Sources of Income Inequality: Productivities vs. Preferences
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Abstract
This paper develops a new method to understand how much of income inequality is due to differences in productivities as opposed to differences in preferences for consumption relative to leisure. In the context of a general static labor supply model, we show that we can invert the relationship between primitives (productivities and preferences) and observables (labor supply decisions). We can express this inverse mapping entirely in terms of reduced form elasticities with respect to the tax rate, thereby yielding a transparent procedure that highlights the relevant parameters for understanding the sources of income inequality. We show that our method can be adapted to allow for labor supply frictions as well as dynamic labor supply decisions with endogenous wage growth. We then implement our method empirically, showing that (1) smaller compensated elasticities, (2) larger income effects, and (3) larger differences between the income and hours worked elasticities imply that preferences play an increasing role in driving income inequality. Finally, we investigate via simulation how sources of inequality affect optimal income tax schedules, showing that (1), (2), and (3) all decrease tax rates relative to a Mirrleesian benchmark in which all income heterogeneity is due to productivity differences.