The Income Distribution Disparity

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Even a disastrous policy blunder is unlikely to lower the real incomes of 25 million Americans by more than 10 percent. Yet that is what happened to the poorest tenth of the population during the 1980s.

Although the typical American family had about the same real income in 1988 as it did in 1978, this was not true of untypical families: the rich and the poor. The best-selling novel of 1988, Tom Wolfe's *Bonfire of the Vanities*, portrayed an America of growing wealth at the top, a struggle to make ends meet in the middle, and growing misery at the bottom. The numbers bear him out. During the 1980s, the rich, and for that matter the upper middle class, became a great deal richer, while the poor became significantly poorer.

In making this comparison, it is important to be careful about starting dates. The great bulk of the population is better off now than it was in the last year of the Carter Administration or the first two years of the Reagan Administration, when the economy was in a deep recession. That recession, however, was transitory—as we will see later, it was part of a deliberate, bipartisan policy of temporarily raising unemployment in order to reduce inflation. The recession years, therefore, provide a misleading base for comparison. The more appropriate comparison is with a time of more "normal" unemployment, which puts us back to 1979. When one does this, the growth in inequality is startling.

One recent study concludes that, after adjusting for changes in family size, the real income before taxes of the average family in the top 10 percent of the population rose by 21 percent from 1979 to 1987, while that of the bottom 10 percent *fell* by 12 percent. If one bears in mind that tax rates for the well-off generally fell in the Reagan years, while noncash benefits for the poor, like public housing, became increasingly scarce, one sees a picture of simultaneous growth in wealth and poverty unprecedented in the twentieth century. The same study estimates that the fraction of Americans who are "rich" (defined by an arbitrary but constant standard) nearly doubled from 1979 to 1987, even while the fraction of families defined by the U.S. government as living in poverty simultaneously increased by 15 percent.

Even these numbers probably fail to capture the full extent of what has happened, because they miss the real

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extremes. The ranks of the extremely well-off were reinforced by the vast fortunes made by traders and investment bankers on Wall Street, and by huge increases in executive compensation. Meanwhile, the amount of sheer misery in America has surely increased much faster than the official poverty rate, as homelessness and drug addiction have spread.

Long-term comparisons of income distribution are fraught with difficulties, but for what it is worth, standard calculations show that the surge in inequality in the United States after 1979 reversed three decades of growing equality, pushing the income shares of the top and bottom categories to their highest and lowest levels, respectively, since 1950. Since measures of inequality in 1950 were magnified by widespread rural poverty, it is probably safe to say that income distribution within our metropolitan areas is more unequal today than at any time since the 1930s.

While some conservatives do not consider income distribution a valid issue for public concern, the changes in that distribution in the 1980s had a far more important effect on people's lives than any deliberate government action. After all, even a disastrous policy blunder is unlikely to lower the real incomes of 25 million Americans by more than 10 percent; yet that is what happened to the poorest tenth of the population during the 1980s. Not everyone agrees that the soaring inequality of the 1980s was a bad thing, but it is a simple fact that the growth of both affluence and poverty in the 1980s largely reflected changes in the distribution of income, rather than in its overall level.

An extra $1,000

There are at least two reasons for arguing that the increased inequality of the 1980s changed *overall* welfare for the worse. First, most Americans do care at least a little bit about how well-off others are, and it is hard to argue with the conclusion that an extra thousand dollars of income matters more to a poor family than to someone whose income is already in six digits. Second, the income distribution colors the whole tone of society: A society with few extremes of wealth or poverty is a different, and surely more attractive, place than one with a yawning gulf between rich and poor.

In the long run, income distribution is not as important a determinant of economic well-being as productivity growth, but in the 1980s increasing inequality in income distribution, rather than growth in productivity, was the main source of rising living standards for the top 10 percent of Americans. And the 1980s were the first decade since the 1930s in which large numbers of Americans actually suffered a serious decline in living standards.

Yet income distribution, like productivity growth, is not a policy issue that is on the table. This is partly because we don't fully understand why inequality soared, but mostly because any attempt to reverse its trend appears politically out of bounds.

One reason that action to limit growing income inequality in the United States is difficult is that the growth in inequality is not a simple picture. Old-line leftists, if there are any left, would like to make it a single story—the rich becoming richer by exploiting the poor. But that's just not a reasonable picture of America in the 1980s. For one thing, most of our very poor don't work, which makes it hard to exploit them. For another, the poor had so little to start with that the dollar value of the gains of the rich dwarfs that of the losses of the poor. (In constant dollars, the increase in per family income among the top tenth of the population in the 1980s was about a dozen times as large as the decline among the bottom tenth.)

To tell the story of what happened in the 1980s, it is necessary to paint a more complicated picture. At least three separate trends have combined to make our society radically less equal. To begin with, at the very bottom of the scale, the so-called "underclass" grew both more numerous and more miserable. Entirely unrelated, as far as anyone can tell, was a huge increase in the incomes of the very rich. In between, among those who work for a living, the earnings of the relatively unskilled fell while the earnings of the highly skilled rose.

Let's start with the underclass. While there is no generally accepted statistical definition of the underclass, we all know what it means: that largely nonwhite hard core of people caught in a vicious circle of poverty and social collapse. Attempts to measure the size of the underclass, like those of Isabel Sawhill at the Urban Institute, suggest that it began growing during the 1960s, and has continued to grow, perhaps at an accelerating rate, since then. In the 1960s and 1970s, social programs were expected to cure persistent poverty; in the 1980s they were widely accused of indirectly perpetuating it. At this point it appears that if you increase spending on the poor, they have more money; if you reduce it, they have less; otherwise, it doesn't make much difference. That is, neither generosity nor niggardliness seems to make much difference to the spread of the underclass. Conservatives argue that the welfare system has reduced incentives and contributed to the growth of the underclass; liberals respond that Reagan's cuts in social spending contributed to the growth of the underclass by making it more difficult for the poor to climb out of poverty. Both could be right. The most important causes of the growth in the underclass, however, like the sources of the productivity slowdown, lie more in the domain of sociology than of economics.

The increased incomes of the rich and very well-off present less of a puzzle than the growth of the underclass. While high incomes have been made in a variety of ways, one source stands out above all: finance. The 1980s were a golden age for financial wheeling and dealing, and the explosion of profits in financial operations has helped swell the ranks of the really rich—those earning hundreds of thousands or even millions a year.

Most Americans live between the stratosphere and the lower depths, and for them the growth in inequality has been yet a different story. First, there was the yuppie phenomenon: the rise of two-income families with $50,000 or more in annual income. Second, wage differentials among occupations widened: the real wages of blue-collar workers have declined fairly steadily for the past decade, and earnings of highly educated workers have risen rapidly. (The ratio of earnings of college graduates to those of high school graduates declined during the 1970s from 1.5 to 1.3, then rose to 1.8 during the 1980s.)

What we really don't know is why these phenomena have all happened now. The rise of two-income professional couples reflects the lagged effects of the women's movement, plus the aging of the baby boom generation. The surges in pay differentials and in market manipulation are more mysterious. Politics may have had something to do with it. The Reagan years provided a tolerant climate both for tough bargaining with workers and for financial wheeling and dealing. Other forces, like the decline of smokestack America and the consequent restructuring of the U.S. economy, may also have played a role.

What to do?

Whatever the reasons for soaring inequality in the 1980s, what can policy do about it? In particular, can anything be done about the extremes of wealth and poverty that have emerged in the past decade?

The problem with poverty, as an issue, is that it has basically exhausted the patience of the general public. America launched its War on Poverty in the 1960s—a time of rising incomes and widespread optimism about government activism. This "war" was supposed to be social engineering, not merely charity. It was intended not simply to raise the living standards of the poor, but to help them work their way out of poverty. Yet poverty did not decline. Despite sharp increases in aid to the poor between the late 1960s and the mid-1970s, poverty remained as intractable as ever, and the underclass that is the most visible sign of poverty grew alarmingly. Today, relatively few people believe, as so many did in the 1960s, that government can do much to help the poor become more productive; all that it seems able to do is raise their standard of living by giving them more money (and influential books, like Charles Murray's *Losing Ground*, deny even that).

But if aid to the poor is simply charity, then its political base is nothing more than public generosity. In a time of budget deficits and largely static living standards for the average American, such generosity does not come easily. There are some modest signs of a resurgence of social activism; money may eventually become available to deal with the conspicuous poverty of the homeless; and Congress has made an effort to reform the tax system to help the working poor. But any systematic initiative to raise the incomes of the poor seems unlikely for many years.

As for the rich, a few public policy initiatives might cut down on some of their sources of income. For example, tighter regulation of financial markets might limit the number of people with incomes in the tens of millions, and a cooled-off financial market might indirectly put some limits on executive pay. For the most part, however, the only way to make the rich less so is to tax them. Yet this conflicts, or is perceived to conflict, with other policy goals—such as encouraging risk-taking and entrepreneurship. Given that the deepest problem with the U.S. economy is slow productivity growth, it is difficult to argue for tax increases that might reduce incentives, even if some people make large sums in return for dubious contributions. In effect, there seems to be a public consensus that Donald Trump is the price of progress.

So income distribution, like productivity growth, is a policy issue with no real policy debate. The growing gap between rich and poor was arguably the central fact about economic life in America in the 1980s. But no policy changes now under discussion seem likely to narrow this gap significantly.