Letter to Mr. N. G. M., Professor of Economics, Harvard University

Berlin, December 24, 2013

Dear Professor M.,

The following is written by somebody who long ago grew up in the tradition of ORDO-liberalism (Walter Eucken, Wilhelm Roepke and partly also F. A. Hayek) and who then switched from economics and social sciences to philosophy and eventually had, until his retirement, a chair for political philosophy and theory of science in Munich. I don't know whether you would call him a leftist. But I certainly know that he sees himself as a radical liberal and exactly therefore not as a Manchester liberal.

A few days ago, I read your very interesting article “Defending the One Percent” in the *Journal of Economic Perspectives* (27 [2013] 21-34). There are various points on which I can easily agree. But there are some which I may not understand or understand wrongly, and some where I have a strong tendency to disagree. And I am afraid these are the most important ones, since they affect the two main statements of your article: the thesis that the income of the very rich reflects more or less their economic contribution, and what you call your normative conclusions and their “philosophical” basis (“just-deserts perspective”).

It seems to me doubtful that the One Percent deserve their monetary position (income and assets), and I would add that even just deserts are not the philosophically adequate basis for normative conclusions. The following remarks go along with your article.

You write, that the high earners in the USA made significant economic contributions, but that they also have reaped large gains. Well, already here my questions arise: 1) Given the economic contribution of a company, how can one determine the individual *share* in it? 2) Given that share, how can one determine the *height* of a gain which corresponds to that individual share? 3) Are there normative consequences to be drawn and which if that is necessary?

With regard to the exorbitant income especially of CEOs, it is notoriously ignored that in an economy, based on the division of labour, an *individual* achievement can hardly be determined (similarly the success of an advertising or a PR campaign). There are various factors which have a causal influence on the profit of a company, particularly in the form of the indispensable employees. I doubt that anybody would seriously maintain, that the CEO of a big company with some thousands of employees (in Germany often addressed as “*Mit*arbeiter”, *col*laborators) produces himself alone an achievement more than hundred times as big as that of a skilled worker in that company.[1]

To the third question I'll come later, when a “healthy dose of political philosophy” is needed.

I totally agree with what you say about rent-seeking. I am not familiar with the American situation. But in Germany (and also in the EU altogether), rent-seeking plays an important role; see for instance some favourable regulations for the motorcar industry, for the agribusiness and even now

[1] The Carl-Zeiss-Factories in Jena had determined in their statute from 1896 (!), that the income of the members of the management should not exceed the average income of a worker in the company more than ten times. And they excluded any bonus for output. Plato had suggested four times (Nomoi, book 5). I consider a share of the CEO twelve times the amount of a skilled worker in his company to be a fair amount.

still for the banks. That is of course clearly a distortion of competition which indeed makes a change in policy urgent.

I also agree with what you report about Goldin and Katz, but I am not yet persuaded when you suspect for the 1 percent similar forces at work. I just cannot see the effect changes in technology should have on the income of the 1 percent altogether. Sure, there are some fields where some “highly educated and exceptionally talented individuals” may be needed who then strike it rich. But why and how should digital technologies have any effect on the income of the CEOs of motorcar combines, big banks or hedge funds. Even to speak of them as “highly educated and exceptionally talented” seems to me at least in the case of Germany quite exaggerated. I am unable to see any significant difference between them and those who held their position twenty or thirty years ago.

I cannot judge whether the situation in the USA is so idyllic as it seems to be after your analysis. But I do know that in Germany it is strongly different. First, in many important areas, the market economy is far from being perfectly competitive. There are rather some significant distortions of competition by the patent law, by the law on the limited companies, by the general terms of business of many companies, by various kinds of interlocks, accumulation of offices, by secret cartels, by subventions, etc. Second, the many scandals alone (corruptions of all kind, unallowed arrangements, briberies, contracts against decency etc.) in which so-called honourable banks or industrial companies in all European countries were and still are involved, would suffice to proof that the competitive economy is distorted.

To what you rightly say about the finance industry, I would only like to add that a well-functioning society includes, admittedly, a well-functioning economy (a “socially productive way” should be determined not only in terms of *economic efficiency*), but it is more than that, and it therefore needs, aside from the allocation of talent, an appropriate policy response in order to put a stop to the game of such people whom one could observe in droves, especially during the last 15 years, in Wall Street, in the City of London, in Frankfurt/Main. (You will know the interesting book about this subject by: Anat Admati and Martin Hellwig: “The Bankers' New Clothes: What's Wrong with Banking and What to Do about It”, Princeton University Press 2013)

I take your judgment as from an economic expert for granted, that the failure to achieve equality of opportunity would normally lead to inefficiency as well (not to mention here the normative questions with regard to that inequality).

You have some doubts with regard to Stiglitz’s thesis about inequality, and you make the point about heritability of intelligence (and other dimensions). So, your argument goes: parents higher IQ – children higher IQ; higher IQ – higher income.

I am a bit afraid of a petitio principii. Higher intelligence is said to be reflected, on average, in higher income. Well, since top managers in fact have a high income, it speaks well for a high intelligence. For their part, they pass it on to their children. And if these – as it is indeed the case – also have a high income, then they have it due to their genetic dowry.

Before I come to a more crucial point, I confine myself to say that it seems to me rather daring to assume that the curve of income in a society is parallel to the IQ-curve. The gross income of a German top manager is, on average, 5 million Euros; my own income before retirement would be just under 100.000 Euros. It is, I dare say, quite unlikely that an average top manager has an IQ or other “dimensions” which surpass mine fifty times.

Now the crucial point: If intelligence would be, other than inequality of opportunity and family environment, a decisive factor for the height of income, then the percentage of graduates with a PhD (= people with a rather similar IQ) who later wind up in the 1 percent has to be expected as the same for all classes. But at least for Germany rather the opposite is true. There is indeed, especially since the educational reform measures in the seventies, a social opening of high schools and universities, also with regard to a PhD study. But this opening had and still has no effects on the recruitment of top managers.[2] A lot of research work has been done in this field about the situation in Germany. The result does not allow any doubt: the percentage of PhD graduates ending up in top management, whose parents belong to the upper middle class or to the upper class is significantly higher than the percentage of those who stem from the lower classes. That means, that family environment[3] is a decisive factor for entering top management (and also a high position in the judiciary). This result holds as clearly also for France and the UK. Equality of opportunity to study and to make a PhD is one thing, equality of opportunity with regard to arriving at top positions is another thing.[4] After the PhD and independent of it, the further career is subject to a social selection. The higher the business position, the higher the weight of the social background; and there is a driving-out-competition from above to below.

Your view is, as you say, shaped by personal experience. Well, such an experience is not an extremely solid basis for answering the asked question. I had, by the way, the same experience.[5] But, in fact, the mentioned studies also show a different result with regard to the sphere of politics and of science. In both spheres the percentage of workers and lower middle class children to become a professor or a high rank politician is much higher than the respective percentage for chil-

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[2] That a social opening also of this recruitment has a positive effect on the distribution of income in a society as well, can be seen in Scandinavia, especially in Sweden.

[3] This may even have a direct effect on the recruitment process. What counts more are the indirect effects: on manners, attitude, behaviour (see Pierre Bourdieu, *La distinction. Critique sociale de jugement*, Paris 1979). Bourdieu speaks about dress- and behaviour-codes, an all-round education, and, particularly, personal sovereignty and self-confidence.

[4] A figure I have about the USA tells me that approximately a third of the top managers have studied at one of the top ten universities; and I somewhere read that the chance to study there is much higher for a student from the upper middle and upper class than for one from the lower and lower middle class. Today, I read in an article by Matthew O'Brien, *How elite universities are killing the American dream* (The Atlantic, June 19, 2013): "even when kids from low-income households *do* outperform those from high-income households, it's far from a guarantee that they'll end up earning more as an adult. [...] *rich kids without a college degree are 2.5 times more likely to end up rich than poor kids who do graduate from college* [...] there's only a 10 percent chance that a college grad from the bottom quintile will end up in the top quintile, but a 25 percent chance that a non-college grad from the top quintile will stay there. [...] it's clear enough why so many well-off kids who don't get a college degree stay well-off. But it's less clear why higher education isn't more of a path to prosperity for low-income children. [...] very few high-achieving students from low-income households end up even applying to a selective college. (Here, "high-achieving" is defined as the top 10 percent of overall test-takers on the SAT I or ACT, and a "selective" college is one of the top 236 schools in the country.) This, of course, is *not* how high-achieving, high-income students play the college admissions game. They follow their guidance counselors' advice, and apply to a few "reach" schools, a handful of "match" schools, and a "safety" school or two. [...] It's a totally different game for high-achieving, low-income students, because nobody tells them how to play it. Aside from magnate school kids, they mostly don't have parents or teachers or counselors with much experience applying to selective colleges. Nor do many know, despite the best efforts of the schools to inform them otherwise, that the most selective colleges have very generous financial aid packages that can take tuition all the way down to zero. Indeed, Harvard is pretty much free, including room and board, for students whose parents make $ 65,000 or less.[...] This is how the American Dream ends. Not with a bang, but a whimper of elite school applications by poor kids. Like it or not, the Ivies and other top schools are our conduit to the top, and far too many low-income students who should be there are not. As David Leonhardt of the *New York Times* points out, only 34 percent of high-achieving, low-income students attend a selective college versus 78 percent for high-achieving, high-income students. This has to be the most boneheaded way we as a society perpetuate the people at the top. The deck is already more than stacked against kids growing up in low-income households—their parents often aren't as involved or even around—and we're not helping the ones who do succeed to succeed more."

[5] By the by, I also know quite well the amount of luck I had in my career.

dren from the upper middle class and the upper class. So, even if your and my personal experience reflects a general pattern, we cannot conclude from it that it is also true for the other spheres of top positions.

You speak about the relationship between work efforts and incentives. In the recent election campaign in Germany, a proposal was discussed (supported by the Social Democrats, the Greens and the more leftist PDS) to raise the income tax maximum from 45 to 49 percent. It was not successful. The standard counter argument referred to the mentioned relationship. But it is totally unlikely that a top manager would work less or even go abroad[6] because of such an increase. – At present, there is no wealth tax in Germany and the capital transfer tax is relatively lenient. But even here a reference to that relationship is taken as a warning of an increase.

With your critical comment on utilitarianism I can easily agree. You come to a decisive point when you emphasize that we need a model of optimal government taxes and transfers that departs significantly from conventional utilitarian social planning. I think the main task to start with is to determine what exactly has to be taken as “merit” and how it is individually measured, and then to determine the adequate reward for it. The simple answer that merit is rewarded by the income obtained on the market is certainly not adequate. There are quite a lot of types of contribution to society which cannot be adequately determined by the value of one’s marginal productivity.

At the end you speak about Obama’s reference to the benefits principle. What he says in your quotation is actually a kind of positive version of what Hobbes had formulated in a negative way with regard to the status naturalis (“natural condition of mankind”) in contrast to the status civilis (State): “Whatsoever therefore is consequent to a time of war where every man is enemy to every man, the same is consequent to the time wherein men live without other security than what their own strength and their own invention shall furnish them withal. In such condition there is no place for industry, because the fruit thereof is uncertain, and consequently no culture of the earth, no navigation nor use of the commodities that may be imported by sea, no commodious building, no instruments of moving and removing such things as require much force, no knowledge of the face of the earth; no account of time, no arts, no letters, no society, and, which is worst of all, continual fear and danger of violent death, and the life of man solitary, poor, nasty, brutish, and short.” (Leviathan, ch. 13)

From here on, we have to leave the field of positive economics and sociology and to enter, as you rightly say, the field of political (or legal) philosophy. The first philosopher who thought in Obama’s terms was the Platonic Socrates, when he gave, in a fictitious dialogue (*Crito* 49-53) between him and *the laws and the commonwealth*, his reasons for not making use of the opportunity to escape from his prison in order to save his life. Recently, the French actor Depardieu became a Russian citizen because he found the income tax in France of 75 percent confiscatory. Well, if Socrates for his part would have left Athens and gone to the tyrant in Syracuse, his disciple Plato surely would have said that a city like Athens would not need such a creature. But, in place of De-

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[6] The usual justification of top manager salaries, at least in Germany, refering to the alleged danger that otherwise these managers would go abroad, is based on a myth. If one takes the eight countries UK, France, Germany, Italy, Spain, USA, Japan and China together, then the percentage of foreigners who are a CEO of one of the 100 biggest companies or groups of companies comes out not to be higher than 5 percent, and if one does not count those who have the same mother tongue and a similar cultural background (Austrians and Swiss in Germany; Australians, Irish, Canadians and South-Africans in the USA and the UK), the figure goes down to 2 percent. The main reason is the undiminished predominance of traditional national career patterns. The reference to the mentioned danger has no basis in reality. Its main function clearly is to publicly justify the permanent increase of the exorbitant incomes of top managers which, instead, are based on a shift of social power in favour of the elites.

pardieu, Socrates would have paid the taxes voluntarily and carried on to prefer the Pyrenees to the Urals.

You try to lead Rawls' "original position" theory ad absurdum. I had great fun with your kidney case. But, to be honest, I took it rather as a nice joke. After Rawls' *A Theory of Justice* had been published some 40 years ago, I dealt a lot with the book. It did not convince me altogether. But one certainly cannot lift it off its hinges with the kidney case because that just misses the very idea of Rawls' proposal. My own position is a Kantian one.

Even in the case of more or less perfect equality of opportunity, two questions still have to be answered: 1) whether and why top managers deserve the money they get, and 2) whether the State nevertheless has the right to raise the rate on high incomes up to 75 or even 90 percent. This brings us to the normative field of political philosophy.

You call, from the just-deserts perspective, such rates confiscatory and unjust, because a large share of the fruits of someone else's labour is seized by the government.

Well, the first question is whether someone's income is indeed nothing but the fruits of his/her labour, so that it can be taken as the indicator for a just reward. The case where somebody gets more than the fruits of his *own* labour I have dealt with already. But there is also the opposite case. What would be the indicator for reward to Vincent van Gogh? For what he had produced in the last ten years of his life, he then got hardly a penny. These days, he would get some billion dollars. Just deserts? Or take Mrs. Rowling: her profit with *Harry Potter*, which surpassed by far – say – that of Joyce's *Ulysses*, does not correspond to a *special* achievement; she was just lucky. The usual justification for such a profit goes (tautologically) like this: The fact that Mrs. Rowling's productivity is extraordinary is reflected in the high figures of sold copies and thereby in her profit; and this profit is justified (just deserts) since it is in accordance with her productivity. In fact, the achievement is equated with the success on the market. One deserves the money because one earns it. Income has its justification in itself. We have here a modification of the right of the stronger-argument already led ad absurdum by Rousseau in his *Contrat Social*.

Your formulation "fruits of someone *else's* labour" makes me assume that you particularly think of redistribution of income. But an even stronger reason to focus on raising taxes (income, wealth, capital transfer[7]) for the upper middle and the upper class is maintaining and improving the *res publica* as a civil state based on the principle of (real!) freedom for everybody. Therefore, it is primarily not about redistribution of income in order to reach more equality and thereby justice; but rather about financing the various tasks of the *res publica*; and this even under the not very convincing condition that the prices on the labour market don't reflect some market failure and are insofar "just".

Even a highly competitive market economy works only, when and because the participants don't live in a *status naturalis*, but in a *status civilis*, i. e. in a State, on whose quality the market's ability to work is totally dependent. Even "just deserts" are possible only through the State which guarantees the working order of the market. For the benefits of the various public goods the members of the *res publica* have to pay contributions according to their share in the benefits. Although it is quite difficult, if not impossible, to determine this share positively, it is rather easy to do it ex negativo. If one takes the distribution of income and wealth in Germany between the very rich and

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[7] By the way, up to now I have not seen any halfway convincing argument in favour of a right of inheritance. Haslett even tries to show, that such a right contravenes the principles of capitalism and why it does. (D. W. Haslett, Is Inheritance Justified?; in: Philosophy and Public Affairs, 15 (1986) 122-155)

the very poor and asks then how this distribution would probably look like if all these people would be born, grown up, live and work in Mali, Chad or Papua New Guinea (States, as bad as they are, still different from the stateless *status naturalis* described by Hobbes). I think one may reasonably doubt that Mr. Winterkorn, CEO of VW with an income of some 15 million Euros, also there would earn more than 300 times as much as his present shrewd chauffeur or his bear-strong caretaker. He might even have less income than them. In short, the height of one's income reflects not only some kind of achievement, but also, and the higher the more so, the benefit one has from the public goods. And the corresponding curve is certainly strongly progressive.

You will probably know the intellectual experiment long ago presented by, I think, some public-choice theorists: A singer from the Bahamas wants to become a citizen of the USA. The American authorities say that he would get the citizenship applied for, if he would agree to a maximum tax rate of 90 percent. On the Bahamas he is indeed very successful. But given the small population, he gets from his concerts $ 50.000 from which he pays 20 percent taxes, $ 40.000 remaining. In the USA, his profit will rise up to $ 5.000.000, minus 90 percent, remaining $ 500.000. I guess the gentleman will agree to the condition.

Completely independent of the reason to finance the indispensable tasks of the State particularly by the rich, there is a direct reason to avoid too big a gap between the income and fortune of the rich and the poor: from a certain size upwards, such a gap constitutes, as Plato already knew, a real test for the *res publica.*[8]

There is a last and somehow the most fundamental argument for the State's right and duty to seize even large shares of high income, fortune and inheritance. Using the force of government is legitimate only, and indeed, when it aims at establishing and protecting *universal* freedom in all spheres of the society and thus also in the market economy. Freedom, in this context, does not mean, as Kant says it, „wild, lawless freedom" (of „locusts"), but freedom of everybody in accordance with a universal law of freedom. Exactly therefore, not only the misuse of economic power has to be controlled, but economic power as such, whenever it has as a consequence the actual limitation of the lawful freedom of those, who are, respectively can be, subject to it.

Sincerely yours,

Georg Geismann

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[8] The frustration with the whole political system in Germany clearly shows in the elections. Between 1990 and 2000 about 80 percent went to the polls, more or less the same figure in all income quintiles. Since then the percentage went down to 70 percent. But more important is the fact that this result is caused by the abstention of the lower classes, while the voting behaviour of the higher classes has hardly changed. The higher the social status, the higher the turnout at the election.