

Income Inequality in the United States

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Congress

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Vice Chair Klobuchar, Chairman Brady and Members of the Committee,

My name is Robert Reich. I am currently Chancellor's Professor of Public Policy at the Goldman School of Public Policy at the University of California at Berkeley, and Senior Fellow at the Blum Center for Developing Economies at the University. Thank you for giving me the opportunity to testify before this Committee today on a troubling phenomenon that's been increasing for over thirty years: widening inequality of income -- and, in consequence, of wealth, upward mobility, and political power in the United States.

I have been studying this issue for much of the last three decades, written a number of books on the subject, and sought in various ways to address it under three presidents, most recently as Secretary of Labor under President Clinton. I have even gone so far as to help make a movie about it, entitled "Inequality for All," which is just out on DVD, iTunes, and On Demand, should any of you or your staffs wish to take a look.

I should say at the outset that some inequality is inevitable, if not necessary. If an economy is to function well, people need incentives to work hard and innovate. The question is not whether inequality is good

or bad. It is at what point inequality becomes so wide as to pose a serious threat to economic growth, to our ideal of equal opportunity, and to our democracy. I believe we are reaching that tipping point, or have already reached it.

The data

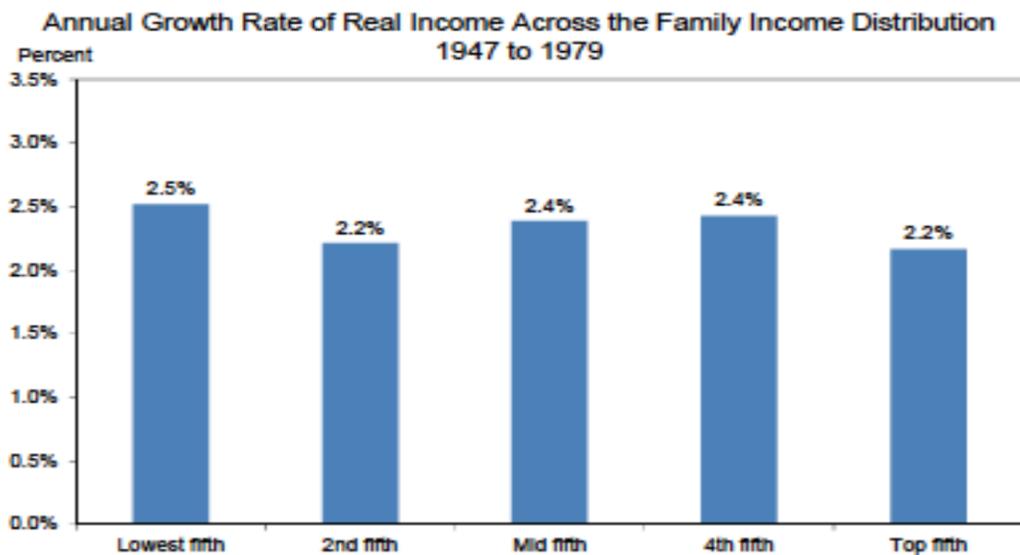
Most data are prone to different interpretations, but the data on widening inequality are remarkably and disturbingly clear. The Congressional Budget Office has found that between 1979 and 2007, the onset of the Great Recession, the gap in income -- after federal taxes and transfer payments -- more than tripled between the top one-percent of the population and everyone else. The (after-tax, after transfer) income of the top one-percent increased by 275 percent, while it increased 18 percent for the bottom quintile of the population, incomes and less than 40 percent for the middle three quintiles.

The gap has continued to widen in this recovery. According to the Census Bureau, median family and median household incomes have been falling, adjusted for inflation, while the income of the wealthiest 1 percent has soared by 31 percent. My colleague Emmanuel Saez has calculated that 95 percent of all economic gains since the recovery began have gone to the top 1 percent. Figures 1A and 1B contrast what's happened to the upper, middle, and lower fifths of the population in two periods, from 1947 to 1979, and from 1979 to 2010. Figure 2 shows how much income has flowed to the top 1 percent between 1916 and 2009.

Wealth has become even more concentrated than income. An April 2013 Pew Research Center report documents that between 2009 and 2011, the mean net worth of households in the upper 7 percent of the wealth distribution rose by an estimated 28 percent, while the mean net worth of households in the lower 93 percent dropped by 4 percent.

Figure 1A

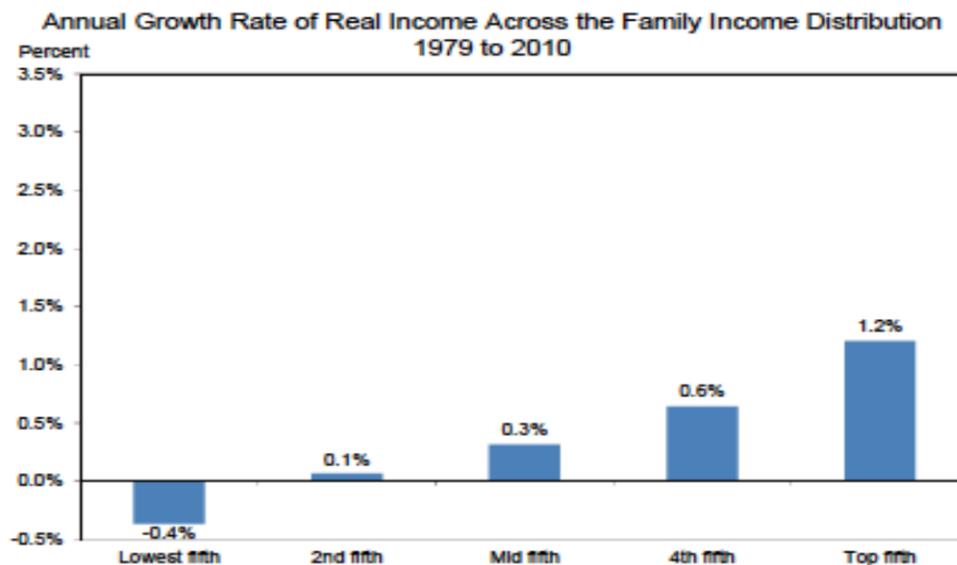
We grew together: Real Family Income Growth 1947-1979



Source: Alan Krueger, President's Council of Economic Advisors, The Rise and Consequences of Economic Inequality, 2012

Figure 1B

Then we grew apart: Real Family Income Growth 1979 to 2010



Source: Alan Krueger, President's Council of Economic Advisors, *The Rise and Consequences of Economic Inequality*, 2012

The threat to economic growth

In the United States, consumer spending accounts for approximately 70 percent of economic activity. If consumers don't have adequate purchasing power, businesses have no incentive to expand or hire additional workers.

Because the rich spend a smaller proportion of their incomes than the middle class and the poor, it stands to reason that as a larger and larger

share of the nation's total income goes to the top, consumer demand is dampened. If the middle class is forced to borrow in order to maintain its standard of living, that dampening may come suddenly -- when debt bubbles burst.

Consider what happened in 1929 and 2008. Figure 2 shows that the two peak years of inequality over the last century -- when the top 1 percent garnered more than 23 percent of total income -- were 1928 and 2007. Figures 3 and 4 show that each of these periods was preceded by substantial increases in borrowing, which ended notoriously in the Great Crash of 1929 and near meltdown of 2008.

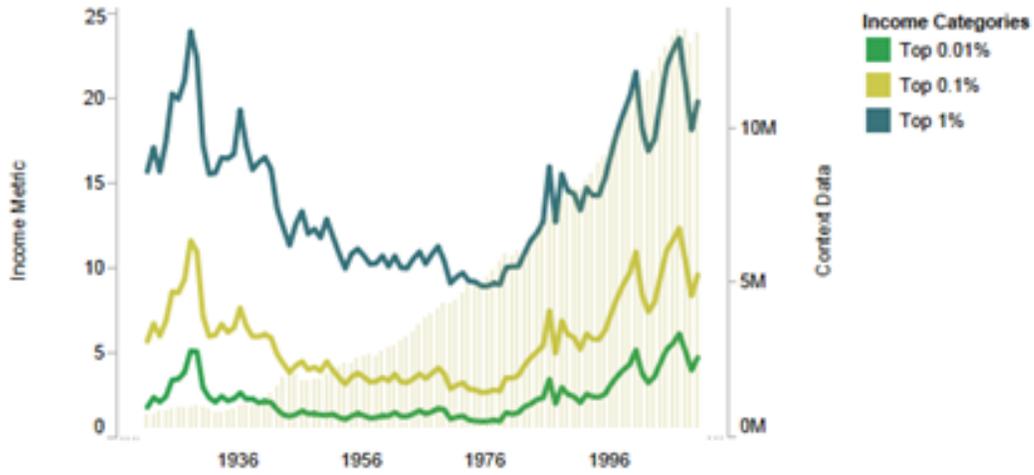
The anemic recovery we are now experiencing is in my view directly related to the decline in median household incomes after 2009, coupled with the inability or unwillingness of consumers to take on additional debt and of banks to finance that debt -- wisely, given the damage wrought by the bursting debt bubble.

We cannot have a growing economy without a growing and buoyant middle class. We cannot have a growing middle class if almost all economic gains go to the top 1 percent.

Figure 2

Share of total income going to top 1%, top .1%, and top .01%

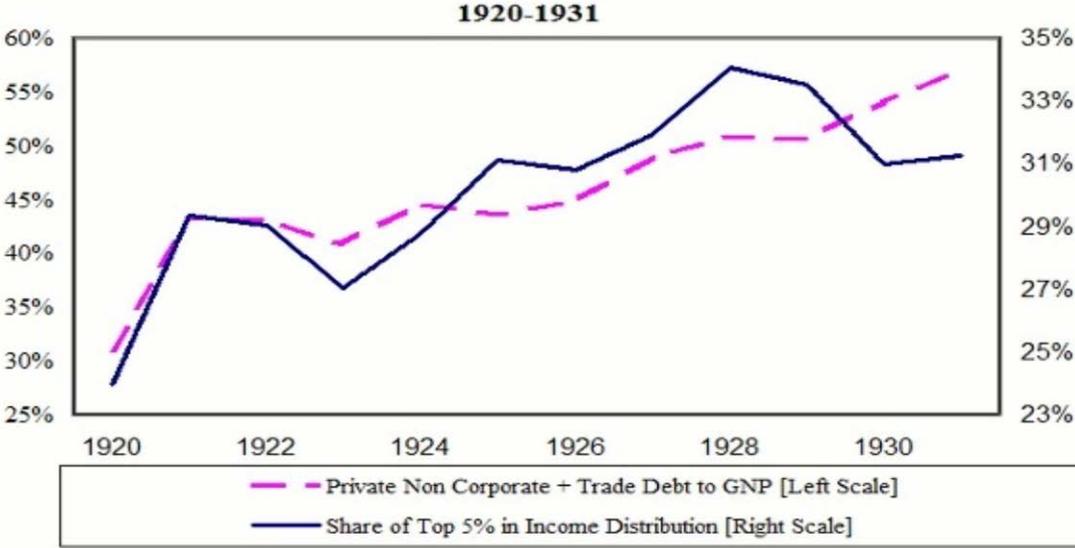
US Income Share Including Capital Gains and Real GDP (Millions of 2005 \$'s)



Source: Saez & Piketty (2012)

Figure 3

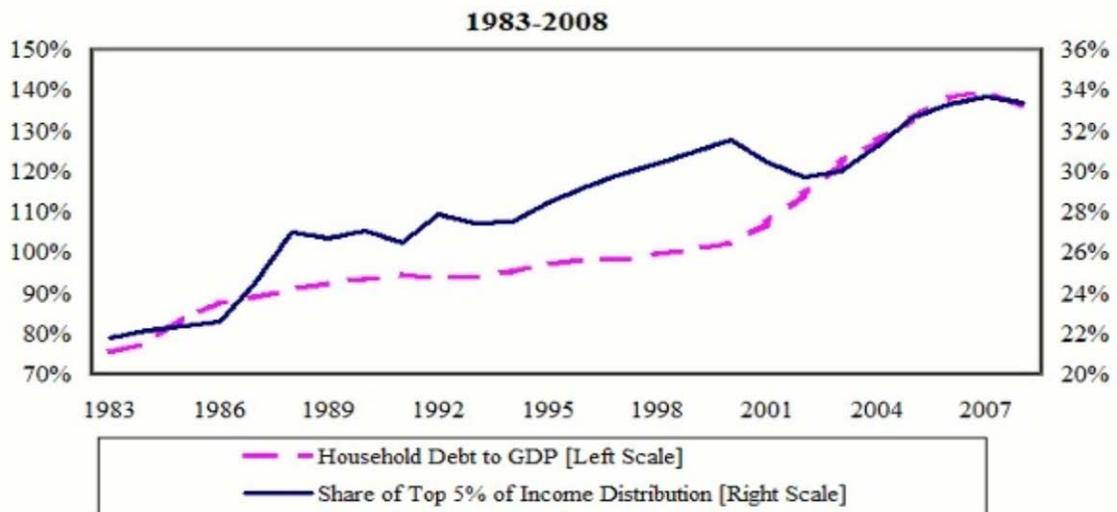
Inequality and Borrowing Before Bubble Bursts



Source: "Inequality, Leverage, and Crisis," Michael Kumhof and Romain Ranciere, 2010.

Figure 4

Inequality and Borrowing Before Bubble Bursts, 1983-2008



Source: "Inequality, Leverage, and Crisis," Michael Kumhof and Romain Ranciere, 2010.

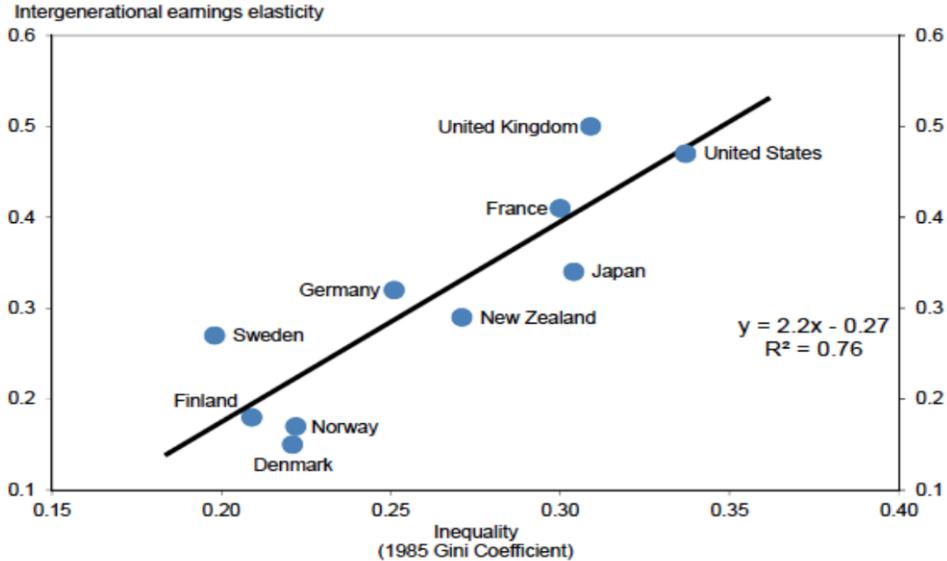
The threat to equal opportunity

Widening inequality also challenges the nation's core ideal of equal opportunity, because it hampers upward mobility. High inequality correlates with low upward mobility, as you see in Figure 5.

But has widening inequality reduced upward mobility? The studies are not conclusive because the velocity of upward mobility is difficult to measure. But even under the unrealistic assumption that it is no different today than it was thirty years ago, it's easy to understand how widening inequality hampers upward mobility. Because the distance between the bottom rungs and top rungs of the income ladder is much greater now, anyone ascending it at the same speed as before will necessarily make less progress up the ladder.

Figure 5

“The Great Gatsby Curve”: Higher income inequality associated with lower intergenerational mobility



Source: Corak (2011), OECD, CEA estimates.

The threat to our democracy

The connection between wide inequality and the undermining of democracy has been long understood. As the great Supreme Court justice Louis Brandeis said in the late nineteenth century, when America faced a similar degree of inequality as it does now -- an era characterized by urban squalor as well as robber barons whose lackeys literally deposited sacks of money on the desks of friendly legislators -- "we may have a democracy, or we may have great wealth concentrated in the hands of a few, but we cannot have both."

When money flows upwards, political power tends to follow. I do not mean by this to question the integrity of any elected official. But no member of today's House of Representatives or Senate is entirely immune from this phenomenon.

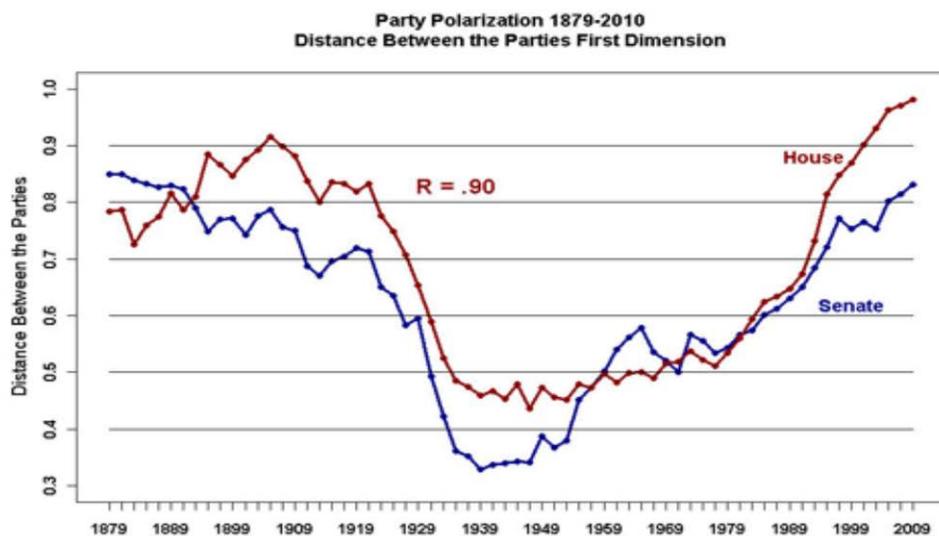
The threat to our democracy also comes from the political divisiveness and polarization that also accompanies high levels of inequality, as seen in Figure 6, which is a measure developed by political scientists of the distance between median Republican and median Democratic roll-call votes on a range of key economic issues. As you can see, political partisanship, as measured in those median voting patterns of members of both parties, almost directly tracks the level of inequality. I don't think it a coincidence that the shape of the graph in Figure 6 is almost the same as the shape of the graph in Figure 2, measuring the share of the nation's income going to the top 1 percent.

What accounts for this high correlation? Let me suggest that when large numbers of Americans are working harder than ever but getting

nowhere, and see most economic gains going to a small group at the top, they suspect the game is rigged -- that government and the wealthy (including big corporations) are somehow in cahoots, conspiring against the rest. Some of these people can be persuaded that the culprit is big government; others, that the blame falls on the wealthy and big corporations. The result is more partisanship, fueled by anti-establishment populism on both the right and the left of the political spectrum.

Figure 6

Political Divisiveness



Source: Poole and Rosenthal (2012), VOTEVIEW (<http://voteview.com/blog/?p=221>)

Why this has happened

Between the end of World War II and the late 1970s, the U.S. median wage grew in tandem with American productivity. Both roughly doubled in those years, adjusted for inflation.

But after the late 1970s, while productivity continued to rise at roughly the same pace as before, wages began to flatten. See figure 7.

In part, this was due to the twin forces of globalization and labor-replacing technologies that began to hit the American workforce like strong winds -- accelerating into massive storms in the 1980s and 1990s, and hurricanes since then.

Containers, satellite communications technologies, and cargo ships and planes radically reduced the cost of producing goods anywhere around the globe, thereby eliminating many manufacturing jobs or putting downward pressure on other wages. Automation, followed by computers, software, robotics, numerically-controlled machine tools, and widespread digitization, further eroded jobs and wages.

These forces didn't erode all incomes, however. In fact, they added to the value of complex work done by those who were well-educated, well-connected, and fortunate enough to have chosen the right professions. Competition for the lucky few perceived to be the most valuable saw their pay skyrocket.

But that's only part of the story. Instead of responding to these gale-force winds with policies designed to upgrade the skills of Americans, modernize our infrastructure, strengthen our safety nets, and adapt the

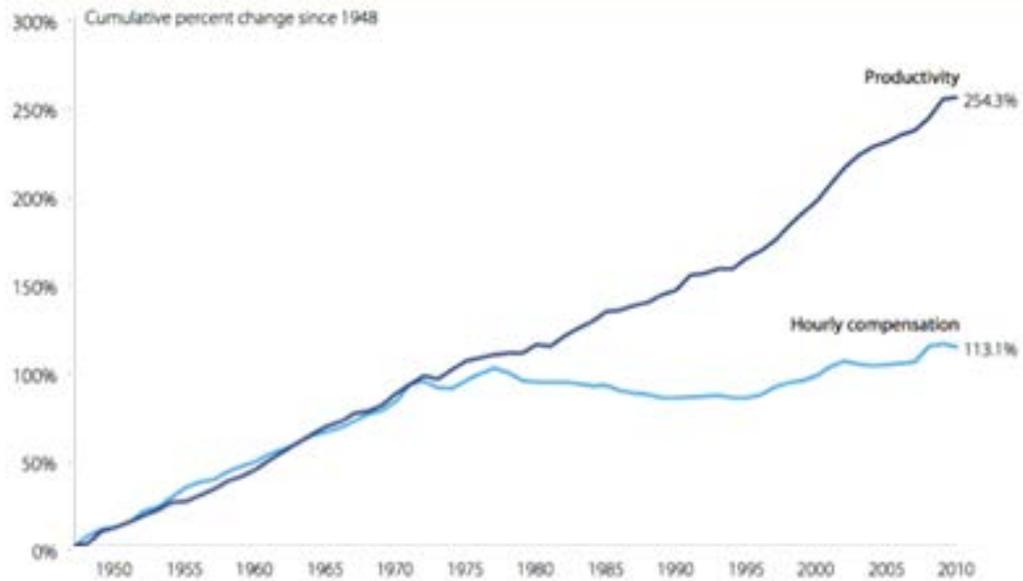
workforce -- and pay for much of this with higher taxes on the wealthy -
- we did the reverse. We began disinvesting in education, job training,
and infrastructure. We began shredding our safety nets. We made it
harder for many Americans to join unions. In fact, the decline rise and
decline in unionization directly correlates with the rise and decline of
the portion of income going to the middle class (see Figure 8). And we
reduced taxes on the wealthy.

We also deregulated. Financial deregulation in particular made finance
into the most lucrative industry in America -- as it had been in the
1920s. Here again, the parallels between the 1920s and recent years
are striking, reflecting the same "bridge" pattern we've seen before.
See Figure 9.

Other advanced economies have faced the same gale-force winds but
have not suffered the same inequalities as has the United States,
because they have helped their workforces adapt to the new economic
realities -- leaving the United States as the most unequal of all
advanced nations by far.

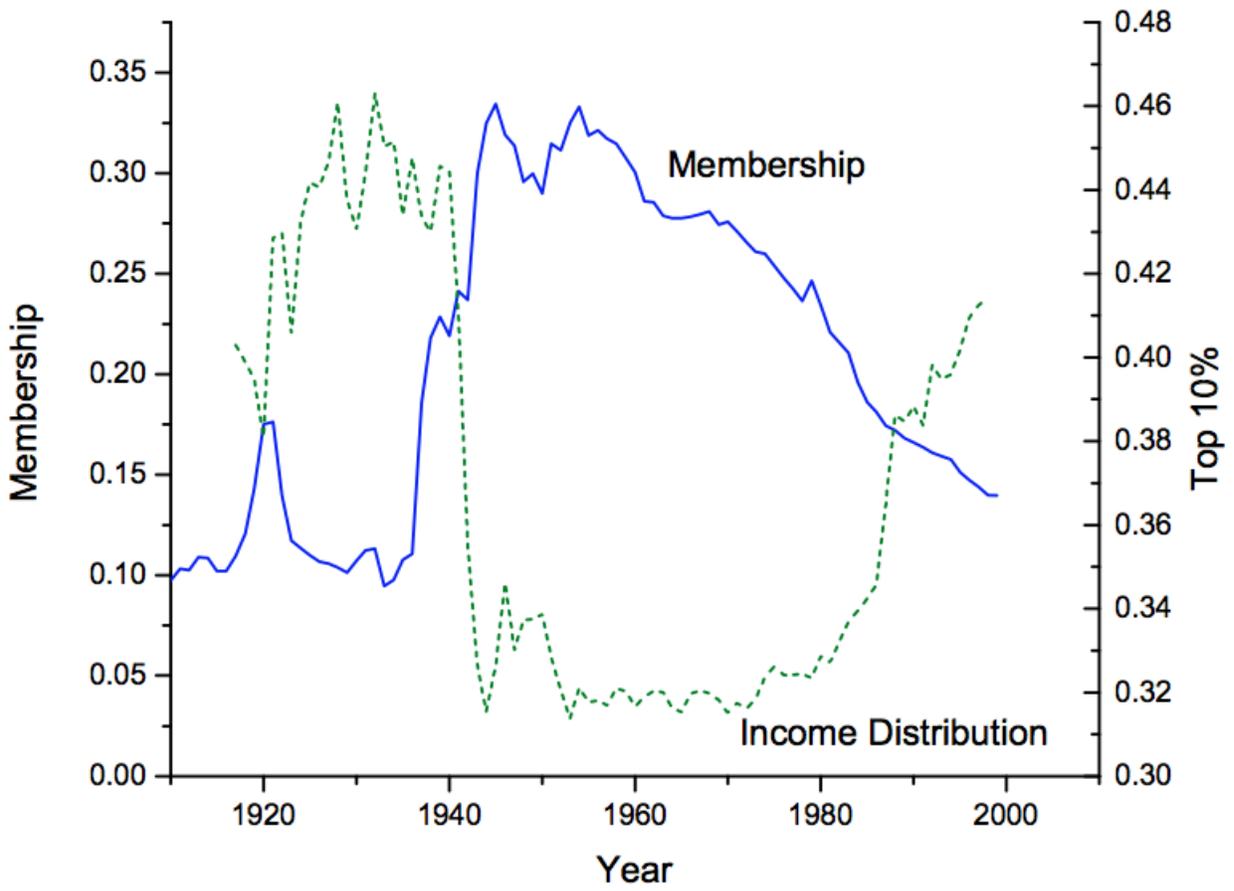
Figure 7

The Puzzle: Wages kept up with productivity until late 1970s



Source: Economic Policy Institute

Figure 8



Source: Census Bureau, Current Population Survey, and Hirsch et al. "Estimates of Strength of Union Density by State"

Figure 9

Median financial sector wage relative to median wage for all other industries



Source: T. Philippon, "Wages and Human Capital in U.S. Financial Industry", (2012)

What to do

There is no single solution -- no magic bullet -- to reversing widening inequality. But I'd recommend six policies in particular:

1. *Make work pay.* The fastest-growing categories of work are retail, restaurant (including fast food), hospital (especially orderlies and staff), hotel, child care, and elder care. But these jobs tend to pay very little. A first step toward making work pay is to raise the federal minimum wage

to at least \$10 an hour, and expand the Earned Income Tax Credit. No American who works full time should be in poverty.

2. *Unionize low-wage workers.* As we've seen, the rise and fall of the American middle class correlates almost exactly with the rise and fall of private-sector unions, because unions gave the middle class the bargaining power it needed to gain a fair share of the gains from economic growth. We need to reinvigorate unions, beginning with low-wage service occupations that are sheltered from global competition and from labor-replacing technologies. Lower-wage Americans deserve more bargaining power.

3. *Invest in education* -- from early-childhood through world-class primary and secondary schools, affordable public higher-education, good technical education, and lifelong learning. Education should not be thought of as a private investment; it is a public good that helps both individuals and the economy overall. Yet for too many Americans, high-quality education is unaffordable and unattainable. Every American should have an equal opportunity to make the most of herself or himself.

4. *Invest in infrastructure.* Many working Americans -- especially those in the lower rungs of the income ladder -- are hobbled by an obsolete infrastructure that generates long commutes to work, excessively high home and rental prices, inadequate access to the Internet, insufficient sources of power and water, and unnecessary degradation of the environment. Every American should have access to an infrastructure suitable to the richest nation in the world.

5. *Pay for much of this by raising taxes, especially on the wealthy.* Between the end of World War II and 1981 -- then the wealthiest

Americans were getting paid a far lower share of total national income - the highest marginal federal income tax rate never fell below 70 percent, and the effective rate (including tax deductions and credits) hovered around 50 percent. But with Ronald Reagan's tax cut in 1981, and then George W. Bush's tax cuts of 2001 and 2003, taxes on top incomes were slashed, and tax loopholes favoring the wealthy, widened. The implicit promise -- sometimes made explicit -- was that the benefits of such cuts would trickle down to the broad middle class and even to the poor. As has been shown, however, nothing trickled down. At a time in American history when the after-tax incomes of the wealthy continue to soar, while median household incomes are falling, and when we must invest far more in education and infrastructure, it seems appropriate to raise the top marginal tax rate, and close tax loopholes that disproportionately favor the wealthy.

6. *Constrain Wall Street.* The financial sector has added to the burdens of the middle class and the poor through excesses that were the proximate cause of an economic crisis in 2008, similar to the crisis of 1929. Even though capital requirements have been tightened and oversight strengthened, the biggest banks are still too big to fail, or jail, or curtail -- and therefore capable of generating another crisis. The Glass-Steagall Act, separating commercial from investment-banking functions, should be resurrected in full, and the size of big banks should be capped.

7. *Get big money out of politics.* Finally, but not the least, we must limit the political influence of the great accumulations of wealth that are now threatening our democracy and drowning out the voices of average Americans. The Supreme Court's decision in *Citizens United vs. Federal Election Commission* must be reversed -- either by the Court

itself, or by Constitutional amendment. In the meantime, we must move toward public financing of elections -- for example, with the federal government providing candidates in general elections for House and Senate and for the presidency two dollars for every dollar raised from small donors.

It will take a movement

I would begin by raising the minimum wage. But I'm not so unrealistic as to believe other measures designed to reverse widening inequality will be enacted any time soon. I've served in Washington, and know how difficult it is to get anything done unless the broad public understands what's at stake and actively pushes for reform. That's why we need a movement against economic inequality and in favor of shared growth – a movement on a scale similar to the Progressive movement at the turn of the last century that fueled the first progressive income tax and antitrust laws, the women's' suffrage movement that got women the vote, the labor movement that helped animate the New Deal of the 1930s and fueled the great prosperity of the first three decades after World War II, the Civil Rights movement that achieved the landmark Civil Rights and Voting Rights Acts, and the environmental movement that spawned the Environmental Protection Act and other critical legislation.

Time and again, when the situation demands it, America has saved capitalism from its own excesses. We put ideology aside, and do what's necessary. No other nation is as fundamentally pragmatic. We will

reverse the trend toward widening inequality eventually. The question is how much damage will have been done to our economy, our democracy, and our ideal of equal opportunity in the meantime.

Thank you.

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