How American Income Inequality Hit Levels Not Seen Since The Depression

WASHINGTON (Reuters, By Emily Kaiser) - In 2007, when the world was on the brink of financial crisis, U.S. income inequality hit its highest mark since 1928, just before the Great Depression.

Coincidence? Maybe not.

Economists are only beginning to study the parallels between the 1920s and the most recent decade to try to understand why both periods ended in financial disaster. Their early findings suggest inequality may not directly cause crises, but it can be a contributing factor.

This raises a host of social, economic and political questions. Should public policy aim to reduce inequality, and if so by what means? Does concentrated wealth at the top of the income spectrum generate asset bubbles, or vice versa? Could raising taxes or interest rates ward off financial meltdowns?

Americans are generally not bothered by inequality because they believe with hard work, they, too, can strike it rich. Government policies aimed at spreading the wealth rarely get much support. (Remember 2008, when then-candidate Barack Obama's campaign-trail comment about redistributing the wealth catapulted "Joe the Plumber" into media stardom?)

"It is usually only left-leaning rich people that care about inequality in the U.S.," said Carol Graham, a senior fellow at the Brookings Institution think tank who studies the economics of happiness.

Those attitudes may be subtly shifting, although it is unclear that this is anything more than just a temporary knee-jerk reaction to the latest bout of turmoil.

Public opinion polls show voters mixed on whether to back higher taxes on the wealthiest households, as President Obama has proposed. The issue is so contentious that Congress put off its decision until after the November 2 midterm elections.

Resentment toward Wall Street is simmering as bankers' paychecks swell to pre-crisis levels while unemployment remains more than twice as high as it was in 2007. Some

politicians have been voted out of office simply because they supported the $700 billion bank bailout enacted in 2008.

Yet there is nowhere near majority backing for the sort of progressive New Deal policies passed during the Great Depression, which helped narrow the wealth gap and keep it contained until it resumed widening in the 1970s.

This time around, the wealth disparity narrowed in 2008 because rich households took a heavier hit from the financial crisis, but Census Bureau data shows it turned around immediately. In 2009, inequality was at the highest level since Census began tracking household income in 1967.

America has one of the largest wealth gaps among advanced economies. Based on an inequality measure known as the Gini coefficient, the United States ranks on a par with developing countries such as Ivory Coast, Jamaica and Malaysia, according to the CIA World Factbook.

TRACKING THE DIVIDE

Emmanuel Saez, a University of California, Berkeley, economist who was awarded a 2010 MacArthur Foundation "genius" grant for his work on income inequality, said recession-induced income declines for the super-rich tend to be fleeting unless there are "drastic" regulatory and tax policy changes.

His research with co-author Thomas Piketty shows the top 1 percentile of households took home 23.5 percent of income in 2007, the largest share since 1928, but that slipped back to 20.9 percent in 2008. (Unlike Census, Saez relies on IRS tax data, which is released with a two-year lag, so he does not yet have figures for 2009.)

During the last period of economic expansion, 2002 to 2007, the top 1 percent enjoyed 10.1 percent annual income growth, adjusted for inflation. For the other 99 percent, the growth rate was just 1.3 percent, Saez found. That meant the top 1 percent received 65 cents of every dollar in income growth.

"We need to decide as a society whether this increase in income inequality is efficient and acceptable and, if not, what mix of institutional reforms should be developed to counter it," he concluded.

COMMON THREADS

There is little agreement among economists about what precisely links high inequality to crises, which helps explain why so few officials saw the financial upheaval coming.

Rapid expansion of credit is one common thread.

Robert Reich, a Berkeley public policy professor and a labor secretary under President Bill Clinton, thinks stagnant middle-class wages led households to pull equity from their homes and overload on debt to maintain living standards.

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Raghuram Rajan, a professor at the University of Chicago's Booth School of Business and a former chief economist of the International Monetary Fund, believes governments tend to promote easy credit when inequality spikes to assuage middle-class anger about falling behind.

"One way to paper over the rising inequality was to lend so that people could spend," Rajan said.

In the 1920s, it was expansion of farm credit, installment loans and home mortgages. In the last decade, it was leveraged borrowing and lending, by home buyers who put no money down or investment banks that lent out $30 for each $1 held.

"Housing credit gave you an instrument to assist those falling behind without them feeling they're beneficiaries of some sort of subsidy," Rajan said. "Even if their incomes are stagnant, they feel really good about becoming homeowners."

BUBBLES AND YACHTS

Another theory is that concentration of wealth at the top sends investors searching for riskier interest-bearing savings. When so much cash is sloshing around, traditional safe investments such as Treasury debt yield very little, and wealthy investors may seek out fatter returns elsewhere.

Mark Thoma, who teaches economics at the University of Oregon, wonders if the flood of investment cash from the ultra-rich -- both in the United States and abroad -- encouraged Wall Street to create seemingly safe mortgage-backed securities that later

proved disastrously risky.

"When we see income inequality rising, we ought to start looking for bubbles," he said.

Kemal Dervis, global economy and development division director at Brookings and a former economy minister for Turkey, said reducing inequality isn't just a matter of fairness or morality. An economy based on consumption needs consumers, and if too much wealth is concentrated at the top there may be times when there is not enough demand to support growth.

"There may be demand for private jets and yachts, but you need a healthy middle-income group (to drive consumption of basic goods)," he said. "In the golden age of capitalism, in the 1950s and 60s, everyone shared in income growth."

MISSING THE LINK

The fact that economists are even examining the link between inequality and financial crises shows just how much the thinking has changed in the wake of the Great Recession.

Paul Krugman, the Nobel prize-winning economist, said that before 2008, when he spoke of inequality approaching levels last seen before the Great Depression, it would inevitably lead to questions about whether another crisis was looming.

"No, I'd say -- there really isn't a clear reason why high inequality should lead to macroeconomic crisis," he recalled in a presentation to a conference on income inequality in June.

Now, he says, he is considering whether inequality somehow creates macroeconomic vulnerability.

Krugman certainly wasn't the only one who dismissed the idea of a connection between inequality and crisis before the latest episode.

Ajay Kapur, a Deutsche Bank strategist, spotted the inequality parallels between the 1920s and the most recent decade, but didn't see the meltdown coming. The former Citigroup strategist created a stir five years ago when he built an investment strategy around his thesis that essentially divided the world into two camps: the rich and the

rest.

Kapur told clients in 2005 that the United States and a handful of other economies were developing into "plutonomies" where the wealthy few powered economic growth and consumed much of its bounty, while the "multitudinous many" shared the leftovers.

Plutonomies come around only once or twice a century, he argued -- 16th century Spain, 17th century Holland, the Gilded Age. The last time it happened in the United States was during the "Roaring 1920s".

There was money to be made by buying shares of luxury companies that made toys for the rich, he told clients, suggesting a basket of stocks that included upscale retailer Burberry and luxury home builder Toll Brothers.

"When I presented this to clients, they said, 'Okay, this is interesting because you're telling me what happened in the 1920s is happening right now, and you obviously know what happened after 1929, right?'," Kapur said in an interview.

His response? That can't happen again because we know better now.

"To be perfectly honest.... I certainly didn't think it would all melt down in 2007. I'd be lying if I said that."

Kapur still isn't convinced there is a direct connection, and points out that 2007 and 1928 are only two data points and it's dangerous to draw conclusions from such a small sample.

SEEDS OF INEQUALITY

Inequality doesn't always lead to financial crisis, which makes it difficult for policymakers to know when it might be growing into a serious problem that ought to be addressed.

Many of the root causes -- technological advances, financial innovation, higher education -- are social goods, not ills, so it makes little sense to attack them.

The traditional view among economists is that combating inequality would hurt growth. Many argue that inequality is "if anything, favorable to -- or at least a

necessary by-product of -- economic growth," as Federal Reserve Bank of Dallas researchers wrote in a 2008 paper on inequality.

In the decades before the Great Depression, advances in mass-production and transportation enabled large-scale factories to churn out more goods with fewer workers.

In the past two decades, the big change was the explosion of personal computing and the Internet. The ability to instantaneously transmit masses of information over thousands of miles meant workers no longer needed to be in the same place, and jobs could easily shift to low-cost locales such as Bangalore, India, or Shenzhen, China.

Demand for unskilled labor fell. The relatively small segment of the population with the qualifications to compete -- in the 1920s, a high school diploma; in today's economy, a college degree -- earned more money, widening the wealth gap.

Unemployment data bears that out. Even before the latest recession started in late 2007, the jobless rate for those with only a high school diploma was more than double the rate for those with at least a Bachelor's degree. As of September 2010, unemployment among high school graduates was 10 percent; for those with a four-year college degree it was just 4.4 percent.

This suggests one government response to inequality should be to channel more money into education, said Jack Ablin, chief investment adviser for Harris Private Bank in Chicago.

Ablin said only a small sliver of his high net-worth clients inherited their wealth, so simply comparing wealth concentration between the 1920s and now may be a bit unfair.

"Becoming wealthy in the olden days was almost genetic," he said, referring to wealth handed down from generation to generation.

I CAN BE BILL GATES

The work hard, get rich formula is deeply embedded in the American psyche, which helps explain why Americans have generally tolerated inequality.

For every dynastic family name such as Kennedy or Rockefeller, there are those who

reached the top through creativity and sweat, from Sam Walton who built the global Walmart empire from a single dime store in Arkansas, to Google founders Larry Page and Sergey Brin who started their company in a garage.

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Rags to riches tales are an integral part of what makes the United States a beacon to immigrants who dream of a better life. No one embodies that better than President Obama, whose mother once turned to food stamps to feed her family, yet he was able to attend top-tier universities and aspire to the most powerful office in the world.

Graham, the Brookings economist who studies happiness, said most Americans, including the poor, believe that hard work is more important than luck in getting ahead.

"If I work hard enough, I too can be Bill Gates," is how Graham explains the philosophy.

The only groups that don't share that view and consistently rank toward the bottom on measures of happiness are the long-term unemployed and those without health care, she said.

Both groups grew during the recession. As of September, there were 6.1 million people who had been out of work for more than six months, more than four times as many as there were at the start of the recession.

Deborah Coleman is one of the long-term unemployed. There is no disguising the anger felt by the 58-year-old former telecommunications company manager in Cincinnati, who has been out of work for more than two years.

"Am I pissed that I have lost everything while the rich on Wall Street are still living it up? You bet I'm pissed," she said. "I'm one of the many people who've lost everything and then been swept under the carpet."

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TAXING THE RICH

Graham does not yet have enough data to determine whether attitudes toward inequality shifted after the financial crisis, but she suspects there has been very little movement.

The debate over whether to extend Bush-era tax cuts for the wealthiest households may provide an early litmus test. Obama has proposed keeping the lower tax rates only for families making less than $250,000, but Republicans and a handful of Democrats went them extended for all.

Obama's framing of the issue suggests the White House does not see much voter support for using tax policy to even out income inequality.

On the campaign trail in 2008, Obama told Joe Wurzelbacher, who became known as Joe the Plumber, that if the economy is good for those at the bottom, it's going to be good for everyone. His comments about redistribution sparked fury among conservatives who saw it as evidence the future president harbored socialist leanings.

Since that "spread the wealth" gaffe, Obama has chosen his words more carefully and regularly points out that he is no modern-day Robin Hood.

Ending the tax breaks for the wealthiest "isn't to punish folks who are better off -- God bless them -- it is because we can't afford the $700 billion price tag," Obama said recently.

His opponents say imposing higher taxes would kill the economic recovery because the rich spend, invest and hire more than everyone else, faintly echoing the plutonomy theme laid out by Deutsche Bank's Kapur.

DREAMLESS DEAD

Like cholesterol, there is a "good" and a "bad" kind of inequality, according to Francois Facchini, an economist at the University of Paris.

The "good" kind is aspirational. It encourages people to strive toward success, like Graham's Bill Gates analogy. The "bad" kind fosters disillusionment, a feeling that no matter how hard you work, you cannot win.

Pollster John Zogby sees a growing number of Americans falling into the second category. He calls them the "Dreamless Dead," those who no longer believe in the

existence of the American Dream of hard work begetting success.

Those who work hard but fail to get ahead lose faith in the dream, he said. Beginning in the 1990s, Zogby noticed an increase in the percentage of people who said they were working in jobs that paid less than previous positions.

"That's when I started to zero in on the American Dream because my assumption was it was going up in smoke," he said.

In the early 1990s, 14 percent of those polled by Zogby said they were making less money than they had before. After the recession, the percentage had more than doubled.

Janet Townsend, who has worked at General Motors for 34 years, is one of those faced with the prospect of a drastic pay cut. She was told she'd have to take a 50 percent wage reduction because GM wanted to sell the Indianapolis plant where she works to a private investor. Union workers opposed the deal. The plant will be shut next year.

"I haven't seen any auto executives or Wall Street bankers taking a paycut, in fact their pay seems to keep going up," she said. "This country is built on the principles of life, liberty and the pursuit of happiness.

"But when a corporation tries to make me take a 50 percent pay cut, then you're taking away my right to pursue happiness while enhancing your own."

A NEWCOMER TO WASHINGTON

If inequality can lead to financial catastrophe and voter outrage, should Washington try to stop it from getting too wide?

Obama's avoidance of spread-the-wealth comments would indicate the White House does not think there is political backing for policies aimed explicitly at redistribution.

However, at least one new arrival to Washington's policy-making scene, Fed Vice Chairman Janet Yellen, has expressed concern that extreme inequality could ultimately undermine American democracy.

"Inequality has risen to the point that it seems to me worthwhile for the U.S. to seriously consider taking the risk of making our economy more rewarding for more of

the people," she wrote in a 2006 speech.

The public policy response depends on what the root problem really is. Thoma, the University of Oregon economist, said it still isn't clear whether bubbles cause inequality or inequality causes bubbles.

If it is the former, Yellen and the Fed could play a role in preventing disaster by raising interest rates or tightening regulation when they see evidence of a dangerous asset price bubble building.

Fed Chairman Ben Bernanke has argued that interest rates are too blunt of an instrument to prick asset bubbles because they could tip the entire economy into recession rather than targeting a narrow source of instability.

If inequality is the core issue, more progressive taxes or investing in education programs might be more effective.

ON AVERAGE, YOU'RE DOING OKAY

Before policymakers can act, they will need to get better at identifying unsafe imbalances.

The most commonly used measuring tools, such as per capita income, can be misleading because they report at averages. Data on average income, for example, can be skewed by huge gains at the top, making spending power appear higher than it really is.

Willard Wirtz, who was President John F. Kennedy's labor secretary in the 1960s, is often credited with saying: "When you have your head in the freezer and your feet in the oven, on average you are doing okay."

Steve Landefeld, director of the Bureau of Economic Analysis which produces thousands of reports including GDP, has proposed adding more data series that might serve as an early warning system that imbalances were building.

One bright red flag that policymakers seem to have missed pre-crisis was the disconnect between swiftly rising house prices and stagnant wages for most middle-class workers.

TESTING SOCIAL COHESION

Left alone, income inequality looks likely to continue rising at least through this year. The stock market has already regained more than half of the ground lost between an October 2007 all-time high and a March 2009 trough. Those gains flow disproportionately to the wealthy.

Meanwhile, the overall unemployment rate will probably end the year about where it started, at 9.7 percent, while the education gap widens. The jobless rate for college graduates has come down by 10 percent since January; for those who didn't finish high school, it has risen 1 percent.

This pattern has been in place for more than a decade and it has not generated much popular support for addressing income inequality. That may change as strained U.S. finances eventually force officials to choose where to cut spending.

In the next five years, the government debt burden may reach a critical point where it is growing at a faster rate than the economy, pushing up taxes and diverting money that could be spent more productively on research or education.

Credit rating agency Moody's has warned that the budgetary decisions facing the United States and many other rich countries may "test social cohesion."

"Will society accept the measures that need to be taken to stabilize the debt position of the government?" Moody's analyst Steven Hess said in an interview.

"Economic growth is not going to get the country out of the negative debt trajectory it now faces," he said.

Means-testing social security payouts so that less money goes to the wealthiest would be one way to help curb the deficit and income inequality at the same time. Other ideas might include phasing out tax write-offs for mortgage interest for higher-income homeowners.

Both options are likely to be considered by a federal deficit commission that is due to report its findings in December. Its recommendations, however, are not binding, so Congress may choose an entirely different path -- one that does less to address inequality.

Hess said he did not expect the sort of riots and protests that have marked austerity pushes in Greece and other parts of Europe, but said inequality can heighten social tension.

Kapur, the strategist behind the plutonomy thesis, said the forces that put the United States into his plutonomy category appear to have peaked, and he has shifted his investment focus to emerging markets where returns look sweeter.

Although he did not see the financial crisis coming back in 2005, he accurately predicted what would eventually undermine his investment strategy. Time will tell whether he also foreshadowed shifts in U.S. attitudes toward inequality.

"Perhaps one reason that societies allow plutonomy is because enough of the electorate believe they have a chance of becoming a Pluto-participant," he wrote back then.

"Why kill it off if you can join it? In a sense, this is the embodiment of the 'American Dream'. But if voters feel they cannot participate, they are more likely to divide up the wealth pie, rather than aspire to be truly rich."

(Additional reporting by Nick Carey and Kim Dixon; Editing by Jim Impoco and Claudia Parsons)

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