FIRST PRINCIPLES

The Height of Inequality

America's productivity gains have gone to giant salaries for just a few

BY CLIVE CROOK

In 1971, Jan Pen, a Dutch economist, published a celebrated treatise with a less-than-gripping title: *Income Distribution.* The book summoned a memorable image. This is how to think of the pattern of incomes in an economy, Pen said (he was writing about Britain, but bear with me). Suppose that every person in the economy walks by, as if in a parade. Imagine that the parade takes exactly an hour to pass, and that the marchers are arranged in order of income, with the lowest incomes at the front and the highest at the back. Also imagine that the heights of the people in the parade are proportional to what they make: those earning the average income will be of average height, those earning twice the average income will be twice the average height, and so on. We spectators, let us imagine, are also of average height.

Pen then described what the observers would see. Not a series of people of steadily increasing height—that's far too bland a picture. The observers would see something much stranger. They would see, mostly, a parade of dwarves, and then some unbelievable giants at the very end.

As the parade begins, Pen explained, the marchers cannot be seen at all. They are walking upside down, with their heads underground—owners of loss-making businesses, most likely. Very soon, upright marchers begin to pass by, but they are tiny. For five minutes or so, the observers are peering down at people just inches high—old people and youngsters, mainly; people without regular work, who make a little from odd jobs. Ten minutes in, the full-time labor force has arrived: to begin with, mainly unskilled manual and clerical workers, burger flippers, shop assistants, and the like, standing about waist-high to the observers. And at this point things start to get dull, because there are so very many of these very small people. The minutes pass, and pass, and they keep on coming.

By about halfway through the parade, Pen wrote, the observers might expect to be looking people in the eye—people of average height ought to be in the middle. But no, the marchers are still quite small, these experienced tradespeople, skilled industrial workers, trained office staff, and so on—not yet five feet tall, many of them. On and on they come.

It takes about forty-five minutes—the parade is drawing to a close—before the marchers are as tall as the observers. Heights are visibly rising by this point, but even now not very fast. In the final six minutes, however, when people with earnings in the top 10 percent begin to arrive, things get weird again. Heights begin to surge upward at a madly accelerating rate. Doctors, lawyers, and senior civil servants twenty feet tall speed by. Moments later, successful corporate executives, bankers, stockbrokers—peering down from fifty feet, 100 feet, 500 feet. In the last few seconds you glimpse pop stars, movie stars, the most successful entrepreneurs. You can see only up to their knees (this is Britain: it's cloudy). And if you blink, you'll miss them altogether. At the very end of the parade (it's 1971, recall) is John Paul Getty, heir to the Getty Oil fortune. The sole of his shoe is hundreds of feet thick.

As Garrison Keillor ironically informs his listeners, not every child can be above average. But when it comes to incomes, the great majority can very easily be below average. A comparative handful of exceptionally well-paid people pulls the average up. As a matter of arithmetic, the median income—the income of the worker halfway up the income distribution—is bound to be less than average.

This is true in every economy, but in some more than others. Back when Pen wrote his book, incomes were already more skewed in America than in Britain. Over the past thirty-five years, and especially over the past ten, that top-end skewness has greatly increased. The weirdness of the last half minute of today's American parade—even more so the weirdness of the last few seconds, and above all the weirdness of the last fraction of a second—is vastly greater than that of the vision, bizarre as it was, described by Pen.

Lately economists have been using new data to look more closely within the top decile of American incomes. What they've found is startling. Here are some results from Ian Dew-Becker and Robert Gordon of Northwestern University. Between 1966 and 2001, median wage and salary income increased by just 11 percent, after inflation. Income at the 90th percentile (six minutes from the end of the hour-long parade) increased nearly six times as much—by 58 percent. At the 99th percentile (the last thirty-six seconds), the rise was 121 percent. At the 99.9th percentile (3.6 seconds before the end), it was 236 percent. And at the 99.99th percentile (0.36 seconds, representing the 13,000 highest-paid workers in the American economy), the rise was 617 percent.

That is worth repeating: Over thirty-five years, the rise in wages and salaries in the wide middle of the income distribution was 11 percent. The rise in wages and salaries at the top of the income distribution was 617 percent.

This is (pretax) wage and salary income, not investment income. Many commentators attribute rising American inequality to growth in profits at the expense of salaries and wages. That's wrong: labor's share of national income does not seem to be trending up or down. What has changed is how much of labor's share goes to top earners. Since the mid-1970s, and especially since the mid-1990s, the dramatic rise in the share of national income earned by the very rich is due not to the strength of their investment portfolios but to their growing share of labor income.

7″

2′6″

10th percentile

35th percentile

Productivity growth has always been seen as perhaps the single most important indicator of rising, broad-based prosperity. But remarkable growth in top-end pay, together with the relative constancy of labor's overall share of income, has an obvious implication: the highest earners are now capturing most of the gain in national income caused by economy-wide productivity growth.

This is quite disturbing. Historically, rising productivity has been a tide that lifted nearly all boats. For more than twenty years during the long surge of productivity growth that followed the Second World War, median incomes in the United States rose as quickly as the highest incomes. This came to be regarded as normal—and, seen from a global vantage point, it still is. The dispersed benefits of high aggregate productivity are the reason why jobs of almost every kind pay better in rich countries than in poor ones.

Mechanics and hairdressers are paid far more in America than in Mexico, even though their individual productivity may not be that different in the two places; north of the border, workers share in the economy's higher overall productivity. A lot depends on whether this continues to be true. It is the very point that the new findings call into question.

The study by Dew-Becker and Gordon asks, "Where Did the Productivity Growth Go?" Over the past thirty-five years, that growth did not lift most boats, or even very many boats. Between 1966 and 2001, only 10 percent of American workers saw their incomes rise at least as fast as economy-wide productivity did. More astonishing still, according to the study's authors, from 1997 to 2001, the top 1 percent captured far more of the real national gain in wage and salary income than did the bottom *50 percent*. And even within that highest percentile, the gains were heavily concentrated at the top.

Such extreme skewness is new. It suggests that a huge proportion of the economy's productivity gains are neither being passed on to consumers through lower prices—which would have the effect of raising real incomes very broadly—nor being distributed to investors as profit, nor even being used to raise the wages of most employees in industries seeing rapid productivity growth. Rather, they're being diverted to a comparative handful of employees.

Why is this happening? Nobody is sure, but Dew-Becker and Gordon suggest a combination of two things: for one small group, sports and media celebrities, income growth has come from a perfecting of the labor market; for a different group, top corporate executives, it has come from a breaking down (or even an overthrowing) of the market. Those two segments account for most of the 13,000 people in the 99.99th percentile—with total earnings of $83 billion in 2001.

A classic 1981 study by the late economist Sherwin Rosen worked out "The Economics of Superstars" and anticipated part of what has happened. The demand for stars in the sports and entertainment industries is such that small differences in talent cause disproportionate gaps in earnings. As technology puts stars in front of bigger audiences, their incomes multiply. Rosen could not have foreseen the media innovations of the past decade, but they have plainly given stars access to far more fans.

I find it interesting that there is no popular unease over the stupendous sums paid to Tiger Woods, or Eminem, or Tom Cruise. And, you might ask, why should there be? They are worth the price of the ticket, at least in the view of their audiences. If they are in demand worldwide, good luck to them. An economist would say the market is working.

The case of fat-cat chief executives arouses different feelings—as it should. In most cases, there is no audience-multiplication factor to account for the dramatic rise in CEO pay. If a Rosen-type process were at work, you would not expect to find that CEO pay had surged only in the United States (and to a lesser extent in Britain). Numerous widely reported cases of pay for no performance are also awkward to explain. When boards give big noncontractual severance packages to bosses fired for incompetence, you have to ask whether this second stratospheric zone of the labor market, unlike the superstar zone, is working properly.

Corporate-governance reforms that would help shareholders keep CEOs in check might do some good. If I'm skeptical, it's partly because shareholders already have some (admittedly limited) powers, and they usually let things slide. That might change if CEO pay continues to rise. At some point, the subdued "outrage constraint" that some corporate-governance activists wish to revive might kick in again. That would be a good thing.

Perhaps the CEOs' appetites can be curbed. Maybe the superstars will find that their audiences cannot widen without limit. And perhaps, if both those things happen, productivity growth will again raise incomes broadly, as it once did, and as it is supposed to. If not, how much longer before the dwarves get restless? ■

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INEQUALITY ON PARADE

The distribution of work income in the United States, 2001

The height of each figure is proportional to his or her salary and wages. A worker of average income is assumed to be five feet ten.