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Why do we have so much income inequality?

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By Louis D. Johnston | 11/16/11

"We are the 99 percent!"

With that chant, the Occupy Wall Street movement thrust U.S. income distribution into public policy debate. It had already entered Minnesota politics in 2010 and 2011 when Mark Dayton proposed that taxes on upper-income taxpayers should increase.

Economists began addressing these issues more than 300 years ago when William Petty created estimates of English national income and its distribution. Let's take a look at what we've learned since then. It may surprise you.

U.S. income distribution

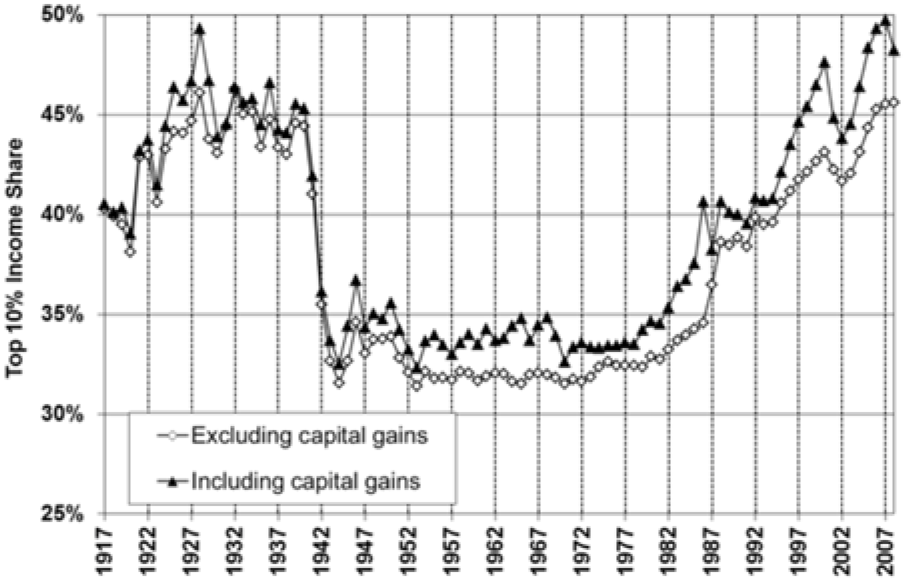
Emanuel Saez of the University of California, Berkeley, and Thomas Piketty of the Paris School of Economics spent much of the past 20 years gathering and synthesizing data on the income distributions in industrialized countries. (You can see their work at the World Top Incomes Database.) Drawing on information from U.S. income tax returns, Saez and Piketty go back to 1913 to show how the distribution of income changed over the past century.

The chart below traces the income accruing to the top 10 percent of income earners since 1917.

The income share of the top 10 percent fell in the late 1930s and early 1940s, and stayed at that lower level until the late 1970s, when it started to rise and reached the same levels as the 1920s.

It turns out that most of this story is driven by changes in the top 1 percent's share, as shown in the next graphic.

Income share of top 1 percent, 1913-2008



Source: Saez and Piketty, "Income Inequality in the United States, 1913-1998" in Quarterly Journal of Economics

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Between 1940 and 1980, the top 1 percent of households received roughly 10 percent of national income. The share they collected in the late 2000s doubled to about 20 percent.

Minnesota experienced similar, though less exaggerated, trends. In its report "Income Distribution Trends in Minnesota," the Minnesota State Demographic Center says: "In Minnesota, the results are more equivocal. From 1990 to 2000, growth at both the top and bottom of the income range was considerable and was higher than the growth for the middle levels of income." Changes in the income distribution over the 2000s were also more muted in Minnesota.

Income inequality and economic growth

One response to these data, to the governor and to the Occupy Wall Street protestors is that there is a trade-off between greater income equality and economic growth. Alan Viard, a scholar at the American Enterprise Institute, recently expressed this view when he wrote that increasing taxes on high-income households "poses significant economic disadvantages, as they provide a large share of the nation's savings, which finance the investments that drive long-term growth." More bluntly, he implies that economic growth is driven by the savings of the wealthy and that taxing them at higher rates will slow the economy. Thus, high levels of income inequality are the price we must pay for economic growth.

Research does not support this. Economists, in general, and economic historians, in particular, have shown that economic growth is primarily driven by productivity improvements, not by higher saving rates. Saving and capital accumulation are important sources of growth, but they are dwarfed by our ability to use our resources more efficiently and in new ways — in other words, by productivity.

Further, there is no evidence of a trade-off between economic growth and income inequality. Jeffrey G. Williamson, emeritus professor of economics at Harvard, has analyzed economic growth and inequality in Europe, North America, Latin America and Asia for the past 250 years. In his book "Inequality, Poverty, and History," Williamson writes that the supposed growth/equity trade-off is "not based on hard evidence or policy experimentation, but rather on theory, allegation, and, it turns out, spurious historical correlation."

Williamson reached two important conclusions. First, income inequality does rise during industrialization. This is primarily due to the fact that productivity in certain sectors of the economy grows more rapidly than in others, leading to faster increases in income in some occupations than in others.

Second, the rise in inequality does not fuel growth. Specifically, Williamson finds that increased inequality does not lead to either higher saving rates or faster capital accumulation. Further, high-income households do not have higher saving rates than lower-income households, so redistributing income from lower to upper income people does not increase investment. Thus, even if saving were an important source of growth, increased income inequality would not promote faster growth.

To put these two results simply: Economic growth causes income inequality, but income inequality does not cause or promote economic growth.

Even more questions

Income inequality rose dramatically in the United States. since 1980. To a lesser extent, this was true for Minnesota as well. But income inequality did not promote more rapid economic growth; rather, the engine of growth has been and continues to be productivity gains.

This leaves us with even more questions. Why did American income inequality fall and then rise over the past 70 years? Will policies that involve more government spending and transfers in an effort to reduce inequality hurt economic growth? We'll tackle these questions next week.