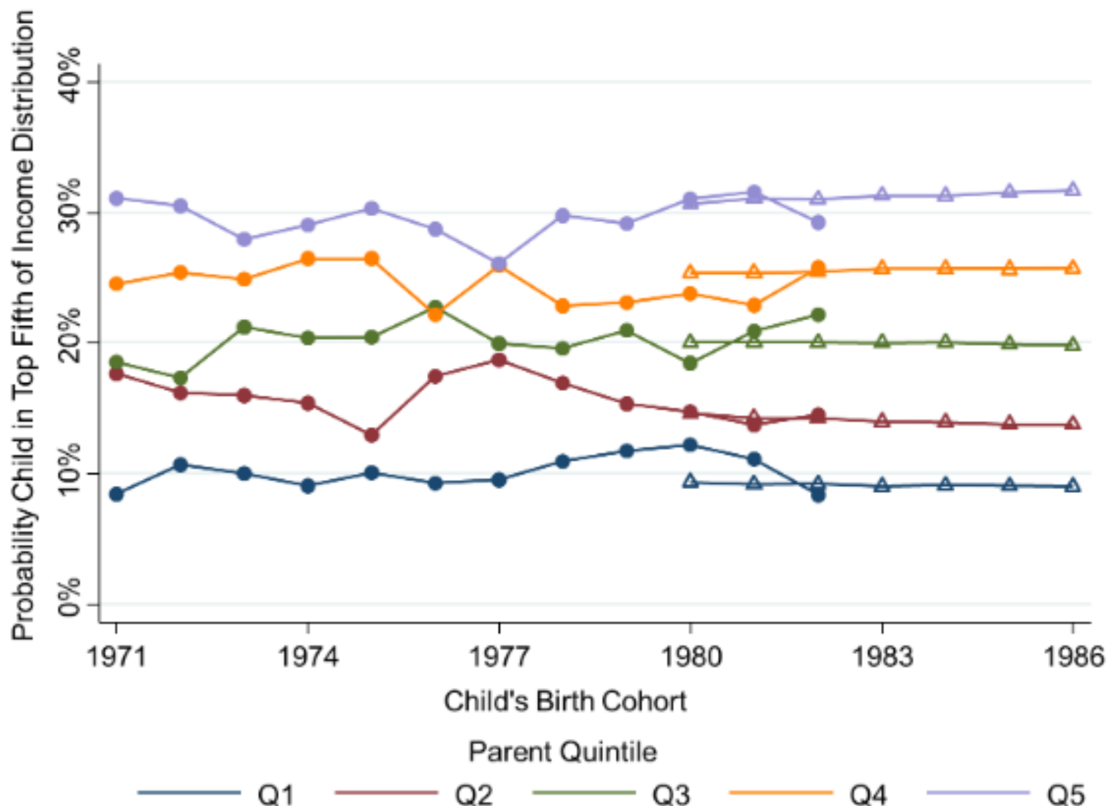
That variation does not stem simply from the fact that some areas have higher average incomes: upward mobility rates, Mr. Hendren added, often differ sharply in areas where average income is similar, like Atlanta and Seattle.

The gaps can be stark. On average, fairly poor children in Seattle – those who grew up in the 25th percentile of the national income distribution – do as well financially when they grow up as middle-class children – those who grew up at the 50th percentile – from Atlanta.

Geography mattered much less for well-off children than for middle-class and poor children, according to the results. In an economic echo of Tolstoy's line about happy families being alike, the chances that affluent children grow up to be affluent are broadly similar across metropolitan areas.

Given the rise in the percentage of total income of the top groups, there is remarkably little difference in income mobility during the last 45 years. While the bottom income group and the top income group are further apart (the income inequality is increased) the chances of moving from the bottom group to the top group are roughly the same.

Figure 3. Probability of Reaching Top Quintile at Age 26 by Birth Cohort



The researchers concluded that larger tax credits for the poor and higher taxes on the affluent seemed to improve income mobility only slightly. The economists also found only modest or no correlation between mobility and the number of local colleges and their tuition rates or between mobility and the amount of extreme wealth in a region.

But the researchers identified four broad factors that appeared to affect income mobility, including the size and dispersion of the local middle class. All else being equal, upward mobility tended to be higher in metropolitan areas where poor families were more dispersed among mixed-income neighborhoods.

Income mobility was also higher in areas with more two-parent households, better elementary schools and high schools, and more civic engagement, including membership in religious and community groups.

Regions with larger black populations had lower upward-mobility rates. But the researchers'

analysis suggested that this was not primarily because of their race. Both white and black residents of Atlanta have low upward mobility, for instance.

The authors emphasize that their data allowed them to identify only correlation, not causation. Other economists said that future studies will be important for sorting through the patterns in this new data. Still, earlier studies have already found that education and family structure have a large effect on the chances that children escape poverty.

(I commend the professors for making all of their data and analysis available.)

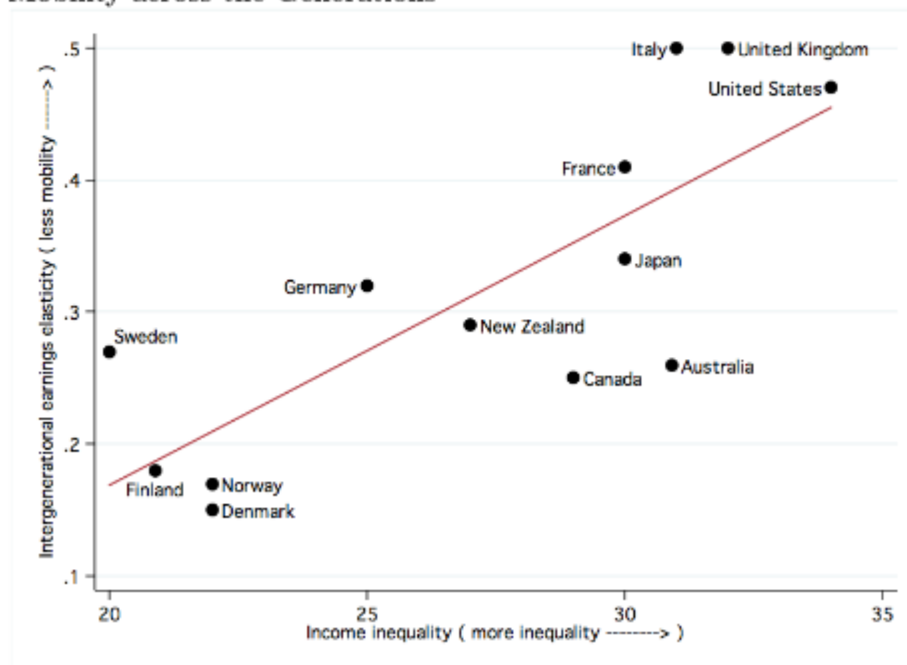
To me their study reinforces my basic premise that valid conclusions about causes of income inequality are more difficult to come by than are the simple correlation analyses presented in many academic and political policy papers offered by various advocates in support of their personal policy choices (both conservative and liberal).

Upward Mobility Across Nations

Finally we will look at a study by Miles Corak of the University of Ottawa that shows the correlation between socioeconomic mobility and income inequality. Notice that Sweden (along with the rest of Scandinavia) shows some of the lowest income inequality and highest social mobility, while the reverse is true for the US.

Figure 1

The Great Gatsby Curve: More Inequality is Associated with Less Mobility across the Generations



Source: Corak (2013) and OECD.

Silence of the Left

Conveniently for the discussion of our topic, John Goodman posted a brief article on Townhall.com this week called "Silence of the Left":

> The topic du jour on the left these days is inequality. But why does the left care about inequality? Do they really want to lift those at the bottom of the income ladder? Or are they just looking for one more reason to increase the power of government? If you care about those at the bottom then you are wasting your time and everyone else's time unless you focus on one and only one phenomenon: the inequality of educational opportunity. Poor kids are almost always enrolled in bad schools. Rich kids are almost always in good schools.

It turns out that homes cost roughly 20% more in areas with good schools. School choice is already in effect because people with more money buy homes in areas with better public schools. Children of families with less money on average tend to be stuck in lower-performing public schools.

Goodman cites a Brookings Institution study that investigated the same phenomenon nationwide:

- Across the 100 largest metropolitan areas, housing costs an average of 2.4 times as much, or nearly $11,000 more per year, near a high-scoring public school than near a low-scoring public school.

- This housing cost gap reflects that home values are $205,000 higher on average in the neighborhoods of high-scoring versus low-scoring schools. Near high-scoring schools, typical homes have 1.5 additional rooms and the share of housing units that are rented is roughly 30 percentage points lower than in neighborhoods near low-scoring schools.

Goodman continues:

> You almost never see anything written by left-of-center folks on reforming the public schools. And I have noticed on TV talk shows that it's almost impossible to get liberals to agree to the most modest of all reform ideas: getting rid of bad teachers and making sure we keep the good ones."
>
> Here is the uncomfortable reality:
>
> 1. Our system of public education is one of the most regressive features of American society.
>
> 2. There is almost nothing we could do that would be more impactful in reducing inequality of educational opportunity and inequality overall than to do what Sweden has done: give every child a voucher and let them select a school of choice.
>
> 3. Yet on the left there is almost uniform resistance to this idea or any other idea that challenges the power of the teachers' unions.

That "socialist" bastion of income equality and mobility – Sweden – uses vouchers for education.

Krugman argues against school vouchers because they might reduce support for public schools. And then he actually writes, "And – dare we say it? – we should in general oppose privatization plans if they are likely to destroy public sector unions."

We have total academic, bureaucratic, and teachers'-union capture of public education. We are subjecting our children to an education system that that was designed for and that worked remarkably well during the first two industrial revolutions but that is now utterly inadequate for the coming Age of Transformation. The new New York City Mayor, Bill de Blasio, is working to shut down many of the best-performing schools in his city – charter schools – which are hated by teachers' unions. Rather than ask what is good for the children, he and many others simply want to expand the power of the unions.

If we want to do something about income inequality, perhaps we should think about the data that shows the remarkable correlation between education, educational opportunity, and income.

Exclusive Video: An Interview with Janet Yellen

My friend Jim Bruce, the producer of the fabulous documentary on the US Federal Reserve system, *Money for Nothing,* conducted a remarkable two-hour interview with Janet Yellen when she was the president of the San Francisco branch of the Federal Reserve. He has edited the interview down to a little more than 10 minutes of the most important parts. For the time being, it is exclusively available at Mauldin Economics at this link.

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You can order your own DVD of *Money for Nothing* at a link underneath the video interview. If you have not seen it, you should get it and make sure that it is played in schools and for social groups everywhere. This is the most powerful video presentation on the role and history of the Federal Reserve that has ever been done. It's hard for me to recommend it enough, and I'm proud to be able to offer it to readers of *Thoughts from the Frontline.*

Argentina, South Africa, New York, Europe, and San Diego

I leave next Wednesday evening for Argentina for 12 days, then return home for eight *hours* before I take off for 12 days in South Africa. I'm going to try something new this trip and post a few pictures and comments to Twitter. Follow me if you like. After South Africa I'm back home for like a day before I have to run up to New York to do some videos. Then it's back home for a few weeks (or so it appears) before I head to Amsterdam, Brussels, and Geneva. I'll come home for a few days and then hightail it to San Diego for our Strategic Investment Conference – one of my real highlights of the year. And then – where were we? – ah yes, I'll be home for more than two whole weeks before heading to Tuscany for a few weeks of vacation. Whew. I will be ready to relax at the end of all that travel.

Today was all about the one-year birthday party of my granddaughter Addison Porter. It was held at my apartment, since there were lots of family member and friends who wanted to help us celebrate the event. Given the occasion, I thought it would be appropriate to play Disney family tunes over the sound system. My own kids grew up with Disney music, and I've learned to appreciate it. A very special tune came on –one of my favorite songs of all time. We know it as the introduction and ending to the Disney movie *Pinocchio.* It's Jiminy Cricket singing "When You Wish upon a Star." If you listen to it, notice that the books Jiminy Cricket is leaning against as he sings are *Peter Pan* and *Alice in Wonderland* – and this was prior to Disney's actually turning them into movies. The singing is done by Cliff Edwards, who was known as Ukulele Ike. His lilting falsetto created a song sensation that the American Film Institute says is the seventh-best movie song of all time and easily the top Disney song. Edwards was quite popular back in the '20s and '30s, and his number-one song was "Singing in the Rain." Sadly, he had a troubled life and ended up broke, a welfare patient in a California nursing home. That said, he left us one of the most beautiful melodies of all time. Just a little nostalgic trivia brought on by a granddaughter's birthday. And yes, she is gorgeous. My daughter Amanda mischievously placed a small cake with lots of pink cream icing on her lap and let her explore the icing and cake with her hands, which of course ended up all over her face, giving everyone great photo opportunities. And now when I wish upon a star, I will think of Addison and that icing-splattered face.

And now it is time to hit the send button. I'll be writing to you in the next few weeks from far locales, but I'll stay in touch, and *Thoughts from the Frontline* will come at more or less the same time on the weekend. Thanks for taking the time to read, and keep those cards and letters coming.

Your thinking about my granddaughter's education analyst,

John Mauldin

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