Income Inequality and the Great Recession

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Report by the U.S. Congress Joint Economic Committee
Representative Carolyn B. Maloney, Chair
Senator Charles E. Schumer, Vice Chairman

EXECUTIVE SUMMARY

This week, the U.S. Census Bureau will release new statistics on income inequality in the United States, allowing for an assessment of the impact of the Great Recession on our nation's income distribution. In preparation for that data release, the Joint Economic Committee (JEC) analyzed income inequality in the United States in the years preceding the Great Recession, and found:

- **Income inequality has skyrocketed.** Economists concur that income inequality has risen dramatically over the past three decades.
- **Middle-class incomes stagnated under President Bush**. During the recovery of the 1990s under President Clinton, middle-class incomes grew at a healthy pace. However, during the jobless recovery of the 2000s under President Bush, that trend reversed course. Middle-class incomes continued to fall well into the recovery, and never regained their 2001 high. The first year of the Great Recession dealt a sharp blow to middle-class families, who had not yet recovered from the pain of the last recession.
- **High levels of income inequality may precipitate economic crises.** Peaks in income inequality preceded both the Great Depression and the Great Recession, suggesting that high levels of income inequality may destabilize the economy as a whole.
- **Income inequality may be part of the root cause of the Great Recession.** Stagnant incomes for all but the wealthiest Americans meant an increased demand for credit, fueling the growth of an unsustainable credit bubble. Bank deregulation allowed financial institutions to create new exotic products in which the ever-richer rich could invest. The result was a bubble-based economy that came crashing down in late 2007.
- **Policymakers have a great deal of leverage in mitigating income inequality in order to stabilize the macro-economy.** In the decades following the Great Depression, policy decisions helped keep income inequality low while allowing for continued economic growth. In contrast, policy decisions made during the economic expansion during the Bush administration failed to keep income inequality in check, and may have exacerbated the problem. Policymakers working to rebuild the economy in the wake of the Great Recession should heed these lessons and pay particular attention to policy options that mitigate economic inequality.

INCOME INEQUALITY AND THE GREAT RECESSION

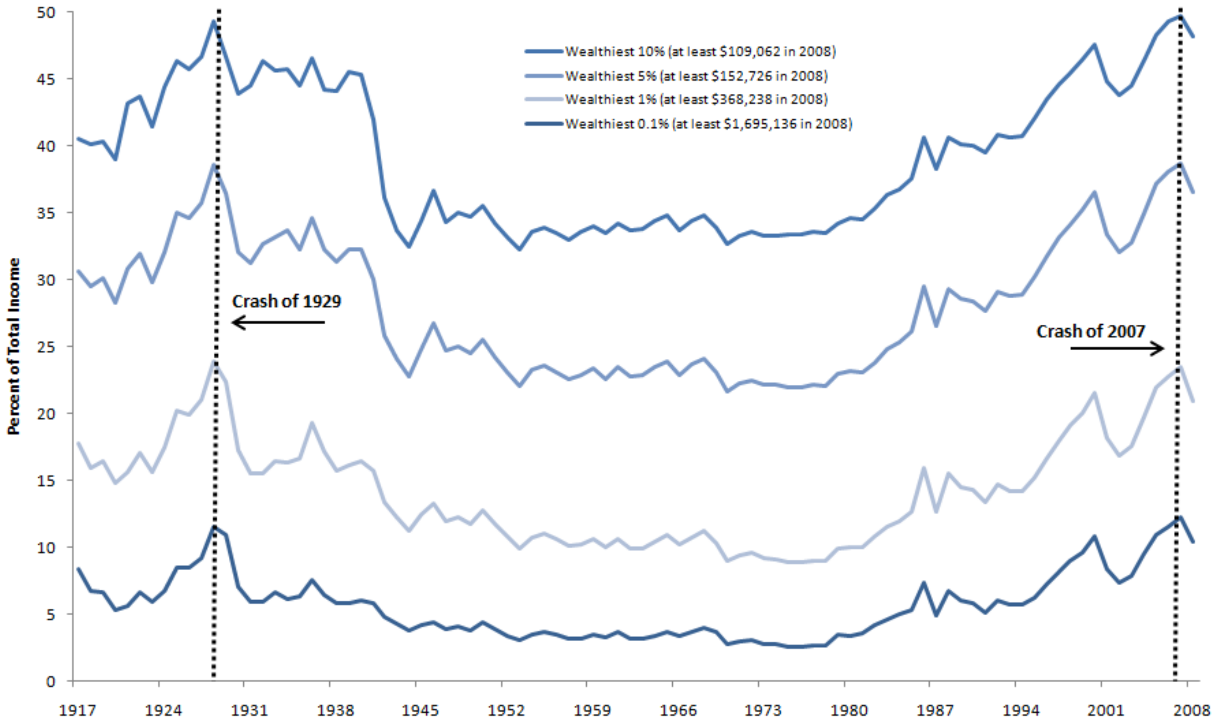
Income inequality has worsened in the U.S.

Over the past three decades, income inequality has grown dramatically. After remaining relatively constant for much of the post-war era, the share of total income accrued by the wealthiest 10 percent of households jumped from 34.6 percent in 1980 to 48.2 percent in 2008.[1] Much of the spike was driven by the share of total income accrued by the richest 1 percent of households. Between 1980 and 2008, their share rose from 10.0 percent to 21.0 percent, making the United States as one of the most unequal countries in the world.[2] Moving even further up the income distribution, the share of income accruing to the wealthiest 0.1 percent of households – those with incomes of at least $1.7 million in 2008 – has grown sharply as well. In short, the evolution of income inequality in the United States is largely driven by the trends at the very top of the income distribution, as very wealthy households have continued to accrue an ever-greater share of the nation's total income.

Income inequality peaked prior to the United States' two most severe economic crises – the Great Depression and the Great Recession (See Figure 1). At the peak of the stock market bubble that capped the Roaring Twenties, in 1928, the share of income accruing to the top decile peaked at 49.3 percent. The crash that followed set off the cascade of events that would ultimately land the United States in the deepest recession in history. Nearly 80 years later, on the eve of the Great Recession in 2007, the share of income held by the wealthiest 10 percent topped its earlier high when it hit 49.7 percent.

Income inequality fell somewhat between 2007 and 2008, as the Great Recession dragged down family economic fortunes across the economic spectrum. The new Census data are likely to show a continued dip in income inequality. At the same time, the Great Recession has pushed more Americans into poverty and depressed average household incomes. The dip in inequality triggered by recessions is typically temporary. The long-term upward trend in income inequality has been persistent over the last three decades, with slight downturns during recessions reversed during the recovery periods that follow. For instance, in the aftermath of the 2001 recession, the share of total income amassed by the top decile dropped 3.8 percentage points (from 47.6 percent in 2000 to 43.8 percent in 2002). During the recovery, however, inequality skyrocketed, hitting a historic high in the run-up to the Great Recession. In short, recessions may ease inequality in the short-term, but they will not reverse the long-term trend toward an increasingly skewed income distribution.

Figure 1. Income Inequality Peaks Prior to Severe Economic Crises
Wealthiest Americans' Share of Total Income, 1917-2008

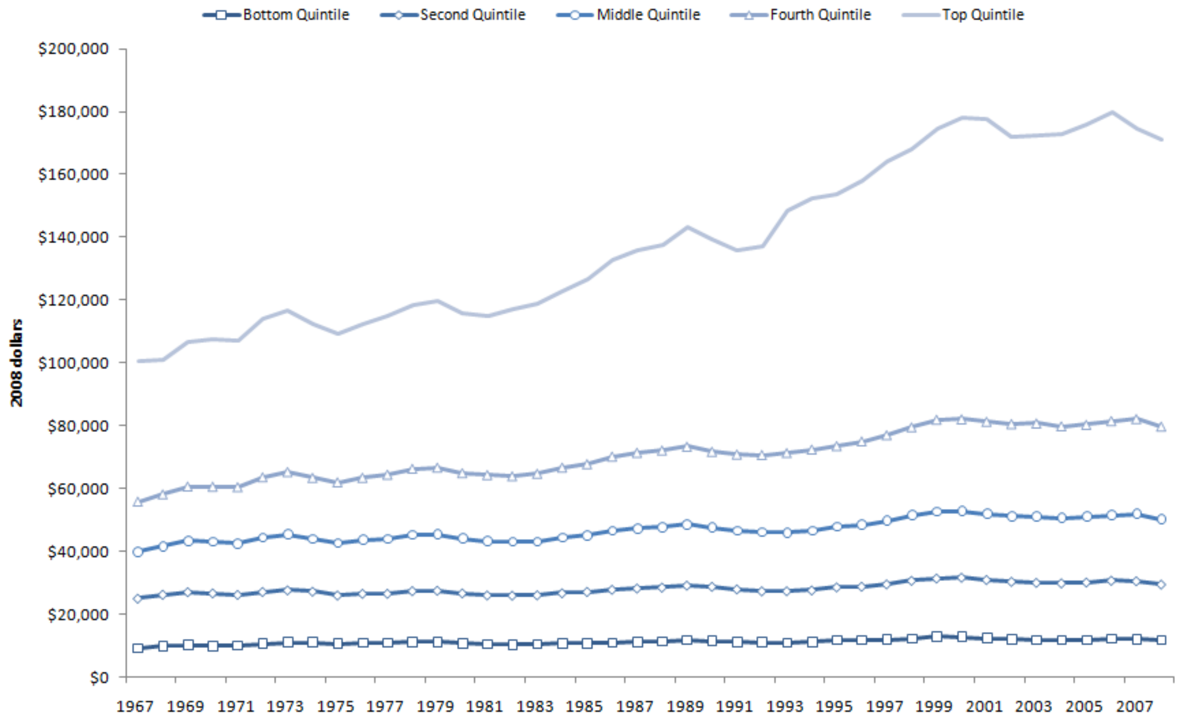


Source: JEC Majority Staff based on analysis of Internal Revenue Service data by Emmanuel Saez and Thomas Piketty.
Note: Income is defined as market income, including capital gains.

Middle-class incomes are stagnant.

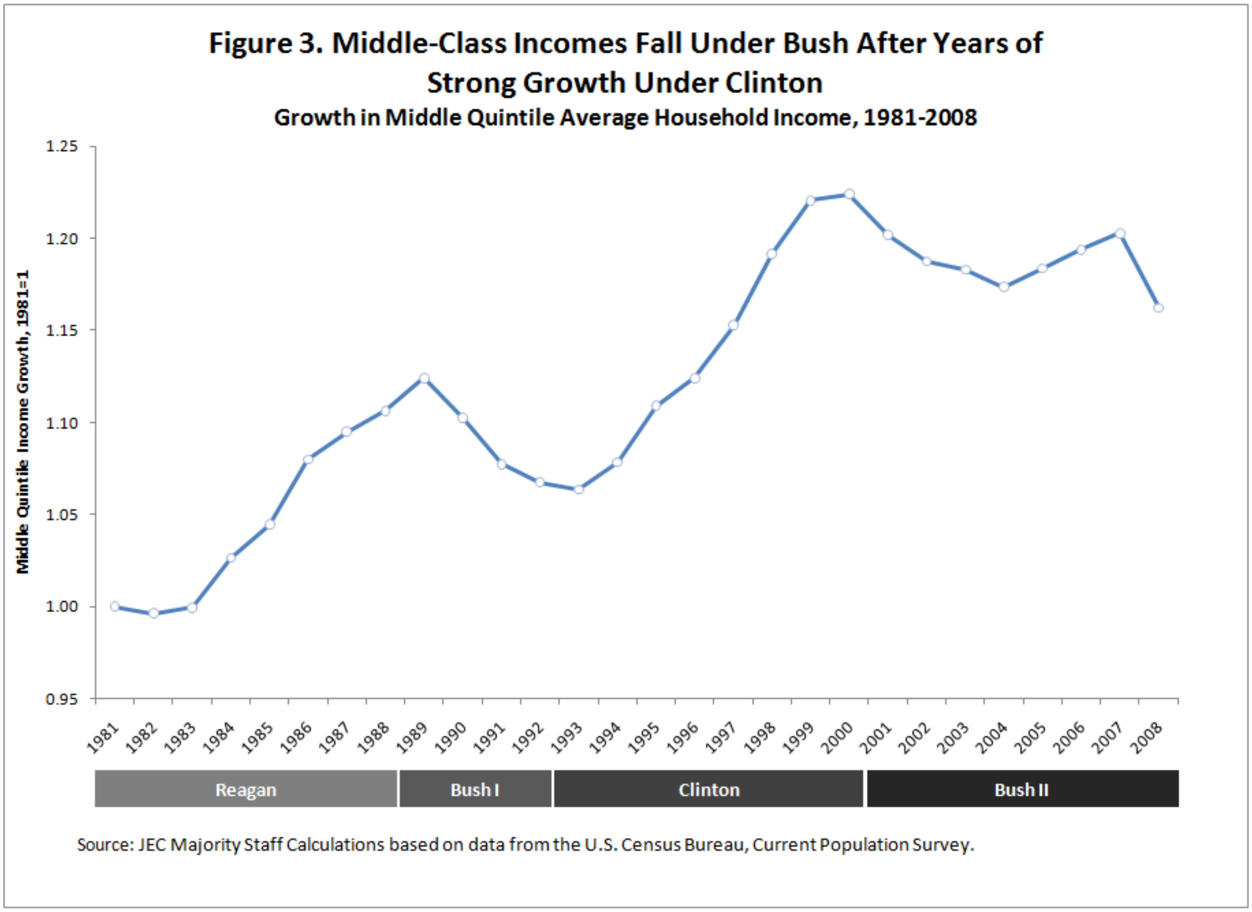
While the rich have gotten richer, middle-class Americans have been left behind. Between 1967 and 2008, incomes for the top 20 percent of Americans grew by $70,600 – gains of over 70.3 percent. Income growth for the middle quintile was far slower, growing by just $10,200 – a 25.7 percent increase (See Figure 2).

Figure 2. Middle-Class Incomes Stagnate While the Rich Get Richer
Average Household Incomes by Quintile, 1967-2008



Source: JEC Majority Staff Calculations based on data from the U.S. Census Bureau, Current Population Survey.

The Bush years were especially hard on the middle class, particularly when compared to the gains seen by middle income Americans during the Clinton administration (See Figure 3). During both the recession of the early 1990s and the downturn of the early 2000s, middle-class incomes fell. During the recovery of the 1990s under President Clinton, middle-class incomes grew at a healthy pace. However, during the jobless recovery of the 2000s under President Bush, that trend reversed course. Middle-class incomes continued to fall well into the recovery, and never regained their pre-recession high. The first year of the Great Recession dealt a sharp blow to middle-class families, who had not yet recovered from the pain of the last recession.



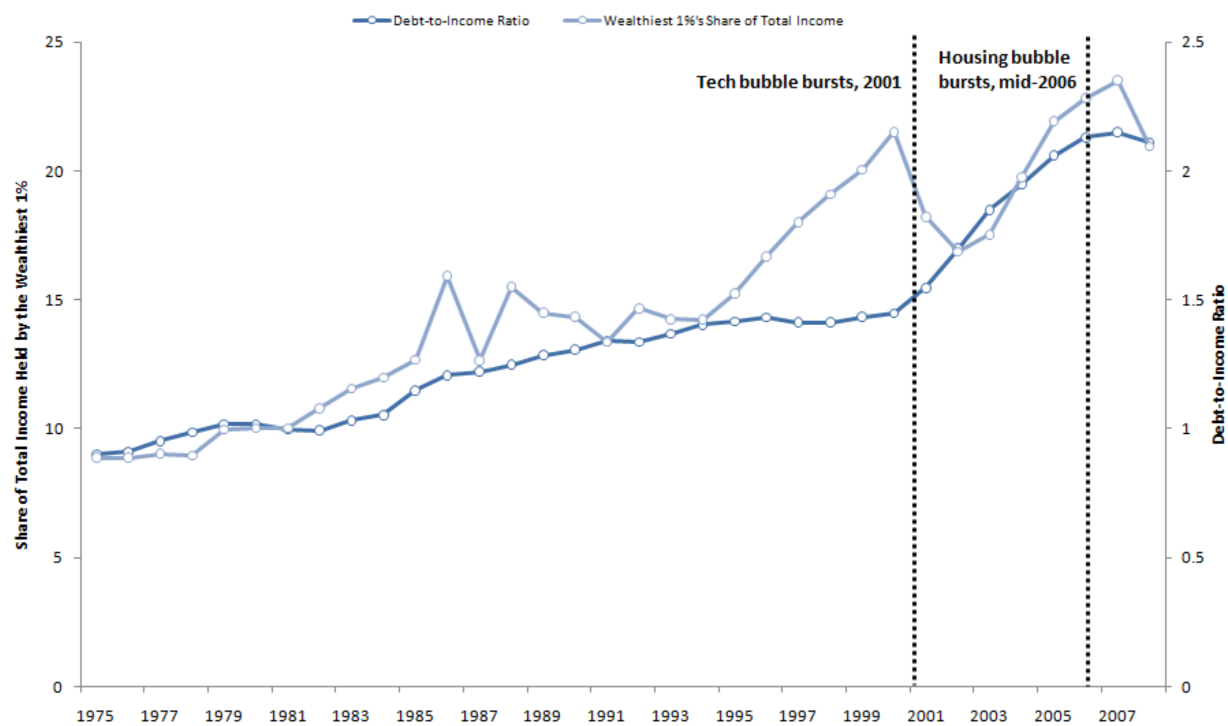
Income inequality may fuel economic crises.

Severe income inequality may make the economy more vulnerable to a deep recession. In the case of the Great Recession, income inequality fueled economic instability in two ways. First, stagnant middle-class incomes meant increased demand for credit, fueling an unsustainable bubble. Second, the ever-richer rich amassed increasing sums of money to invest in new financial products. Bank deregulation allowed for the development of exotic financial instruments, and the collapse of this house of cards instigated the Great Recession.

The everyday consequence of stagnant middle-class paychecks is the creation of demand for credit in order to make ends meet – and to keep up with the Joneses, as the rich get richer. Former Chief Economist of the International Monetary Fund Raghuram Rajan argues that, instead of attacking the root causes of rising income inequality in the U.S., policymakers made access to credit much easier for low-income households in order to support their spending, especially home purchases.[3] Household debt as a share of household income grew astronomically over the same period as the explosion in income inequality (See Figure 4).

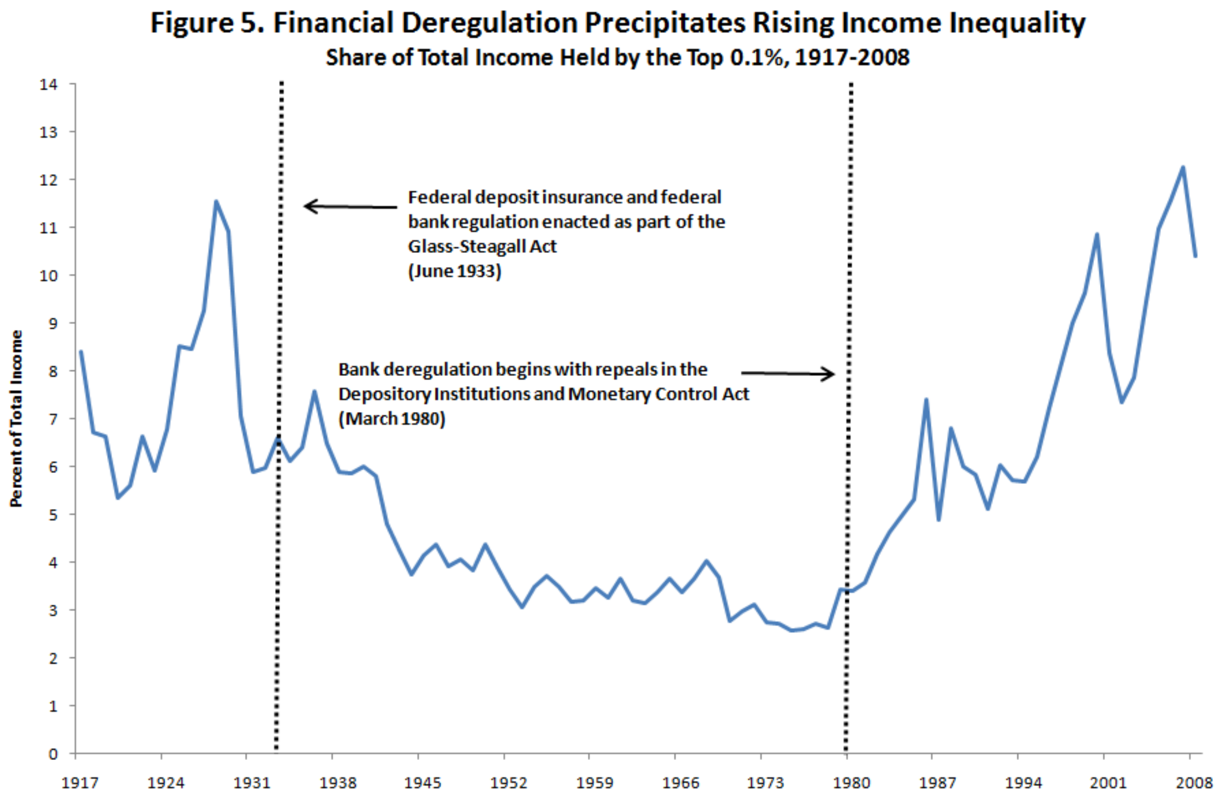
Growth in debt-to-income was particularly sharp during the jobless recovery of the 2000s, as middle-class families' incomes remained stagnant and borrowing skyrocketed. That expansion of lending to middle- and low-income households created a boom in consumption and fueled the economic growth of the early 2000s. But it was not sustainable, and the collapse of the housing market was the result of households across the United States bearing levels of debt with incomes that simply could not keep pace. Ultimately, excessive borrowing on the part of those left behind as the rich grew richer helped spark the housing bubble whose implosion helped trigger the start of the Great Recession.

Figure 4. Household Debt-to-Income Ratio Grows with Income Inequality



Source: JEC Majority Staff calculations using household debt data from the Federal Reserve's Flow of Funds and income data (wage and salary disbursements) from the Bureau of Economic Analysis's NIPA; analysis of Internal Revenue Service data by Emmanuel Saez and Thomas Piketty. The top 1% had at least $368,238 in income in 2008.

In tandem with easing lending standards, the financial services industry developed ever-more-complicated exotic financial instruments in response to the demand for new investment opportunities from the ever-richer rich. Bank deregulation allowed for this speculative behavior, which precipitated the collapse of the American economy (See Figure 5).



Source: JEC Majority Staff based on David Moss' interpretation of an analysis of Internal Revenue Service data by Emmanuel Saez and Thomas Piketty.
Note: Income is defined as market income, including capital gains. The top 0.1% had at least $1,695,136 in income in 2008.

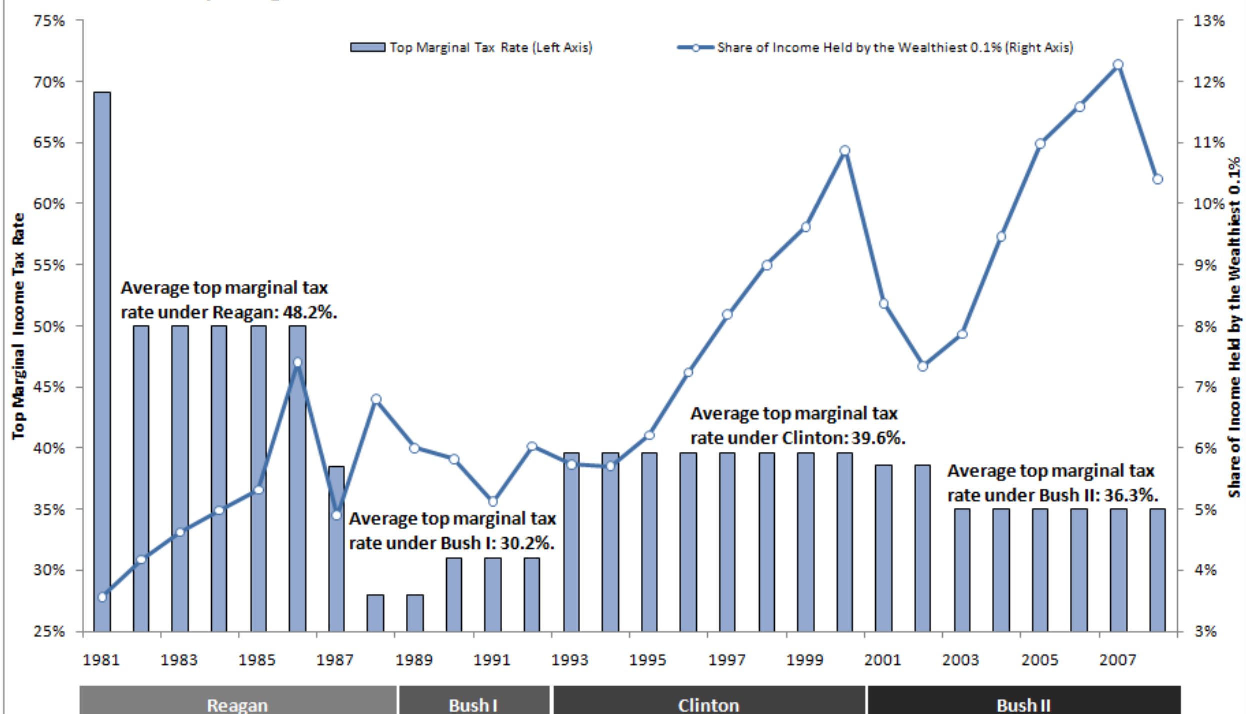
Policymakers have substantial leverage to mitigate income inequality and thereby stabilize the economy as a whole.

Economist Emmanuel Saez, winner of the 2009 John Bates Clark Award for his contribution to economic thought and knowledge, argues that income inequality will remain stubbornly high "unless drastic regulation and tax policy changes are implemented."[4] Saez makes a strong case for the importance of policy in mitigating the rise in income inequality, arguing that "the retreat of institutions developed during the New Deal and World War II – such as progressive tax policies, powerful unions, corporate provision of health and retirement benefits, and changing social norms regarding pay inequality" may be responsible for the explosion in inequity in our nation.[5]

Tax policy is an important lever that allows policymakers to ensure fairness and reign in runaway inequality. The lowering of the top marginal tax rate from 1981 through 2000 coincided with the dramatic rise in the share of income going to the very wealthiest American households (See Figure 6). In response to growing income inequality stemming from decades of cuts in the top marginal tax rates, the Clinton administration instituted policy changes that required the ever-richer rich to pay a small additional slice of their income in taxes. The upward movement in the top marginal tax rate in the Clinton era was relatively minimal; the top rate remained lower than they were during the Reagan administration. Moreover, higher marginal tax rates for the richest households did not lower these households' income. Indeed, the real income of the wealthiest 1 percent grew at an annual rate of 10.3 percent during the Clinton administration, when the top marginal tax rate rose from 31.0 percent to 39.6 percent.[6]

Figure 6. Divergent Policy Responses to Income Inequality

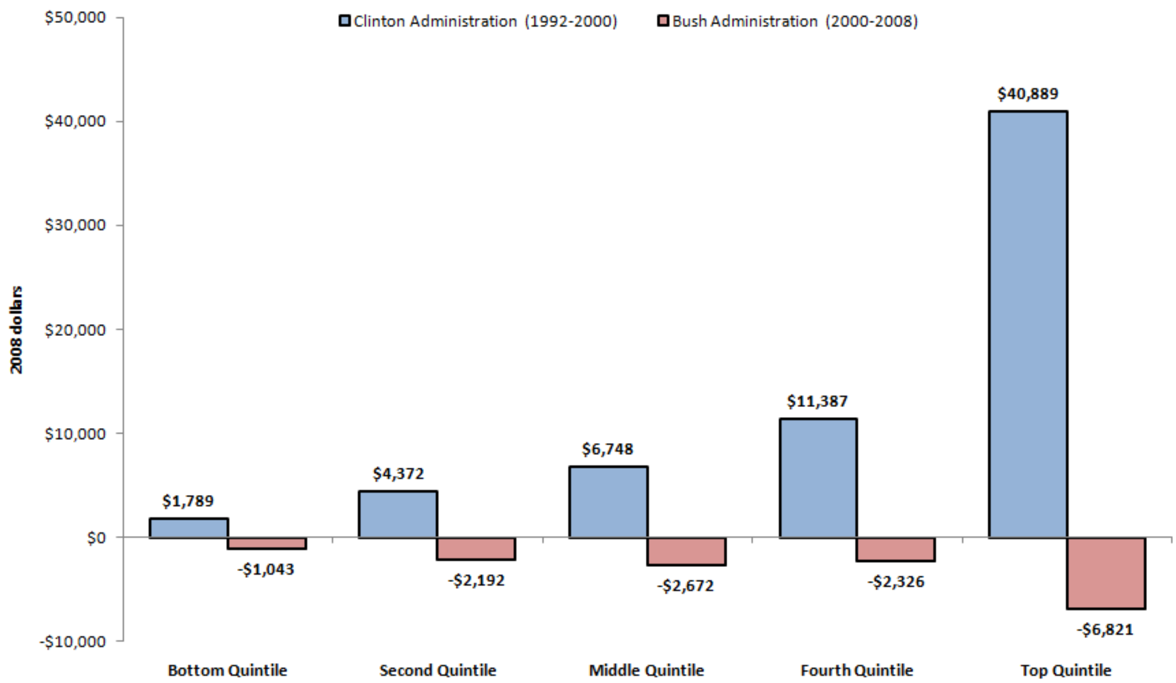
Top Marginal Tax Rate and Wealthiest American's Share of Total Income, 1981-2008



Source: JEC Majority Staff based on Income share data from analysis of Internal Revenue Service data by Emmanuel Saez and Thomas Piketty. Top marginal tax rate data from the Urban Institute/Brookings Institution Tax Policy Center.

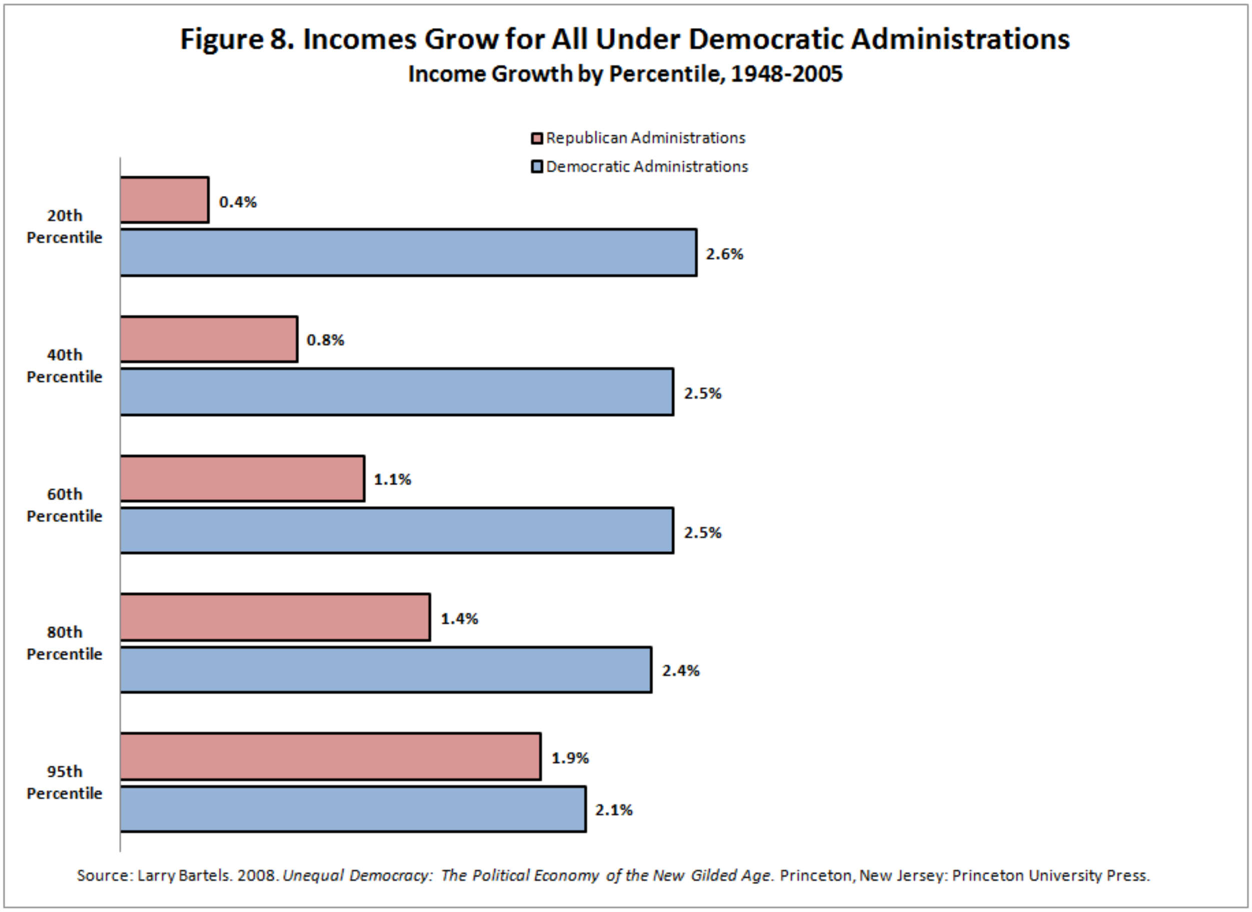
Because of those tax policy shifts, the Clinton administration ushered in a period of income growth for families across the income distribution (See Figure 7). The economic boom of the 1990s impacted all Americans, regardless of their position in the income distribution. Middle income Americans saw their incomes increase by over $6,700 during the Clinton years. Wealthy Americans saw their incomes grow as well. Under President Clinton, the rising tide lifted all boats, not just the yachts. In comparison, Bush's tax cuts did not translate into prosperity. Middle-class Americans' incomes fell by over $2,600, or over 5.0 percent, during Bush's eight years in office. While the Great Recession certainly explains some of the loss of middle-class families' incomes under President Bush, it is not entirely to blame. The middle class entered the Great Recession in a precarious state.

Figure 7. Incomes Grew Across the Distribution Under Clinton, But Dropped for All Under Bush



Source: JEC Majority Staff Calculations based on data from the U.S. Census Bureau, Current Population Survey.
Note: In order to measure changes in incomes over an administration, calculations compare income levels in the year prior to an administration taking office with the income levels in the administration's final year in office.

As a general rule, Democratic administrations' policies have ushered in periods of sustained economic growth for all Americans, not just the wealthy (See Figure 8). In contrast, Republican administration's policies deliver far more to the wealthiest Americans than to the remainder of the income spectrum. Looking across all presidential administrations from 1948 through 2005, incomes for Americans in the 60th percentile – roughly the middle of the distribution – grew an average of 2.5 percent under Democrats, while they grew by just 1.1 percent under Republicans. Moreover, the rich don't suffer at the expense of middle and lower income groups' progress under Democrats. Indeed, incomes for the 95th percentile of American households have grown more under Democrats than under Republicans. In simple terms: Democratic policies lift all boats, not just the yachts.



Policymakers today have the opportunity to continue the work begun by President Clinton, and help steer America back onto a course of economic growth where rising tides lift all boats, rather than just the wealthiest American's yachts. Retaining the Bush tax cuts for all households, instead of letting them expire for the top two income brackets, would make the income tax system less progressive and could further exacerbate income inequality and economic fragility.

[1] Calculations by Emmanuel Saez using Internal Revenue Service data. See http://elsa.berkeley.edu/~saez/. Income refers to market income, including capital gains. Note that the exclusion of capital gains from the calculations of income inequality does not change the underlying trend.
[2] Ibid. See also Piketty, Thomas and Emmanuel Saez. 2007. "Income Inequality in the United States, 1913-2002." http://elsa.berkeley.edu/~saez/.
[3] Rajan, Raghuram G. 2010. *Fault Lines: How Hidden Fractures Still Threaten the World Economy*. Princeton: Princeton University Press. Rajan and other prominent economists suggest that root causes at the heart of growing income inequality in the United States over the last three decades include the decline of unions, the erosion of the progressive taxation system, the declining real value of the minimum wage, and skills-biased technological change. See, for example, Levy, Frank and Peter Temlin. 2007. "Inequality and Institutions in 20th Century America."

Industrial Performance Working Paper, Massachusetts Institute of Technology. http://web.mit.edu/ipc/publications/pdf/07-002.pdf.
[4] Saez, Emmanuel. 2010. "Striking It Richer: The Evolution of Top Incomes in the United States." http://elsa.berkeley.edu/~saez/saez-UStopincomes-2008.pdf.
[5] Ibid.
[6] Ibid.