The Wealth Debate

EDITED BY: DAN BEUCKE AND MARK GIMEIN

The Great Compression: How War And Taxes Made Us All Middle Class, And Why That's Changed

Posted by: Mark Gimein on December 14, 2011 at 8:30 AM

Last week, my colleague Dan Beucke wrote about the latest work of economists Thomas Picketty, Emmanuel Saez, and Stefanie Stantcheva, who presented a case for top tax rates as high as 83 percent. That rate essentially is confiscatory: the point of it really is not just to raise revenue for the government, but to put a limit on how high incomes should go. That's an idea very foreign to the debate today—but it wasn't always so, and if you want to understand the 20th century history of the income gap, it's worth looking closely at the times during and after the Second World War when that kind of taxation was public policy.

But first a little back-story: The obvious question to ask about the explosion of income at the top is why, especially in the US, it has taken off so fast since the 1980s. Picketty and Saez have done a lot of work analyzing top incomes around the world, though, and they raise a related and subtly different question: not "Why has the income gap grown?" but **"Why did the income gap *fall* dramatically during the Second World War and stay so low through the 1970s?"** When it comes to income, you can think of that period as The Great Compression. And what needs explaining is not why there's a big income gap—that's been the situation through most of history—but why in those four decades the gap narrowed so much.

Here's where things get interesting. Nominally, the Picketty/Saez/Stantcheva paper is about the

ABOUT

"The Wealth Debate" is a running discussion of wealth, poverty, the economy and income inequality in the U.S. and the world. It was started shortly after the Occupy Wall Street movement sparked a global protest about the fallout from the financial crisis and money in politics. You can reach the editors, Dan Beucke and Mark Gimein, by email, or follow BloombergNow on Twitter to keep up with posts.

Analyses or commentary in this blog are the views of the author and or commentators, and do not necessarily reflect the views of Bloomberg News.

RSS Feed: Occupy Wall Street: The Income Gap Debate

RECENT POSTS

Bonuses Dive, Stocks Tank: Goodbye Income Gap?
no comments yet

The Great Compression: How War And Taxes Made Us All Middle Class, And Why That's Changed
21 comments

Welcome to the Income-Gap Capital of the U.S.A
no comments yet

Lexus Christmas Commercials and Wealth Envy
93 comments

The Wealth Watch: 10 Must-Read Links
no comments yet

CATEGORIES

CEOs China Europe Goldman Sachs NYSE Occupy Wall Street Zuccotti Park art banks capitalism data globalization government housing income inequality investment jobs labor law media military veterans profits protests real estate retirement sports business students taxes youth

ARCHIVES

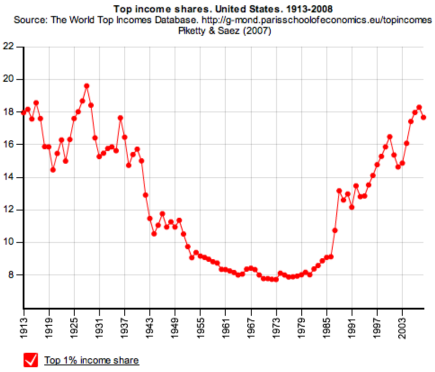
December 2011 November 2011 October 2011

most economically efficient tax rate for high incomes. Get past the pages of equations, though, and a lot of it is really about building an economic model to answer that question about the Great Compression. That model goes something like this:

During World War II tax rates rose to confiscatory levels because it was believed that very high incomes reflected profiteering, not real work. With the government taking so much money, managers lost their incentive to bargain for extravagant wages. High tax rates through the 1970s reinforced the social perception that there was an upper acceptable bound to incomes. Dan's already quoted the authors' key line on this:

> "Policy makers at that time probably considered—rightly or wrongly—that at the very top of the income ladder, pay increases reflect mostly greed and socially wasteful activities rather than productive work effort."

When tax rates got cut, things didn't go back instantly to where they'd stood decades earlier (as they might have if people were just hiding income from the IRS). It took a long period of tax cuts and social changes for managers and stars to recognize and use their full bargaining power. That has brought us to where we are now, with the income share of the top slice of earners just about back to where it was the 1920s.



The data on this is well known, but if you haven't seen it, here's a chart of the share of income going to the top one percent in the US. The Great Compression is the big trough in the center.

Picketty, Saez and Stantcheva dance around explicitly taking a position on just how much of the income at the top is a product of waste and collusion among managers. There's "rightly or wrongly," and the next sentence about how "it's a complicated empirical issue." Really, though, it's pretty clear where the authors stand. The 83 percent tax rate they talk about in their latest work is actually a bit lower than rates went in World War II and the post-war years. The National Taxpayer's Union, an anti-tax group, has a chart of those, with top rates reaching 94 percent in the war and remaining at 91 percent until 1963.*

Rates that high are designed to discourage any company from paying the kind of salaries at which they'd kick. They're really a *de facto* income cap. That's certainly one solution to the rising income gap. I think right now, though, it's a solution for which there will be very few takers.

Picketty, Saez, and Stantcheva might chalk that up to how thoroughly the wealthy have changed the terms of the political debate, but there's a lot more to it than that. Just as some on the left miss the relative economic equality of the post-War years, there are plenty on the right who miss the Ozzie and Harriet mores. There's no going back to that, for either the left or the right. And there's justification even for those who don't make mega-incomes to suspect that confiscatory taxes at the top of the economic scale will also mean higher taxes lower down.

Still, the 83 percent tax is a good thought experiment. The income gap can narrow only if (a) if incomes at the top get pushed down, (b) income gets redistributed through taxes or (c) wages at the bottom and middle rise a lot, and fast. The Picketty/Saez/Stantcheva paper basically argues for (a)—that's what happened in the Great Compression. It's pretty clear that a lot of folks would prefer (c)—in fact, I'd argue strenuously that if you really care about *poverty*, not just punishing the rich, you should definitely prefer it. Much of the current discussion of that, though has been little more than wishful thinking. Capping the incomes of the wealthy seems like neither a direct nor an efficient solution to the problems of the poor and middle class, but it does underline just how far we are from a better one.

**Those brackets applied to incomes of $200,000 (later $400,000) and up. There were some very high pre-war brackets, but only for a tiny slice of incomes. The highest pre-war rate of 79% only kicked in at $5,000,000.*

Photograph: Lambert/Getty Images

READER COMMENTS

Fladabosco
December 14, 2011 8:47 AM
83% is only confiscatory if you also delete all the great tax dodges they have. If you make 2 million a year and have to pay 83% on 100,000 of it, it ain't confiscatory.

Joe
December 14, 2011 9:12 AM
Raising income taxes to a level as high as 83% will only give the government incentive to spend money on wasteful programs or start another war to justify Bush-era defense spending levels.

Bill Soldner
December 14, 2011 9:24 AM
Changing the income tax rate has very little effect on the "rich". During this period three methods of getting wealthy worked well: 1. business were built, profits were ploughed back, and upon retirement the business was sold. Capital gains taxes were much lower than income taxes. 2. Owners bought "perks" like aircraft, second homes, etc. all owned by the business. 3. Profits were concentrated overseas, this is still done today. The "rich" stay rich because they are smart, good luck changing that!!

Sampa
December 14, 2011 10:59 AM
I thought that the top incomes were taxed as much as 90%. Is this the statutory rate or the effective tax rate? Also, let's not forget that prior to those high taxes, the wealthy were basically not taxed at all -- a drive down Bellevue Ave in Newport, RI will show you what the wealthy did with that money. Lawyers fought for guys like the Vanderbilts to pay as little as 2% taxes, if I remember correctly.

Randy
December 14, 2011 11:08 AM
The authors neglict to mention the 50% exclusion on long-term capital gains and 27.5% depletion allowance for oil and gas that, among other tax code changes, lowered substantially the high marginal rates.

PsedoTurtle
December 14, 2011 12:11 PM
Taxes aside for the moment, there were a lot of reasons why the US economy literally exploded after WWII, instead of crashing into a major recession as one would expect after coming off of years of excess war production.

For example, we should have experienced the same economic consequences that we did immediately after WWI, but we did not.

So, looking solely at taxes is missing the "forest for the trees."

I am not aware of a single economist who has addressed this anomaly. It is almost as though the sudden expansion in the US economy was normal, when history would argue strongly against that reasoning.

I have thought long and hard about this issue (having lived through the Ozzie and Harriet times myself, but that is another story).

Personally, I don't think taxes had a lot to do with it (an answer I am sure you will like), but the fact that the US economy expanded because we moved directly from WWII into the Cold War, and the hyper-spending of WWII never decreased, but expanded instead.

That, and millions of veterans coming home, to jobs that were expanding instead of contracting due to the Cold War, and you get the anomaly of the middle class.

Now, however, with the end of the Cold War and those US jobs being "outsourced" to cheaper labor because the global risk of doing so has decreased dramatically, we are about to get the major recession/depression we should have gotten right after WWII ended.

Essentially, we have been on a "war footing" since we ramped up the US economy in the early 1940s and have been expanding that unsustainable war spending ever since.

THAT is the real reason why the US is about to go over a cliff -- the prolonged "war economy" is finally over, and we are about to collapse as we should have immediately after WWII.

The problem is that we now have to "work off" around 75 years of unsustainable military spending, and that bubble has grown to truly massive proportions -- and now it also includes "war profiteering" as well since any safeguards taken during WWII have long since disappeared.

CPA/MBA

Jeff
December 14, 2011 12:13 PM
So this is basically a book report on the Picketty, Saez, and Stantcheva paper...

Robert Drake
December 14, 2011 12:25 PM
Folks, it's not the pursuit of happiness--it's the pursuit of status. Of the status types, pursuit of wealth status produces the most economic activity. Moderate wealth of others can be a motivating factor, but extreme wealth becomes discouraging, forcing people to drop out of the economic status game and move to other status venues. If you want to grow the economy, reduce wealth disparity and give more people a chance to compete for wealth status.

Dan Green
December 14, 2011 12:29 PM
odd how governments set up all the rules, and when people work with them to their benefit the masses miss out

Peter FitzSimon
December 14, 2011 12:57 PM
The argument for a confiscatory marginal tax rate is that it actually supports investment. It encourages the wealthy to leave profits in a business rather than take them out as income to be spent on yachts, 4th or 5th homes etc. The idea is similar to the 401K. Allow some of your income to be shifted into a 401K and it can grow tax protected. With stocks it's even better. Your shares grow tax protected and you can withdraw income at a lower capital gains tax rate or even as dividends. Of course you can't have a high corporate tax rate.

Urownexperience
December 14, 2011 1:15 PM
We don't have to do anything. Let greed play out to its certain and predestined conclusion - mass revolt. Then watch the fun.

Mark701
December 14, 2011 3:02 PM
I am not interested in punishing the rich simply because they're rich. What irritates me is that those people are rich because of the taxes paid by the middle class that built an infrastructure that allowed them to get rich. Look at it this way, where would Bill Gates be if he had tried to start Microsoft in Somalia? Now we are supposed to accept that it's ok for them to pay less even though the infrastructure that enables them to be wealthy is maintained with tax revenues. To add insult to injury some of the wealthiest US corporations pay ZERO taxes. After 10 minutes at work I paid more taxes than Exxon Mobil, GE and BoA COMBINED in 2009. This is the kind of gross inequality I want fixed.

Mark701
December 14, 2011 3:03 PM
I am not interested in punishing the rich simply because they're rich. What irritates me is that those people are rich because of the taxes paid by the middle class that built an infrastructure that allowed them to get rich. Look at it this way, where would Bill Gates be if he had tried to start Microsoft in Somalia? Now we are supposed to accept that it's ok for them to pay less even though the infrastructure that enables them to be wealthy is maintained with tax revenues. To add insult to injury some of the wealthiest US corporations pay ZERO taxes. After 10 minutes at work I paid more taxes than Exxon Mobil, GE and BoA COMBINED in 2009. This is the kind of gross inequality I want fixed.

Andrey
December 14, 2011 3:28 PM

Those whole thing is a sham. how can you tax anyone, they will shelter the whole thing, launder it. you cannot steal people's money (life) that easily. stealing only angers folks and most are not as stupid as before. i would suggest lower taxes to 7% total. that will probably work and folks will not have to be dishonest all the time

Juan

December 14, 2011 3:31 PM

Change the income tax please. I don·t want to work any more.

Kacper

December 14, 2011 3:39 PM

I'd be okay with an 83% top marginal tax rate like they had in the 50s to 80s as long as they also brought back all those tax loopholes and shelters they had in the 50s to 80s.

John LaGrua

December 14, 2011 3:47 PM

If you outsource the manufacturing jobs which supported the middle class and build the economy on high tec ,intellectual work the gap.yawns The US ceated the transitor and Japan built a middle clas work force on such innovation.China is following the same pattern.We have gutted the economy to buy low cost goods from abroad but created unemployment at home.

Someone

December 14, 2011 5:39 PM

Everyone is missing the point. The only reason US economy exploded after the war is this: The dollar became the reserve currency, and at the same time, the private central bank expanded the amount of currency by lending it into existence. On top of that, banks expanded it even more through fractional lending. Whoever controls the issuance of money and its QUANTITY is the full master of all. These cycles of inflation and deflation are solely controlled by the banks, and they also have the power to create and end world wars. Time to wake up people. The control is NOT in the hands of who you think it is.

USDOT Guy

December 14, 2011 6:15 PM

Well, I'll tell you what happens with these confiscatory tax rates. Politicians don't index the brackets, so after not too longer lots of people are paying those rates.

I lived in NYC in the 1980s. My salary was around $50,000 (not a rich man's salary, even then, in NY). The legislature had set a 10% income tax rate on all the big spenders earning more than $20,000 back in the early 60s -- and never changed it. So, with Federal, state, and local taxes, plus Social Security, I was paying 65% of each marginal dollar in taxes.

How do you all like the sound of that? Anyone want to sign up? Didn't think so.

As long as it's "the rich" we can get all angry and righteous. But in the end, the middle class will pay those confiscatory taxes because that's where the money is.

If you don't understand that, you're all fools.

Ed B

December 14, 2011 6:26 PM

Andrey - Money = life? If you classify taxes as stealing, how do you classify profit making on someone's labor? There are tons of businesses out there that charge say $50 an hour for a worker that they pay $20 an hour. Is that stealing?

Roland

December 14, 2011 6:53 PM

83% for corporations is not confiscatory, it's an R&D stimulant. Boeing in the '50's (about that rate) decided to use the money to build a demonstrator rather than pay Uncle. Result: the Dash80, which gave birth to the jet age.

POST A COMMENT

Name Comment

Email

Submit Comments

SPECIAL REPORTS

Fix This/Transportation

- Crisis in Japan
- Health Care
- Sentiment Analysis

More Special Reports

BUSINESS TOOLS

- B-School Comparison
- B-School Calendar
- BW for Mobile
- E-mail Newsletters
- RSS
- White Papers

A-Z INDEX

- BW Authors
- BX Topics
- Private Companies
- Public Companies

LISTS & RANKINGS

- Best Global Brands
- Best Places to Launch a Career
- Best Providers of Customer Service
- Best Undergraduate Business Schools
- Business School Rankings & Profiles
- BW 50: Best Performing Companies
- Top 100 IT Companies
- Most Innovative Companies

BLOGS

- EconoChat
- Euro Crisis
- Investing
- Joshua Green on Politics
- Occupy Wall Street
- On Media
- Small Business
- Technology

SOCIAL MEDIA

- @BW on Twitter
- BW on Facebook

SLIDESHOW GALLERY

- Autos
- Business Schools
- Design
- International
- Innovation
- Investing
- Managing
- Policy
- Real Estate
- Small Business
- Technology

MAGAZINE

Current Issue

SUBSCRIBE NOW

Bloomberg

About | Advertising | Custom Publishing | EDGE Programs | Reprints | Terms of Use | Disclaimer | Privacy Notice | Ethics Code | Contact Us | Site Map