SEARCHING FOR THE SUPPOSED BENEFITS OF HIGHER INEQUALITY

Impacts of Rising Top Shares on the Standard of Living of Low and Middle-Income Families

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While it is common knowledge that the gap between the rich and the poor in the U.S. has been rising over recent decades, there has been little research into the impacts of this trend. In our PERI Working Paper, “Searching for the Supposed Benefits of Higher Inequality,” we examine the impact of rising inequality on the incomes of poor and middle-income families. We find that greater concentration of income in the hands of the affluent causes incomes at the middle and lower levels to fall. As the rich get richer, the poor (and the middle class) get poorer.

Commonly “too much” inequality or rising levels of inequality are considered unfair because they violate widely shared values over the distribution of wealth and appropriate rewards for hard work. Others, however, suggest that increased inequality is good for society, as it spurs on entrepreneurs and investors, leading to economic growth, which will generate benefits for everyone—the core of “trickle-down” economic policy. We examine the substantial literature on the impacts of inequality on economic growth, and find that researchers have failed to achieve any sort of consensus. Various studies find positive impacts, negative impacts, and no impacts on growth from increased levels of income inequality.

We ask instead whether or not greater inequality raises the standard of living of non-affluent households. Using state data on income levels and the distribution of income, we examine the impacts of increases in the share of income going to the top 10% and top 1% of the income distribution since the late 1970s on the incomes of middle and low-income households. We find that the income of low and middle-income households falls as the disparity in incomes rises. These findings are consistent even with research showing higher inequality leads to greater overall economic growth.

For references, notes, and data tables, please see the full study.

The views expressed in this paper are those of the authors and should not be interpreted as those of the Congressional Budget Office or the University of Massachusetts.

Figure source: Piketty and Saez (2010) analysis of IRS data.
FINDINGS

Our findings show that rising inequality leads to falling incomes for low and middle-income families. For low-income families the effect is immediate, large and statistically significant. The impacts at the middle of the income distribution are smaller, but remain significant when lagged impacts of inequality are included.

Even without introducing a time-lag, our findings clearly show that when we control for cyclical and external variables, inequality has a negative impact on the incomes of the non-affluent. With the time lag this relationship becomes even stronger. A 15 year lag, for example, suggests that a 10 percent increase in inequality from 15 years ago leads to a 1.6 percent decline in current income level for middle-income families.

The same basic findings hold when we look at earning instead of income, low-income groups instead of middle-income, and when we look at changes in the top 10% share of income instead of top 1%. The findings also remain strong when we vary our definition of low and middle-income.

WHY DOES INEQUALITY LOWER INCOMES?

There are a number of ways that increasing concentrations of income and wealth could lead to lower income and earnings among non-affluent households. For example, if the rich spend a larger portion of their income on luxury items, imports, travel, or in other ways that do little to boost domestic demand, then concentrating more income in fewer hands could undermine local and regional economies. And when affluent households invest in stocks, bonds, and privately-held corporations in other states or countries, there is no obvious way that the savings of the rich boost a particular state or local economy. Ultimately, the basic economic behavior of the rich could be steadily undermining the economic conditions that supported rising incomes for low and middle-income households for so many decades.

Another driver behind this trend is what Robert Reich called the “secession of the successful”—the rise in affluent families who live in gated communities, send their children to private schools, and increasingly oppose paying for public services. This segregation undermines the tax base in lower-income communities making it harder to afford schools and other public services.

When communities become less safe and less able to educate their children, then the lower and middle-income families in those communities can expect their economic prospects, including their earnings and their incomes, to diminish.

It is also possible that the changes in income among non-affluent households are not caused directly by rising inequality, but are instead lagged effects of the same factors that caused the rising inequality in the first place. In 1979, labor unions represented 27 percent of American workers, but that share declined to 13 percent by 2010. And despite a number of increases in recent decades, by 2010 the federal minimum wage had just 74 of the purchasing power compared to 1969. The decline of these institutions, along with rising globalization, could also be contributing to the decrease in earnings and incomes.

Another plausible explanation for growing inequality that could also account for falling earnings and incomes among the non-affluent is “skill-biased technological change (SBTC).” A number of studies have found evidence that changes in technology have driven up the earnings of skilled workers and left the relatively unskilled to face decreased demand and falling wages. Similarly, the “superstar” story suggests that a handful of talented or well-placed individuals have been able to capture increasingly large shares of revenue in various fields (singers, actors, authors, and athletes, for example) because of the “audience magnification” produced by advances in communications technology. Indeed, several recent papers have argued that superstars, as well as lawyers and CEOs, account for a large portion of rising inequality in recent years. Strong arguments both in support of and in opposition of the SBTC and “superstar” theories can be made.

THEORIES OF INEQUALITY AND GROWTH

A substantial literature on the impacts of inequality on economic growth has evolved over the last 15 years. The question has been addressed from a range of theoretical perspectives. Neoclassical economic theory
assumes that some level of inequality is required to provide incentives for labor, leading to a trade-off between equity and growth. In addition, it suggests that inequality creates incentives for the more productive use of resources; and is associated with innovation, risk-taking, and entrepreneurship.

Standard Keynesian theory suggests that high-income households save more, and that redistribution from the rich to the poor will reduce savings and investment, and by extension, growth. At the same time, however, high inequality is thought to limit domestic demand, reducing the potential for industrialization and growth. To the extent that the rich spend substantial sums on luxury goods or invest in unproductive activities, this theory argues that redistribution from rich to poor will tend to increase growth.

In part because of the theoretically ambiguous relationship between inequality and growth, as well as the political implications of the relationship, an ever expanding empirical literature on the question has arisen. But so far, these analyses have failed to achieve consensus on either the direction or the magnitude of the impacts of inequality on growth.

The United States presents a unique opportunity for an in-depth empirical study of a single country, since it has some of the world’s most reliable inequality data available over a long contiguous time period – most of the 20th century. Combining the number of states, the length of time for which data are now available, and the number of available economic variables, state level analysis provides a very high number of observations compared to cross-country studies, and this increases the accuracy of estimates. Nonetheless, as in the cross-country literature, the studies of inequality and growth in the United States do not reach a consensus on the link between inequality and growth.

Even among the most rigorous of the studies examining inequality and growth, any small positive impact of rising inequality on economic growth is not sufficiently large to make up for the lost income at the bottom due to the shift in the distribution. Using one of these studies as a baseline, we ask: how long it would take a boost in economic growth to produce income increases for the non-affluent that are large enough to make up for the losses to from the shift in the distribution? We find that under no scenario will current workers recoup their income losses during their lifetimes. Using a 3\% discount rate, we find that overall economic growth does not compensate for income losses from distribution shifts for 165 years. Using a more modest 5\% discount rate, that point never arrives at all.

EMPIRICAL STUDIES OF INEQUALITY AND GROWTH

Numerous cross-country studies have been conducted in an attempt to determine empirically the effect of inequality on growth. Some of these studies find that higher inequality depresses overall economic growth; others show it encourages growth, still others find no relationship at all. Even examination of the same data set rarely leads to the same conclusions about the relationship between inequality and growth. Many of the studies that find inequality generates growth find only a weak effect. That effect is not strong enough to compensate for the shift of income from the non-rich to the rich. In other words, the pie may be growing, but not nearly fast enough to make up for the fact that a few people are hogging more and more of the slices.

The study uses data for the fifty states from the late 1970s until the late 2000s. The analysis explores whether states with above average increases in inequality also experience above average increases in family incomes, and controls for a host of relevant economic factors often omitted in other studies of inequality. The panel data also allow us to examine possible lags in the relationship between income inequality and the standard of living of non-affluent houses.

DATA AND METHODOLOGY

The ambiguous findings on the impact of inequality on the well-being of non-affluent households through the mechanism of economic growth underscore the need for a more direct examination of this relationship. Instead of simulating the implied income levels using findings from the growth literature, we looked at the relationship between inequality and average income levels for middle and low-income families.

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A complete description of the modeling approach is described in the full study. We controlled for time and state-varying economic factors which are expected to be correlated with both income and distribution, including average hours worked, the unemployment rate, the rate of employment growth, the share 20-24 year old share of the total population, the black share of the population, the median house price, and the total state population. We examined the relationship with no time lag, and with lags of 1, 5, 10 and 15 years.

To download the full study, *Searching for the Supposed Benefits of Higher Inequality*, please go to the PERI website at www.peri.umass.edu.

**About the authors**

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