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Economic Inequality in North America: Who Should Be Paying Attention?

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Abstract: Recent awareness of how economic inequality has increased in the US and Canada, combined with the jobless recovery, poses challenges to business opportunities that have not existed since the decade of the 1930's. These challenges are unlikely to disappear in the short run with the application of existing macroeconomic policy measures. While some inequality is integral for incentives and effectiveness of markets, too much of it can be destructive to growth. The financial crisis of 2008 confronts business with the question: should it merely wait for matters to improve or consider contributing to dealing with it—possibly by exploring new approaches to doing business. This paper will focus on the causes of growing inequality, and discuss to what degree policy responses have been successful. The paper looks at macroeconomic trends and policies leading up to the crisis of 2008. It will show that tax and monetary policies implemented by US governments during much of the 2000's mostly exacerbated the inequality issue. The controversial bailouts of big financial institutions and the lack of economic opportunities for those in the lower income brackets compounded the problem. The paper finally raises discussion points about the implications of a depressed consumer demand for business, structural change in the US economy, what governments can do to alleviate inequality and if there is room for partnerships between business and government.

Key words: distributive; inequality; social welfare

JEL code: D630

1. Introduction

Rising inequality—both income inequality and opportunity inequality—is a growing reality internationally; not only in the USA, the UK and Canada but also in Russia and China.

Nonetheless inequality does not get investigated, analyzed or discussed in any way comparable to poverty and unemployment. The consensus has long been that a growing economy raises all boats, and that redistribution reduces the incentive to generate wealth. However, a recent special report by *The Economist* presents growing inequality as one of the biggest social, economic and political challenges of our time (Oct. 13, 2012). This echoed the seventh edition of the World Economic Forum's *Global Risks Report* (2012). Concern is raised that today's economic and social inequality may reverse the gains of globalization and hamper economic progress.

This paper investigates two of the points made by *The Economist* magazine: First, "although the modern global economy is leading to wider gaps between the more and the less educated, a big driver of today's income distributions is government policy." Second, a lot of today's inequality is inefficient reflecting market and

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government failures that reduce growth and future prosperity (*The Economist*, Oct 13, 2012, p. 6).

In order to limit the scope, the focus of this paper will be the inequality situation in the USA-the largest, most influential economy in the world and where the Occupy Wall Street movement began. Analysis and discussion will also focus on the distribution of income and economic opportunities rather than wealth, despite even greater inequality in wealth distribution. The question that arises from current concern about income inequality in the USA is whether it now needs more serious attention. Are there urgent enough reasons to attempt steps to mitigate the inequality or will it dissipate of its own accord if the dynamics of markets are left to deal with it?

2. Does Inequality Matter?

A certain level of inequality has always been assumed to be both necessary and beneficial for growth in market economies, because it encourages risk taking and compensates entrepreneurs for innovations. The question now is if we have crossed the threshold where the cost of economic inequality is more than the benefit?

The relationship between economic growth and income inequality is uncertain. Analysis by Berg & Ostry suggests that "inequality can bring significant longer-run benefits for growth" (2011, p. 3)—the rising tide lifts all boats analogy. Evidence on whether economic growth can in turn lead to a more equitable distribution of income over the long run is not conclusive. A UK roundtable (De Lontelo, 2011) concluded that economic growth on its own is insufficient for reducing inequalities. Furthermore, high levels of inequalities can impede economic growth by reducing productivity, lengthening the period before recovery of growth resumes after downturns, inhibiting the evolution of economic and political institutions of accountability and undermining civic and social life that sustains effective collective decision-making.

In a recent and influential book Wilkinson and Pickett (2009) show that inequality has far-reaching negative effects. Using data for 23 countries, the authors regressed health and social indicators with levels of income inequality and found that more negative values on health and social indicators are consistently correlated with higher income inequality. Their findings indicate that the cost of inequality is the deterioration of social relations and mental health, weaker educational performance, higher levels of violence, imprisonment and generally more dysfunctional societies.

The Wilkinson and Pickett (2009) study was met with substantial criticism ranging from data quality, selective choice of health and social problems and the exclusion of certain countries. The authors responded to the criticism in detail, maintaining that they used official data from reputable sources such as UNICEF, often used more than one source of data and acknowledging that not all the social problems included in the study supported their hypothesis.

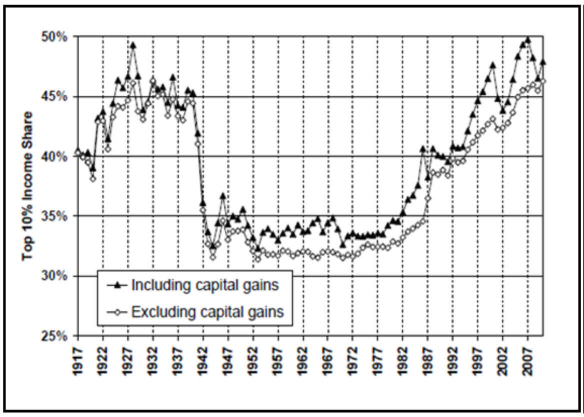
Various obvious economic reasons exist for paying attention to the distribution of rewards in a free society. Stiglitz (2011) proposes that growing inequality is the flip side of shrinking opportunity. Diminished opportunity leads to labour market inefficiency because human capital is not used in the most productive way. In addition, many of the distortions that lead to inequality undermine efficiency by diverting resources away from the real economy. Most important, according to Stiglitz, is the lack of public investment in infrastructure, education and technology that follows today's declining public revenue.

3. What the Data Shows

There is no consensus among researchers regarding data or methods appropriate to evaluate whether inequality has grown. In an extensive review article about distribution over the long run Atkinson, Piketty and Saez showed that the pattern and trends of inequality in the USA exhibit the same characteristics that can be found in many countries (JEL, 2011). Their key empirical findings are that in the more than twenty countries studied, almost all experienced a dramatic drop in top income shares in the first part of the twentieth century, mostly due to the two world wars and the inter-war depression. Top income shares did not recover in the immediate decades following the end of WWII. However, over the last thirty years, top income shares have increased substantially in English speaking countries as well as in India and China.

Investigation by Piketty and Saez (2012) shows that in the US, the top decile income share increased from less than 35% during the 1970s to about 50% in the last decade. This increase is in large part due to an unprecedented surge in top wage and other incomes. More than 15% of US national income shifted from the bottom 90% to the top 10% over the past 30 years.

Figure 1 clearly shows a broadly U-shaped trend in the share of income going to the rich in the US over the course of the last 100 years, with a fairly drastic acceleration since the middle of the 1970’s. In 1979 members of the top one per cent got 9% of total income while in 2009 they got 20%. In effect, real income of the top 1% in the USA grew 7 times faster than the real income of the bottom 99% between 1976 and 2007. These findings are corroborated by the research of Bakija, Cole and Heim (2010).



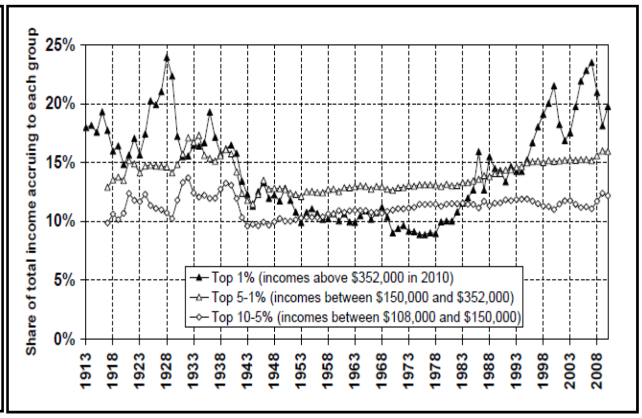


Figure 1 US top decile income share 1917-2010 **Figure 2 US top 15% income share 1913-2010**

Source: Piketty and Saez (2003), series updated to 2010. (Income is defined as market income including capital gains but excludes all government transfers).

When the trend for the top 10% is broken up into smaller subgroups, the topmost 1% experienced the most dramatic growth. In effect, the *top 1% alone* absorbed almost 60% of aggregate US income growth between 1976 and 2007 (Piketty & Saez, 2012). On the other hand, the average hourly earnings of the average production worker effectively stagnated from 1979 to 2008, and compared to 1972 earnings have actually decreased (Bureau of Labour Statistics, 2010).

One of the most talked about aspects of the changing US income distribution pattern is the stagnation of income in the US middle class. Data shows median inflation-adjusted family income peaked in 2000 at $64,232, and it has fallen by roughly 6 percent since then (David Leonhart, NY Times Online, July 23, 2012).

The conclusions of Saez and Pikketty are not universally shared. Burkhauser, Larrimore, and Simon (2012) suggest that when focusing on households rather than tax units, different results emerge regarding growth in middle class incomes. They argue that households may be more appropriate units because family structure has changed and the rise of cohabitation means that adults sharing a household might be in fact separate tax units. With different assumptions about household sharing units, Burkhauser, Larrimore, and Simon suggest that middle incomes have grown more than the tax data would suggest. They argue that in effect, modest improvement in post-tax-and-transfer disposable income occurred for middle-income groups over the period from 1979 to 2007. However, this debate continues.

4. Reasons for Growing Inequality

It is not straightforward to identify the reasons for the growing trend of inequality in the US. A measure of agreement exists about the contributions of the following:

(1) The government's tax policies—moving away from using the tax system to lessen income differentials.

(2) Shifts in the labour market that

(a) Diminished the availability of less-skilled blue collar jobs,

(b) Created a growing demand for higher skilled information, health and financial management services, and

(c) Originate from changes in technology and globalization.

(3) The events that led to the collapse of the housing market and the bailout of large financial institutions.

The first reason for the growing inequality is the US government's tax policy. The proponents of supply-side thinking suggest that tax breaks for the wealthy will lead to economic growth, and everyone will be better off as growth creates wealth that "trickles down" to all strata of society. The Bush-era tax cuts of the 2000's provide a test to these claims.

Hungerford (2012) shows that throughout the late-1940s and 1950s, the top marginal tax rate was typically above 90%; while today it is 35%. Additionally, the top capital gains tax rate was 25% in the 1950s and 1960s, 35% in the 1970s; today it is 15%. Piketty and Saez (2007) findings about the trend in federal taxes over the last 50 years support Hungerford's study. Individual income taxes declined sharply from 2000 to 2004 following the tax cuts of the Bush administration, falling from 10.3 percent of GDP in 2000 to 7.0 percent of GDP in 2004. The corporate income tax has also shrunk dramatically: it was typically 3.5-4.0 percent of GDP in the 1960s, but had fallen to 1.6 percent of GDP by 2004. The same is true for the estate tax; it collected about 0.6 percent of GDP in the 1960s but declined to 0.25 percent of GDP in 2004.

The most telling finding regarding the effect of US taxes on income distribution that emerges from the data is that the progressivity of the U.S. federal tax system at the top of the income distribution has declined dramatically since the 1960s. For example, the top 0.01 percent of earners paid over 70 percent of their income in federal taxes in 1960, while they paid only about 35 percent of their income in 2005. Table 1 shows that in 1960, average taxes collected were fairly flat from the 20th to the 90th percentile, and then rose sharply. By 1980, average taxes collected from the very top income groups, especially within the top percentile, had declined sharply, while average tax rates collected from the 40th to the 95th percentiles had risen. From 1980 to 1990, tax rates at the top declined, while tax rates in the middle class stayed constant. Average federal tax rates for the middle class have remained roughly constant over time.

In addition to promised broadly spread economic benefits, it was argued the large tax cuts would not translate into a deficit, because growth would be so strong that the tax cuts would pay for themselves. Even those who admitted that the tax cuts might not be fully self-financing still made strong claims about faster economic growth offsetting much of the lost revenue. When evaluating if tax cuts lead to real GDP growth, Hungerford (2012) shows that the growth rate of real per capita GDP increased annually by 2.4% in the 1950s, compared to less than 1% in the 2000's, after the Bush tax cuts. Hungerford's report concludes there is no definite evidence to support a clear relationship between the reduction of top marginal tax rates and economic growth.

Not only is the relationship between tax cuts and economic growth not clear, but most of the gains from economic growth in recent decades have gone to the top of the income distribution while the inflation adjusted wages of the working class have been relatively flat. While CEO pay and corporate profits rose impressively over the past 20 years, the pay of production workers only rose by 4% (Anderson S. et al., 2006). In addition, the tax cuts did not pay for themselves, as the US deficit ballooned. While state and local tax revenues and spending have increased, federal revenues have declined to the lowest level in decades. This resulted in annual deficits and increasing long-term debt (NY Times, Nov 29, 2012).

Table 1 Federal Tax Rates by Income Group from 1960 to 2004

	Average federal tax rates (percent)					
Income groups	1960	1970	1980	1990	2000	2004
Full population	21.4	23.3	26.6	25.8	27.4	23.4
P20-40	13.9	18.5	16.3	16.2	13.1	9.4
P40-60	15.9	20.2	21.4	21.0	20.0	16.1
P60-80	16.7	20.7	24.5	24.3	23.9	20.5
P80-90	17.4	20.5	26.7	26.2	26.4	22.7
P90-95	18.7	21.4	27.9	27.9	28.7	24.9
P95-99	23.5	25.6	31.0	28.6	31.1	27.2
P99-99.5	34.0	36.1	37.6	31.5	35.7	31.3
P99.5-99.9	41.4	44.6	43.0	33.0	38.4	33.0
P99.9-99.99	55.3	50.1	51.0	34.3	40.2	34.1
P99.99-100	71.4	74.6	59.3	35.4	40.8	34.7

Note: The table displays the average federal tax rate (including individual, corporate, payroll, and estate) for various groups of the income distribution, for various years. 2004 figures are based on 2004 tax law applied to 2000 incomes adjusted for economic growth; Source: Piketty and Saez, 2007.

The second group of factors flow from changes and shifts in the US labour market in what can be called America's de-industrialization.

The fact that employment in routine occupations has been disappearing is well documented by recent job polarization literature (Acemoglu, 1999; Autor et al., 2006; Goos & Manning, 2007; Autor & Dorn, 2012). This literature finds that occupations focused on routine tasks tend to be middle-waged. Thus, the disappearance of routine occupations in the past 30 years represents a "polarization" of employment because the middle of the wage distribution has been hollowed out. Following each of the 1991, 2001, and 2009 recessions, per capita employment in routine occupations fell and never recovered. This lack of recovery in routine employment accounts for the jobless recoveries experienced in the aggregate. Prior to 1991, routine job losses in recessions were accompanied by strong routine job recoveries (Thoma, 2012).

A recent report by McKinsey (Manyika et al., 2012) also supports these changes in the labour market. It shows that in the United States nearly all net new job creation over the past decade has been in interaction jobs (those involving complex problem solving); nearly five million interaction jobs were created between 2000 and 2009. At the same time more than three million jobs in production (involving the conversion of physical material into finished products) and transaction (those that can be scripted, routinized or automated) disappeared. Many of those interaction jobs were added in “non-tradable” sectors, such as health care, government services, and education that are not exposed to global competition. Going further back, data from the Bureau of Labor Statistics show that between 1962 and 2008, employment in manufacturing jobs decreased by 23%, while employment in construction more than doubled and in financial services more than tripled.

In a study for the Business Council, Michael Mandel offered some salient facts about the long-term job situation in the US economy (Mandel, 2010). He found that the abovementioned job losses from the beginning of the 2008 recession followed a trend that already showed up in the business cycle that began in 2001 and ended in 2007 (see Figure 3 below).

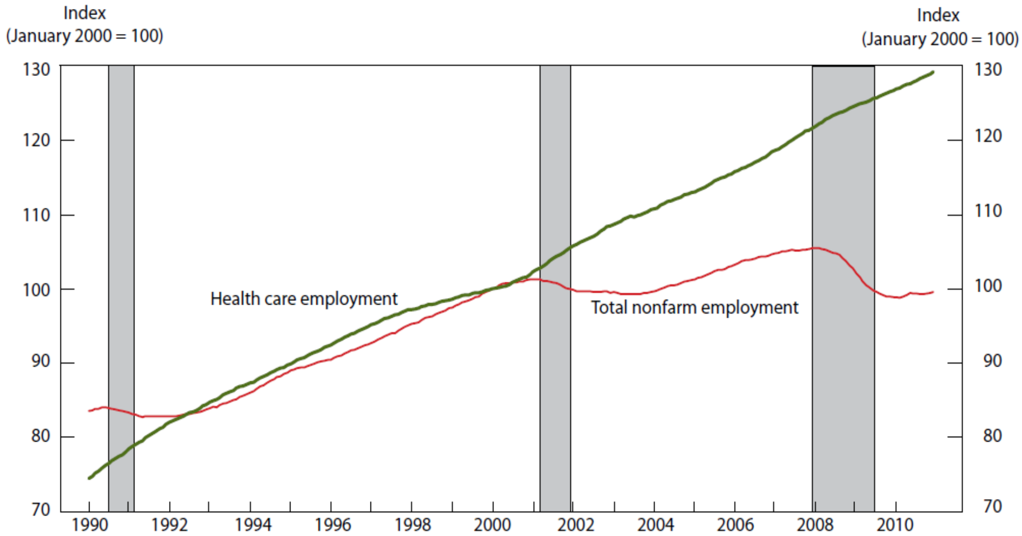


Figure 3 Total Nonfarm and Health Care Indexes of Employment, Seasonally Adjusted, 1990-2010
Note: Shaded areas represent recessions as determined by the National Bureau of Economic Research (NBER).
Source: U.S. Bureau of labor statistics.

In addition, Mandel argues that expectations in recent times about where new jobs would come from in the US did not materialize. When globalization and IT made it possible and profitable to shift the production of manufactured goods to low-wage countries, it was expected that jobs creation would come from designing new, advanced products and pursuing breakthrough innovations that set up entire new industries in the US. While some of the latter did occur, Mandel suggests that a wide range of potential breakthroughs have fallen short since 1998. Examples are in: cancer treatment; cloning; fuel-cell vehicles; gene therapy; miniaturized machines; and tissue engineering. While the Bureau of Labor Statistics projected a net gain of almost 3 million jobs in leading-edge industries over the period 1998-2008, in reality these industries *lost* 68,000 jobs in this period.

The above traits in the current situation bring forward the notion that perhaps we are in the midst of a major technological and economic shift. Globalization allowed companies to take advantage of lower relative costs around the world, aided by low transportation costs and improvements in telecommunication. This process left blue-collar workers particularly vulnerable to the crisis of 2008-2009. Automation and technological improvements further meant fewer factory jobs for low skilled workers. Workers with strong cognitive, communication, and problem-solving abilities that are required for the most sophisticated types of work have experienced low unemployment and rising wages—the opposite of what has been happening to workers at lower skill levels. The result is growing polarization of opportunities in the labour market.

The polarization of the labour market is evident in the fact that, even though the unemployment rate remains stubbornly high, companies around the US find it difficult to fill some vacancies. In 2011, when the US unemployment rate exceeded 9 percent, a McKinsey Global Institute survey of 2,000 US companies found that 30 percent had positions open for more than six months that they could not filled. This suggests growing evidence of a mismatch between the jobs available and the education workers pursue (Manyika, 2011). This same research also projects that the United States may have 1.5 million too few workers with college or graduate degrees—and nearly 6 million more workers lacking a high school diploma than employers will demand. McKinsey's report therefore suggests that major changes in the educational system are needed to provide job-specific skills to students who will not go on to college. The opportunity thus exists to amend non-university post-secondary education to focus community college and trade school programs on the skills needed for specific jobs.

The final factor aggravating inequality is the result of the US financial crisis of 2008-2009. Lending to sub-prime borrowers exploded at the beginning of this century. This expansion of credit was based on the notion that house prices always increase, implying that households were no longer at risk of defaulting on their mortgage loans, as they could always sell the property to repay the debt.

This view had two palpable consequences. On the one hand, the quality of the loans the banks were willing to grant deteriorated as standards for lending diminished. In addition, the accessibility to cheap credit inflated real estate prices, allowing households to borrow against the rising value of their homes. This ability to access credit for consumption from the value of homes fuelled economic growth for the most part of the 2000's, even though incomes had stagnated, and the portion of the US economy represented by wages had declined to an all-time low. A recent study by McKinsey (2012) calculates that American consumers extracted $2.2 trillion in home equity cash refinancing and home equity loans between 2003 and 2007. Assuming that 20 percent of this money went directly to consumption, it is calculated that US consumption growth would have been around 2 percent per year, rather than the 3 percent that was recorded, without the extra available cash. Once the housing market bubble collapsed, households were unable to tap their homes for resources, and started the painful deleveraging process that is currently taking place.

Since the first quarter of 2006, the much discussed implosion in the housing market has meant that U.S. households lost over $7 trillion in home equity. In the four prior recessions of the last 40 years, the effect on home equity was comparatively minor; indeed in some recessions home equity even continued to increase (Ellen & Dastrup, 2012).

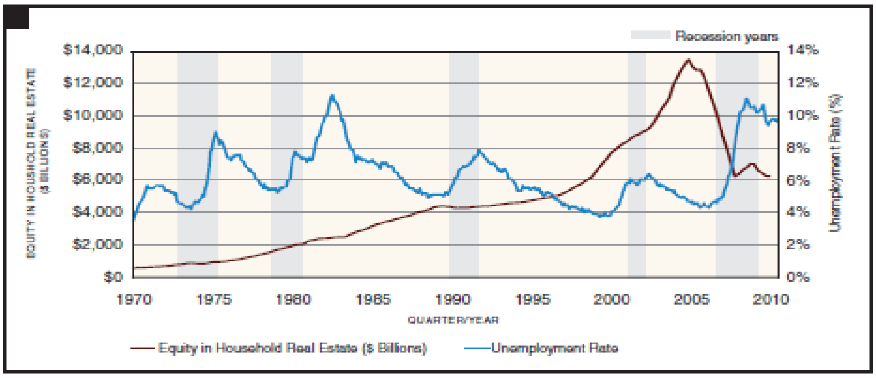


Figure 4 Unprecedented Home Equity Declines and Sharp Unemployment Increases in the Late 2000's

Source: Board of governors of the federal reserve systerm; Bureau of labor statistics.

With the burst of the financial bubble, the US economy found it had nothing to fall back on. De-industrialization had left the US vulnerable to a shock in the construction and real estate markets, as well as the banks vulnerable to a fall in house prices. As home prices began to collapse, financial institutions found themselves at the brink of bankruptcy as the market for asset-backed securities froze. The government in the US decided to bail out the financial industry in an attempt to avoid a 1930's-style meltdown. This left households and governments in an unsustainable position: overburdened with debt and with a rising jobless rate. This aggravated the inequality issue, as rich bankers that had imperiled the economy were handed billions of dollars whilst the rest of America suffered the direct impact of growing joblessness. The situation of households was also aggravated by the fact that they had borrowed against the sinking value of their homes. In fact, total credit market debt owned by households almost doubled between 2000 and 2008, reaching the staggering amount of 14 trillion dollars.

The question was then, how to re-start the growth engine of the economy? Households had high levels of debt, which made it impossible for them to consume more. The high levels of debt, also forced households to begin deleveraging, which hurt economic growth and government tax receipts. Governments were also at their limit. The need to re-capitalize the banks had put strain on public finances. The banks were caught in a vicious cycle, too. Households defaulting on their loans imperiled the banks. Governments overburdened with debt saw their AAA credit ratings stripped, hurting the banks as the quality of the government bonds deteriorated, crippling their ability to lend money. It was clear that the three main sectors of the economy remained weakened by the crisis, and efforts to adjust any of these sectors produced negative externalities on the other two as the scheme below illustrates.

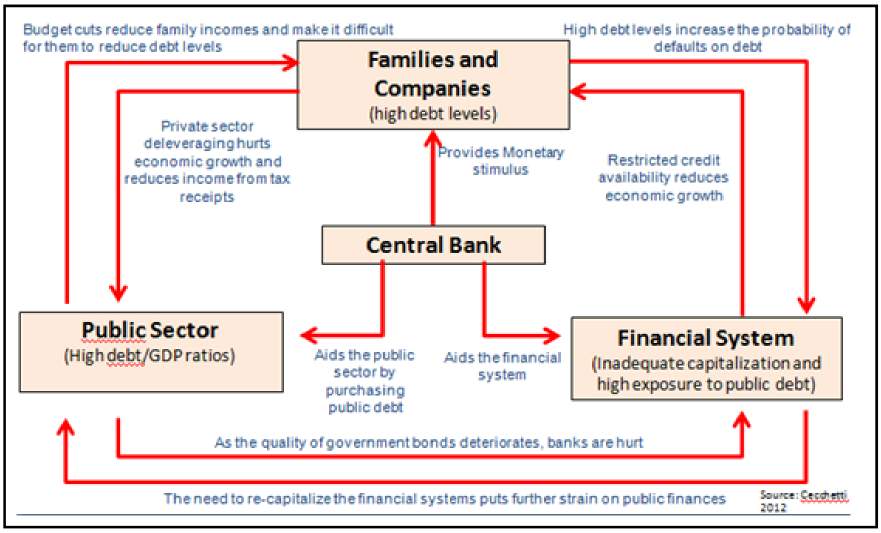


Figure 5 The Vicious Cycle of the Economic Melt-down

With the government, households and banks unable to respond effectively to the crisis, the attention then turned to the Federal Reserve. In December 2008, the Federal Reserve interest rate was lowered to near zero, and has remained at that level since then. In addition, the Fed started an asset purchasing program that came to be known as the round one of quantitative easing, (QE) increasing its balance sheet assets from 880 million dollars at the end of the third quarter of 2008 to over 2.3 trillion dollars in May 2009. Round two of quantitative easing took total assets to over 2.8 trillion, and round three—announced in September 2012—promised to buy 40 billion dollars a month worth of mortgage backed securities with no pre-announced ending date.

The consequence of quantitative easing was that it supported stock and bond prices and directly bolstered the net worth of the top 10% of Americans who own stocks, bonds and other financial instruments. The ownership of stocks, bonds and pooled investment funds is such that the richest 10% of Americans own more than 77% while the bottom 50% own merely 1.1% of these financial assets. Quantitative easing then could not but aggravate economic inequality in America by inflating the price levels of financial assets of the richest Americans while doing little to support economic growth or create jobs for the average person.

Perhaps, one of the most salient dimensions of the recent recession (2007 to 2009) has been its exceptional nature in both the suddenness of the economic collapse and the long duration of its employment consequences. Unemployment more than doubled, from 4.5 percent to 10.6 percent in the 26 months from the onset of recession to the peak of unemployment in January 2010. By contrast, it took 38 months for unemployment to double in the recession of the early 1980s. A year after the peak joblessness of the recent recession, the unemployment rate had fallen only 1.5 percentage points below the peak, whereas by January 1984 it had fallen 2.6 percentage points below the peak (Hout & Cumberworth, 2012, p. 4). These results are substantiated by similar research from the Fed (Aaronson, Mazumder, & Schechter, 2010)

The pace of economic growth has been unable to make up for the losses in the labour market during the financial crisis. In addition, the labour force participation rate fell to a 30-year minimum, indicating a rise in the "discouraged worker" phenomenon. The question has to be asked: What happens to the unemployment rate if the current expansion lasts as long as any of the three most recent expansions? Employment may not recover fully until 2020. The basic questions for business that depends on US consumer demand thus become increasingly important: Where would consumption come from? If the basic mechanism for putting purchasing power into the hands of consumers, namely jobs, breaks down, mass-market business models could become unsustainable.

5. Who Should Pay Attention?

From the data and analysis provided above it is clear that serious grounds exist for concern about the possible economic and political fallout from the rising gap between the very rich and the rest of US society.

Effective responses require a reasonable degree of consensus about the causes and possible solutions to the inequality issue. The recent presidential race in the US showed that such consensus is nowhere in sight. Yet business (especially small to medium sized) has to perform its task and pursue its objectives in this unsettled context, one in which the buying power of consumers has taken a serious blow, public and private debt burdens are enormous and unemployment is high and stubborn.

When the reasons for the current state of inequality were discussed above, the first thing that became evident was the diminishing use of taxation to ameliorate the asymmetric remuneration outcomes of participation in the economy. In some constructive way greater progressivity has to be restored. The issue is how? Various proposals to acquire a larger contribution to income tax revenue from the very wealthy have been proposed and merit exploration and discussion. This includes:

- Introducing several higher income tax brackets for millionaires: the proposed Fairness in Taxation Act (HR 1124) would address this by adding five additional tax brackets for incomes over $1 million;
- Limiting overseas corporate tax havens abuse;
- Introducing a tax on stock and derivatives transactions (like the EU is on its way to do);

- Revamping the estate tax to include progressive rates on large estates;
- Ending preferential treatment for income from dividends and capital gains.

Studies (Anderson et al., 2011) have calculated conservatively that these changes to the tax situation could contribute $400-500 billion annually to government revenue. Tax increases for the rich have until recently been out of the question in the political arena in Washington. One reason is the successful political lobbying of very wealthy corporations and individuals—something that middle class consumer or smaller business groups cannot afford to match. Another reason is what Suzanne Mettler (2011) called the “submerged state” in which Americans are unaware of the social benefits provided by the state and strongly oppose them in principle even though they are the recipients of those very benefits.

Although it can be a complicated topic, monetary policy and easing could be directed more explicitly towards bringing greater room for new financing within smaller and more local financial institutions. The question then is whether the business sector can benefit from addressing inequality, and if there is room for partnerships between business and government. Possible co-operation emerged in the aftermath of the crash in the US housing market. As indicated, home ownership is a major form of household equity. This provides room for initiatives that allow local governments to assist neighborhoods blighted by toxic home loans and foreclosures through the use of eminent domain. A town would essentially “buy” seized home loans from the banks at fair current market value and then arrange for private lenders to help homeowners buy back their own homes, only at a current market price, thus rescuing the homeowner from being underwater.

In the longer term, the financial crisis made it clear there is a need for better cooperation among different levels of government. While the federal government was able to implement some anti-cyclical fiscal and monetary policies, the effectiveness of these policies may have been watered down as governments at the state and municipal level had to cut expenditures and raise taxes to deal with slumping tax receipts, economic activity and housing valuations.

There is also a need to address the gap between the skills of American workers and job vacancies. Policies that facilitate access to relevant post-secondary education will play a paramount role in the future, as well as re-training programs for low-skill workers and the long-term unemployed. It also appears that businesses, educational institutions and students would benefit much from increasing communication among them to help students target the skills and jobs that industry demands.

It is clear that business alone cannot be burdened with solving the current inequality reality. Tax reforms, investment in education, new technologies and active labour market policies are an integral part of an action plan aimed at reducing inequality. There is likely room for cooperation and partnerships between government and business, especially at local level.

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