The rising costs of US income inequality

By Laura Tyson

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During the last several decades, income inequality in the United States has increased significantly – and the trend shows no sign of reversing. The last time inequality was as high as it is now was just before the Great Depression. Such a high level of inequality is not only incompatible with widely held norms of social justice and equality of opportunity; it poses a serious threat to America's economy and democracy.

Underlying the country's soaring inequality is income stagnation for the majority of Americans. With an expanding share of the gains from economic growth flowing to a tiny fraction of high-income US households, average family income for the bottom 90% has been flat since 1980. According to a recent report by the Council of Economic Advisers, if the share of income going to the bottom 90% was the same in 2013 as it was in 1973, median annual household income (adjusted for family size) would be 18%, or about $9,000, higher than it is now.

The disposable (after tax and transfer) incomes of poor families in the US have trailed those of their counterparts in other developed countries for decades. Now the US middle class is also falling behind.

During the last three decades, middle-income households in most developed countries enjoyed larger increases in disposable income than comparable US households. This year, the US lost the distinction of having the "most affluent" middle class to Canada, with several European countries not far behind. Once the generous public benefits in education, health care, and retirement are added to estimates of disposable family income in these countries, the relative position of the US middle class slips even further.

The main culprit behind the languishing fortunes of America's middle class is slow wage growth. After peaking in the early 1970s, real (inflation-adjusted) median earnings of full-time workers aged 25-64 stagnated, partly owing to a slowdown in productivity growth and partly because of a yawning gap between productivity and wage growth.

Since 1980, average real hourly compensation has increased at an annual rate of 1%, or half the rate of productivity growth. Wage gains have also become considerably more unequal, with the biggest increases claimed by the top 10% of earners.

Moreover, technological change and globalization have reduced the share of middle-skill jobs in overall employment, while the share of lower-skill jobs has increased. These trends, along with a falling labor-force participation rate during the last decade, explain the stagnation of middle-class incomes.

For most Americans, wages are the primary source of disposable income, which in turn drives personal consumption spending – by far the largest component of aggregate demand. Over the past several decades, as growth in disposable income slowed, middle- and lower-income households turned to debt to sustain consumption.

Personal savings rates collapsed, and credit and mortgage debt soared, as households attempted to keep pace with the consumption norms of the wealthy. For quite some time, growing income inequality did not slow consumption growth; indeed, "trickle-down consumption" pressures fostered more consumer spending, more debt, more

bankruptcy, and more financial stress among middle- and lower-income households.

The moment of reckoning arrived with the 2007-2008 financial crisis. Since then, aggregate consumption growth has been lackluster, as middle- and lower-income families have been forced to reduce their borrowing and pay down their debt, often through painful defaults on their homes – their primary (and often their only) asset.

As these families have tightened their belts, the pace of consumption spending and economic growth has become more dependent on earners at the top of the income distribution. Since the recession ended in 2009, real consumption spending by the top 5% has increased by 17%, compared to just 1% for the bottom 95%.

The recovery's pattern has reinforced longer-run trends. In 2012, the top 5% of earners accounted for 38% of personal-consumption expenditure, compared to 27% in 1995. During that period, the consumption share for the bottom 80% of earners dropped from 47% to 39%.

Looking to the future, growing income inequality and stagnant incomes for the majority of Americans mean weaker aggregate demand and slower growth. Even more important, income inequality constrains economic growth on the supply side through its adverse effects on educational opportunity and human-capital development.

Children born into low- and high-income families are born with similar abilities. But they have very different educational opportunities, with children in low-income families less likely to have access to early childhood education, more likely to attend under-resourced schools that deliver inferior K-12 education, and less likely to attend or complete college.

The resulting educational-attainment gap between children born into low and high-income families emerges at an early age and grows over time. By some estimates, the gap today is twice as large as it was two decades ago. So the US is caught in a vicious circle: rising income inequality breeds more inequality in educational opportunity, which generates greater inequality in educational attainment. That, in turn, translates into a waste of human talent, a less educated workforce, slower economic growth, and even greater income inequality.

Although the economic costs of income inequality are substantial, the political costs may prove to be the most damaging and dangerous. The rich have both the incentives and the ability to promote policies that maintain or enhance their position.

Given the US Supreme Court's evisceration of campaign-finance restrictions, it has become easier than ever for concentrated economic power to exercise concentrated political power. Though campaign contributions do not guarantee victory, they give the economic elite greater access to legislators, regulators, and other public officials, enabling them to shape the political debate in favor of their interests.

As a result, the US political system is increasingly dominated by money. This is a clear sign that income inequality in the US has risen to levels that threaten not only the economy's growth, but also the health of its democracy.

Laura Tyson, a former chair of the US President's Council of Economic Advisers, is a professor at the Haas School of Business at the University of California, Berkeley, a senior adviser at the Rock Creek Group, and a member of the World Economic Forum Global Agenda Council on Gender Parity.