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Bringing Inequality Back In

Looking at the U.S. economy over the past half-century, what jumps out is the sustained rise in inequality in wages, incomes and wealth, especially those at the top pulling away from the rest of us. We also see that higher inequality is associated with slower income growth. From 1947 to 1979, family incomes grew at about the same pace across the income spectrum, about two percent per year. But in the period 1979-2007, just before the economic crisis, families in the bottom quintile experienced essentially no income growth, while families in higher quintiles saw progressively greater annual income growth. But all quintiles – even the top one – saw their wages grow more slowly than two percent. It is only those at the very top of the income spectrum who saw higher rates of income growth.

Economists used to assume that developed economies would just become more equal over time. In 1955, Simon Kuznets hypothesized a long-run relationship between inequality and economic growth. His data from the first half of the 20th century led him to conclude that countries would initially become more unequal as they developed, and then, after reaching a certain level of economic development, they would become more equal again. In hindsight, the trend toward greater economic equality was an aberration due to the economic consequences of two world wars and the Great Depression rather than a long-term development. Indeed, this is the conclusion Thomas Piketty reaches in his book *Capital in the 21st Century*, in which he builds on Kuznets's data and methods. Indeed, data from the World Top Incomes Database show that the period of greater equality in developed economies in the mid-20th century was transient.

There is a long tradition in economics arguing that any policy that reduces inequality would be counterproductive. The trade-off happens because monetary rewards and penalties, that is, economic incentives, drive productive activity. These rewards and penalties are optimal for growth, and economic interventions are distortionary and will lower growth. One could oppose inequality on political or humanitarian grounds but not economic ones. There is also a long tradition of seeing capital accumulation as a positive side effect of inequality. Inequality means that some can amass capital, which drives growth. Further, wealthy people can afford to be patient and wait for an investment to pay off. However, recent studies that make use of new data find that, over the long term, as inequality increases, it drags down economic growth and reduces economic stability.

The relationship between inequality and growth will happen through a variety of institutions and norms, many of which are levers for policymaking. We focus here on three areas where inequality could affect economic growth and stability: human capital, consumption and institutions.

Perhaps the most intuitive way to link inequality with economic growth is via human capital, the development of workers' skills and abilities. Inequality of income and wealth may create a situation where only those born into high-income or high-wealth families can truly develop their talents. There is some emerging evidence that this is increasingly the case in the U.S. The gap between the outcomes for children of rich households and the outcomes for children of middle-income households is growing much faster than any other gap. About half of this increase is due to an increasing correlation between income and educational outcome. In other words, one extra dollar of income buys more educational success than it did in the past. Rich children enter kindergarten much more prepared for school than the children of middle and low-income households. This inequality in education among children ages zero to five occurs before children ever enter a classroom. So the policy response to this inequality ought to target the years before primary school.

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The role of inequality in the issues of consumption and demand is not yet fully understood, but there is very persuasive research showing that the rising inequality of wealth had a key role in the damage wrought by the bursting of the housing bubble. The rapid increase in U.S. household debt during the 2000s and the distribution of that debt helped lead to the Great Recession and the current slow recovery. Interestingly, from 2002 to 2005, most of the increase in credit went to counties where wages were actually declining. Credit growth and wage growth were negatively correlated. When the housing bubble burst, the counties with the largest declines in total net worth were the ones where spending declined the most. The inequitable distribution of debt thus exacerbated the crisis.

Of the channels though which inequality might affect growth, the institutional channel is certainly the most amorphous and least well understood. *Why Nations Fail* by Daron Acemoglu and James Robinson has a simple yet powerful explanation for what drives long-run economic growth. Societies that create inclusive institutions that encourage and allow for broad participation in economic and political life are more likely to be prosperous. Societies that create extractive institutions that enrich elites over the rest of the society will end up worse off in the long run. A recent finding that is particularly troubling is that legislation in the U.S. does not become law unless the rich support the effort.[1] That is, the wealthy hold the trump card.

That being said, I would like to suggest a few policy options that might help reduce inequality and boost economic growth. For families at the bottom of the income distribution in the U.S., an increase in the minimum wage would be a welcomed policy response. The purchasing power of the minimum wage has decreased substantially since its peak in 1968. The federal minimum wage has not been increased in more than five years, and this stagnation has contributed significantly to inequality at the bottom of the income distribution. Furthermore, empirical research has found that moderate increases in the minimum wage have no discernible effect on employment.

One way to reverse the growing inequality of educational outcomes is to increase investments in early childhood education, specifically the provision of universal pre-kindergarten for all children in the U.S. alongside policies that help low- and middle-income families alike learn and practice the parenting skills that contribute to better educated and more socially equipped children. These investments could help reduce the gap in skills between the children of well-off families and those at the middle and bottom of the income spectrum in the U.S.

The implementation of a financial transaction tax would also do quite a bit to alleviate economic inequality. The U.S. financial sector has played a large role in the drastic rise of inequality at the top of the income distribution. Given the role of rent-seeking in the rise of the finance sector, we are likely to find that a tax on financial transactions would not be harmful to economic growth and might actually be helpful by channeling resources to more productive uses.

The primary reason that U.S. policymakers are not implementing policies that reduce inequality is because they fear such policies will be “job killers.” If I have heard that argument once, I have heard it a million times. We need to publicize recent research showing this is not the case. We also need to understand what it is that will ultimately improve the lives of working families by improving their living standards. This requires further research to gain a better understanding of the economics as well as the proper policy responses. It will not be an easy task, but it is a critically important one.

1 M. Gilens, B.I. Page: Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens, in: Perspectives on Politics, Vol. 12, No. 3, 2014, pp. 564-581.