The Great Divide: America’s Inequality, Its Causes and Consequences

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Enormous growth in inequality

• Especially in US, and countries that have followed US model

• Multiple dimensions of inequality
  • More money at the top
  • More people in poverty
  • Evisceration of the middle
  • Inequalities in wealth exceed those in income
  • Inequality in health—especially large in US
  • Inequality in access to justice
Share of Income Earned by Top 1 Percent, 1975–2014

Note: Data for all countries exclude capital gains.
Stagnation: U.S. median household income (constant 2014 US$)

Source: U.S. Census Bureau
Decline in median income of full-time male worker

Real Median Income of Full-Time Male Worker, 1965-2014
U.S. minimum wage, 1938-2012

Most invidious aspect: inequality in opportunity

- Not a surprise: systematic relationship between inequality in incomes (outcomes) and inequality of opportunity
Income inequality and earnings mobility

Source: “United States, Tackling High Inequalities Creating Opportunities for All”, June 2014, OECD.
Global inequality

- Almost all OECD countries have seen increased inequality in last 30 years
- The trend around the world is somewhat mixed, but remains a concern almost everywhere
Gini changes in OECD

Global inequality: Ginis worse in many countries, late 2000s vs. 1980s

<table>
<thead>
<tr>
<th></th>
<th>1985-90</th>
<th>After 2008</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Gini</td>
<td>36.3</td>
<td>38.8</td>
<td>+2.5</td>
</tr>
<tr>
<td>Pop-weighted Gini</td>
<td>33.9</td>
<td>37.3</td>
<td>+3.4</td>
</tr>
<tr>
<td>GDP-weighted Gini</td>
<td>32.2</td>
<td>36.4</td>
<td>+4.2</td>
</tr>
<tr>
<td>Countries with higher Ginis</td>
<td>32.0</td>
<td>36.2</td>
<td>+4.5</td>
</tr>
<tr>
<td>Countries with lower Ginis</td>
<td>42.8</td>
<td>39.5</td>
<td>-3.3</td>
</tr>
</tbody>
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Global inequality: income growth by percentile, 1988-2008

Global inequality: income growth by percentile

• What previous chart means is that, globally:
  • Very rich—those at far right of graph—have seen their incomes grow at a high rate
  • Developing Asian middle class (especially China) has also grown at a fast rate. This is represented by those in middle-left of the graph.
  • The incomes of the world’s very poor—those on the far left of the chart—have not kept pace.
  • Advanced country middle class incomes—those around the 80th percentile—have stagnated completely

• (This is the analysis that Branko Milanovic has put forward)
Major changes in understandings of inequality

- Trickle down economics doesn’t work
  - There never was good theory or empirical evidence in support
  - In a way, Obama administration and Fed tried it again: bail-out to banks was supposed to benefit all; QE would work by increasing stock market prices, benefitting mostly those at top

- “Repeal” of Kuznets law
  - Was period after WWII, the “golden age of capitalism,” an aberration, the result of the social cohesion brought on by the war?
    - With the economy now returning to the natural state of capitalism?
  - Or is the increase in inequality after 1980 a result of a change in policies?
Major changes in understandings of inequality

- Large differences in outcomes/opportunities among advanced countries
  - Suggesting that it is policies, not inexorable economic forces that are at play
  - Inequality is a choice
  - A result of how we structure the economy through tax and expenditure policies, through our legal framework, our institutions, even the conduct of monetary policy
    - All of these affect market power, bargaining power of different groups
    - Even access to jobs and able to participate in labor market
    - Resulting in different distributions of income and wealth before taxes and transfers
• Beginning about a third of a century ago, we began a process of rewriting the rules

  • Lowering taxes and deregulation was supposed to increase growth and make everyone better off

  • In fact, only the very top was better off—incomes of the rest stagnated, performance of the economy as a whole slowed
Major changes in understandings of inequality

- “Repeal” of Okun’s Law
  - Economies with less inequality and less inequality of opportunity perform better
  - Equality and economic performance are complements
- Many reasons for this
  - Lack of opportunity means that we are wasting most valuable resource
  - Macro-economic
    - Instability: Link between inequality and frequency of crises has been shown by IMF as well as others.
    - Weaker growth
      - Richest consume a smaller proportion of their incomes than the poor or middle
      - Greater equality would strengthen aggregate demand
      - Small and medium-sized businesses, buoyed by strong middle class, are drivers of economic growth
• Weaker growth (cont’d)
  • Political economy
    • Harder for divided society to make needed public investments in infrastructure, technology, education, etc.
    • As democratic processes are skewed (e.g. in U.S.), policies that protect interests and rents of wealthiest replace those that support broad-based growth

• Erosion of trust
Major changes in understandings of inequality

- We can afford to have more equality
  - In fact, it would help our economy
  - Some much poorer economies have chosen more equalitarian policies

- Because inequality is the result of policies, it is shaped by politics
  - Economic inequality gets translated into political inequality
  - Political inequality leads to economic inequality
  - Vicious circle
Broader consequences

- Undermining democracy
- Dividing society
- Especially when inequalities are on racial and ethnic lines
- Resulting in basic necessities of a middle class society being increasingly out of reach of large proportion of population
- Retirement security, education of one’s children, ability to own a home
Critique of Piketty’s interpretation

Piketty: Because \( r \) (the return on capital) exceeds the growth rate \( (g) \), capitalists wealth and income will increase relative to national income

- But what matters is \( s \cdot r \), and in standard models, \( s \cdot r < g \)
- Return on capital is endogenous
  - Models need to have macro-/micro- consistency
  - If \( W \) were \( K \) (wealth and \( K \) were same), then law of diminishing returns would imply \( r \) would fall
  - And wages would rise
- Can’t explain large differences between growth in average wages and productivity
  - Even if technical change is skill-biased
Disconnect between productivity and a typical worker’s compensation, 1948–2014

Note: Data are for average hourly compensation of production/nonsupervisory workers in the private sector and net productivity of the total economy. "Net productivity" is the growth of output of goods and services minus depreciation per hour worked.

Source: EPI analysis of data from the BEA and BLS (see technical appendix for more detailed information)
Explaining stylized facts

• Can only explain $\frac{1}{2}$ to $\frac{3}{4}$ of growth in wealth income ratio by national savings

• Wealth “residual” explained best by growth of rents
  • Land rents
  • Exploitation rents (monopoly power, political power)
  • Intellectual property rents

• Wealth can go up even if “K” is going down
  • And many increases in wealth associated with rents lead to decreased productivity
Explaining growth of land rents

• Urbanization

• Positional goods

• Bubbles
  • On bubble paths, wealth may go up, even as K decreases

• Monetary and financial policies affect value of land
  • Rules governing collateralization
• In modern economy, key distinction is not so much between debtors and creditors, but between life cycle savers and inherited wealth
  
  • Differences in portfolio composition
  
  • QE has benefits inherited wealth at expense of life cycle savers, contributing to inequality
Further question: distribution of wealth among individuals (e.g. of inherited wealth)

- Balance between centrifugal and centripetal forces
  - Policies and other economic changes have changed that balance
  - Leading to an equilibrium with more inequality
Consequences of inequality for the global economy

- Growth in 2015 weakest since Global Financial Crisis and one of poorest performances in recent decades
- Underlying problem: lack of global aggregate demand
- One of reasons: high level of inequality
- Inequality also affects aggregate demand indirectly
- Increases instability
- Realization of this creates uncertainty
- Uncertainty leads to lower investment
Concluding comments

• Addressing inequality is a vital step in bringing global economy back to health

• Incremental changes will not suffice
  • There is a comprehensive agenda which will significantly reduce inequality and increase equality of opportunity

• Urgency—decisions today will affect inequality decades later
  • Key is rewriting the rules once again

• Real question is not economics: it is politics