1 The Pie and How We Slice It

Introduction

In one of the more useful metaphors of all time, the income of the economy has been likened to a pie.[1] Choose your favorite—apple, cherry, key lime, whatever. Economic growth is what makes the pie bigger, and the bigger, the better.[2] The distribution of income is how we slice the pie. From that pie that represents society's income, do we get a big slice or a tiny little sliver? Our standard of living ultimately depends on two things. One, it depends on how big the slice is that we get from that pie. Two, it also depends on how big the pie is to begin with. Someone with a thin slice from a very big pie may truly be better off than someone with a large slice from a small pie.

Metaphorically, the income "pie" in the United States exceeded $18 trillion in 2015 (United States Department of Commerce 2016). If sliced equally among the more than 325 million residents (United States Bureau of the Census 2016a), that would have allowed over $55,000 for each man, woman, and child. A four-person household would have been able to have an income of over $220,000, a pretty decent standard of living!

But the pie is not sliced equally. Quite the contrary. Some people barely make enough to survive. Others earn more in a year than most of us will earn over our entire career; or several careers, for that matter. Annually for the last several years, venerable *Parade* magazine has published a special report on "What People Earn" (Thompson and Brunner 2016).[3] The report includes some commentary on the current state of the economy and how that is affecting income and job opportunities, but its most memorable feature is always a photo gallery of a randomly selected group of Americans giving their name, age, occupation, hometown, and income. The 2016 report included many middle-income people, like Blanca Rios, a thirty-four-year-old elevator constructor who earned $100,000, Sharon Davies, a forty-eight-year-old Spanish immersion teacher who earned $77,809, and Donald Stanton, a sixty-four-year-old corrections officer (Thompson and Brunner 2016). It included several low-income people, like Paul Lisai, a thirty-two-year-old dairy farmer, who earned $10,000, Brandon Williams, a twenty-five-year-old magician, who earned $25,000, and Hilary Knight, a twenty-six-year-old professional hockey player, who earned $22,000

(Thompson and Brunner 2016). And it included several "superstars" with astronomical incomes, like Taylor Swift, a twenty-six-year-old singer/songwriter, who earned $80,000,000 (that's $80 million), Kevin Hart, a thirty-six-year-old actor who earned $28,500,000, and Michelle Phan, a twenty-nine-year-old YouTube personality and beauty entrepreneur who earned $3,000,000 (Thompson and Brunner 2016).

This book is about how we slice the pie. The issues involved are important for three big reasons. The first is the perception of economic justice. While most people do not believe in equal slices for all, most people's sense of economic justice is offended if some people receive slices "too small" (Okun 1975, 94–95). And some people are upset if others receive slices "too big." The second is the connection between the relative size of the slices and how easy it is for individuals to change their "station in life." One of the important elements of what Americans believe about their society is that it is a land of boundless opportunities. Regardless of how poor your background, if you work hard and play by the rules either you or your offspring will have a good chance of enjoying a much richer life. This is part of what is sometimes called *The American Dream*. The great fear is that if inequality is too severe, those paths of upward mobility will simply be shut off. The third is the connection between the relative size of the slices and the size of the pie itself. Many economists would argue that there is typically a trade-off between the size of the pie and the equality of the slices (Okun 1975). If we slice the pie more equally, we will end up with a smaller pie. Others would argue that, contrary to the previous assertion, the pie could be sliced more equally and made larger by judicious slicing (Haveman 1988; Pressman 2016).

The "slicing the pie problem" will be dealt with as four separate pieces, but this approach is only for expositional convenience. Each piece is tightly interlocked with the others, and the connections will be made clear. The first piece, called the Inequality piece, explains how the marketplace and government policy interact to determine the relative size of the slices different people consume. How are the owners of the factors of production rewarded in the marketplace? How and to what extent does government policy redistribute income and what impact does it have on incentives? The second piece, the Discrimination piece, investigates whether the size of a slice depends on race, ethnicity, gender, or any of a whole host of factors that do not represent individual "merit," and the impact of government policies to combat the problem. The third piece is the Poverty piece. Poverty means a slice "too small." How do we define too small, how many people receive slices too small, and are problems with people or the economy to blame? The fourth piece is the Mobility piece. Can people with small slices today reasonably hope to get larger slices later in life and is there hope for their offspring? Is mobility in the long term an antidote to inequality in the short term, or does short-term inequality prevent long-term mobility?

None of these issues is the private property of the discipline of economics. A comprehensive understanding will require a multidisciplinary

approach combining insights from economics with sociology, psychology, political science, history, law, and philosophy. But, truth be told, this book will emphasize economic analysis.

The issues involved are extraordinarily controversial. In fact, competent scholars are quite capable of holding diametrically opposed views on all the big issues. Regarding inequality, in a 2013 speech President Barack Obama said, "So let me repeat: The combined trends of increased inequality and decreasing mobility pose a fundamental threat to the American Dream, our way of life, and what we stand for around the globe" (Obama 2013). This should be juxtaposed with "This book's main argument is therefore that inequality is not itself good or bad, fair or unfair. Nor are increases in inequality" (Watson 2015, 10). Regarding racial discrimination, we have, "Race and Ethnicity play a central role in understanding the structure of inequality in the United States" (Lundberg and Startz 2000, 269) juxtaposed with,

> At the heart of these retreaded 1960s arguments is the notion that statistical disparities between groups are strange and sinister, and can only be explained by discrimination based on "stereotypes." What I discovered in the course of my 16 years of research . . . is that statistical disparities among groups is the rule—not the exception—in countries around the world.
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> (Sowell 1998b)

Regarding gender discrimination, we have, "The same forces that tend to constrain the earnings of minorities and lower-income classes also operate to limit the employment and income opportunities of women" (Schiller 2004, 204) juxtaposed with, "We conclude that complaints about systematic economic discrimination against women simply do not square with the evidence" (Furchtgott-Roth and Stolba 1999, xi). Regarding poverty, we have, "In no other developed country is the poverty rate as high as in the United States" (Mangum, Mangum, and Sum 2003, 10) juxtaposed with, "We have indeed eliminated poverty in the United States. By historical standards, no one—not a single person in our civilization—lives in poverty" (Boudreaux 2005). With respect to mobility, we have, "It is also true that income inequality as conventionally measured has been increasing since the late 1960s and that this has not been accompanied by any *increase* in mobility rates. Thus, growing annual income inequality implies growing lifetime income inequality as well" (McMurrer and Sawhill 1998, 6) juxtaposed with:

> Annual snapshots of the income distribution might deserve attention if we lived in a caste society, with rigid class lines determining who gets what share of the national income—but we don't live in a caste society. . . . To argue that upward mobility is being lost, we would have to show that the poorest remain stuck where they are, with little hope of making themselves better off. Nothing could be further from the truth.
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> (Cox and Alm 1999, 72)

Are you ready for some controversy?

WHAT'S IN THE PIE?

The preceding section talked about an "income pie," but that is only an approximation. The pie that we ought to be concerned about consists of this stuff called utility. The term *utility* is used by economists to refer to the feeling of satisfaction that a person gets from consuming goods and services. People are assumed to attempt to maximize their utility—to try to act in such a way as to make them as well-off as possible. A successful society, then, creates the most utility possible and allocates it equitably among persons, or, to continue in a metaphorical vein already begun, bakes the largest pie it is capable of baking and slices it in the most equitable manner.

Utility comes from the bundle of goods and services we consume, recognizing that this bundle consists not only of such obvious items as food, clothing, and shelter, but also such things as how healthy we are, how secure we feel, what civil rights we have, how much leisure we enjoy, how respected we are, how loved we are, the quantity and quality of our friends, how much fulfillment we get from life, how much fun we have, and many others. There is no way to directly measure the amount of utility we get from a bundle of goods and services. People cannot tell you how many *utils* (a util is one unit of utility) of utility they receive, and we cannot attach electrodes to a person's head and measure them. In principle we could measure them indirectly by asking people how much they would pay for each of the items in the bundle and then adding all items, but there would be little reason to be confident in the answers we got (how much would you pay for the amount of fun you have?).

In short, we do not have a measure of people's utility and hence cannot say precisely how the utility pie is cut. Does that mean the book should stop at this point? Maybe it should, but economists are loath to simply surrender when faced with data shortcomings. Rather, they make do with what they have, which means using approximations.

What is the best approximation of utility? In the preceding section and throughout much of the rest of the book, people's income is used to represent their level of well-being. This makes a certain amount of sense. Your income is a major determinant of how many tangible goods and services you can buy, and may very well be positively correlated with your health, security, and most of the other intangible factors that influence utility.[4] Also, income data are widely available in long time-series, large cross-section, and large panel data sets. But rich people are not always happy, so there are obviously gaps. Income data will be supplemented with whatever else is relevant and available, including but not limited to data on wages, earnings, wealth, consumption, occupational status, unemployment, and surveys of who has health insurance, whether people feel safe in their homes, ownership of consumer durables, and many other bits and pieces of data. The measurable pie has many components.