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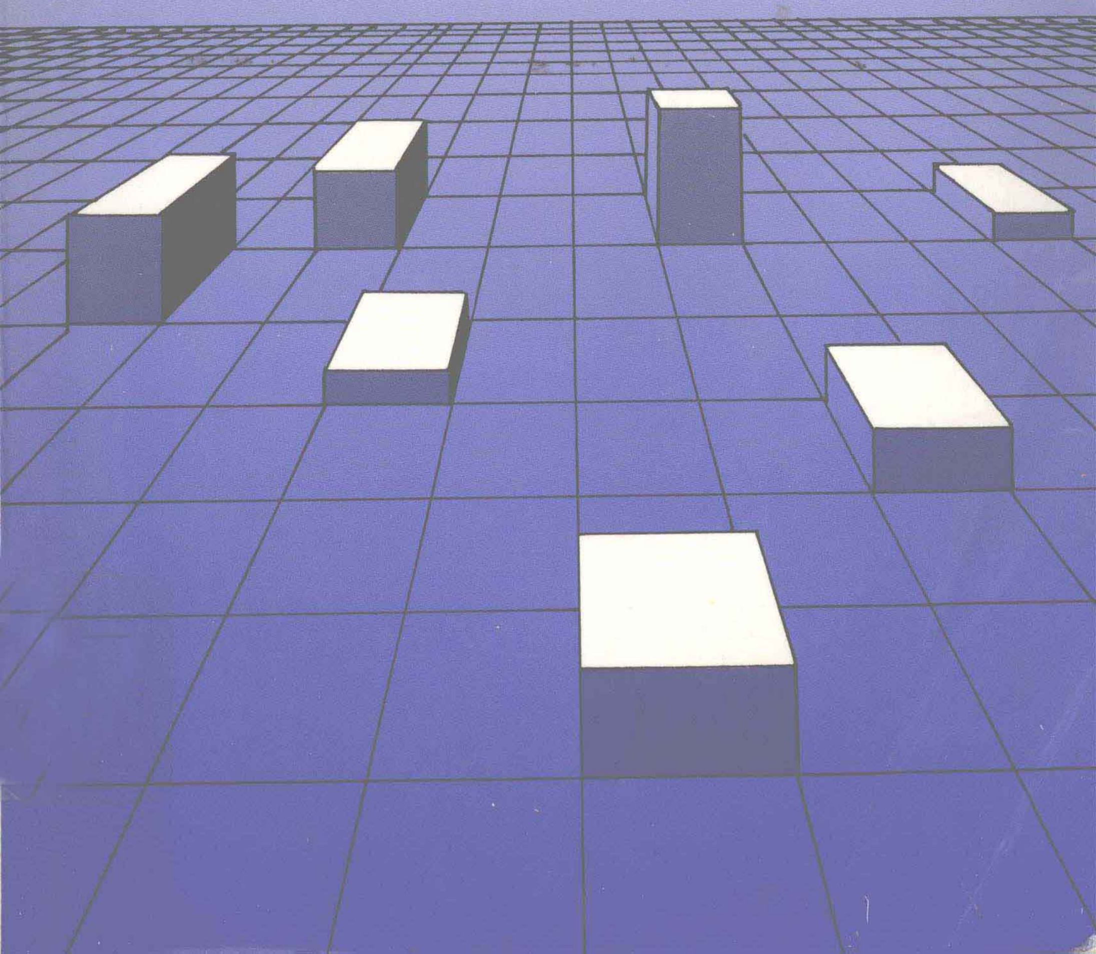
Rising Inequality In America

Edited by Sheldon Danziger and Peter Gottschalk



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To Our Children,
Jacob and Anna, and Julie

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PART ONE

Background

1

Introduction

Sheldon Danziger / Peter Gottschalk

Conventional wisdom about income inequality in America is radically different in the early 1990s than it was ten to fifteen years ago. At that time, Alan Blinder (1980) began a review article on the distribution of economic well-being by noting that "the more things change, the more they remain the same." Blinder's central conclusion was " . . . when we . . . consider the *distribution* of economic welfare—economic equality, as it is commonly called—the central stylized fact is one of *constancy*. As measured in the official data, income inequality was just about the same in 1977 . . . as it was in 1947." (p. 416) Henry Aaron (1978) put it even more colorfully by stating that following changes in the income distribution "was like watching the grass grow." (p. 17)

Economists were puzzled as to why inequality of family income in the post–World War II era had been so stable, despite the rapid growth of government spending in general, and antipoverty spending in particular (Reynolds and Smolensky, 1977). Inequality, in contrast to poverty, was not much discussed in Congress or in the media. Economists writing in the late 1970s did not expect inequality to increase. Indeed, Robert Haveman (1977) concluded that

> If one were inclined to speculate, . . . it would not be unreasonable to forecast that, in 1985, analysts will attribute a modest reduction in income inequality during the 1975–1985 decade to some combination of (1) an overhauled and somewhat larger income support system, (2) a reformed federal revenue system resulting in increased effective tax rates on higher income recipients, (3) a

significantly expanded public employment policy, and (4) a modest reduction of labor market rigidities, including a reduction in labor market discrimination against racial minorities. [p. 19]

Jeffrey Williamson and Peter Lindert (1980), using a model that had successfully replicated two centuries of United States inequality experience, also projected falling inequality for the 1980s:

There are, it seems, three good reasons for expecting continued downward pressure on the pay advantages of the more skilled: Labor force growth will drop off and remain low throughout the 1980s; more balanced patterns of productivity growth are likely to be forthcoming in the wake of the jump in the relative price of the fuels; and the pattern of factor proportions has converged among sectors in a fashion that makes further leveling likely as average skill levels grow. [p. 289]

Peter Gottschalk (1981) was similarly optimistic about the trend in poverty. His projections, based on forecasts of the growth in mean earnings, earnings inequality, and the assumption that cash transfers would grow as fast as national income, were for a 1985 poverty rate of 9 percent.

We now know that these and other researchers did not foresee the slowdown in mean earnings, the rise in earnings inequality, the continuing high poverty rates, and the diminished governmental concern with poverty and inequality that characterized the 1980s. In fact, all four of Haveman's expected policy changes were reversed in the 1980s. The income support system is now somewhat smaller, effective tax rates on higher income recipients are lower, most public service employment programs have been eliminated, and much recent attention has been focused on persistent labor market discrimination (e.g., Kirschenman and Neckerman, 1991). After thirty years of relative constancy, a period that was ending when Blinder, Haveman, Williamson and Lindert, and Gottschalk were writing, we have experienced a decade of rising inequality of both earnings and family income.[1]

Economists, Congress, and the media are now focused on rising inequality and the growing gap in living standards between the rich and the poor. As Lynn Karoly demonstrates in her chapter, there is no doubt that inequality of earnings and family income have increased.[2] As a result, the old conven-

[1] See Karoly (Chapter 2) and Gramlich, Kasten, and Sammartino (Chapter 7) in this book for reviews of trends in inequality and the effects of government policies during the past decade.

[2] The only dissenting voices are Mayer and Jencks (1991), who use consumer expenditure, rather than income, measures of inequality. They find that inequality of expenditures did not increase between the early 1970s and mid-1980s. However, Cutler and Katz (1991), using the same consumer expenditure data for a different time period, show that inequality of expendi-

tional wisdom that "a rising tide lifts all boats" has been rejected. We now know that the 1980s was a decade of "uneven tides." Most small boats were docked where the tides were low, while the few large boats, docked in different harbors, rose with the uneven tides.

Although we know what happened in the 1980s, we do not know what will happen when the next economic recovery begins. The recent recession has probably led to an even higher level of inequality in 1992 than in 1989. But there is no simple explanation of the causes of the increased inequality of the 1980s. Will inequality continue to increase over the next decade as it has over the past decade? Why did inequality not fall during an almost eight-year economic recovery? What role have demographic factors played? Did changes in government programs and policies with regard to minimum wages, taxes, and income transfers contribute to rising inequality? These are some of the questions addressed by this volume.

While we have learned much about the trend in inequality from dozens of recent studies, the following statement, written in 1920 by Hugh Dalton, serves as an appropriate introduction to this volume:

> The question whether the inequality of income is increasing or decreasing in modern communities is one of the most important questions in economics. Many writers have attempted to answer it, but their answers do not generally carry much conviction. To determine whether, under modern conditions, inequality tends to increase or decrease, involves the enumeration of a large number of distinct and conflicting tendencies and the weighing and balancing of them one against the other. [Quoted in Brady, 1951, p. 4]

Recent research has taught us that Dalton was correct. There are no simple explanations. No single factor accounts for the many complex changes in the distribution of income. Rather than looking for a single "smoking gun," recent studies have tried to gauge the relative importance of alternative explanations. Those explanations that seem to be either inconsistent with the data or quantitatively too small to explain the rising inequality of the 1980s have been discarded. This volume continues in that spirit by bringing together original essays that explore several possible explanations for growth in inequality. Our objective is to fill in several gaps in our understanding of the causes of changes in inequality.

To place these studies in context, we first present a brief overview of the historical changes in inequality and the evolution of the conventional wisdom

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tures did increase between 1980 and 1988. Thus, part of the Mayer-Jencks results reflect the earlier period they study. Since our concern is with the 1980s, the Cutler-Katz results are more relevant.

regarding the interpretation of these trends. We then briefly describe the chapters in this volume.

Historical Changes in Earnings and Family Income Inequality

In the most comprehensive review of long-run changes in income inequality, Williamson and Lindert (1980) place the post–World War II stability in inequality into historical perspective. After documenting the dramatic leveling of income differences between the Great Depression and the end of World War II (1929 to 1945), they conclude that

> the leveling ceased by 1950. By almost any yardstick, inequality has changed little since the late 1940s. If there has been any trend, it is toward slightly more inequality in pre-fisc income and toward slightly less inequality in post-fisc income. This stability has been extraordinary even by twentieth century standards. [p. 92]

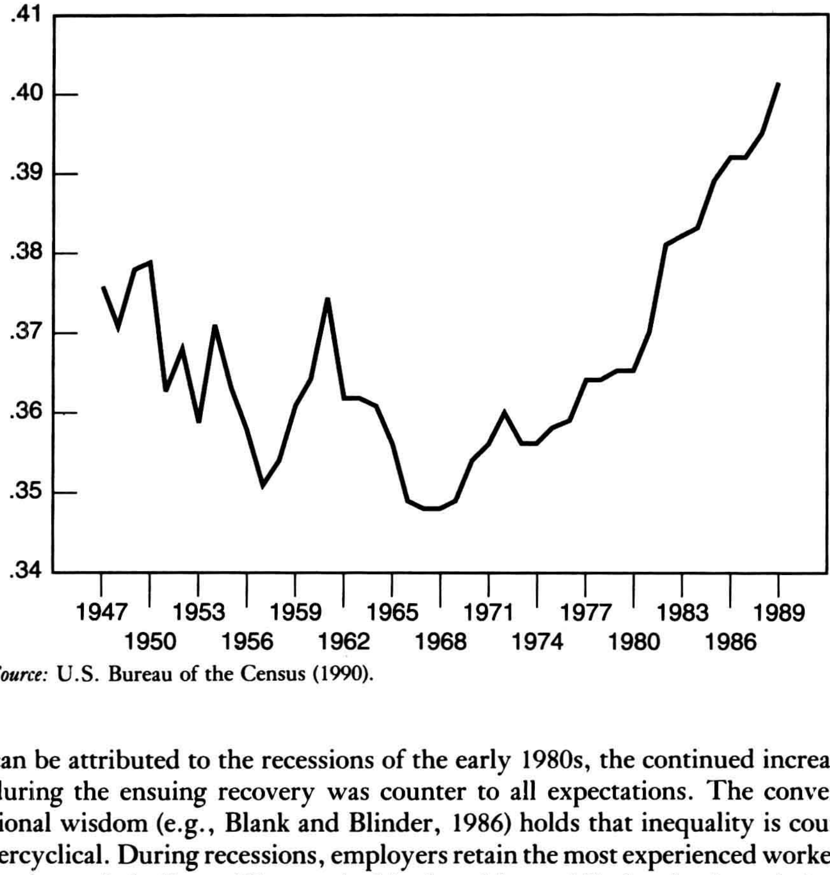
Figure 1.1, however, shows that just as Williamson and Lindert were going to press, the "extraordinary" stability in family income inequality was breaking down. While the Gini coefficient for family income had declined by .013 points over three decades (from .378 in 1949 to .365 in 1979), it jumped by .036 points in the next decade (from .365 in 1979 to .401 in 1989).[3]

Another way to view this increased inequality is to compare families at different points in the distribution. Growth in mean family income was very rapid and widely shared between 1949 and 1969. The inflation-adjusted income of a family at the 20th percentile grew by 92 percent, while the income of a family at the 80th percentile grew by 82 percent. In contrast, mean income grew very little over the next two decades. Growth was substantial for families at the top of the distribution, while those at the bottom actually lost ground. In 1989, the real income of a family at the 20th percentile was 5 percent below the 1969 level, while that of a family at the 80th percentile was 19 percent higher.

Figure 1.1 shows inequality in family income rising almost continually after 1975. While the sharp increase in inequality between 1979 and 1983

[3] Levy (1987) has shown, and we agree, that the published Census data presented in Figure 1.1 overstate the trend toward inequality because they are based only on money income and exclude taxes paid and government noncash payments, such as Medicare and food stamps. However, accounting for noncash benefits and taxes would lead to an even greater increase in inequality during the 1980s, as public benefits to the poor and taxes on the wealthy were both cut.

Figure 1.1 Gini Coefficient of Family Income: 1947–1989



Source: U.S. Bureau of the Census (1990).

can be attributed to the recessions of the early 1980s, the continued increase during the ensuing recovery was counter to all expectations. The conventional wisdom (e.g., Blank and Blinder, 1986) holds that inequality is countercyclical. During recessions, employers retain the most experienced workers as demand declines. The newly hired and least-skilled, who have below-average earnings, are laid off and experience disproportionate income losses. Recoveries are characterized by increased employment of the least experienced. Such countercyclical swings in inequality have characterized most recoveries prior to the 1980s.

Blank and Blinder's (1986) prediction of the degree of inequality for 1989 demonstrates not only that the expansion of the 1980s had a counterintuitive impact on inequality, but also that inequality increased by a substantial amount. They estimated a model for the 1948–1983 period that describes how the income share received by each quintile of families had varied over the business cycle. Then they predicted what the income distribution would look like in 1989, given several scenarios. Their optimistic scenario, about which they said ". . . it is most unlikely for the economy to grow for seven

Table 1.1 Changes in the Distribution of Family Income: 1973–1989

	Share of Income Received by Each Quintile			1983–1989 Change in Income Share	
	1973 (1)	1983 (2)	1989 (3)	Prediction (4)	Actual (5)
Lowest Quintile	5.5%	4.7%	4.6%	+0.6%	−0.1%
Second	11.9	11.1	10.6	−0.2	−0.5
Third	17.5	17.1	16.5	+0.1	−0.6
Fourth	24.0	24.4	23.7	0.0	−0.7
Highest Quintile	41.1	42.7	44.6	−0.8	+1.9

Sources: For Columns (1), (2), and (4), Blank and Blinder (1986); for Columns (3) and (5), U.S. Bureau of the Census (1990).

years without a recession" (p. 206), used inflation and unemployment rates for 1989 that turned out to be quite similar to the actual 1989 values.

Columns 1–3 of Table 1.1 show the actual Census Bureau data on the income share received by each quintile of families in 1973, 1983, and 1989. As expected, inequality increased between 1973 and 1983, a period of falling real family income and increasing unemployment. Blank and Blinder's predicted changes in quintile shares for the 1983–1989 period are shown in Column 4, and the actual changes between 1983 and 1989 are shown in Column 5. Even though family income increased and inflation and unemployment declined between 1983 and 1989, inequality increased. The income share of the bottom 80 percent of families was lower in 1989 than in 1983 or 1973.

The 1989 income shares received by the lowest and the highest quintiles deviate the most from the Blank-Blinder predictions. The income share of the lowest quintile fell to 4.6 percent instead of rising to 5.3 percent and the share of the top quintile increased to 44.6 percent instead of falling to 41.9 percent. As the chapter by Edward Gramlich, Richard Kasten, and Frank Sammartino demonstrates, most of the income growth of this top quintile was actually concentrated among the top 1 and 5 percent of all persons.

The economic performance of the 1980s was atypical, and, in some ways, resembled the 1920s. While Williamson and Lindert considered the 1920s to be atypical, their description of it, which follows, sounds similar to patterns observed in the 1980s.

> This leveling was then undone in the 1920s, with higher-paid groups increasing their pay advantage over both the urban unskilled and farm labor. By 1929,

> the gaps between traditionally high-paid and low-paid jobs were almost as wide as in 1916, when the widest gaps in American history seem to have prevailed . . . The return to inequality in the 1920s was so great that . . . the real income gains for the top 7% of the nonfarm population alone matched the increase in real personal income, leaving no apparent net gain for the rest of the population. [p. 81]

By the late 1980s, there was widespread agreement in the public and academic press about the broad outlines of the distributional changes that had taken place. The causes of the change were, however, much less well understood. Research into the causes of changes in inequality were severely hampered by the dimensions of the problem—a complete explanation would involve nothing less than a full general equilibrium model of labor and capital markets with sufficient detail to capture the changes in labor markets institutions, demographics, and public policies that occurred during the 1970s and 1980s.

Rather than starting with a grand behavioral model, research in this area has tended to be exploratory and descriptive. By describing the dimensions of the problem and seeing whether potential explanations are consistent with the stylized facts, researchers have focused attention on a smaller number of potential hypotheses. The chapters in this book follow in this tradition by exploring specific changes in labor markets, demographic trends, and public policies that could have affected inequality.

Overview of Essays in this Volume

In Chapter 2, Karoly lays out the facts by answering the following questions: When did inequality begin to increase? What was the trend in the 1980s? Does the trend in inequality differ for individuals versus families, for men versus women, for blacks versus whites? Has inequality of family income (or individual earnings) grown due to decreases at the bottom or increases at the top of the distribution or both? Are the answers to these questions sensitive to the inequality measure used?

Karoly analyzes annual data on earnings and family income from the March 1964 through March 1990 Current Population Survey computer tapes. She examines a variety of income concepts and consumer units (family income, income of families and unrelated individuals, income adjusted by family size) and a variety of inequality measures (the relative income of percentiles, the variance of the logarithm of income). She concludes that inequality has been increasing by all measures. Furthermore, many of the time-series show that the relative economic status of families in the bottom of the distribution has been falling for almost two decades.

According to Karoly, the 1980s were unique in the extent of the relative gains of the rich. Although definitions of "classes" are arbitrary, she finds that the upper classes, as well as the lower classes, increased in the 1980s and that the middle class declined.

Labor Market Factors

The essays in Part II explore alternative explanations for changes in the distribution of earnings. Since labor market income accounts for about 70 percent of family income, changes in the distribution of earnings potentially offer the most important explanations for changes in the distribution of family income.

To put the essays on labor market changes in this volume into context, we briefly review the major findings from the rapidly growing literature on increased earnings inequality.[4] The puzzle that these studies attempt to unravel is why inequality between skill groups and within skill groups (e.g., the earnings of college-educated, white males, with one to five years' experience, working full-time year-round) increased during the late 1970s and 1980s. For example, in Chapter 3, Kevin Murphy and Finis Welch show that college graduates with one to five years of experience earned about 32 percent more than high-school graduates with similar experience in 1978. This college premium rose to 60 percent by 1989. Such large changes in such a short time span have seldom been experienced.

Research undertaken during the late 1970s and early 1980s focused primarily on supply-side factors to explain changes in both between- and within-skill class inequality (e.g., Murphy and Welch, 1988). For example, researchers explored the hypotheses that decreases in earnings among low-wage workers reflected labor supply responses to increased government transfer benefits, or that decreased wage rates of young workers reflected the excess supply of inexperienced workers as the baby boomers entered the labor market.

These and other supply-side explanations can explain, at most, only a small part of the recent increase in inequality. Although it could be argued that the baby boom depressed the relative wages of less-experienced workers during the 1970s, the fact that the earnings of young workers did not spring back when the baby boom was followed by the baby bust has eroded support for this supply-side explanation. Likewise, while increased income transfers could have induced labor force withdrawals and reduced the annual earnings

[4] For a review of all the recent studies, see Levy and Murnane (1991).