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Why Inheritance Is Not a Problem

By N. Gregory Mankiw

Is inherited wealth making a comeback?

Yes, says Thomas Piketty, author of the best seller "Capital in the Twenty-First Century." Inherited wealth has always been with us, of course, but Mr. Piketty believes that its importance is increasing. He sees a future that combines slow economic growth with high returns to capital. He reasons that if capital owners save much of their income, their wealth will accumulate and be passed on to their heirs. He concludes that individuals' living standards will be determined less by their skill and effort and more by bequests they receive.

To be sure, one can poke holes in Mr. Piketty's story. Since the book came out, numerous economists have been doing exactly that in book reviews, blog posts and academic analyses.

Moreover, given economists' abysmal track record in forecasting, especially over long time horizons, any such prognostication should be taken with a shaker or two of salt. The Piketty scenario is best viewed not as a solid prediction but as a provocative speculation.

But it raises the question: So what? What's wrong with inherited wealth?

First, let's consider why parents leave bequests to their children. I believe that this decision is based on three principles:

INTERGENERATIONAL ALTRUISM This starts with the prosaic premise that parents care about their children. Economists simplify this phenomenon with the concept of "utility," a measure of lifetime satisfaction or happiness. Intergenerational altruism within the family is modeled by assuming that the utility of Generation One depends on the utility of Generation Two.

And it doesn't stop there, because future generations will also care about their children. Generation Two's utility depends on Generation Three's utility, which depends on Generation Four's utility, and so on. As a result, each person's utility depends not only on what happens during his own lifetime but also on the circumstances he expects for his infinite stream of descendants, most of whom he will never meet.

CONSUMPTION SMOOTHING People get utility from consuming goods and services, but they also exhibit "diminishing marginal utility": The more you are already consuming, the less benefit you get from the next increase in consumption. Your utility increases if you move from a one- to a two-bathroom home. It rises less if you move from a four- to a five-bathroom home.

Because of diminishing marginal utility, people typically prefer a smooth path of consumption to one that jumps around. Consuming $50,000 of goods and services in each of two years is generally better than consuming $80,000 one year and $20,000 the next. People smooth consumption by saving in good times and drawing down assets when conditions are lean.

REGRESSION TOWARD THE MEAN This is the tendency of many variables to return to normal levels over time. Consider height. If you are much, much taller than average, your children will most likely be taller than average as well, but they will also most likely be shorter than you are.

The same is true for income. According to a recent study, if your income is at the 98th percentile of the income distribution — that is, you earn more than 98 percent of the population — the best guess is that your children, when they are adults, will be in the 65th percentile. They will enjoy higher income than average, but much closer to that of the typical earner. (This regression to the mean over generations, of course, has nothing to say about a nation's overall income inequality, which is an entirely separate issue.)

This phenomenon is clearest for the most extreme cases. In their own times, John D. Rockefeller and Steve Jobs each created one of the world's most valuable companies and made a ton of money along the way. They must have known it was unlikely that their children would accomplish the same feat.

Together, these ideas explain why top earners often leave sizable bequests to their families. Because of intergenerational altruism, they make their consumption and saving decisions based not only on their own needs but also on those of their descendants. Because of regression toward the mean, they expect their descendants to be less financially successful than they are. Hence, to smooth consumption across generations, they need to save some of their income so future generations can consume out of inherited wealth.

This logic also explains why many people *aren't* inclined to reduce their current spending so they will have money saved for bequests. For those in the bottom half of the income distribution, regression toward the mean is good news: Their descendants will very likely rank higher than they do. Even those near the middle can expect their children and grandchildren to earn higher incomes as technological progress pushes productivity and incomes higher. Only for those with top incomes does the combination of intergenerational altruism, consumption smoothing and regression toward the mean lead to a significant role for inherited wealth.

From a policy perspective, we need to consider not only the direct effects on the family but also the indirect effects on the broader economy. Rising income inequality over the past several decades has meant meager growth in living standards for those near the bottom of the economic ladder, and one might worry that inherited wealth makes things worse. Yet standard economic analysis suggests otherwise.

When a family saves for future generations, it provides resources to finance capital investments, like the start-up of new businesses and the expansion of old ones. Greater capital, in turn, affects the earnings of both existing capital and workers.

Because capital is subject to diminishing returns, an increase in its supply causes each unit of capital to earn less. And because increased capital raises labor productivity, workers enjoy higher wages. In other words, by saving rather than spending, those who leave an estate to their heirs induce an unintended redistribution of income from other owners of capital toward workers.

The bottom line is that inherited wealth is not an economic threat. Those who have earned extraordinary incomes naturally want to share their good fortune with their descendants. Those of us not lucky enough to be born into one of these families benefit as well, as their accumulation of capital raises our productivity, wages and living standards.