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Income inequality: Why it took off in recent years

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MINNPOST

Income inequality: Why it took off in recent years

By Louis D. Johnston | 11/23/11

Last week I examined income inequality trends in the United States over the past 90 years. But here's the big question many Americans are pondering these days: *Why* has income inequality been growing so fast lately?

A number of explanations have been offered; let's scrutinize them:

It's all an illusion

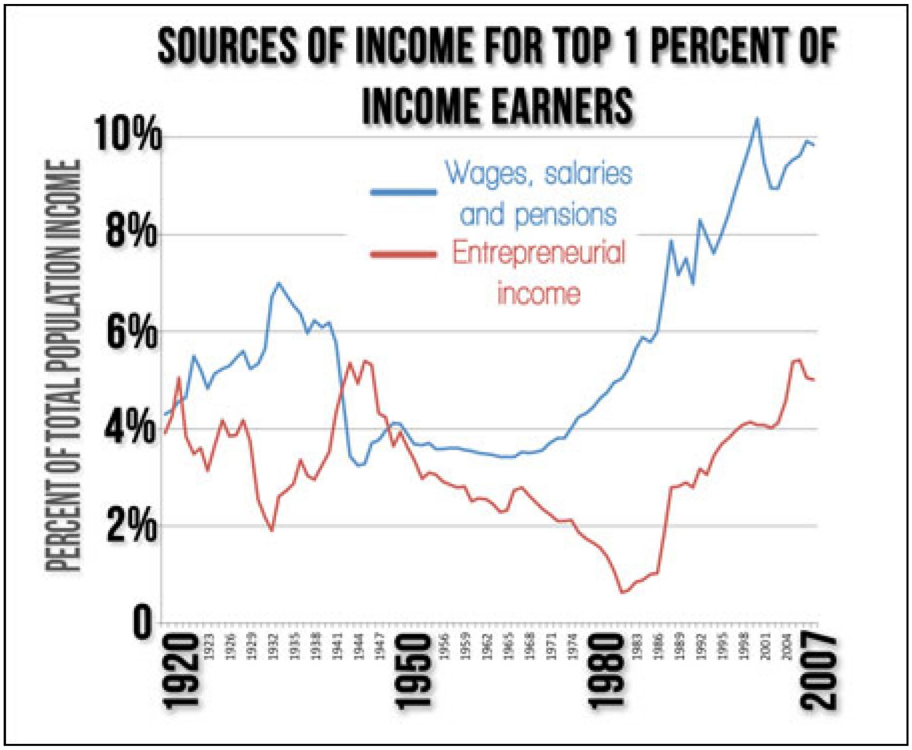
This idea first appeared in the early 1990s, and still reappears from time to time. The basic notion is this: The apparent increase in inequality is actually the result of changes in how income is reported on tax returns. In other words, there is no real increase in inequality, just a relabeling of income that makes it appear that way.

For instance, many small companies today are organized as S-corps, allowing their owners to report their income on their personal income tax form. This benefits them because they pay a lower tax rate than if they had organized as a C-corps, a standard stand-alone corporation that must file a separate tax return.

This change and others was the result of federal tax reforms enacted in 1986. These reforms caused an increase in reported incomes among the top income earners, but it was not an actual increase in their incomes.

Emanuel Saez of the University of California, Berkeley, and Thomas Piketty of the Paris School of Economics, whose data I discussed in last week's article, examine this possibility and reject it. The chart below shows the share of income received by the top 1 percent of income earners by source of income.

The line labeled "entrepreneurial income" measures income received via S-corps and similar tax



Source: Ivaredo Facundo, Anthony B. Atkinson, Thomas Piketty and Emmanuel Saez, "The World Top Incomes Database"

The column on the left shows the percent of all income that the top 1 percent of income earners received as wages and as entrepreneurial income.

vehicles. This clearly jumped after the 1986 tax reforms. However, the line for "wage, salaries, and pensions" rose even more steeply, with wages and the like for the top 1 percent increasing from less than 4 percent of total income to roughly 10 percent of total income. So even without the effects of altered corporate-income reporting, income inequality rose sharply.

It's all Reagan and Bush's fault

Another possibility is that tax policies favoring upper-income earners increased income inequality. That is, the tax cuts of the early 1980s and early 2000s disproportionately benefited the rich, increasing their share of total income.

The data do not support this hypothesis. The Congressional Budget Office (CBO) computes lifetime effective tax rates — the share of income people pay in taxes over the course of their life — by income levels. (The report is available here.) CBO's analysis confirms that effective taxes decreased for upper-income people, but they fell for those with lower incomes as well. So tax policy was probably a wash in terms of income inequality.

It's globalization

The share of trade in U.S. output, measured as exports plus imports, rose from less than 10 percent to over 30 percent between 1960 and 2010. The share grew especially starting in the late 1970s. Did this cause increased income inequality?

The data are mixed. In 1994, economists Paul Krugman and Robert Z. Lawrence analyzed the data and found that trade, in general, and outsourcing, in particular, probably increased wages a bit at the upper end of the income distribution and decreased wages a bit at the lower end. However, the effect was small relative to the rise in inequality up to that point.

Since 1994, economists have argued about this and reached no consensus. Some analysts, such as Krugman himself, say trends changed starting in the late 1990s and that globalization depressed wages for manufacturing workers and others engaged in sectors that had a lot of exposure to trade. Others have examined the same data and found little evidence to support this argument.

It's about technology and economic growth

Claudia Goldin and Lawrence Katz, professors of economics at Harvard, provide the best analysis of increasing income inequality in their book "The Race Between Education and Technology."

As they explained in an article in the Milken Institute Review: "The title of our book on this subject was taken from a remark by Jan Tinbergen, the first Nobel laureate in economics. Inequality, he said, is the outcome of a race between education and technology. When technological advance vaults ahead of educational change, inequality generally rises. By the same token, when increases in educational attainment speed up, economic inequality often declines."

Goldin and Katz document how, between the 1920s and the 1970s, America "went to high school" and saw the nation's average educational achievement rise from middling to the highest in the world. This made it possible for U.S. workers and companies to adopt and utilize the latest and greatest technologies developed anywhere in the world, providing the foundation for paying the highest average wages in the world. As a bonus, rising educational attainment created a larger pool of potential innovators; their innovations drove rapid productivity growth, further increasing average incomes.

Goldin and Katz point out that income inequality began rising when educational attainment stopped rising in the 1970s, and has continued to increase as the rate of technological change has outstripped our ability to adapt and use it.

Institutional change and income inequality

One ingredient is missing from all of these explanations: the interaction between markets and their institutional environment.

For example, businesses can pay out productivity increases through higher wages and benefits, keep the fruits of innovation as profits or do some combination of both. Firms tended to do the former before 1980 and the latter after 1980. Why?

Peter Temin and Frank Levy, economics professors at MIT, provide an answer in their paper "Inequality and Institutions in 20th Century America." They write that rising income inequality derives in part from "the shift from one complex of policies to another — from the Treaty of Detroit to the Washington Consensus."

The Treaty of Detroit refers to a set of policies that prevailed from the end of World War II to the late 1970s. Under this arrangement, Temin and Levy write, "even in peacetime, business-labor relations would remain a tri-partite process" with government actively involved "as the third man in the ring." Labor-management relations were conducted with government playing the neutral party acting to curb the excesses of each side. The result was both healthy profits and rising incomes across the board.

This framework collapsed in the late 1970s. Specifically, "the firing of the air traffic controllers, the 1978 defeat of labor law reform and the lowering of tax rates were signals that the third man — government — was leaving the ring," the economics professors argue. "From that point on, business and labor would fight over rewards in less regulated markets with many workers in an increasingly weak position." In a nod to a similar set of policies that governed international trade, Temin and Levy call this new situation the Washington Consensus.

Why did the Treaty of Detroit collapse? There are myriad reasons, but one in particular is critical: Average labor productivity grew much more slowly starting in 1973. This meant that the pie from which wages and profits were cut did not grow as rapidly after 1973 as before, so arguments over how to slice pieces became increasingly heated. Unfortunately, economists are still not sure why productivity growth slowed, and even more frustrating, why it began growing more rapidly again after 1995.

Inequality and public policy

The rise in income inequality is real. Changes in educational attainment and social and political institutions contributed the most to the more polarized income distribution.

One important question remains: Will policies that involve more government spending and transfers in an effort to reduce inequality hurt economic growth? We'll address it next week.