

Yes, the Wealthy Can Be Deserving

By N. GREGORY MANKIW

In 2012, the actor Robert Downey Jr., played the role of Tony Stark, a.k.a. Iron Man, in “The Avengers.” For his work in that single film, Mr. Downey was paid an astounding \$50 million.

Does that fact make you mad? Does his compensation strike you as a great injustice? Does it make you want to take to the streets in protest? These questions go to the heart of the debate over economic inequality, to which President Obama has recently been drawing attention.

Certainly, \$50 million is a lot of money. The typical American would have to work for about 1,000 years in order to earn that much.

That sum puts Mr. Downey in the top ranks of American earners. Anything more than about \$400,000 a year puts you in the much-talked-about 1 percent. If you earn more than about \$10 million, you are in the top 1 percent of the top 1 percent. Mr. Downey makes it easily.

Yet, somehow, when I talk to people about it, most are not appalled by his income. Why?

One reason seems to be that they understand how he earned it. “The Avengers” was a blockbuster with worldwide box-office receipts of more than \$1.5 billion.

Of that amount, only about 3 percent went to pay Mr. Downey. In other words, if you bought a matinee movie ticket for, say, \$8, about 25 cents went to pay for Mr. Downey’s acting. If you have seen the movie, you might be tempted to say: “He gave a great performance. I’m happy to pay him a quarter for it.”

People are similarly unperturbed when they learn that in 2013, E. L. James, author of the “Fifty Shades of Grey” trilogy, earned \$95 million, or that in the same year the basketball star LeBron James earned \$56 million in salary and endorsements. When people can see with their own eyes that a talented person made a great fortune fair and square, they tend not to resent it.

But actors, authors, and athletes do not make up the entire ranks of the rich. Most top earners make their fortunes in ways that are less transparent to the public.

Consider chief executives. Without doubt, they are paid handsomely, and their pay has grown over time relative to that of the average worker. In 2012, the median pay of C.E.O.'s for companies in the Standard & Poor's 500-stock index was nearly \$10 million. Did they deserve it?

Critics sometimes suggest that this high pay reflects the failure of corporate boards to do their job. Rather than representing shareholders, this argument goes, those boards are too cozy with the chief executives and pay them more than they are really worth.

Yet this argument fails to explain the behavior of closely held corporations. A private equity group with a controlling interest in a firm does not face this supposed principal-agent problem between shareholders and boards, and yet these closely held firms also pay their chief executives similarly high compensation. In light of this, the most natural explanation of high C.E.O. pay is that the value of a good C.E.O. is extraordinarily high.

That is hardly a surprise. A typical chief executive is overseeing billions of dollars of shareholder wealth as well as thousands of employees. The value of making the right decisions is tremendous. Just consider the role of Steve Jobs in the rise of Apple and its path-breaking products.

A similar case is the finance industry, where many hefty compensation packages can be found. There is no doubt that this sector plays a crucial economic role. Those who work in banking, venture capital and other financial firms are in charge of allocating the economy's investment resources. They decide, in a decentralized and competitive way, which companies and industries will shrink and which will grow. It makes sense that a nation would allocate many of its most talented and thus highly compensated individuals to the task.

In addition, recent research establishes that those working in finance face particularly risky incomes. Greater risk requires greater reward.

To be sure, some people find ways to get rich at others' expense. Bernard Madoff most famously comes to mind. The solution here, however, is not to focus on the income distribution but to devise better regulation and oversight.

A reliable tax system is also important to ensure that the wealthy pay their fair share to support the public weal. That is generally the case. Our tax system is far from perfect and is arguably in dire need of reform, but examples of the tax-dodging wealthy are not at all the norm.

The Tax Policy Center estimates that in 2013, the top one-tenth of 1 percent of the income distribution, those earning more than \$2.7 million, paid 33.8 percent of their income in federal taxes. By contrast, the middle class, defined as the middle fifth of the income distribution, paid just 12.4 percent.

So, by delivering extraordinary performances in hit films, top stars may do more than entertain millions of moviegoers and make themselves rich in the process. They may also contribute many millions in federal taxes, and other millions in state taxes. And those millions help fund schools, police departments and national defense for the rest of us.

Unlike the superheroes of “The Avengers,” the richest 1 percent aren’t motivated by an altruistic desire to advance the public good. But, in most cases, that is precisely their effect.