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A Surge in Inequality

International competition and the feminization of poverty are distorting the distribution of income. The remedy may be an aggressive investment in education and technology

by Lester C. Thurow

Since the late 1970's a significant and disturbing shift has been taking place in the distribution of income and wealth in the U.S. The shares of total income going to different segments of the population have changed in such a way that the rich are getting richer, the poor are increasing in number and the middle class has trouble holding its own. The trend can be described as a surge toward inequality.

According to the U.S. Bureau of the Census, the share of total income that went to the top 20 percent of all families was 43.5 percent in 1985, the highest level recorded since the data were first collected in 1947. (In earlier periods the income share of this group had moved narrowly between 40.5 and 41.5 percent of total income.) Conversely, the income share of the bottom 60 percent of the population in 1985 was 32.4 percent, the lowest level ever recorded. (This group's share was slightly less than 36 percent in the late 1960's.)

If one looks at the data of the Federal Reserve board on income distribution, the movement toward inequality is seen to be even more pronounced. The board's set of data includes items not counted in the Census Bureau's definitions of income; among them are returns on wealth such as capital gains and retained earnings. Between 1969 and 1982 the people in the top 10 percent of the population raised their income share according to this set of data from 29 to 33 percent of total income, those between the 60th and 90th percentiles held even at 39 percent and the bottom 60 percent saw their share fall from 32 to 28 percent.

Federal Reserve board figures also show that wealth is much more unequally distributed than income. The top 2 percent of the population receive 14 percent of total income and have 28 percent of total net worth. Similarly, the top 10 percent's share of income (33 percent) almost doubles to a 57 percent share of net worth. In contrast, the bottom 50 percent of the population have 4.5 percent of total net worth. About half of the country's top wealth holders got there by inheriting their holdings and half through their own efforts. In the top wealth group 98 percent are white.

Wherever one looks—industries, occupations, age groups—the surge toward inequality is evident. From 1976 through 1985 the number of middle-income male jobs (defined here as those paying from 75 to 125 percent of median male earnings, or from \$13,334 to \$22,224 in 1985) declined from 23.4 to 20.3 percent of the male work force. The decline was even larger (from 38 to 32.6 percent) for males who worked full time all year. In a period when total male employment was growing by 7.4 million jobs, 400,000 middle-income male jobs were disappearing; there were small gains in jobs in the upper segments and large gains in the lower segments of the earnings distribution.

The forces underlying the distribution of income and wealth can be understood best if they are arranged in sequence. The sequence starts with the growth in output per hour of work. Productivity and hours of work, taken together, determine how much extra output is available to be divided among the economically active members of the population. This output is then divided into two separate income flows: earnings (returns on work effort and skills) and capital income (returns on the ownership of physical plant and equipment). The separate income flows are then further divided among individual earners and individual capitalists. Government takes off a share in the form of payroll taxes and corporate income taxes.

Since the same person can be both an earner and a capitalist, earnings and capital income must then be recombined to determine total individual incomes. Those incomes must be further combined into household units to determine the distribution of the ability to buy goods and services. Government takes a share of household income in the form of personal income taxes but returns part of its total tax collections to those same households in the form of social-welfare benefits such as Social Security checks. What remains is the disposable income that can be used to buy consumer goods or to augment one's wealth.

One can follow this sequential chain along its length to see exactly where greater inequality is entering the sequence. The pressures toward inequality begin with the growth of output. The rate of growth of the country's gross national product has essentially halved in the past two decades, from 3.8 percent per year in the decade 1960 through 1969 to 2 percent per year in 1979–85. With output growing much more slowly and the economy operating with much more excess capacity, competition for the smaller additions to output was bound to intensify. For

ECONOMIC SHIFT from well-paid manufacturing jobs to service jobs that usually pay less is caused to a major extent by two factors. The first is the closing of heavy-industry facilities such as the U.S. Steel Corporation's National Works at McKeesport, Pa. (*top*), because of intense international competition. The second factor is the rapid growth of service businesses such as those that occupy the Lenox Square Shopping Center in Atlanta (*bottom*). The move to low-wage jobs tends to shift distribution of income.

example, some people who had been fully employed at good jobs would be pushed out of the labor market or squeezed down into more marginal economic positions. Indeed, unemployment has averaged 8.1 percent in the 1980's compared with 4.8 percent in the 1960's.

When one looks to see exactly who has been squeezed, the result is somewhat surprising. From 1976 through 1985 male incomes (after correcting for inflation) have fallen 8.4 percent and female incomes have risen 6.9 percent. Male incomes are still far above female incomes (median earnings of $24,999 versus $16,252 for full-time, year-round workers). Faster income gains by women are not what is closing the gap, however; in fact, their rate of increase is actually slower than it has been in the past. Instead the reason for the closing of the gap is reductions in male incomes. The most entrenched workers have lost the most.

The proximate cause of the slowdown in the growth of output is easy to find: the rate of growth of productivity declined by a factor of three, from 2.7 percent per year between 1960 and 1970 to .9 percent between 1979 and 1985. The ultimate causes of this slowdown in productivity are harder to find, somewhat mysterious and a subject of controversy among economists. What is clear is that the slowdown cannot simply be traced to a diminution in the quantity or quality of the inputs (capital, labor and technology) to the economy. Moreover, whatever is happening here is not happening to America's major international industrial competitors. The growth of productivity in countries such as West Germany and Japan is from three to five times the U.S. rate. Whatever the reason, a much slowed rate of growth of per capita income is a central reality from which an analysis of the distribution of income and wealth must start.

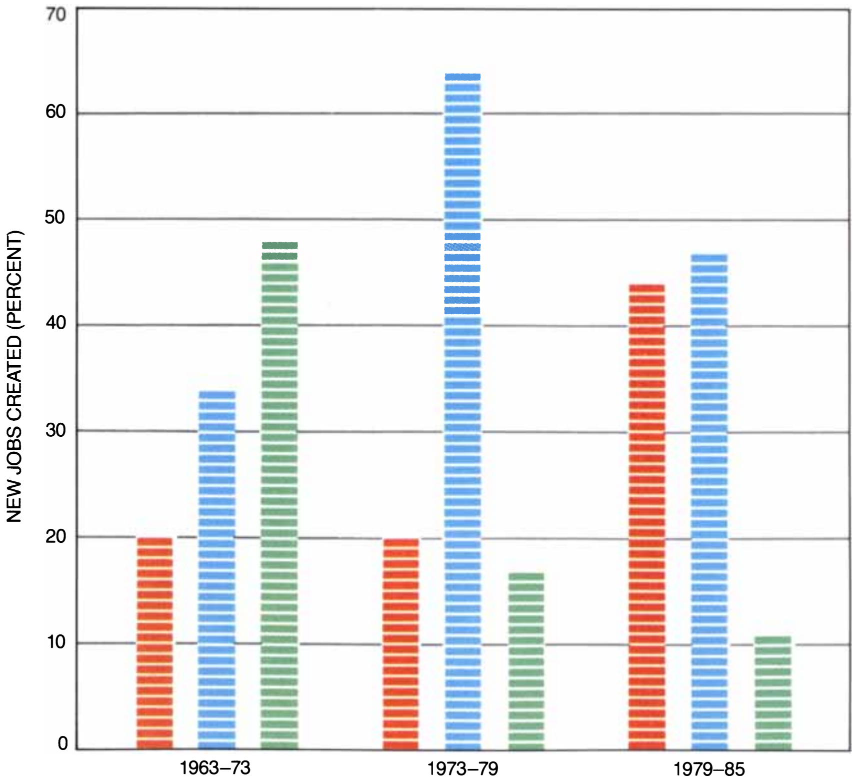
In what at first glance seems paradoxical, a low growth of productivity leads to a high growth of employment, and vice versa. Europe and Japan have had good growth of productivity but little creation of jobs. European employment is no higher now than it was in the early 1970's. The U.S. has had a bad productivity performance but has created 28.4 million jobs since 1970.

In reality there is no paradox. With low productivity growth it just takes more people to produce a given volume of extra output. If output and productivity are both growing at 3 percent, no new jobs are generated, but if output is growing at 3 percent and productivity at 1 percent, employment must grow by 2 percent. The new jobs, however, will not be associated with the wage gains that would have gone with them if productivity were growing more rapidly and output were expanding at an even faster pace.

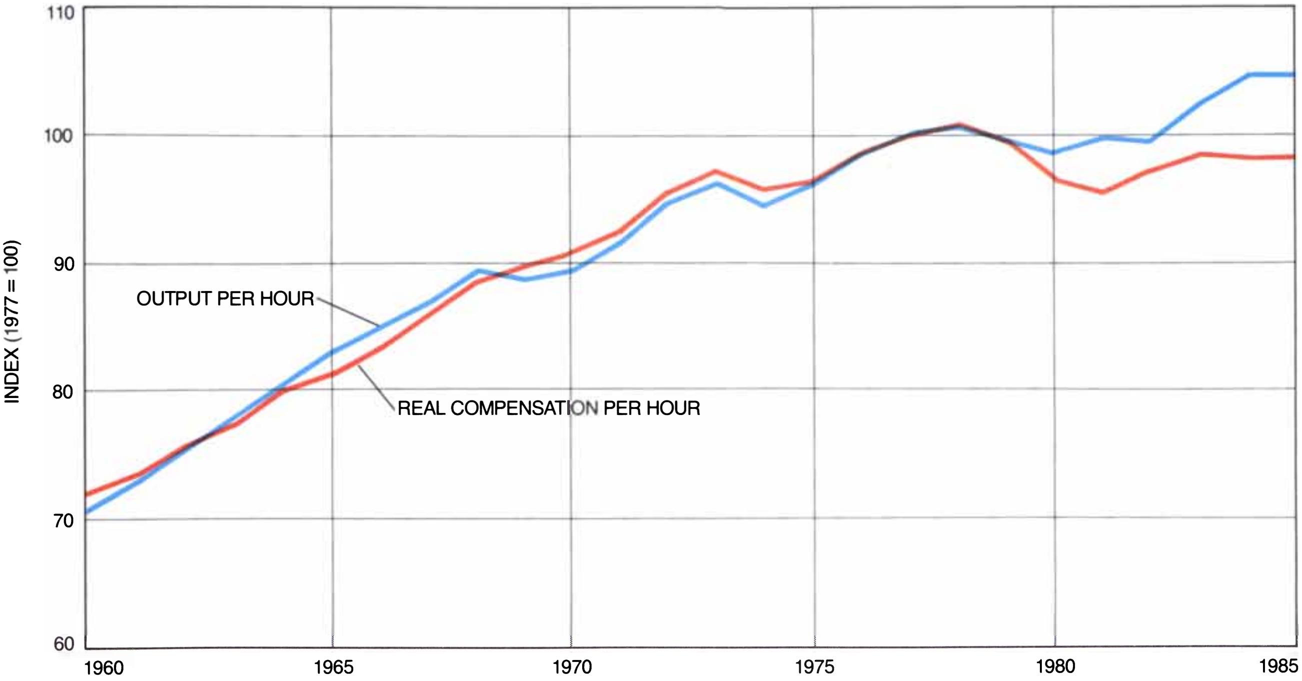
Just such an effect can be seen in the wage gains associated with the millions of new jobs. After correcting for inflation, the compensation to labor per hour of work rose 2.7 percent per year from 1960 through 1969 but fell .4 percent between 1979 and 1985. Moreover, the new jobs were associated with a much more unequal distribution of earnings. Of the 10.7 million new earners added to the economy between 1979 and 1985, 48.6 percent were paid less than $10,000 (in 1985 dollars), 30.5 percent were paid from $10,000 to $25,000 (37.6 percent of the work force was in that range in 1979) and only 20.9 percent were paid more than $25,000 (compared with 23.2 percent in 1979). Right across the earnings distribution the new jobs were inferior to those the economy had been generating before 1979.

The distribution of output into two shares—one for labor and one for capital—affects the final distribution of personal income since capital income is much more unequally distributed than labor income. If one leaves aside homes and real estate, the top 2 percent of all families are found to own 54 percent of all net financial assets (stocks, bonds, pension funds and so on), the top 10 percent to own 86 percent and the bottom 55 percent to have zero or negative financial assets. This means that if the share of total output going to capital rises, the distribution of total income will automatically become more unequal because the most unequal component (capital income) is growing at the expense of the more equal one (labor income). The data in fact show a slight shift in the functional distribution of income: labor's share of the G.N.P. fell from 60.3 to 59.5 percent between 1979 and 1985.

Sometimes the Reagan Administration's tax and social-welfare policies are given the chief responsibility for the growing inequality, but this ignores the fact that the movement toward inequality began before the president was elected. The Administration's social-welfare cutbacks have in fact turned out to be fairly modest, adding at most probably only a few hundred thousand people to the poverty roll. Most of the four million people who have been added to that roll



CHANGE IN PAY for newly created jobs is charted for three periods. The chart shows the percentage of new jobs at the low-wage (*red*), mid-wage (*blue*) and high-wage (*green*) levels. The wage levels are defined respectively as less than $7,400 per year, between $7,400 and $29,600 and more than $29,600. The figures are in constant 1986 dollars.



OUTPUT AND COMPENSATION have been diverging since 1980 in the nonfarm business sector. The data are presented on an index for which 100 represents the situation in 1977. The source of the figures is *The Economic Report of the President, 1986.*

since 1979 were not forced into poverty by the Administration's social-welfare policies; they were added by much more fundamental economic forces.

Similarly, changes in taxes have had little impact. Federal and state income taxes are progressive, meaning that the proportion of one's income paid in these taxes goes up as one's income goes up. Payroll taxes, state sales taxes and local property taxes are regressive, meaning that the proportion of one's income paid in these taxes goes down as one's income goes up. The net result is a tax system that is basically proportional. The percentage of income paid in taxes does not differ significantly from one income class to the next. The tax changes in 1981 were slightly regressive, but the changes enacted last year were slightly progressive, leaving the tax system about where it was when President Reagan took office.

Those who want a comforting explanation of inequality often point to demography. More young, unskilled and inexperienced baby boomers have entered the nation's labor force, and one should expect them to be paid less, the argument goes; when they become middle-aged and more skilled, the distribution of income will automatically reverse its current surge toward inequality. Therefore the surge need not concern policy makers; it will take care of itself eventually.

Neither part of this argument holds up under close inspection. If one keeps the age distribution of the work force constant at 1967 levels and calculates what the 1982 distribution of earnings would have been for that spectrum of ages rather than for the actual age distributions in 1982, the increase in inequality turns out to be just as large as the one actually observed. Today's inequality is being produced not by a more unequal age distribution of the population but by growing inequality in the earnings of each age group.

Nor does it automatically follow that relative incomes will rise simply because workers grow older. If the income of today's young baby-boom worker is lower than it has been in the past because of population pressures, those pressures will still exist when the baby-boom age cohort becomes middle-aged, because the cohort will still be crowded. Its members will still have lower earnings than they would have if they faced fewer contemporaries.

What, then, is the cause of the rising inequality in the distribution of earnings? There are two major forces: (1) intense international competitive pressures, coupled with high unemployment, and (2) a rising proportion of female workers.

The nation's huge balance-of-trade deficit (about $170 billion last year) is merely the most visible symbol of a much more competitive international economy. Numbers such as $170 billion are so large as to be meaningless to most people, but perhaps they can be made meaningful if one understands that it takes one million full-time, year-round employees in U.S. manufacturing to produce $42 billion worth of goods. Hence the trade deficit of some four times that amount has squeezed more than four million workers out of manufacturing and forced them to take other jobs. Because manufacturing is fairly highly paid and tends to have a more egalitarian distribution of earnings than other sectors such as services do, noncompetitiveness in manufacturing leads directly to more inequality in the distribution of earnings.

The U.S. is much more heavily involved in world trade than it used to be, but the rest of the industrial world is also much more competitive technologically than it used to be. In the past Americans did not have to compete much to export enough to pay for the small proportion of products that the nation wished to import. When the U.S. did compete, it did so on the basis of superior technology rather than lower production costs. Today's competition is among technological equals whose competition is based on which nation has the lowest production costs rather than which has the most superior technology.

With input-output techniques it is possible to isolate the earnings distributions of the industries that either export or compete with imports. This calculation reveals that both industry groups pay higher wages than the economy as a whole. In 1983 the median wage in exporting industries was $18,637 and in industries that compete with imports it was $19,583; for the entire economy the median was $16,168.

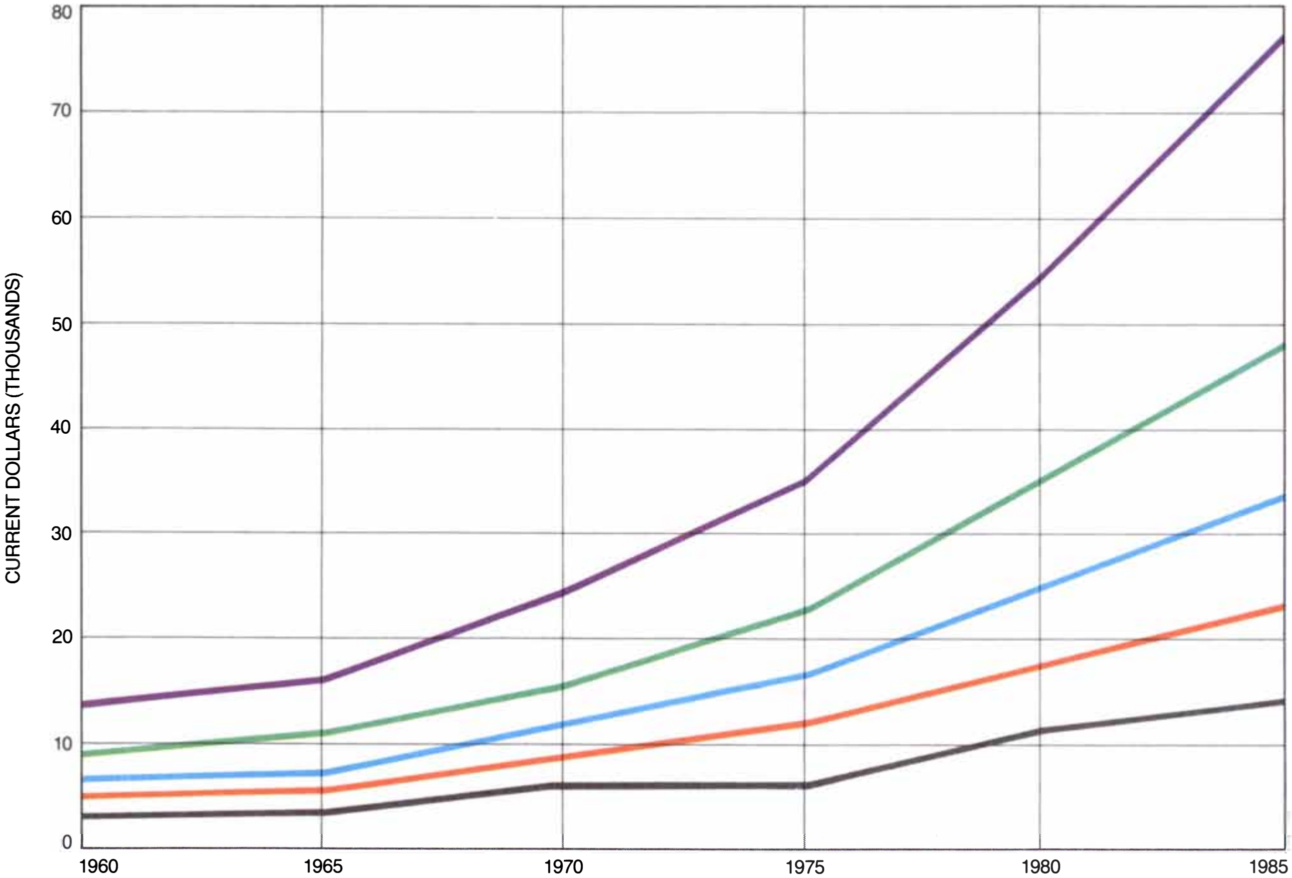
In addition to paying higher wages the exporting and import-competing industries generated a more equal distribution of earnings. In 1983, 41 percent of the entire work force worked at jobs that paid less than $12,500 per year, whereas only 31 percent of the workers in exporting industries and 30 percent of those in industries competing with imports held such jobs. Furthermore, whereas 56 percent of the total work force earned from $12,500 to $50,000 per year, 66 percent of the workers in exporting industries and 67 percent of those in the industries competing with imports were at that level. Yet at the very top of the income distribution the percentages were essentially equal: 2.6 percent of the export work force, 2.7 of the import-competing work force and 2.7 percent of the entire work force earned more than $50,000 per year.

The meaning of these statistics is that when exports fall and imports rise to create a trade deficit, the distribution of earnings moves toward inequality. Jobs are lost in both exporting and import-competing industries and are replaced by jobs with lower, more unequal earnings in the rest of the economy. This factor is the principal reason for the observed decline in earnings of males. The industries that have been hit hardest by international competition—automobiles, steel and machine tools—are precisely the ones that have provided a large number of upper-middle-income male jobs. For women a service job does not mean a lower wage, but for men it does.

If one looks at earnings by industry or occupation, it is evident that the major effect of foreign competitive pressure has been to increase the variation in earnings within each occupation or industry and to push workers down the earnings ladder. Some of this effect might have been offset if unemployment had been low and the sectors of the economy not involved in international trade had been forced to raise productivity and wages in order to attract good workers. Instead high unemployment meant a plentiful labor supply, and wages could if anything be reduced and made more unequally distributed in those sectors that were not affected by international trade.

Another part of the surge in inequality can be traced to women, or more accurately to society's economic treatment of women. Since women are paid much less than men and are much more likely to be part-time workers, a rising proportion of female workers automatically leads to a more unequal distribution of earnings. The average female worker makes 52 percent of what the average male makes, and the average full-time, year-round female worker makes just 65 percent of what her male counterpart makes.

This phenomenon, together with an increasing proportion of households headed by females (up from 28 to 31 percent of all households in the few years between 1979 and 1985), has led to a low-income population that is increasingly dependent on the earnings of women: the feminization of poverty. Women and children account for 77 percent of those in poverty, and half of the poverty population live in



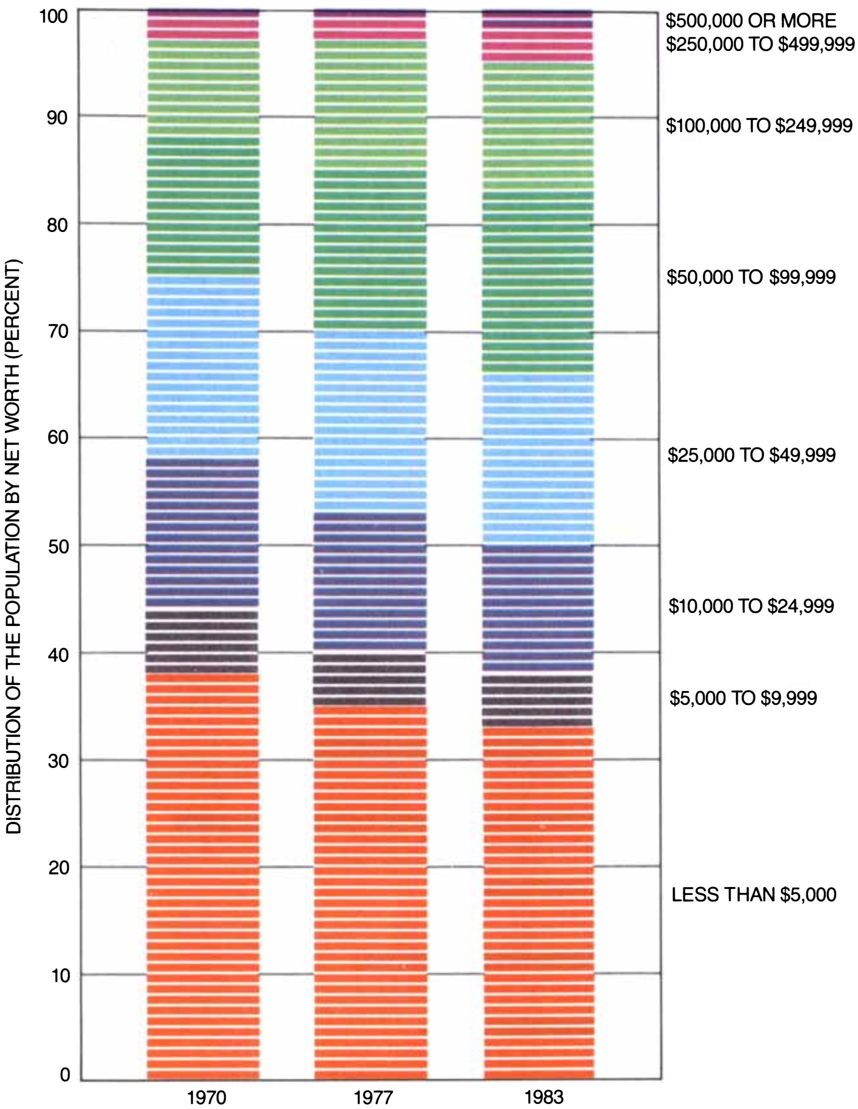
FAMILY INCOME has been changing in distribution quite significantly over the past decade. The four lower curves show the maximum income in the 20 percent of the population with the lowest income (*gray*), the 20 percent with the second-lowest income (*red*), the middle-income group (*blue*) and the next-to-highest group (*green*). The purple curve represents families that are in the top 5 percent of income groupings. The data, encompassing 63.5 million families in 1985, are from the Bureau of the Census.

families headed by females with no husband present. The average female worker earns barely enough to keep a family of four above the poverty line. To do more than just escape from poverty a female must have a job substantially above the average.

The work situation of women does not merely affect the lower end of the income distribution. Women are increasingly influencing what a family must do if it wishes to have a middle-class standard of living. In 1984 the U.S. had 87 million households. Some 50 million of them were traditional husband-wife families, 40 million of which had earnings (most of the others consisted of retired couples). Of the 40 million, 28 million (70 percent) reported earnings by both husband and wife. These families had a median income of $31,000–$22,000 earned by the husband, $9,000 by the wife.

Among working men only 22 percent will earn $31,000 or more on their own, among working women only 3 percent. As a result few families can afford the $31,000 middle-class life unless both husband and wife have jobs. And although the dominant pattern today is a full-time male worker and a part-time female worker, the pattern is rapidly shifting toward a way of life in which both husband and wife work full time. In 1984, 11 million families had two full-time workers, and those families had a median income of $39,000–$24,000 earned by the husband and $15,000 by the wife. As an increasing number of families have two full-time workers, the households that do not will fall farther and farther behind economically.

Rising female participation in the labor market is also one of the factors leading the incomes of the highest-earning families to grow much faster than those of average families. If high-income males marry high-income females and low-income males marry low-income females (tendencies that are borne out by the available statistics), the net result is wider income gaps as potentially high-income women married to already high-income males enter the labor force.



NET WORTH of families has been changing in distribution since 1970. Each narrow colored bar represents 1 percent of the families in the U.S. In 1970 some 38 percent of families had a net worth of less than $5,000, in 1983 some 33 percent. At the top levels (from $50,000 to more than $500,000) the percentages have been rising. Data are in constant 1983 dollars and exclude such durable items as automobiles and home furnishings.

To describe the trend toward inequality as a surge might imply a high rate of change. Such is not the case; like a glacier, this kind of economic trend in reality moves quite slowly. A national economy can easily adjust to a shift in the distribution of purchasing power. It simply produces more low-income products, more high-income products and fewer middle-income products. The discount (K-Mart) and upscale (Bloomingdale's) department stores thrive while the stores in the middle (Gimbels) go out of business.

The Great Society programs of the 1960's to alter the distribution of income grew out of the political unrest of the civil-rights movement. Black and Hispanic households still have incomes far below those of whites (respectively 59 and 70 percent of white incomes), but the majority no longer seem to care and the minorities, even if they are not happy, do not seem to be aggressively complaining.

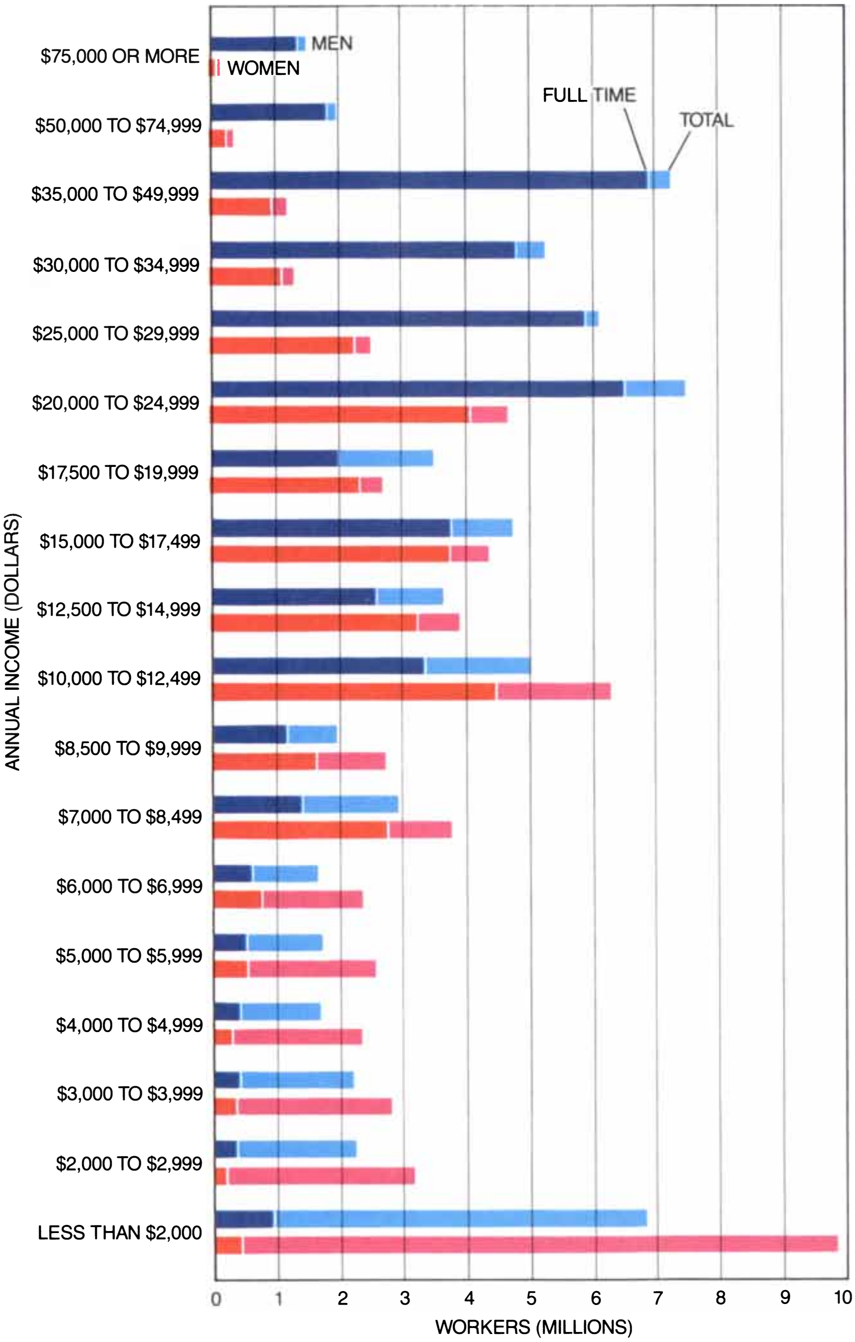
The distribution of income in Japan is about half as unequal as that in the U.S. In West Germany, before taxes and transfers, 28 percent of the population have less than half the median income; in the U.S. the figure is 27 percent. After taxes and transfers, however, West Germany is left with only 6 percent of its population in that predicament, whereas the U.S. is left with 17 percent. But to say that the Japanese and the Germans have or want less inequality is not to say that Americans want less inequality.

At the beginning of the Reagan Administration, David A. Stockman, the director of the Office of Management and Budget, declared that the distribution of income was not an appropriate subject for public remediation. The Administration was overwhelmingly reelected and is still popular in the public-opinion polls. Such polls also find that most of the public are in general satisfied with their economic circumstances.

One answer may be that no one

cares. If that is so, Americans have changed. The past 100 years of American economic history show government deliberately adopting policies to prevent the growing inequalities that all too often seemed to be arising. In the last half of the 19th century the Interstate Commerce Commission was established and the antitrust laws were enacted to stop a growing concentration of wealth and to prevent that wealth from being used exploitatively. The railroads were not to be allowed to exploit their economic advantage over farmers and the oil trust was not to be allowed to exploit the urban consumer. Compulsory education for all was established to create an egalitarian distribution of human capital and more marketable skills in order to prevent large inequalities in earnings.

In the 20th century inheritance taxes and progressive income taxes were adopted to lessen inequalities. The rising inequalities of the Great Depression brought Social Security, unemployment insurance and eventually medical insurance for the elderly and the poor to prevent people from falling out of the middle class when confronting unemployment, illness, old age and other harsh facts of life.



HIGHER-PAYING JOBS are mainly held by men; women predominate in jobs at low levels of pay and also in part-time work at the lower pay scales. The data are for 1985.

Whether one calls the increase in inequality modest or large depends on one's perspective. The bottom 20 percent of all families, who have seen their share of income decline by 18 percent since 1969, would no doubt call it large. However it is described, the surge is still under way, and no one can predict when it will stop.

Once the income-distribution problem has become so acute that it actually creates social or political unrest, it will be very difficult to solve. Politically it is a lot easier to prevent an increase in the income share of a dominant group than it is to adopt policies designed to take income away from that group. In economic health care as in medical health care, prevention is always better than remediation but—it must be admitted—is just as seldom undertaken.

Prevention or remediation, whichever, will require a return to the structural policies of the 19th century rather than to the tax and transfer policies of the 20th century. Regardless of what one thinks about the role of taxes and transfers in limiting inequality, they are clearly not the appropriate means for counteracting the current surge in inequality.

The heart of the solution will have to be found in a higher rate of growth of productivity and enhanced international competitiveness. Here the solution is not simply to lower the value of the dollar in order to regain a balance between exports and imports, although a dollar of lower value will have to be part of the cure until productivity growth can be enhanced. A lowered dollar is simply a way to have a national "giveback" and lower everyone's wages and capital incomes in relation to those in the rest of the industrial world. The wisest policy would aim not to lower the U.S. standard of living but to raise productivity so that the nation can compete in world markets while its private sector pays good wages and receives acceptable profits.

Economically what has to be done is as clear as the politics of doing it are murky. To compete in industries that pay high wages and make goods of high value a country must ensure that its labor force is as well educated and skilled as any in the world, must keep up with or ahead of competitors in investment in capital equipment and must make sure that the technologies being employed are the most effective. Comparisons with either Japan or Europe reveal that the U.S. is not world class in any of those areas. The problem is not that the U.S. is doing worse than it used to but that the rest of the world is doing much better.

Judged by educational attainments and working skills, the U.S. lags far behind. How could one expect American children to learn in a 180-day school year what Japanese children learn in a 240-day school year? Yet the political difficulties of extending the school year are formidable. Both West Germany, with elaborate apprenticeship programs, and Japan, with extensive company training programs, have well-developed systems for teaching technical skills to people who are not bound for college. Such people are the forgotten majority when it comes to training in the U.S. Yet the Administration gutted the training programs of the Department of Labor.

American companies invest only half as much as the Japanese and two-thirds as much as the Europeans. To invest more the American family must save more than 4 percent of its income. Eliminating consumer credit would go a long way toward raising the personal-savings rate, but what politician wants to advocate that?

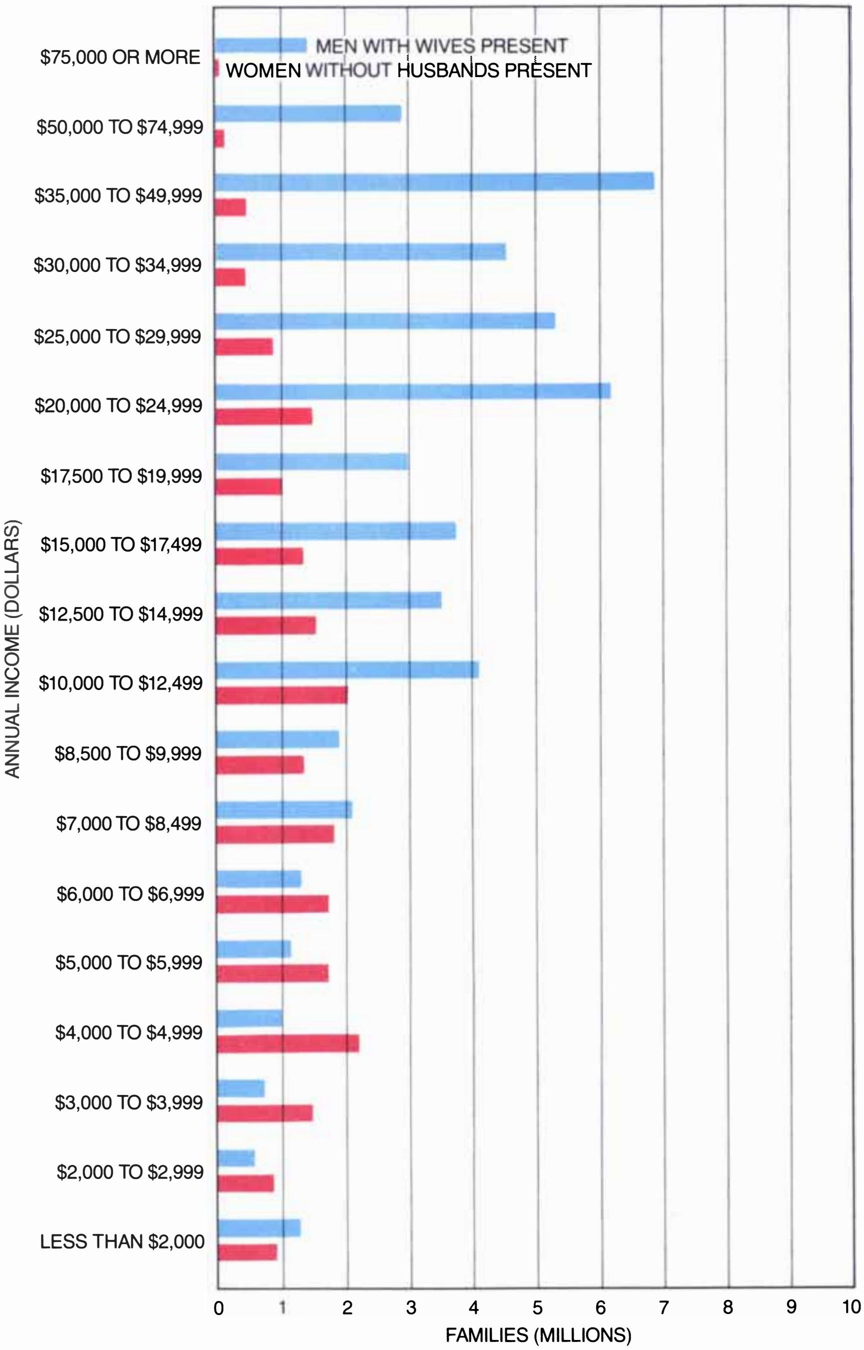
Civilian spending on research and development as a fraction of the gross national product now lags behind that of Japan, West Germany and France. One way or another, however, governments pay for almost all R&D spending in every country. To spend more on R&D means higher government spending and more taxes. No one in the U.S. wants to pay more taxes. That is why the Federal deficit is more than $200 billion.

In short, the solutions to the problem of competitiveness are visible and at hand. To say that the nation knows how to solve its problems with competitiveness, however, is not to say that it will solve them.

Working women are a fact of life. If the U.S. wants to avoid increasing inequality and the feminization of the lower reaches of the income distribution, it will have to do something to raise the earning capacity of women. One can argue about whether the issue is one of comparable worth (female occupations that are simply paid less than male occupations because of habit, history and exploitation) or the relative skills of female workers. Probably both factors contribute to creating the problem. In any case, the society must do something to improve the earnings of women if current trends toward inequality are not to continue.

Families headed by women raise a variety of sociological, religious and ethical issues; they certainly create an economic problem. They are unlikely ever to be able to attain an economic standard of living anywhere near that enjoyed by intact two-earner families. Their problems can be lessened, however, by adopting efficient social policies that make fathers pay to support their children even if they do not live with them. Nature may make mothers but society can make financial fathers. There is an easy solution: if a court orders child-support payments, the Federal Government automatically sends the mother a monthly support check for that amount and collects the money from the father through the Internal Revenue Service—with the state guaranteeing a minimum level of support whatever the amount collected from the father may be.

If history is any guide, the current surge in inequality will sooner or later be met with a political countersurge to contain it. The nature of that countersurge, however, remains buried deep below the political ice.



FEMINIZATION OF POVERTY is evident in this depiction of the incomes of families in data for March, 1986. Families headed by women predominate at the lower levels.