On the Gap Between the Rich and the Poor

By
Young Back Choi

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I S the gap between the rich and the poor in America growing larger? If so, why is it growing, and has it gotten too big? And should we do anything about it?

Many people apparently believe that income and wealth inequality increased excessively in the United States in the 1980s and 1990s. For some the evidence is anecdotal, based on general impressions of what they see in their own neighborhood, on TV, or in the newspapers. Others may be familiar with formal studies that offer statistical evidence of a trend toward more inequality.

Such studies often are cited by social critics who see increasing inequality as a serious problem. The perceived trend toward more inequality, they say, threatens us with a two-tiered society, one in which the relatively few people at the top live in luxury while those at the bottom of the income and wealth distribution suffer the loss of the “American dream.” These critics believe that the government should take more steps to correct the problem of inequality—namely, by taxing the rich and redistributing income and resources to the poor.

As Professor Young Back Choi points out in the pages that follow, there are many problems with this argument. To begin with, measuring the gap between the rich and the poor is difficult. Those who believe that the existing level of inequality is excessive assume that we have accurate estimates of it. But, as Professor Choi describes, the available statistics have shortcomings and are open to misuse, distortion, and exaggeration. If adjustments are made for differences in such things as household size, age, and the value of things such as future pensions promised by employers, future Social Security benefits, and non-cash benefits provided by the government to the poor, the degree of inequality turns out to be smaller than that suggested by critics using the official data.

Defining what is meant by “excessive” inequality is another challenge. What might initially strike people as excessive or unjust might seem reasonable after they take into account the factors that often contribute to differences in income and wealth. For example, most people would not find anything wrong with someone earning twice as much as another by working twice as much, or with a competent surgeon earning many times more than a janitor. Indeed, many people would find it unjust if two people in these different circumstances earned the same income. For the purpose of discussing policies aimed at reducing inequality, it is important to understand the sources of that inequality.
It is also crucial to understand that there is a difference between being poor in absolute terms and being poor relative to others. An increase in inequality (that is, in relative poverty) is not the same thing as an increase in absolute poverty. American families who are at the bottom of the income distribution today are richer than the families who were at the bottom a decade ago. Their standard of living is higher than it was for most Americans did 50 years ago and higher than it is in much of the rest of the world today.

As John Kenneth Galbraith once said, "Wealth is not without its advantages, and the case to the contrary, although it has often been made, has never proved widely persuasive." The goal of this book is not to persuade readers that there are no differences in wealth or that the rich have no advantages. Rather, Professor Choi argues that the gap has been overstated, that a widening gap does not equate to an increase in poverty, and that the advantages of the rich over the poor are not as great or insurmountable as some suggest. He also argues that attempts to equalize the income or wealth distribution are likely to discourage economic activity and restrict social mobility. The result, he suggests, could be far from what the social critics might care to imagine.

About the Author

Young Back Choi is a Professor at St. John's University, where he teaches a variety of courses in economics. He has published numerous books, book chapters, and scholarly papers on entrepreneurship, economic development, transition economies, income distribution, the history of economic ideas, and methodology. Professor Choi has been a visiting scholar at George Mason University, Washington University, the Social Philosophy and Policy Center, the Max-Planck Institute for Comparative Economic Systems (Germany), Kokugakkuin University, and the American Institute for Economic Research. He has been a Faculty Associate of the Program on the Foundations of the Market Economy, New York University since 1994. Professor Choi received his Ph.D. in Economics from the University of Michigan in 1986.
INTRODUCTION

ALTHOUGH the distributions of income and of wealth have always been unequal in the United States, commonly cited evidence suggests that the distributions are becoming more concentrated. One measure of income inequality is the Gini coefficient, which is plotted in Chart 1. The chart shows the Gini coefficient increasing steadily between 1968 and 1994, suggesting increasing income inequality. (The Gini coefficient can range from zero, meaning perfect equality, to 1, meaning the concentration of all income in one person.) The trend in the inequality of wealth, as opposed to income, was even more pronounced during the same period.

Some analysts attribute the growing inequality in income and wealth of the late 1980s and the early 1990s to changes in demography, the labor-market, industrial structure, and the money supply. For example, both the large-scale relocation of traditional manufacturing to sites overseas and the industrial transition to high tech and service industries hastened by the strengthening of the dollar greatly reduced the demand for less-educated male labor in the 1980s. At the same time, the supply of young and less-educated males increased relative to the more educated, reflecting a low premium on education during the preceding decades. Also, increased competition in the labor market by women contributed to the trend.

Changes in the composition of families (with increasing proportions of

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Chart 1: Gini Coefficient of Income Inequality, 1967-2001

Source: U.S. Census Bureau (2002), Table 1E-6. The method of income data collection since 1993 is different from that prior to 1993. This explains the sudden increase in Gini coefficient from 1992 to 1993.
two-income households, on the one hand, and households headed by single parents, on the other) and of immigrants (over three quarters of whom in recent years have less than high school education) also significantly contributed to the increased statistical dispersion of income distribution. A final factor that contributed to the trend was the rapid increase in the prices of assets such as stocks and real estate. In short, the changes in income and wealth dispersion over the last two decades reflect changes in the relative prices of different kinds of labor (or skills) and assets.

This evidence, however, does not seem to satisfy social critics—including a number of prominent economists at prestigious universities. They view the increasing inequality of income and wealth distribution as serious problems. For example, Paul Krugman, of Princeton University, asserts: "[It] doesn't take much imagination to envision what our society will be like if this process continues for another 15 or 20 years...a...dystopia, in which a few people live in luxury while the majority grovel [sic] in Third World living standards."4 Richard Freeman, of Harvard University writes: "Falling or stagnating incomes for most workers and rising inequality threaten American ideals of political 'classlessness' and shared citizenship. Left unattended, the new inequality threatens us with a two-tiered society—an 'apartheid economy'—in which the successful upper and upper-middle classes live fundamentally different lives from the working classes and the poor.... For many it promises the loss of the 'American dream.'"5 Finally, Frank Levy, of MIT observes: "If markets produce increasingly unequal outcomes...we can reasonably expect a collapse of popular support for markets and other pro-growth policies."6

Indeed, social critics voice some serious concerns about the recent trends in increasing inequality of income and wealth. Many of them insist that the government do something—namely, tax the rich and redistribute the revenue to the poor.

Most Americans, however, accept that individuals earn different incomes and have different net worths. For why wouldn't income and wealth differ among individuals, given that people are different in so many other ways—looks, intelligence, temperament, heights, weights, athletic abilities, tastes, places and time of birth, etc.? An economist who chooses a position in academia rather than a job on Wall Street is well aware of the income disparity between the two careers. A compassionate civic-minded woman may quit her second job and volunteer her time at a community center. This is how most Americans conduct their affairs. They do not see any reason to single out individual differences in income and wealth as social problems.

This American attitude puzzles many social critics. Writing in 1970, the
late James Tobin, a Professor at Yale University and Nobel laureate in economics, put it this way:

American attitudes toward economic inequality are complex. The egalitarian sentiments of contemporary college campuses are not necessarily shared by the not-so-silent majority. Our society, I believe, accepts and approves a large measure of inequality, even of inherited inequality. Americans commonly perceive differences of wealth and income as earned and regard the differential earnings of effort, skill, foresight, and enterprise as deserved. Even the prizes of sheer luck cause very little resentment. People are much more concerned with the legitimacy, legality, and fairness of large gains than with their sheer size.7

Contemporary critics of inequality maintain that this attitude stems from an unawareness of the trends of increasing inequality in income and wealth distribution and the seriousness of the problems thereof. Critics, therefore, aim to educate the public about how extreme and unfair the distribution of income and wealth has become and how inequality would lead (if it has not already led) to problems. Some think it is time to declare “the moral equivalent of war” in order to create greater equality.8

Hence, a growth industry in academia has sprung up documenting and publicizing the evidence of the excessiveness of inequality and proposing various redistribution programs. Social critics of inequality often hold endowed-chairs at prestigious universities such as Harvard, Yale, Princeton, and Cornell. There are Ph.D. programs on inequality at Harvard and Cornell. Research Institutes such as the Jerome Levy Institute, and major funding agencies including the MacArthur, Russell Sage, and Ford Foundations devote considerable resources to support such critics. The research reports these scholars and institutes produce are lengthy and detailed, but the proposed remedies are often one-dimensional and simplistic—e.g., give $6,000 to every American child born to insure a more level playing field9, or give each American a onetime grant of $80,000 when he or she reaches early adulthood.10

However, social critics tend to be long on rhetoric and short on careful analysis and sound reasoning. There is much obfuscation of facts, muddling of concepts, and misinterpretation (or disregard) of economic principles (even by eminent economists!). Let me list some of them:

1. Critics pronounce that inequality in distribution has become excessive (or intolerable) but do not offer a standard by which to judge.

2. Critics often fail to distinguish between poverty and inequality, talking as if they are one and the same.11 Although income inequality in the U.S. is not the lowest among industrialized nations, the per capita income of the poorest 10 percent of the U.S. population is higher than
the average income of the world population.\textsuperscript{12}

3. Critics often talk as if people remain at the same income level over time. However, many academic studies consistently suggest that there is substantial income mobility in the United States. In one study almost 58 percent of the people in the lowest income quintile in 1974 moved into higher income quintiles by 1991. And almost eight percent moved to the highest income quintile.

4. Critics maintain that the rich have an inherent advantage over the poor (or less well-off) and, therefore, the poor are condemned to increasing hardship and despair. This assertion is not consistent with the continuous improvement in the poor's standard of living in recent centuries.

5. Critics allege that inequality is unjust because: a) the rich gain at the expense of the poor; b) the rich get a disproportionate share of the gains from trade; c) the bounty of the rich is unearned; and d) the rich are undeserving. They ignore that income is earned, by and large, by producing what others want. Consequently, other things being equal, people who work harder, longer, with greater dexterity and skills earn more than those who do not. Critics talk, instead, as if the distribution of income and wealth is predetermined by fate rather than effort.

6. Critics argue that income and wealth inequality are responsible for numerous social problems such as crime, welfare, and poor educational outcomes. They also argue that inequality weakens social bonds by isolating the rich from the poor. With widening inequality, the poor become alienated and withdrawn from the economy and society, while the rich gain an increasingly powerful influence in business and politics—thus weakening democracy. The critics seem to believe—without evidence—that imposing equality would eliminate most social ills.

7. Critics ignore the possibility that forced redistribution might adversely affect individual freedom and prosperity.

This essay aims to examine the evidence and reasoning of social critics' views. In the next two sections, I analyze the common claim that the existing inequality is excessive. Though income and wealth are related and one can be converted into the other, the two will be considered separately—first income and then wealth. Subsequent sections will examine the claims that the rich have an inherent advantage over the poor and that inequality is unjust.
I.

THAT INEQUALITY IN INCOME DISTRIBUTION IS EXCESSIVE

Social critics argue that the inequality in income distribution has become excessive and that collective action is needed to reduce it. Richard Freeman claims that "Income inequality has skyrocketed. In 1979, for example, on an hourly basis, the top decile of men earned four times what the bottom decile earned; by 1993 they were earning five times as much....We have a real problem that must be solved...." Social critics such as Freeman clearly believe that less inequality is better.

However, neither Freeman nor any other social critic has ever offered a criterion by which to judge whether a given degree of inequality is acceptable. Without such a criterion, any judgment that income inequality is excessive is purely arbitrary. Disheartened over the growing inequality since the late 1980s, Paul Krugman observed that the U.S. in 1970 was "a middle-class nation...in which most people live[d] more or less the same kind of life." But what Krugman considers the golden age of equality was regarded as worrisome (in terms of inequality) by the social critics of 1970. For example, writing in 1970, James Tobin noted, "...in the last five years that ...distribution has returned to the forefront of professional and public attention...."

Without offering a defensible rule by which to judge whether inequality in income or wealth is excessive, social critics can always complain about inequality, as long as inequality exists. It is therefore pointless to evaluate whether, and in what sense, social critics' claim of the excessiveness of inequality in income or wealth distribution is valid. Instead, this essay focuses on the social critics' (mis)use of data.

To demonstrate the extent of inequality, social critics commonly compare either the share of income or average income of the highest-earning segment of the population with that of the lowest-earning. For example, in 2001 the income share of the highest quintile was 50.1 percent, or 14 times the lowest quintile's 3.5 percent. (See Table 1.)

Social critics compare the segments of their choosing. For example, they might compare the income share of the highest-earning five percent

<table>
<thead>
<tr>
<th>Table 1: Shares of Household Income by Quintile, 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest (A)</td>
</tr>
<tr>
<td>------------</td>
</tr>
<tr>
<td>Official Census Data</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau (2001), Table 6, p. 14.
with that of the lowest-earning 10 percent or the income share of the highest-earning one percent with that of the bottom 50 percent, and so on. The main point of this type of exercise is to underline the differences in income among different groups of people. To create the impression that inequality is "excessive," they often overstate the degree of inequality by the misuse of data.

In this section, we will examine the income statistics; wealth data will be covered in the next chapter.

**Modifying Income Measurement**

The most commonly used data on American income distribution are from the Current Population Survey (CPS) conducted by the U.S. Census Bureau. CPS measures the money income of households in a year, before taxes and excluding capital gains. (A household consists of all people who occupy a housing unit regardless of relationship. It may consist of a person living alone or multiple unrelated individuals or families living together.16)

By counting only gross money income, the definition of income adopted by the Census Bureau overstates the degree of inequality. This measure of income does not adjust for the taxes paid to Federal, state and local governments that the higher-earning households disproportionately pay, or for the value of noncash transfers that the low-income households disproportionately receive.

Since the early 1980s, the Census Bureau has provided estimates of the effects on income distribution of adjusting for taxes and noncash transfers, among other things. Noncash transfers include items such as food stamps, rent subsidies, free and reduced school lunches, and the value of Medicaid and Medicare. Other adjustments include realized capital gains (or losses), the imputed return on home equity net of property taxes, the value of employer-paid health benefits, and the earned income credit (which is basically a refund of social security taxes for qualifying low-income people).

The overall result of the adjustments shows that the official measure of income overstates the degree of inequality. (See Table 2.)

After the adjustments, the highest quintile’s income share in 2001 falls from 50.1 percent (in the official measure) to 46.5 percent (after all adjust-

<table>
<thead>
<tr>
<th>Table 2: Shares of Household Income by Quintile, 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower quintile (A)</td>
</tr>
<tr>
<td>---------------------</td>
</tr>
<tr>
<td>Official Census Data</td>
</tr>
<tr>
<td>After All Adjustments by the Census</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau (2001), Table 6, p. 14.
ments mentioned above are made), while the lowest quintile’s share rises from 3.5 percent to 4.7 percent. The ratio of the share of the richest quintile to that of the poorest falls from 14.3 to 9.9.

The Census Bureau’s own adjustments, therefore, show that the official measures of income distribution overstate the degree of inequality. But social critics tend to only report the data in Table 1, ignoring the data in Table 2, although it is readily available from the same source.

However, even these Census Bureau adjustments are not all-inclusive. For example, one of the important items left out is the value of financial assistance to college students. Those who are classified as poor can often send their children to college free of charge or at a steep discount. The value of the college tuition benefits may be up to $40,000 per year for each child! Other examples where an adjustment might be made include: (1) special programs for the poor, e.g., free pre-kindergarten, free tutors, free summer camps, etc.; (2) income from underground economy—e.g., the illegal activities, unreported cash-transactions, barter, etc.; (3) private transfers—e.g., charitable gift to individuals, and transfers from relatives and friends; and (4) the value of household production. What is the impact on measures of inequality of leaving these factors out of the income statistics—especially if the poor are more likely to have additional income from these sources?

There are still other factors—such as differences in the household size, the age of the primary earner, costs of living, etc.—that should be considered when discussing the degree of inequality. Let’s briefly consider them in turn.

**Differences in Household Size among Different Income Classes**

According to the Current Population Survey (CPS) data, household size ranges from one to seven or more. Since household size is not randomly distributed across different income levels, any judgments about inequality in income distribution should account for this factor.

An example illustrates the point. Suppose there are two households. Each consists of a married couple with two income earners, earning equal income, say $30,000 each. Total income of each household, therefore, is $60,000 before taxes. The two households have equal income and would be recorded as such in the CPS. Now suppose that one couple divorces. We now have three households—one household with income of $60,000, and two with $30,000 each. To say that the $60,000 household (with two persons) is twice as rich as the $30,000 households (with one person each) does not make any sense.
In 2001, the average number of persons living in households with annual income between $5,000 and $7,499 was 1.6. The average-size household with annual income over $100,000 was 3.21 persons. That is, the size of the households with annual income over $100,000 is twice as large as the average size of households with annual income between $5,000 and $7,499. (See Chart 2.)

With the exception of households with less than $5,000 annual income, the data suggest that household size is not randomly distributed across different income levels—higher household income is associated with larger household size. Drawing inferences about inequality without making an adjustment for differences in the size of household clearly exaggerates inequality.

But how should we adjust the data? The simplest way is to count one person as one person. That is, if a two-person household has twice the income of a one-person household, then the two households should be regarded as having the same income. Rector and Hederman report that, when adjustments are made on 1997 Census data so that each quintile contains approximately the same number of persons, the income share of the lowest quintile rises from 5.6 percent to 9.4 percent and that of the highest quintile falls from 45.3 percent to 39.7 percent.17 (See Table 3.) Accordingly, the ratio of the income share of the highest quintile to the lowest falls from 14 (in the official data), to 4.2.
Table 3: **Shares of Household Income by Quintile, 1997**

<table>
<thead>
<tr>
<th>Official Census Data</th>
<th>Lowest (A)</th>
<th>Second</th>
<th>Third</th>
<th>Fourth</th>
<th>Highest (B)</th>
<th>B/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>After All Adjustments by the Census</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>After Quintiles are Also Adjusted to Hold Same Number of Persons</td>
<td>3.6</td>
<td>8.9</td>
<td>15.0</td>
<td>23.2</td>
<td>49.4</td>
<td>13.7</td>
</tr>
<tr>
<td>After All Adjustments by the Census</td>
<td>5.6</td>
<td>10.8</td>
<td>15.8</td>
<td>22.5</td>
<td>45.3</td>
<td>8.1</td>
</tr>
<tr>
<td>After Quintiles are Also Adjusted to Hold Same Number of Persons</td>
<td>9.4</td>
<td>13.3</td>
<td>16.5</td>
<td>21.2</td>
<td>39.7</td>
<td>4.2</td>
</tr>
</tbody>
</table>

Source: Rector and Hederman (1999).

Some may object to the study by Rector and Hederman, arguing that the cost of living of, say, a five-person household is not five times that of one-person household. One may, instead, use an “equivalence scale,” a scheme of discounting multi-person households used by the federal government to calculate poverty guidelines. (See Table 4.)

Use of such an “equivalence scale” to adjust for household size would not reduce the degree of inequality as much as that suggested by Rector and Hederman’s method.

The method for adjusting for household size, however, is not important for the purpose here. What is important is that the degree of inequality is overstated if the difference in household size is not taken into account.

### Income Fluctuation over Time and Differences in the Age of the Householder

The Census data measure yearly income. There are two reasons why using yearly income data, instead of lifetime income data, tends to overstate the degree of inequality. One is that the household income fluctuates from year to year—through occasional unemployment and business failure, as well as some lucky breaks. In other words, comparing average incomes earned over a long period, which smooths out yearly fluctuations, would reflect less inequality than the annual income data might suggest.

The other reason is that as individuals pass through different phases of life—from young, middle-aged, and aged—their incomes tend to increase over time (as they gain experience and skills) and then fall off upon retirement. Ignoring this evidence, which is what using yearly income data does, leads one to infer that the degree of inequality is greater

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Table 4: **Equivalence Scale Implicit in the Federal Government’s Poverty Line, 1996**

<table>
<thead>
<tr>
<th>Size of Family</th>
<th>1 person</th>
<th>2 person</th>
<th>3 person</th>
<th>4 person</th>
<th>5 person</th>
<th>6 person</th>
<th>7 person</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equivalence scale</td>
<td>1.000</td>
<td>1.279</td>
<td>1.565</td>
<td>2.010</td>
<td>2.370</td>
<td>2.680</td>
<td>3.040</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau.
than it actually is.

To illustrate the point, consider a society made up of three individuals, with identical career and earning patterns. Their lifetime income, therefore, is identical. Suppose now that one is young, one middle aged, and one retired. Their current incomes reflect only differences in their respective stages in life, say, the young earning $30,000, the middle-aged $60,000, and the retired $10,000. The Census Bureau data will report a very unequal distribution of income—the income share of the highest-earning one third of the population is 60 percent—even though the lifetime incomes of the three are equal. In short, it is silly to speak about inequality in income distribution based on the Census Bureau data without making some allowance for differences in the ages of the householders.

Indeed, higher income households tend to be headed by individuals in their prime-working years, say, between the ages of 35 and 54. (See Table 5.) In the highest quintile, 59.5 percent of the households are headed by someone in their prime-working years, while in the lowest quintile, only 25 percent of those householders are in that age group.

On the other hand, poorer households tend to be headed by older or younger people. Householders between the ages 15 and 24 or over age 65 make up 48.5 percent of the lowest quintile, but only 9.9 percent of the highest quintile. If we are to draw a fair inference about the degree of inequality in income distribution, then, we must also adjust the data for differences in the age of householders (assuming that they are primary earners.)

Measuring income over a longer period of time eliminates the problem of overstatement of inequality due to differences in the age of earners and fluctuating yearly income. Peter Gottschalk calculated that considering income over a 17-year period rather than over just one year reduced inequality by 30 percent.20

Table 5: Percent Distribution of the Age of Householder by Income Quintile, 2001

<table>
<thead>
<tr>
<th>Age</th>
<th>Lowest</th>
<th>Second</th>
<th>Third</th>
<th>Fourth</th>
<th>Highest</th>
<th>Top 5 Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-24</td>
<td>8.8</td>
<td>8.4</td>
<td>6.2</td>
<td>3.8</td>
<td>2.0</td>
<td>1.3</td>
</tr>
<tr>
<td>25-34</td>
<td>13.1</td>
<td>17.6</td>
<td>20.3</td>
<td>21.5</td>
<td>14.4</td>
<td>10.8</td>
</tr>
<tr>
<td>35-44</td>
<td>12.9</td>
<td>18.4</td>
<td>23.4</td>
<td>26.8</td>
<td>28.5</td>
<td>27.8</td>
</tr>
<tr>
<td>45-54</td>
<td>12.1</td>
<td>14.7</td>
<td>19.2</td>
<td>24.5</td>
<td>31.0</td>
<td>33.3</td>
</tr>
<tr>
<td>55-64</td>
<td>13.3</td>
<td>12.4</td>
<td>13.8</td>
<td>13.8</td>
<td>16.2</td>
<td>19.1</td>
</tr>
<tr>
<td>Over 65</td>
<td>39.7</td>
<td>28.5</td>
<td>17.1</td>
<td>9.6</td>
<td>7.9</td>
<td>7.8</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau (March 2002), HINC-05-Part I.
Alternatively, Gottschalk's study (based on the University of Michigan's Panel Survey of Income Dynamics) shows the extent to which the income status of people changed between 1974 and 1991, a 15-year interval. (See Table 6.)

Almost 58 percent of the people in the lowest quintile in 1974 found themselves in higher quintiles in 1991, with 7.8 percent making it all the way to the highest quintile. About 46 percent of the people in the highest quintile in 1974 were in lower quintiles in 1991, with three percent descending all the way to the lowest quintile. Although the changes reflect many factors, the life-cycle effects play a prominent role in what people earn in any particular time period.

A study based on U.S. income tax returns in 1979 and 1988—a nine year interval—also suggests a high degree of intra-generational mobility. As Table 7 shows, over 85 percent of those in the poorest quintile in 1979 moved to a higher quintile by 1988, and 40 percent moved into the top two quintiles. Indeed, the chance of someone in the poorest quintile in 1979 remaining there after nine years is the same as someone joining the highest quintile.

That study has been criticized for suffering from certain sampling biases, such as considering only individuals who filed income taxes both in 1979 and 1988. But the point is amply clear that a substantial portion of inequality is attributable to people moving through different phases of life.
in which they earn different incomes.

**Differences in Costs of Living**

Any judgments about the degree of inequality must also take into account that different localities have different costs of living. For example, according to the Census Bureau, the median household incomes in New Jersey and Arkansas in 2000 were $50,538 and $29,780, respectively. Although the median-income-earning New Jersey household brings in about 70 percent more than its Arkansas counterpart, the costs of living are much higher in New Jersey than in Arkansas.

Costs of living differ greatly between urban areas and rural areas, which may in part explain why 24.9 percent of the households in the lowest income quintile live outside metropolitan areas, whereas only 10.4 percent do so in the highest income quintile.

At any rate, without making the appropriate adjustments for differences in costs of living, the CPS data overstates the degree of inequality.

From our discussions thus far, it should be clear that if such factors as taxes, noncash transfers, capital gains, size of household, yearly fluctuation of income, age of head of household, and costs of living were properly accounted for by modifying the income data collected by the Census Bureau, the degree of inequality would be much less than that suggested by social critics using the official data.

Of course, making the appropriate adjustments is extremely difficult theoretically and costly to carry out even when it is possible. But social critics, intent on raising public consciousness about the extent of inequality in income distribution, not only do not bother to warn the public of the difficulties involved with data, but also do not bother to mention the available estimates from the Census Bureau, which correct for taxes and noncash transfers.

**Differences in the Amount of Work Effort and Skills**

The official income statistics presented in Table 1 and Table 2 ignore differences in the amount of work effort or skill levels. But these differences must be taken into consideration if the discussion of inequality in income distribution is to go beyond strictly statistical issues and into the issue of reducing inequality through forced redistribution.

Most people would not find anything wrong with someone who puts in twice as many hours at work and earns twice as much as someone else. Nor would most object to a competent surgeon earning many times more than, say, a janitor.

Indeed, most people would find it very strange and grossly unjust if two
people with the same skills, but working vastly different number of hours or with different intensities, earned the same amount of income. Most people would be equally puzzled if two individuals working the same number of hours, but with vastly different levels of skills and competencies, had the same income. Therefore, for the purpose of discussing policies aimed at reducing inequality, it is necessary to consider how the differences in the amount of work and the level of skill affect income.

Families differ in the number of people working, and the amount of hours they work. Indeed, higher-income families tend to have more people working longer hours than do lower-income households. For example, as shown in Chart 3, the average number of earners among the households earning $100,000 and over is 2.14, while it is 0.33 among the households earning between $5,000 and $7,499. Put differently, the higher income households have almost seven times as many people working as the lower households.

Moreover, the earners in the higher income households are several times more likely to work full time than the earners in the lower income households.

As shown in Chart 4, over 81 percent of the householders earning $100,000 work full-time, compared with 16 percent among the householders earning between $5,000 and $7,499. That is, the head of higher income households are five times as likely to work full-time as those of the lower households. On the other hand, only 10 percent of the householders earn-
Workers with more highly valued skills also tend to earn higher incomes. Although skills are difficult to measure, they tend to be related to age and education. The impact of age on income distribution was addressed earlier. Here we consider the impact of the differences in educational attainment as a proxy for skills. The relationship between the household income and the educational attainment of households is shown in Chart 5.

Roughly three fifths of the households with yearly income over $100,000, have a bachelor’s degree or higher. Only 2.7 percent of those households did not graduated from high school. In contrast, 40.4 percent of households with yearly income between $7,500 and $9,999 have no high school diploma. Only 7.5 percent of such households has a bachelor’s degree or higher.

Since the amount of work and education affect income, any measure used to determine the degree of inequality should account for these factors—especially if the degree of inequality is used as the basis for a redistribution scheme. Moreover, the possibility that the remaining inequality is partially attributable to differences in energy, risk taking, prudence, and ingenuity cannot be ignored. Deciding how to make adjustments for such
factors and what proxies to use is a difficult task.

What I have argued thus far is that the unadjusted official data presented in Table 1, which social critics of inequality use almost exclusively, overstate the degree of inequality. These critics often do not take requisite care in presenting and interpreting the data. I will not speculate unduly on cause. Perhaps they are careless about numbers, which is difficult to maintain since many are economists highly trained in mathematics and statistics, or perhaps they simply prefer numbers that conform to what they want to believe.
SOCIAL critics often complain that wealth in the U.S. is even more unequally distributed than income. For example, Edward Wolff, an economist at New York University and the Jerome Levy Institute, observes, "The calculations ... indicate an extreme concentration of wealth in 1998. The top one percent of families (as ranked by marketable wealth) owned 38 percent of total household wealth, and the top 20 percent of households held 83 percent. Financial wealth is even more concentrated, with the richest one percent ... owning 47 percent of the total household financial wealth and the top 20 percent owning 91 percent. The top one percent of families ... earned 17 percent of total household income in 1997 and the top 20 percent accounted for 56 percent—large figures but lower than the corresponding wealth shares." Wolff further argues that wealth distribution in the U.S. worsened between 1983 and 1995 and that it compares unfavorably with that in Europe or Japan.

Again, social critics do not offer any defensible standard by which to judge whether a given distribution of wealth is unacceptable. They arbitrarily assert that the inequality in wealth distribution is extreme and worse than that of income distribution. Moreover, they often set aside necessary caution in interpreting the available data.

As in the case of income distribution, I have no intention of disputing whether the distribution of wealth is unequal (which it is) or that it is extreme (which cannot be determined because there is no standard). Here, I merely suggest that careless inferences from the commonly available data overstate the degree of inequality. The reason is that the data do not adjust for such factors as the value of expected Social Security benefits, the future tax liabilities on unrealized capital gains, the value of human capital, the life-cycle, and differences in consumption and savings patterns among individuals.

**Exclusion of the Value of Expected Social Security Benefits**

The triennial Survey of Consumer Finances (SCF), sponsored by the Federal Reserve Board, is the best known data source on household wealth in the U.S. The survey defines household "net worth" as "the current marketable or fungible assets less the current value of debts." Assets include: (1) cash and demand deposits; (2) the gross value of owner-occupied housing; (3) other real estate owned by the household; (4) savings deposits, certificates of deposit, and money market accounts; (5) bonds,
stocks and mutual funds; (6) cash surrender value of life insurance plans; (7) cash surrender value of pension plans, including IRA, Keogh, and 401(k) plans; (8) net equity of unincorporated businesses; and (9) value of trust funds. Debts include: (1) consumer debt (including auto loans); (2) mortgage debt; and (3) other debts.

By focusing on “marketable assets,” however, net worth excludes such important nonmarketable assets as the value of expected Social Security benefits. One may wonder why a measurement of wealth should include the value of retirement benefits from private sources—e.g., corporate and union pensions, and individual retirement provisions such as 401(k) plans—as a part of one’s wealth, but exclude the equivalent from Uncle Sam. The lack of marketability of the future Social Security benefits does not make their value any less real; expected Social Security benefits are as real as any annuity whose market value is included in the survey. Most Americans “bank” on them and plan their retirements accordingly.26

Excluding the value of expected Social Security benefits substantially overstates the degree of inequality because Social Security benefits are a proportionally more important part of the wealth of the less-well-off than the more-well-off. The extent of this overstatement is evident in Table 8, which compares the median net worth of different income classes in 1992 with and without the estimated present value of Social Security benefits. Excluding Social Security benefits, the ratio of the median household net worth for households with more than $100,000 in income to that with less than $10,000 is about 493. Including the value of Social Security benefits reduces the ratio to about 19.27 Including the values of other social entitlements—e.g., the present value of expected benefits from the Supplemental Security Income program (for those who do not qualify for Social Security because they did not work long enough or because they are disabled)—further reduces the degree of inequality.28

Instead of accounting for the bias discussed above, some social critics

<table>
<thead>
<tr>
<th>Household Income</th>
<th>Net Worth Without Social Security</th>
<th>Net Worth With Social Security</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$10,000</td>
<td>$1,700</td>
<td>$56,400</td>
</tr>
<tr>
<td>10,000-24,900</td>
<td>28,300</td>
<td>108,600</td>
</tr>
<tr>
<td>25,000-49,900</td>
<td>117,900</td>
<td>231,500</td>
</tr>
<tr>
<td>50,000-99,000</td>
<td>279,300</td>
<td>444,600</td>
</tr>
<tr>
<td>100,000-</td>
<td>837,800</td>
<td>1,052,300</td>
</tr>
<tr>
<td>B/A</td>
<td>492.8</td>
<td>18.6</td>
</tr>
</tbody>
</table>

Table 9: **Percent of Net Worth Held as Equity in Own Home, 2000**

<table>
<thead>
<tr>
<th>Income Quintile</th>
<th>Percent of Net Worth Held as Equity in Own Home</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest</td>
<td>56.2</td>
</tr>
<tr>
<td>Second</td>
<td>43.4</td>
</tr>
<tr>
<td>Third</td>
<td>39.0</td>
</tr>
<tr>
<td>Fourth</td>
<td>32.6</td>
</tr>
<tr>
<td>Highest</td>
<td>24.2</td>
</tr>
</tbody>
</table>


make other adjustments to the data that would further accentuate the degree of inequality. For example, consider Edward Wolff, whose studies on wealth distribution in the U.S. have been widely cited by social critics. Wolff proposes to modify the survey’s definition of “net worth” by subtracting net equity in owner-occupied housing and calling the resulting figure “financial wealth.” He justifies excluding home equity, a substantial asset for many Americans, on the grounds that “it is somewhat difficult to liquidate one’s housing wealth in the short term.”

Note the inconsistency, however: Wolff’s measure excludes the value of owner-occupied housing, but not the value of other real estate properties. Is there any evidence that the latter is more liquid than the former? If not, Wolff’s proposal would not seem warranted.

The equity in owner-occupied housing is more important to households with less wealth. As Table 9 shows, home equity makes up 56 percent of net worth for households in the lowest quintile, whereas it makes up 24 percent of net worth for household in the highest quintile. Although Wolff’s motive for redefining wealth is not clear, it further accentuates the degree of inequality in wealth distribution.

**Exclusion of Tax Liabilities on Unrealized Capital Gains**

Another significant exclusion involves the future tax liabilities on unrealized capital gains, especially given the booming asset markets experienced in much of the 1980s and the 1990s. The effect is to grossly overstate the net worth of the wealthier households. For example, suppose that someone paid $10,000 cash for a vacation house in 1970. (The house is debt-free.) He now learns that the property can be sold for $500,000. In the survey, the full half-million will be counted toward his household wealth. But were he to sell his property, the proceeds would be subject to taxes for ordinary income under the current tax laws—he may end up paying almost 50 percent of his nominal net gain of $490,000 in taxes. In other words, the value of the vacation house net of tax liabilities might be half that reported in the survey.
This reasoning should apply to all unrealized gains that are counted as part of wealth in the survey. For example, if half of the value of financial assets of the very well-off is unrealized capital gains, the future tax liabilities on these appreciated assets (supposing that all future gains are subject to preferential long-term capital-gains tax rates) would be about 40 percent—say, the 28 percent alternative minimum tax and about 12 percent state and local taxes as in New York City. The result overstates financial wealth by about 25 percent.

Consider another example. In 2002, Forbes magazine estimated that Bill Gates had a net worth of $43 billion. Although it is difficult to know what kinds of financial arrangements he has, the bulk of his net worth probably consists of unrealized capital gains related to Microsoft stock. Assuming that he would be subjected only to long-term capital gains of 15 percent (the state of Washington has no state income tax), his net worth would be overstated by about 18 percent.

These are, of course, just a few examples. There is no simple way to estimate the extent of overstatement due to excluding the future tax liabilities on capital gains yet to be realized. The calculation will differ in different states, for different income brackets, and is subject to changes in tax codes. But the direction of overstatement is clear. The larger the proportion of unrealized capital gains, the greater the exaggeration is.

**Exclusion of the Value of Human Capital**

"Human capital" is a term economists use to describe man’s ability—both innate and that acquired through training, experience, education, etc.—to be productive. Human capital is the source of most earnings, especially for professionals and highly-skilled people. The value of human capital to the owner is just as important as any asset, such as CDs, bonds, or rental properties.

However, it cannot be bought and sold in whole, as it is an integral part of a human being. Accordingly, the survey does not count it in net worth. But failing to include the present value of future earnings attributable to human capital in household wealth substantially understates the wealth of the young and the middle class.

Consider the example of a newly minted surgeon with an outstanding student loan of $300,000. The survey would record the surgeon’s net worth as negative. Compare this young surgeon with a 40-year-old invalid with an annuity valued at $1,000,000. (The annuity is contracted to pay to the invalid, say, $50,000 a year for the rest of his life.) The survey would record the invalid’s net worth at $1,000,000. A careless analysis of the data would result in counting the invalid as wealthy and the young surgeon as...
asset-poor, even though the young surgeon expects to earn, say, about $300,000 a year net of taxes for the next 30 years, based on his human capital alone. In contrast with the survey, the value of human capital is often recognized in divorce courts.

Of course, there are many technical difficulties with estimating the value of human capital, but the point is clear: According to the most commonly cited data, many young people and professionals in the early stage of their careers are misleadingly classified as asset-poor, and many retired people with accumulated assets to fund their remaining years are classified as asset-rich. By excluding the value of human capital, the survey data substantially overstate the degree of inequality.

*The Life-Cycle*

An individual’s net worth at any point in time depends on his position in the life-cycle. People tend to build up wealth when they are young. The accumulation tends to reach its peak just before retirement. Upon retirement, people draw down their wealth to provide for their needs in old age. The pattern is clearly visible in Table 10.

It is easy to show that a population consisting of three people with the same lifetime income, but at different stages in life, will have an unequal distribution of wealth. For example, suppose that the three have a net worth of $90,000 when they are young, $600,000 when they are middle-aged, and $310,000 when they are old. Further suppose that one is young, the second middle-aged, and the third old. Ignoring the effects of life-cycle on net worth, one would infer that the wealthiest one third of the population had 60 percent of the nation’s wealth, and that the least wealthy third of the population had only nine percent of the nation’s wealth.

In short, insofar as the effects of the life-cycle are not taken into account, the survey data overstate the degree of inequality in wealth distribution.

*Differences in Consumption and Savings Patterns*

Other things being equal, differences in consumption and saving make a

<table>
<thead>
<tr>
<th>Age</th>
<th>Median</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 35</td>
<td>$11,600</td>
<td>$90,700</td>
</tr>
<tr>
<td>35-44</td>
<td>77,600</td>
<td>259,500</td>
</tr>
<tr>
<td>45-54</td>
<td>132,000</td>
<td>485,600</td>
</tr>
<tr>
<td>55-64</td>
<td>181,500</td>
<td>727,000</td>
</tr>
<tr>
<td>65-74</td>
<td>176,300</td>
<td>673,800</td>
</tr>
<tr>
<td>75 and over</td>
<td>151,400</td>
<td>465,900</td>
</tr>
</tbody>
</table>

big difference in one's wealth over time. That is, two individuals who are identical in many respects, such as income history, years-worked, inheritance, etc., may end up with vastly different net worths.

For example, consider two individuals. Suppose the net worth of the first is recorded by the survey at $3,000,000, that of the other at $10,000. Are we to conclude that the net worth of the first is 300 times as large as that of the other and that the wealth distribution between them is lopsided? Are we to agree with social critics who would say that inequality in wealth distribution is extreme, that the poor are disadvantaged, and government should tax the rich and redistribute the proceeds to the poor? A closer look at the circumstances of the two—especially at their saving patterns—is warranted.

Upon closer look, say, we find that both are retired middle managers, with identical salary histories. Why then are their net worths so different? We discover that the person with the net worth of $3,000,000 has been a miser and has methodically saved and invested, earning a moderate rate of return. His counterpart with the net worth of $10,000, on the other hand, supported a wife, sent his children to boarding schools and financed their college, traveled extensively, and dined out regularly. Just because the miser is 300 times wealthier than the spendthrift, should his wealth be redistributed to the other? Most of the miser’s wealth is merely postponed consumption with token rewards for his saving discipline. Who knows what kind of future consumption plans he has?

Take the story of Oseola McCarthy of Hattiesburg, Mississippi. She spent her entire life as a seamstress, earning only nickels and dimes a day in her youth. Nevertheless, by the time she reached the age of 87 in 1995, she had managed to amass $250,000 in wealth, donating $150,000 to a local college for a scholarship fund for black youth, and distributing the rest among her relatives and her church.

The Oseola McCarthy story, however, is not altogether unusual. While researching their book, The Millionaire Next Door, authors Stanley and Danko found that a surprising number of wealthy Americans earned only modest incomes. They achieved their wealth through systematic saving from early ages, investing conservatively, and allowing the law of compound interest work for them.

Thus far we have discussed many factors that should be considered when analyzing income and wealth distribution. Through careless use of data, some social critics have perpetuated and even encouraged misunderstandings in order to create the impression that the distributions are much
more unequal than they would be if those factors were not ignored.

Let us now turn to analyzing social critics' views about the economic processes that generate income and wealth distribution, and that fuel their hostility to perceived inequality. In the following section, we will address the view that inequality leads to increasing polarization because the rich have an inherent advantage over the poor. The further view that inequality is a sign (or product) of injustice shall be analyzed in the subsequent section.
III.

THAT INEQUALITY GIVES THE RICH UNFAIR ADVANTAGES OVER THE POOR, OR THAT INEQUALITY MEANS DOOM FOR THE POOR

ONE reason social critics see the unequal distribution of income and wealth as a problem is their strongly held belief that the rich have an inherent and unfair advantage over the poor and that this advantage is accentuated by heartless competition in the market. They feel that the rich are bound to get richer and the poor are condemned to increasing misery. This deeply held suspicion was rekindled by the reports of increasing inequality in income distribution in the 1980s and the early 1990s.

Many social critics who believe the rich have inherent advantages over the poor used these reports to support their view that the U.S. was well on the way of becoming a polarized society made up of haves and have-nots. Paul Krugman, one of the most vocal critics of the trend, called those who questioned the validity of the thesis as “hired guns of the Right.”

What is not at issue is that inequality in income and wealth exists or that it has increased over time. For even a faulty measure (as we discussed in the previous two chapters), if used consistently, may still give us a reasonable sense of changes over time. Indeed, the “Gini Coefficient,” a measure of inequality, increased from 0.39 in 1970 to 0.46 in 2001. (However, most of that increase occurred before 1993. Since then, the trend toward increasing inequality has slowed considerably, if not stopped.)

The issue, rather, is the validity of the social critics’ understanding of how the economy works—that is, that the rich get richer and the poor get poorer and that the rich have an unfair and insurmountable advantage over the poor.

I will argue that: (1) growing inequality in income or wealth is not the same as increasing poverty or deprivation of the masses; (2) the apparent advantage of the rich is a short-term phenomenon, that over time, erodes in the face of entrepreneurship and competition; and (3) the implications of the social critics’ view—increasing polarization of income and wealth distribution and the absence of mobility (especially over generations)—are not consistent with observation.

Increasing Inequality vs. Increasing Poverty

Social critics often equate increasing inequality with increasing poverty. For example, Robert Frank, an economist at Cornell University, writes:
...real economic hardships confront families in the lowest quintile of the income distribution. These families...now have lower real incomes than they did in the 1970s, and many fall well below the official poverty threshold.... The incomes of [families in the middle] are now only slightly higher in real absolute terms than they were two decades ago, but substantially lower in relative terms.36

Although income inequality is now greater than it was in the 1970s, according to the data shown in Table 11, the families in the lowest quintile now have higher real incomes than they did in the 1970s. The mean household income of the lowest quintile in 1971 was $8,036, measured in 2001 dollars. In 2001, it was $10,136, a 26 percent increase.

Frank’s claim that middle class incomes are “only slightly higher in real absolute terms than they were two decades ago” is not very specific. The average income of the middle quintile in 2001 was 12.6 percent higher than that in 1992, 19.8 percent higher than that in 1983, and 25.8 percent higher than that in 1971. Describing these increases in income in real terms as “only slightly higher” is misleading. Moreover, Table 11 shows that every income class earned more in 2001 than their counterparts did in previous years.

Robert Frank’s complaint about growing inequality is essentially that the mean income of the highest quintile has increased more than that of those in the lower quintiles. Indeed, the mean household income of the highest quintile increased by about 71 percent between 1971 and 2001 (in constant dollars), compared to a 26 percent increase for the lowest quintile. But that is not the same thing as the lower quintiles getting poorer absolutely.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lowest Quintile</th>
<th>Second Quintile</th>
<th>Third Quintile</th>
<th>Fourth Quintile</th>
<th>Highest Quintile</th>
<th>Poverty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>8,036</td>
<td>20,900</td>
<td>33,888</td>
<td>48,177</td>
<td>85,365</td>
<td>12.5</td>
</tr>
<tr>
<td>1974</td>
<td>9,141</td>
<td>21,896</td>
<td>35,188</td>
<td>50,810</td>
<td>88,735</td>
<td>11.2</td>
</tr>
<tr>
<td>1977</td>
<td>9,057</td>
<td>21,374</td>
<td>35,244</td>
<td>51,810</td>
<td>90,465</td>
<td>11.6</td>
</tr>
<tr>
<td>1980</td>
<td>9,122</td>
<td>22,014</td>
<td>36,232</td>
<td>53,349</td>
<td>93,705</td>
<td>13.0</td>
</tr>
<tr>
<td>1983</td>
<td>8,833</td>
<td>21,573</td>
<td>35,584</td>
<td>53,393</td>
<td>96,617</td>
<td>15.2</td>
</tr>
<tr>
<td>1986</td>
<td>9,159</td>
<td>23,054</td>
<td>38,491</td>
<td>57,973</td>
<td>108,390</td>
<td>13.6</td>
</tr>
<tr>
<td>1989</td>
<td>9,679</td>
<td>23,989</td>
<td>39,876</td>
<td>60,318</td>
<td>117,911</td>
<td>12.8</td>
</tr>
<tr>
<td>1992</td>
<td>9,011</td>
<td>22,480</td>
<td>37,874</td>
<td>58,139</td>
<td>112,653</td>
<td>14.8</td>
</tr>
<tr>
<td>1995</td>
<td>9,631</td>
<td>23,527</td>
<td>39,340</td>
<td>60,475</td>
<td>126,202</td>
<td>13.8</td>
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<tr>
<td>1998</td>
<td>10,003</td>
<td>25,257</td>
<td>42,262</td>
<td>63,362</td>
<td>138,313</td>
<td>12.7</td>
</tr>
<tr>
<td>2001</td>
<td>10,136</td>
<td>25,468</td>
<td>42,629</td>
<td>66,839</td>
<td>145,970</td>
<td>11.7</td>
</tr>
</tbody>
</table>

Frank's statement that "many fall well below the official poverty threshold" is also vague. There are many possible ways to measure poverty, and there are conflicting views about which is the best measure. However, there is no objective definition of poverty, and no objective way of measuring how many people are in poverty.

The "official" measure of poverty used by the U.S. Census Bureau was developed in the 1960s and was originally based on the cost of an adequate diet; specifically, having a money income less than three times the cost of a minimally adequate diet for a family of a given size. Although initially adjusted each year for changes in the cost of the diet plan, poverty thresholds today are recalculated based on price inflation using the Consumer Price Index.

Official poverty is based on money income before taxes. It does not include capital gains and nontax benefits, such as public housing, Medicaid, and food stamps. The threshold for a family of four in 2002 was $18,556. If a family's money income falls below the established threshold, then all members of the family are classified as poor.

Using these criteria to estimate the number of people suffering in poor living conditions has some serious shortcomings, many of which have been discussed earlier. For example, current living conditions depend not only on current income, but also on past income and expected future income. The poor may also benefit from private transfers from charities and relatives, alimony, or unreported income from sources other than wages or salaries (welfare recipients have an incentive to underreport income). One

Chart 6: Poverty Rates

Source: US Census Bureau. Historical Poverty Tables, Table 4.
Table 12: Income and Expenditure Quintiles, 2001

<table>
<thead>
<tr>
<th>Income Before Taxes</th>
<th>Lowest</th>
<th>Second</th>
<th>Third</th>
<th>Fourth</th>
<th>Highest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$7,946</td>
<td>$20,319</td>
<td>$35,536</td>
<td>$56,891</td>
<td>$116,666</td>
</tr>
</tbody>
</table>

| Average Annual Expenditure | $18,883 | $26,492 | $35,660 | $48,722 | $77,125 |


more shortcoming is that noncash benefits are not figured in when calculating poverty rates. Thus, providing the less fortunate with government housing, food stamps, Medicaid, education, etc. would not lift a single one of them out of official poverty.

Although many may be below the official threshold, the poverty rate peaked in 1983 and has been falling since. (See Chart 6.) This would seem to be a positive development.

Using consumption rather than some definition of income as the standard may be more appropriate, since poor families typically spend more than their reported income on consumption. According to the 2001 Consumer Expenditure Survey published by the Bureau of Labor Statistics, the lowest income quintile had an income before taxes of $7,946, but annual expenditures of $18,883. Only the fourth and fifth income quintiles had higher incomes before taxes than annual expenditures. (See Table 12.)

Although the poor spend more than they earn, that does not reflect how they live. The basic goods that all people need to purchase are food, clothing, and shelter. People who cannot afford these basics could be said to be living in genuinely poor conditions. One way to gauge this is to compare what people living in official poverty spent on these necessities over time. Economist Michael Cox and business reporter Richard Alm found that among households below the poverty line, spending on food, clothing, and shelter in 1995 amounted to 37 percent of their consumption, compared with 52 percent in 1975, 57 percent in 1950, and 75 percent in 1920. As the poor spent less and less on basics, they had more discretionary money to spend on consumption goods such as washers and dryers, microwave ovens, VCRs, etc. As Table 13 shows, by 1994, poor households were just as likely to possess certain conveniences as the average household did two decades earlier.

Another way to gauge how people live is to measure well-being. Some types of shortfalls in material well-being are far less common than income poverty. For example, according to U.S. Census Bureau data, 7.5 percent of households in poverty sometimes or often did not have enough of the food they wanted, 13.2 percent missed rent or mortgage payments, and 14.1 percent had a member who needed to visit a doctor or hospital but did
Table 13: Ownership Rates of Various Convenience Items

<table>
<thead>
<tr>
<th>Percent of Households with:</th>
<th>Poor Households 1994</th>
<th>Poor Households 1984</th>
<th>All Households 1971</th>
</tr>
</thead>
<tbody>
<tr>
<td>Washing Machine</td>
<td>71.7</td>
<td>58.2</td>
<td>71.3</td>
</tr>
<tr>
<td>Clothes Dryer</td>
<td>50.2</td>
<td>35.6</td>
<td>44.5</td>
</tr>
<tr>
<td>Dishwasher</td>
<td>19.6</td>
<td>13.6</td>
<td>18.8</td>
</tr>
<tr>
<td>Refrigerator</td>
<td>97.9</td>
<td>95.8</td>
<td>83.3</td>
</tr>
<tr>
<td>Freezer</td>
<td>28.6</td>
<td>29.2</td>
<td>32.2</td>
</tr>
<tr>
<td>Stove</td>
<td>97.7</td>
<td>95.2</td>
<td>87.0</td>
</tr>
<tr>
<td>Microwave</td>
<td>60.0</td>
<td>12.5</td>
<td>&lt;1.0</td>
</tr>
<tr>
<td>Color Television</td>
<td>92.5</td>
<td>70.3</td>
<td>43.3</td>
</tr>
<tr>
<td>VCR</td>
<td>59.7</td>
<td>3.4</td>
<td>0</td>
</tr>
<tr>
<td>Personal Computer</td>
<td>7.4</td>
<td>2.9</td>
<td>0</td>
</tr>
<tr>
<td>Telephone</td>
<td>76.7</td>
<td>71.0</td>
<td>93.0</td>
</tr>
<tr>
<td>Air-Conditioner</td>
<td>49.6</td>
<td>42.5</td>
<td>31.8</td>
</tr>
<tr>
<td>One or More Cars</td>
<td>71.8</td>
<td>64.1</td>
<td>79.5</td>
</tr>
</tbody>
</table>

Source: Cox and Alm, Myths of Rich and Poor, p.15.

Finally, if we are to avoid the mistaken impression that the same people remain trapped at the bottom of the income distribution, remember that people in the lowest quintile often move into higher quintiles over time. As Table 6 showed, almost 58 percent of the people in the lowest quintile in 1974 found themselves in higher quintiles in 1991, with 7.8 percent making it all the way to the highest quintile.

Social critics confuse the distinction between official poverty and living in poor conditions and argue that greater income inequality increases the misery of the poor. But the data show that the poverty rate is falling, and that those in poverty do not necessarily live in misery. The poor tend to be better off than the rich were a century ago, and better off than they were a couple of decades ago. These trends would seem to be positive developments—despite growing income inequality.

**Putative Advantages of the Rich and Entrepreneurship**

For many, it is difficult to imagine a man with fewer initial resources eventually making more money or accumulating more wealth than another man starting with more resources. The accepted wisdom for why “the rich get richer and the poor get poorer” stems from several beliefs. First, although the poor man may attempt to improve his lot by acquiring skills or education, the rich man can do better, given his better ability to finance.

A related notion is what two economists labeled “winner-take-all markets” in which those with the slightest advantage in ability (or schooling or
connections or resources) get the lion's share and those with only slightly less ability get much less. The tendency is believed to apply to actors, singers, fashion models, athletes, and authors, as well as to area's in law, business, technology, investment, and academia. The economists view the spread of the “winner-take-all-markets” as the source of rising inequality.\(^{38}\)

Other scholars note that the rich have a higher saving rate than the poor, and that the poorest save virtually nothing. So even if both earned the same rate of return on their savings, the rich will accumulate wealth at a faster rate, widening the gap between the two groups over time.\(^{39}\)

According to these views, the deck is stacked against the poor, unless “Lady Luck” strikes. Indeed, being rich does have certain advantages, especially in the short run. But is the putative advantage of the rich the dominant feature of the process of generating income and wealth in the market economy?

In the longer run, it is less clear whether being rich matters. Why? Factors other than the ownership of currently valued assets determine income and wealth—for example, entrepreneurship. By discovering better ways of serving consumers, entrepreneurs can create fortunes for themselves and those who work for them and destroy the fortunes of rivals. Do the rich make better entrepreneurs than the poor? In short: no. To understand why, we have to look more closely at what entrepreneurship is.

Entrepreneurship, in brief, consists of discovering and exploiting profitable opportunities—opportunities that others either ignored or somehow overlooked. The essence of entrepreneurship is not in commanding currently valued resources, but in innovation or trying something new and worthwhile. Although the rich may have greater command over currently valued resources, there is no reason to assert that they have superior entrepreneurial skills.

I contend that the rich have a distinct disadvantage over the ambitious poor. The reason is that the rich are already well-off and are less likely to take business risks. The not-so-well-off but ambitious, who have nothing to lose, are more likely to try something new that has a potential for success.\(^{40}\) Hence, the putative advantage of the rich is not secure in the long run. Especially in the U.S., the rich are often supplanted and overtaken by the not-so-well-off.

However, it is not easy to argue in the abstract. A better way to gauge whether the rich have an inherent advantage over the poor is to consider experience. If the rich have an inherent advantage, as many social critics seem to believe, then the distribution of income should become increasingly polarized over time, and we should observe little mobility. But we
observe the contrary, as discussed below.

**Increasing Polarization of Income and Wealth**

The noted trend of growing inequality in income and wealth distribution in the late 1980s and the early 1990s has led social critics to worry whether the middle class will disappear. The social critics’ belief, however, is not consistent with the evidence: the trend toward increasing inequality appears to have leveled off since 1993. (See Chart 1.)

Economic historians find that the pattern of the distribution of American male earnings in the last 150 years is “marked by long periods of relative stability and shorter periods of substantial change.” The periodic changes, however, did not always entail increasing inequality. Moreover, a noted scholar on income distribution observed that “within the group of industrialized countries, the degree of dispersion is broadly the same,” despite differences in economic structures.

What about the recent U.S. historical record? The period from 1930 through the 1960s was characterized by the New Deal, strong unions, the supremacy of the American economy—and declining inequality. In contrast, the period from 1970 through the 1990s was characterized by greater international competition, changes in the industrial structure (skills bias for higher education), demographic changes, the change in the composition of immigrants—and increasing inequality.

Despite the recent increase in inequality, James Heckman notes that the current inequality in distribution is not out of ordinary from the historical perspective: “Wages were no more unequally distributed in 1990 than in 1940. They were even more unequally distributed during the Depression and in earlier periods of economic stress.” Most importantly, since 1993, the “Gini Coefficient” does not appear to be increasing—that is, the trend toward increasing inequality has all but stopped.

There may be a connection between the earlier period of declining inequality (the 1930s through the 1960s) and the later period of increasing inequality (the 1970s through the early 1990s). The social policies in the earlier period—conferring generous benefits on blue-collar workers, heavy regulation of business, and taxing the wealthy—weakened the American economy. This brought about large scale restructuring of industries starting in the 1980s, including relocation of manufacturing jobs overseas, declining union memberships, and the emergence of the service and information technologies sectors. What occurred in the 1980s and 1990s can be seen as direct consequences of the policies of the earlier period that rendered the American economy less competitive. Whatever the cause, projecting the recent trend into the future is unwarranted.
It should also be noted that the alarm raised by the increase in inequality in the 1980s and the early 1990s stemmed from the common misconception that people in the lower quintiles in the 1970s and the 1980s remained there by the 1990s. This does not appear to be the case. As we have seen, people tend to pass through different quintiles during their lifetime. Many people who were part of the lowest income quintile in the 1960s are no longer alive. Many people who are counted in the lowest income quintiles in the 1990s were not born until the 1970s. Somehow, the emphasis on the “share” of certain classes of people (quintiles or deciles) conjures up the image of groups of people that remain identical through time.

**Lack of Mobility**

Social critics who believe the rich have an unfair advantage are concerned with the lack of sufficient intergenerational mobility—i.e., the rich stay rich and the poor stay poor over generations. The lack of intergenerational income mobility implied by social critics’ view, however, is contrary to the evidence. Relatively few remain chronically poor—either within a lifetime or across generations.

Research has shown that there is high intergenerational mobility, i.e., that there is little correlation between fathers’ and sons’ incomes. Gary Becker, a Nobel laureate in economics, observes that in rich countries, including the U.S., “low earnings as well as high earnings are not strongly transmitted from fathers to sons.” Another study observed substantial economic mobility among Americans, with only about 2.6 percent of the population appearing to be chronically poor.

Not everyone accepts these findings. Gary Solon, an economist at the University of Michigan, argues that the impression of America as the “land of opportunity” is based on past studies that overestimated intergenerational mobility. According to Solon, the correlation between fathers’ and sons’ incomes is 0.4 or higher “indicating dramatically less mobility than suggested by earlier research.”

But what does it actually mean to say that intergenerational income correlation is 0.4? Does a father-son earnings correlation of 0.4 represent lack of mobility, as Solon suggests? Solon’s estimate does imply a higher degree of transmission of earnings status across generations than those from earlier studies. But it hardly means lack of mobility.

Consider the following: Given the father-son earnings correlation of 0.4, the expected differences in earnings among sons will be only 40 percent of the differences among their fathers. The expected differences among grandsons will be only 16 percent of the differences among their grandfathers. Furthermore, the expected differences among great-grand
children will be only 6 percent of the differences among their grandfathers. Even with the father-son earnings correlation of 0.4, the impact of the differences in income among individuals become nearly negligible by the third generation.

This is consistent with the data: the degree of mobility in the U.S. is rather striking. Some people might argue that anything short of equality between the probability of the poor becoming rich and the probability of the rich becoming poor is unsatisfactory. However, millions of prospective immigrants wish to vote to the contrary with their feet.

David Harding and others give a more balanced interpretation of their own findings on intergenerational studies, "...if society eliminated all environmental sources of inequality, so that earnings depended entirely on innate ability, the intergenerational correlation between a parent's earnings and a child's earnings would probably be between 0.4 and 0.6. That is not very different from the correlations we observe today."  

**Mobility Among the Super-Rich**

What about mobility among the richest Americans? Mobility among the richest is of special interest in the context of our discussion because if the alleged advantage of the rich is true, it should be more pronounced among the richest. The super-rich should persist through generations. But the Current Population Survey and the Survey of Consumer Finances omit data from the highest earners and the wealthiest (to reduce sampling errors). However, each year *Forbes* magazine publishes a list of the 400 richest Americans.

Table 14 presents the 10 richest Americans on the list in 1995 along

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<tr>
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</thead>
<tbody>
<tr>
<td>W. H. Gates III</td>
<td>Microsoft</td>
<td>N/A</td>
<td>43</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>W. E. Buffett</td>
<td>Investment</td>
<td>31</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>J. W. Kluge</td>
<td>Metromedia</td>
<td>100</td>
<td>1</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>P. G. Allen</td>
<td>Microsoft</td>
<td>N/A</td>
<td>86</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>S. M. Redstone</td>
<td>Viacom</td>
<td>N/A</td>
<td>3</td>
<td>5</td>
<td>18</td>
</tr>
<tr>
<td>R. M. DeVos and J. Van Andel</td>
<td>Amway</td>
<td>102</td>
<td>268</td>
<td>6</td>
<td>113/131*</td>
</tr>
<tr>
<td>S. I. and D. E Newhouse</td>
<td>Media</td>
<td>19</td>
<td>6</td>
<td>7</td>
<td>20/20+</td>
</tr>
<tr>
<td>Waltons</td>
<td>Wal Mart (Inheritance)</td>
<td>2</td>
<td>17</td>
<td>8</td>
<td>4^</td>
</tr>
<tr>
<td>R. O. Perelman</td>
<td>Investment</td>
<td>N/A</td>
<td>5</td>
<td>9</td>
<td>60</td>
</tr>
<tr>
<td>L. J. Ellison</td>
<td>Oracle</td>
<td>N/A</td>
<td>98</td>
<td>10</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: *Forbes*, 400 Richest Americans, various years. *Partnership dissolved; respective ranking. +Brothers' fortunes are listed separately, respective ranking. ^A five-way inheritance of the Wal-Mart fortune; ranking represent each share of the inheritance among the widow and four children.
with their prior and subsequent rankings. Note that all, save the Waltons, were self-made. Only twelve years before, five out of the 10 were not ranked among the richest 400. By 2002, some of 10 richest in 1995 were already replaced by newcomers. Of the top 50 richest Americans in 2002, 33 were self-made. Mobility among the richest is high, indeed.

To the extent that the fortunes of the super-rich are based on the founding of firms, a consideration of the list of Fortune 500 companies can give us a sense of mobility among them, as well. Daily we see dominant firms are challenged and supplanted by more nimble rivals, many of which are start-up firms, even in industries that are characterized by intense research and development, or R&D. For example, IBM, after spending many billions of dollars on R&D over the years and hiring people with some of the best credentials, has been challenged by ragtag companies, many of whose heads are college dropouts. Many once-dominant firms have gone bankrupt or fallen into obscurity while other upstart firms rise to dominance. A study of the assets of the 500 largest American industrial firms from 1961 to 1980, found that “at least 16 percent of the firms in the Fortune 500 largest category change every two years. Some of the additions to the 500 were firms that formed and grew into the 500 within ten years.”

Of course, there are Rockefellers, Du Ponts, and Mellons who have more carefully husbanded their inheritances and remain among the richest. However, their fortunes pale compared to the newly found fortunes of Bill Gates (Microsoft), Larry Ellison (Oracle), Warren Buffett (Berkshire Hathaway), Michael Dell (Dell Computer), Jerry Yang (Yahoo), and the like. Moreover, few heirs of great fortunes from the Roaring 20s are still counted among the richest. Obviously, the rich do not always stay on top.

Some may remain skeptical of the evidence considered so far, believing that the moneyed class can skillfully hide their fortunes from the probing eyes of Forbes researchers, and more importantly, from the probing eyes of the Internal Revenue Service. But the suspicion is a speculation, akin to a belief in UFOs. Solid evidence of such circumstances would enable an ambitious journalist or politico to establish a reputation and build a career.

The evidence considered thus far contradicts critics’ claims that the rich have an inherent advantage over the poor and, as a consequence, that inequality will increase. Instead of increasing polarization of income distribution and little or no mobility, we see both long-term stability in the pattern of income distribution and much mobility.

Social critics’ belief about the inherent advantage of the rich over the poor may apply in the short run. In the long run, however, this advantage is vulnerable to entrepreneurship and competition. Despite a host of limiting
factors—e.g., poor education, difficulty in raising capital, lack of connections, etc.—the not-so-well-off frequently achieve success. On the other hand, many rich lose their dominance despite their putative advantages.
IV.

THAT INEQUALITY IS A PRODUCT OF INJUSTICE,
OR SIGNS THEREOF

Thus far, social critics have used the following line of reasoning: According to the data, the U.S. is characterized by excessive inequality in income and wealth, and this inequality hamstrings the poor with disadvantages that cannot be overcome. Not surprisingly, their next step is to conclude that inequality is a product of the injustice of the market economy.

But how do social critics come to have such beliefs? I acknowledge that income and wealth may be distributed unequally, but hold that there is no objective criterion by which to judge that inequality is excessive. And unlike the social critics, I maintain that poverty is not a permanent condition and that the concept of justice is applicable only to individual actions. A wholesale indictment of the “system” rings hollow.

If there were any evidence that someone has gained through unjust acts, our grievance should be against the unjust acts and should have nothing to do with that individual’s income or wealth. The person either committed injustice or not. One should not be convicted of wrongdoing merely because he is rich. By the same token, being poor should not exonerate anyone from wrongdoing. Otherwise, we would exempt all unjust acts that failed to be lucrative. Therefore, the distinction between rich and poor is not relevant to the issue of injustice.

If we lived in a country that was lawless or had unjust laws, ill-gotten income and wealth might well be commonplace. In such a country, few things would be regarded as legitimate. The extant distribution there would hang delicately on the distribution of naked force. But in a country where the law is tolerably upheld so that whenever evidence of wrongdoing surfaces the legal system is mobilized to address the wrong, the basis for believing that all wealth was obtained dishonestly is less clear.

What are the grounds for asserting that inequality is a sign of injustice? If anyone had creditable evidence that someone got rich by illegal means and got away with it, he or she could build a fine political career on it. The social critics’ beliefs about the injustice of inequality are often based on anecdotes or legends of some ill-gotten fortunes. Some even appeal to one or more conspiracy theories, which, by their nature, cannot be disapproved. In short, social critics cling to the belief that inequality is a sign of injustice even when there is no evidence of wrongdoing by anyone that is punishable under the law. I believe that the idea of the injustice of inequality in
the absence of evidence is ill-considered and is largely based on misunderstanding the process of income and wealth generation.

The belief that inequality signifies injustice, even when there is no evidence to the effect, seems to be grounded on four kinds of views about the economic processes: (1) one man's gain is necessarily at the expense of others; (2) voluntary exchanges may be mutually beneficial, but the gains from exchanges are unfairly distributed; (3) all above-average gains are undeserved; and (4) there are negative pecuniary externalities. Let's briefly consider them in turn.

**That the Rich Get Rich at the Expense of the Poor**

Social critics of inequality seem to believe that the rich get rich at the expense of the poor. The belief that one man's gain is derived at the expense of another—as in dividing a pie—is widely held. Whatever the origin of the belief, however, the idea is not applicable to voluntary exchange, which is what market economies are about. One of the most valuable insights of economics is that voluntary exchanges are value-creating and mutually beneficial. Otherwise, the parties to exchanges would not agree to them.

Nevertheless, the erroneous belief that economic processes are a "zero-sum game" has found expression through the ages in denouncing trade as unproductive and parasitic. Even today, in the age of universal commerce, the suspicion persists against gains from economic activities that are based on voluntary exchanges, especially large gains.

Of course, not all large gains are held in suspicion. In fact, most people, including social critics, do not begrudge star entertainers earning tens or even hundreds of millions of dollars a year. Quite the contrary: The public admires big name entertainers such as Bill Cosby, Oprah Winfrey, Michael Jordan, and Magic Johnson, and views their fortunes of stardom as an outcome of voluntary exchanges with their fans. The public may also tolerate the fantastic gains reaped by inventors.

When the source or nature of someone's gain is not obvious, however, suspicion may arise that the gain came at the expense of another. For example, if an ordinary businessman achieves success, critics may wonder who was cheated, exploited, or robbed to achieve it. Pharmaceutical company executives are often scorned for benefiting at the expense of the sick.

The suspicion has a lot to do with not understanding the nature of profit. Profit in a competitive market does not arise from routine practices, but from discovering and pursuing opportunities ignored or overlooked by others. The source of profit, in other words, lies in developing superior
knowledge about market conditions, following through on hunches, etc. Social critics, not being privy to the sources of profit, generally see no basis for it. Since the source of profit is obscure, the critics suspect some sort of injustice—if not derived from illegal actions, then perhaps highly immoral ones.

When the critics come to learn, _ex post_, about the source of profit, they often feel that the sources are too trivial to merit the gains—oblivious of the fact that the whole informational advantage lies in having the information before others. Timing is the crucial factor. Aren't we all so smart in hindsight? Critics, who usually view themselves as intellectually capable, cannot see how so much profit can be justified by such trivialities. Indeed, many American millionaires own small, non-glamorous businesses, including junkyards, insurance agencies, real estate agencies, and small manufacturing concerns.^{57}

Since critics fail to see justifiable causes for profits, they do what is "logical," suspecting wrongdoing on the part of the entrepreneur, however unproven. Once they convince themselves that the rich have gained unjustly, they have few qualms in demanding redistribution in order to achieve justice.^{58}

Critics who view income inequality as unjust do not appreciate the race to discover hidden opportunities, especially opportunities they consider trivial. But this is what drives entrepreneurs. They also fail to accept that entrepreneurs' gains are accumulated through voluntary transactions from which others benefit greatly as well.

**That the Rich Capture a Disproportionate Share of the Gains from Trade**

Critics who would accept in principle the proposition that voluntary exchanges are mutually beneficial may still argue that the gains from trade are not equally or fairly shared. In other words, they assert that the rich and powerful are able to capture the lion's share of the gains based on their superior knowledge or bargaining power.

In Chapter III, I argued that the inherent advantage of the rich is more apparent than real. Yes, in the short run, the advantage of the rich (who command more currently-valued resources) is obvious. In the long run, however, what really matters is discovering profitable opportunities—something the rich do not have an inherent advantage doing. The prospect of profiting from entrepreneurial discovery motivates many to understand what consumers want and to figure out how to best satisfy them. This is the process in which everyone is trying to gain some informational advantage over others with an eye on profit, the process from which the mankind has
benefited mightily.

The key issue under consideration in this section, however, is whether the rich got that way from taking the lion’s share from economic exchanges. Social critics seem to believe that this is so. But why? Who is to judge whether gains from an exchange are fairly divided, if not the parties to the transaction themselves, at the time of transaction? Parties to a potential transaction consider all options available to them at the moment and agree to make the transaction only after they believe that the terms of transaction are superior to the alternatives. Surely, the rich and powerful would prefer to dictate their terms. However, to the extent that economic freedom prevails, they cannot impose their will. For if the terms offered by the rich and powerful are indeed lopsided, then bargain hunters and competitors stand ready to undercut the rich by offering superior terms.

The belief that the rich get rich by grabbing a disproportionate share of the gains from trade often arises from the idea that, to be fair, an exchange should involve things of equal value and that no one should have an informational advantage. It is alleged that information disparities between parties gives rise to power that is used as leverage to wrest an unfair share from the weak. This idea rests on two mistaken views: (1) that an exchange should involve things of equal value to be fair and (2) that no one should have informational advantage over others for an exchange to be fair.

In a voluntary exchange a person always obtains something more valuable than what is given up. For example, suppose Mr. A buys a loaf of bread from Ms. B for $2.00. Mr. A buys the loaf because the loaf is more valuable to him than the $2.00 he is asked to surrender. Ms. B, in turn, sells the loaf of bread because the $2.00 Mr. A agrees to pay is more valuable to her than the loaf of bread. Obviously, neither one believes that the exchange is between things of equal value; if so, they would be indifferent to the exchange. Rather, they think it is mutually advantageous and fair. This is characteristic of all voluntary exchanges. Otherwise, why trade? So, the idea that exchange should be between things of equal value to be fair is mistaken.

Second, the idea that fair trades require all traders to have the same information breaks down under scrutiny. The insistence that no one should have informational advantage undermines trade: The basis of all exchange is obtaining something of higher value in exchange for something of lesser value, as Mr. A and Ms. B do in the above example.

This is consistent with the principle of profit making—buying low and selling high. We are all bargain hunters and profit seekers. For someone to sell at a low price (the counterpart of buying low), he or she must not know
that a higher price is feasible. For someone to buy at a high price (the counterpart of selling high), he or she must not know that a lower price is feasible. If the bargain hunter (or the profit seeker) is forced to inform the potential seller that he can fetch a higher price from someone else, or inform the potential buyer that he can obtain the good at a lower price from someone else, the bargain hunter is forced to give away the source of bargain and will have nothing to do. With the elimination of informational disparity, much of the basis of exchanges is undermined. Furthermore, if no one is allowed to take advantage of informational advantage, no one would be interested in looking for useful information (or discovering profitable opportunities). Consequently, the basis of entrepreneurship is undermined and the economy will stagnate. This most unattractive prospect is probably not what social critics (who insist that the only fair exchange is one in which no one has informational advantage over others) would envision, but that is the implication of their views.

I acknowledge that individuals make mistakes occasionally or even often. But to err is human. The best we can do is to learn from experience and try not to repeat the errors we make. Society would have a much greater problem if, in the name of (a misconceived notion of) fairness, all transactions were made open for renegotiations, in the corrective light of added information and changed circumstances, or at the urging of bystanders, at sometime in the future. For then gains from trade would become completely uncertain. Few, if any, would try to trade at all. The consequence would be a reversion to barbarism and meager living for all.

That Riches are Unearned

Social critics draw a distinction between "earned income" and "unearned income." They believe that only income from labor is earned and that income from other sources—rent, interest and profit—is unearned. (Even the U.S. government adopts the terminology when it creates the category, "earned-income credit.") This distinction is often used to imply that what is "unearned" is unjustified. Since the rich are viewed as deriving the bulk of their income from non-labor sources, their income is regarded as unearned and therefore unjustified.

But the view that non-labor income is unearned and that individuals with higher income (or wealth) derive their income (or wealth) from non-labor sources is based on much ignorance and confusion. First, even if only labor income was considered, earned income would not necessarily be distributed equally—some people work more, harder, smarter, and with more skills than others. Second, unearned income is not the primary source of differences in income among households. Unearned income is less than one third of earned income. According to the U.S. income statistics, about
65 percent of personal income after taxes in 2001 was derived from employment and 20 percent from non-labor sources such as rent, interest, dividends, and proprietor's income. About 15 percent of personal income consisted of government transfers such as the Social Security and welfare provisions. To believe that "unearned" income is responsible for inequality is a mistake. Third, the critics ignore the fact that it is not only the rich who have "unearned" income. The majority of households in the U.S. derive their income from various non-labor sources—through their pension funds invested in stocks and bonds, through their savings (from past earnings) that earn interest, through the appreciation of their homes, etc. Under these circumstances, the question should not be whose income is earned and whose is not, but who has proportionally more or less "unearned" income.

How much unearned income one receives is not necessarily directly related to one's income or wealth. For example, take a retired couple who rely on pensions, and rent a couple of rooms in their house. Though not rich, they receive nearly all of their income from non-labor sources. On the other hand, Lee Iaccocca was paid hundreds of million dollars a year—making him one of the top earners in the world at the time. His income should be classified as earned. Why? Chrysler had hired him to turn around the troubled firm; so the compensation was mostly for his labor, though very highly priced. 59

But more importantly, why regard income from sources other than labor as "unearned" in the first place? The view is based on the belief that only labor creates value, and other factors of production, or rather their owners, merely (and unfairly) partake in the value created by labor. 60 This view ignores the fact that labor alone, without other factors of production, is not very productive. Consider the productivity of millions of souls in Uganda, Somalia, Sudan, or Cambodia, each of whom could create much value, and earn accordingly, if he or she could relocate to an industrialized country where other factors of production are abundant. From this consideration, it is easy to dismiss the view that only labor is productive.

Social critics also ignore the question of how productive assets are acquired. The bulk of the ownership of productive assets comes from saving and investment, activities that require much labor, ingenuity, and discipline.

Critics tend to regard inherited wealth as unearned and the source of much "unearned" income. But they ignore the fact that other inheritances—genetic makeup, upbringing, etc.—have as much, if not greater, impact on the income and wealth of progeny. Why single out the inheritance of money (or near-money) assets as unearned? What about other birthrights
such as intelligence, talents, temperament, disposition, upbringing, looks, and strength, each of which is a valuable asset and in due time can be turned into money or near-money? There is no good reason.

As if to be consistent, however, some thoroughgoing critics have chosen to question the legitimacy of the above-average inheritance of non-money assets as well, as we shall see below.

That Riches Are Undeserved

Even "earned" income is not all justified, or deserved, in the eyes of the discerning social critics. Much of the individual differences in income have to do with differences in endowments, such as skills, talents, drive, intelligence, looks, etc. But what did the individuals who enjoy above-average income (thanks to superior endowments) do to deserve the valuable endowments denied to others? Critics cannot think of any good justification for the good fortune of having the valuable resources (money or otherwise) that are responsible for some individuals doing better than others. Social critics conclude, therefore, that no one deserves to have more than others. For them luck is unfair, and only equality is fair.

But how can anyone explicitly justify what they are born with as merited? All that most reasonable people can say is that it just happens to be that way. For critics, then, the inequality in income and wealth distribution is largely a matter of luck, in the sense that one has little control over the outcome. And no one deserves to be lucky, or luckier than others.

This is perverse reasoning: To keep what one has, one must be able to explicitly justify his or her possessions (or rather one's very being). I wonder whether anyone can explicitly justify the ownership of one's own intelligence, talent, drive, looks, etc., to satisfy the exacting standards demanded by the critics. Or should people be required to justify, for that matter, their longevity or health? Would the critics dare to suggest that those who fail to justify their good health must forfeit their health? Is the following a reasonable demand?: "I am dying of kidney disease. What did you do to deserve two sound kidneys when I am doomed? Since you did not do anything to deserve the good fortune (evidenced by your inability to explicitly justify it), it is unfair that you enjoy life while I suffer and die. It is only fair that you give me one of your kidneys." This is absurd.

Similarly, how can Americans justify their good fortune for being born in the U.S. (compared to others who are unfortunate to be born in, say, Uganda or Liberia or Cuba)? How can this be unfairness be undone? What are Americans supposed to do? Move to Liberia?

But why must the burden of justification be placed on inequality, on
those who are born with superior endowments? I believe that the burden should rather fall on those who, against all things natural, hold equality as the ideal.

**That the Rich (for No Other Reason than Being Rich) Harm the Poor**

Social critics such as Robert Frank insist that inequality in income distribution directly hurts the poor—that the poor suffer a "psychic" injury—through a loss of status. By the same token, the rich gain at the expense of the poor through a gain in status.

According to this view, the manner of acquiring income or wealth does not matter, nor does the absolute level of income. All that matters is relative comparisons. When Mr. A gains more than others from his economic activities, others who have nothing to do with the activities from which the gains are made, (or even those who contributed to his gains by agreeing to enter exchange relationships with Mr. A because they found them a bargain), are harmed by the existence of Mr. A’s relative gain.

Nor does it matter how well off you are in absolute terms. All that matters is whether anyone is better off than you are. If others are relatively better off than you, then you are injured. According to this line of thinking, people would be content, even if everyone had meager living conditions, as long as no one was better off.

This is a pure expression of envy. Envy is man’s desire to eliminate other’s relative gain even if he would become absolutely worse off in the process. Envy is appeased only at equality, regardless of the absolute level of consumption.

Anthropologists have documented that one of the most distinguishing features of poor societies is the relatively free expression of envy and the universal fear of envy on the part of those who come to have above-average gains. The desire to share equally might have made some sense in a hunter-gatherer society from which human beings have emerged only relatively recently. In an environment where food and other resources are very meager, a tribe may enhance its chances for survival by sharing. But the sharing norm is less compelling as human beings have gone through successive stages of economic development—through agriculture, handi-

Robert Frank further suggests that not only do the poor suffer a psychic injury from inequality, thus legitimizing envy, but also that the poor are
financially exhausted in their futile attempts to emulate the rich. Moreover, the poor—financially exhausted—have become hostile to taxes that finance various government programs including programs on the environment, health, education, highways and bridges, etc. So, Robert Frank sees a host of problems arising from inequality. He says that social problems such as the environment, education, health, etc., are neglected because of the taxpayers’ reluctance to pay more taxes. Indeed, Frank views inequality as the source of all social problems!
V. CONCLUSION

In the U.S., social critics are much more concerned about the unequal distribution of income and wealth than the general public. To the critics, inequality is wrong and undesirable, and collective actions are needed to reduce it. Their concerns with inequality involve three issues—that inequality is excessive, that market competition is rigged in favor of the rich, and that the inequality is unfair. I have argued that each of these views are based on a misunderstanding of the facts.

First, since the social critics do not offer any criterion for judging at what level inequality becomes excessive, their assertion cannot be evaluated. Indeed, my focus was on their careless use of the official data to overstate the degree of inequality. When official statistics are properly adjusted for taxes, noncash transfers, the value of social security benefits, household size, the age of primary earners, and differences in costs of living, etc., inequality in income and wealth distribution is much less than that portrayed by the critics. The remaining inequality income is largely attributable to differences in the amount of labor and skill. In the case of wealth, inequality reflects differences in consumption behavior and investment returns, as well as differences in income over time.

Second, the idea that the rich have an inherent advantage over the poor is apparent only in the short run. In the long run, the advantage of the rich over the poor is not as clear-cut. If critics are correct, we should see an increasing polarization of income and wealth and a lack of income mobility. But neither of these is consistent with the evidence. The income distribution has not become increasingly polarized. Already, since 1993, the tendency toward increasing inequality has all but disappeared. Moreover, the U.S. is characterized by a high degree of intergenerational income mobility. The critics’ claim that the rich have inherent advantages reflects a profound misunderstanding of the process of market competition and entrepreneurship.

Third, the attitude that inequality is a sign of injustice arises from the critics’ inability to understand the source of profit in a market economy. Since the sources of profit are often obscure to them, critics regard it as unjust. Such gains, it is reasoned, must be a sign of injustice, even when there is no evidence of wrongdoing. If the critics understood the nature of profit, and how the race for profit has brought forth many of the good things in life, they would not regard profit and inequality as signs of injustice.
The association between income (or wealth) distribution and justice (or fairness) may be triggered by the word “distribution.” Distribution, or more formally “frequency distribution,” is a method of organizing and summarizing data whereby individual observations are distributed in accordance with the few distinct values the variable can take. Accordingly, we speak about frequency distributions of income, or wealth, or height, or weight, or age, etc.

Even so, the word “distribution,” in connection with income and wealth, tends to conjure up in the minds of many an image of someone apportioning a set of resources as in a family. This tendency reflects the habits of mind that the bulk of humanity acquires in being brought up in families. The strength of the appeal of equality as the ideal exists largely in the habits of mind.

Unfortunately, that is a wrong imagery for modern economic processes that operate beyond family, beyond one’s own local community, and even beyond national boundaries. The mistaken imagery of “a national family” conjures up obligations and entitlements that are only appropriate within a real family.64

Though many people have a vague longing for equality, once it is stated explicitly they easily recognize its absurdity as a practicable goal. Equality is impossible to achieve and attempts to achieve it by force would produce many undesirable results. Incentives will be perverted if, in the name of reducing inequality, money is taken away from those who work and given to those who do not, or if money is taken away from those who make available the goods that consumers want (when and how they want them) and given to those who do not render any service to others. If a society tries to redistribute constantly, as it will be bound to do since inequality in distribution is the natural state of things, not only will that society be much poorer through the perversion of incentives, but also it will become increasingly arbitrary and oppressive as well.

Nevertheless, critics maintain that it is necessary and desirable that the opportunities that individuals face be equalized, especially for the young. Many social programs are motivated by such a belief. However, equalization of opportunities is not any easier than equalization of income or wealth. People, as bundles of characteristics, are different along many dimensions. Trying to equalize along only one dimension (measurable income or wealth), disregarding all others—without knowing their values and how the values might change in the near or distant future—is arbitrary and reckless. A poor farm boy may grow up to be a millionaire sports star or a wealthy businessman, while another boy born with a silver spoon in his mouth may degenerate into a wastrel, squandering a fortune and becoming penniless.
A redistribution to equalize the recorded income or wealth during their boyhoods could in fact be transferring wealth from the poor (the wastrel, poor in human capital) to the rich (the farm boy, rich in human capital). One can go on and on.

One important problem with attempting to equalize income or wealth distribution stems from failing to realize that by far the majority of income or wealth is obtained as a result of voluntary transactions among individuals. Income and wealth are typically the cumulative result of market prices received for certain services rendered. Most economists readily recognize prices as crucial in the working of the market, channeling resources to those activities that benefit consumers. To become indignant that income or wealth is unevenly distributed is akin to becoming incensed that a car fetches a higher price than a banana. Demanding that inequality in income or wealth distribution be reduced substantially is like demanding that the price difference between a student violin and a Stradivarius be substantially reduced.

The politics of equalization would entail severe restrictions on what individuals can or cannot do, beyond the general rules of conduct, as economic processes would be forced to conform to some acceptable level of equality. Consequently, if redistributive measures are at all successful, they will produce a stagnant economy through pervasive and strict regulations that discourage economic activities. Furthermore, the attempt to equalize will greatly diminish social mobility, thereby creating a society with more rigid class distinctions. The end result will be far from what the social critics might dare to imagine.
ENDNOTES

1 The Gini coefficient measures the degree to which income dispersion departs from perfect equality. To calculate the Gini coefficient, one must construct the Lorenz curve, representing the cumulative share of income of different households from the least to the highest. The income shares (on the vertical axis) and the income groups (on the horizontal axis), expressed in percentage terms, will form a square, as in the figure below.

If all households had equal income, the Lorenz curve will coincide with the diagonal line. Otherwise, the Lorenz curve will bulge below the diagonal line.

The Gini coefficient is the quotient of the area bound by the diagonal line and the Lorenz curve (A) and the entire area below the diagonal line (A + B). Gini coefficient = A / (A + B). If income distribution is perfectly equal, the Gini coefficient is zero. On the other extreme, if all income is concentrated in one household, the Gini coefficient is one. A higher value of Gini coefficient represents a greater degree of inequality.

It should be noted that the Gini coefficient summarizes an entire distribution with one value. A Gini coefficient, therefore, is compatible with any number of distributions. Consequently, an income distribution with a lower Gini coefficient may not necessarily be preferred to the one with a higher Gini coefficient. The judgment would depend on one's values.


3 Frank Levy and Richard J. Murnane, “U.S. Earnings Levels and Earn-


8 Paul Krugman, op. cit. p. 6.


11 The official definition of poverty itself has obliterated the distinction. Poverty is now measured in relative rather than absolute terms.

12 Author’s calculation. Source for statistics: Table 1, Key Indicators of Development, World Development Report 2003, World Bank.


14 Krugman, op.cit. p. 2.


16 Definition of Household in the Current Population Survey by the Census Bureau: A household consists of all the people who occupy a housing unit. A house, an apartment or other group of rooms, or a single room, is regarded as a housing unit when it is occupied or intended for occupancy as separate living quarters; that is, when the occupants do not live and eat with any other persons in the structure and there is direct access from the outside or through a common hall. A household includes the related family members and all the unrelated people, if any, such as lodgers, foster children, wards, or employees who share the housing unit. A person living alone in a housing unit, or a group of unrelated people sharing a housing unit such as partners or roomers, is also counted as a household. The count of households excludes group quarters.


19 For example, boarding schools grant financial assistance on an annual basis, knowing that family income fluctuates from year to year.

22 Ibid. Table 3, p. 10.
24 Wolff, 1998, op Cit. Making cross-country comparisons is fraught with difficulties given the sensitivity of data to weights and inconsistency of weights used in different countries. Wolff pays no heed to the difficulties, or at least he draws inferences as if there is none.
25 For statistical and practical reasons, the SCF excludes the “super-rich.” One has to rely on *Forbes* and *Fortune* to get a glimpse of them. See below for a discussion of the “super-rich.”
26 Some justify the exclusion of the “Social Security wealth” on the grounds that the Social Security system is a pay-as-you-go system, i.e., it is unfunded. However, not all other pensions are fully funded. More importantly, the majority of Americans organize their lives based on the belief that the Social Security wealth is real. One should ask politicians whether any of them would be willing to argue otherwise.
27 The estimates of the values of the expected Social Security benefits are based on algorithms supplied by the Social Security Administration.
28 Not counting the values of other expected entitlements that are proportionally more important for the less-well-off also further overstates the degree of inequality in wealth distribution. In terms of magnitude, probably these would not be as important as Social Security benefits.
30 Under the current tax code, capital gains on a vacation home are treated as ordinary income. In 1999 the highest Federal marginal income tax rate, for a joint return above $278,450, is 39.6 percent with “the surcharge”. For a couple living in New York City, the state and local income marginal tax rates add up to 11.785 percent. Even if the state and local taxes are fully deductible against Federal income tax, which is doubtful, the effective state and local marginal tax rates would be roughly percent. The combined marginal tax rates would be over 46 percent. This of course does not include the sales tax on the property.
31 I am using the example of the very well-off, who would easily become subject to the Alternative Minimum Tax (AMT), which is basically a 28 percent flat tax, with virtually no deductions. (The only permitted exceptions under the AMT are mortgage interest, certain investment expenses, and charitable contributions.)
32 See “Oseola McCarthy Donates $150,000 to USM”, http://
Even so, one should be mindful that the measurement of income changes over time for various reasons. For example, in Chart 1, the big increase in the Gini Coefficient from 0.434 in 1992 to 0.454 in 1993, reflects more of the change in the way income is measured than change in income distribution itself.


Frank Levy and Richard J. Murnane, op. cit., 1340.


James Heckman "Old Problem, New Despair" in Richard B. Freeman. op. it., 62.

Additional factors have contributed to increasing inequality, viz. changes in the family composition—greater prevalence of divorce, more single-parent families, increased labor participation by women, and two-income earners in many families. Immigration has also played a factor. The immigration rate during the past two decades is more than twice what it was between 1930 and 1970. Moreover, the average educational level of immigrants is much lower than that of Americans.


Solon admits that his model ignores the possibility of different intergen-
erational transmission across income strata. Solon admits the possibility that the correlation is higher for the highest quintile (0.48) and lower for the lowest quintile (0.34). That is, "riches to rags' may occur less frequently than 'rags to riches'." (p. 404)


53 Some fortunes are held in trusts shared by numerous descendants of the fortunes’ founders.

54 See Young Back Choi, op. cit.

55 Some may raise the issue that the rich can afford better legal counsel than the poor. This is beside the point.

56 The “zero-sum game” is a term social scientists use to describe a transaction in which one man gains what the other loses, i.e., the gains of the parties add to zero.


59 Recently, there has been much public outcry against excessive executive compensations—e.g., Jack Welch. Ultimately, executive compensation is a matter for shareholders to decide.

60 Karl Marx built his system of “Scientific Socialism” on this premise.

61 Viewing matters in this way, the critics assume a simple form of materialism, denying any efficacy of human agency.


63 Robert Frank, op. cit.

64 Many who hold equality as the ideal have a peculiar view of equality that stops well within a national boundary. The fact that the poorest in the United States may be far better off than the rich in another country is often viewed with surprising detachment.

50
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