How Inflation is Weakening the Recovery and Harming Low-Income Americans the Most

Joint Economic Committee – Republicans

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INTRODUCTION

Inflation has become a defining characteristic of the COVID-19 economic recovery. As the labor market recovery loses steam and economic growth slows, two common inflation indicators—the Consumer Price Index (CPI) and the Personal Consumption Expenditures Price Index (PCEPI), as well as their core measures—are increasing faster than they have in 30 years. While much of the conversation has focused on whether today's rising prices are transitory or permanent (it is actually a mix of both), less attention has been paid to how inflation is affecting our economic recovery and American families' livelihoods. Unfortunately, the data show that surging prices of everyday items like food, gas, and housing disproportionately affect poor and middle-class Americans.

INFLATION IS HOLDING BACK THE RECOVERY

Growing inflation threatens what could be a turning point in our economic recovery. The number of new daily COVID-19 cases is falling, which caused consumer confidence to rise in October for the first time in four months. Americans are becoming more comfortable in their ability to travel and participate in experiences requiring in-person interactions. Yet, continued supply issues and rising prices are depressing economic growth.

For example, real Gross Domestic Product (GDP) increased at an annual rate of 2.0 percent in the third quarter of 2021, a marked decline from the 6.7 percent increase in the second quarter. This slowdown in GDP growth was primarily driven by a decline in consumer spending, which subtracted a whopping 2.3 percentage points from real GDP. Interestingly, the entire decline in spending can be accounted for by the decrease in motor vehicle sales (especially used vehicles). Facing supply chain disruptions, new vehicles are harder to come by and used vehicle prices have climbed. As a result, surging motor vehicle prices hurt consumption enough to significantly reduce economic growth in the third quarter.

While some evidence suggests that long-run inflation expectations are anchored—meaning consumers are expecting this period of high inflation to be temporary—short-term inflation expectations have been steadily rising and just hit a 13-year high. And while inflation today remains elevated, it is eroding Americans' wage gains across the income spectrum and it is more than enough to erase substantial nominal wage increases among lower-income Americans.[1] Regardless of whether the current high inflation is temporary, or how long it will last, it is having substantial, negative impacts on Americans today.

INFLATION DISPROPORTIONATELY HARMS LOW-INCOME AMERICANS

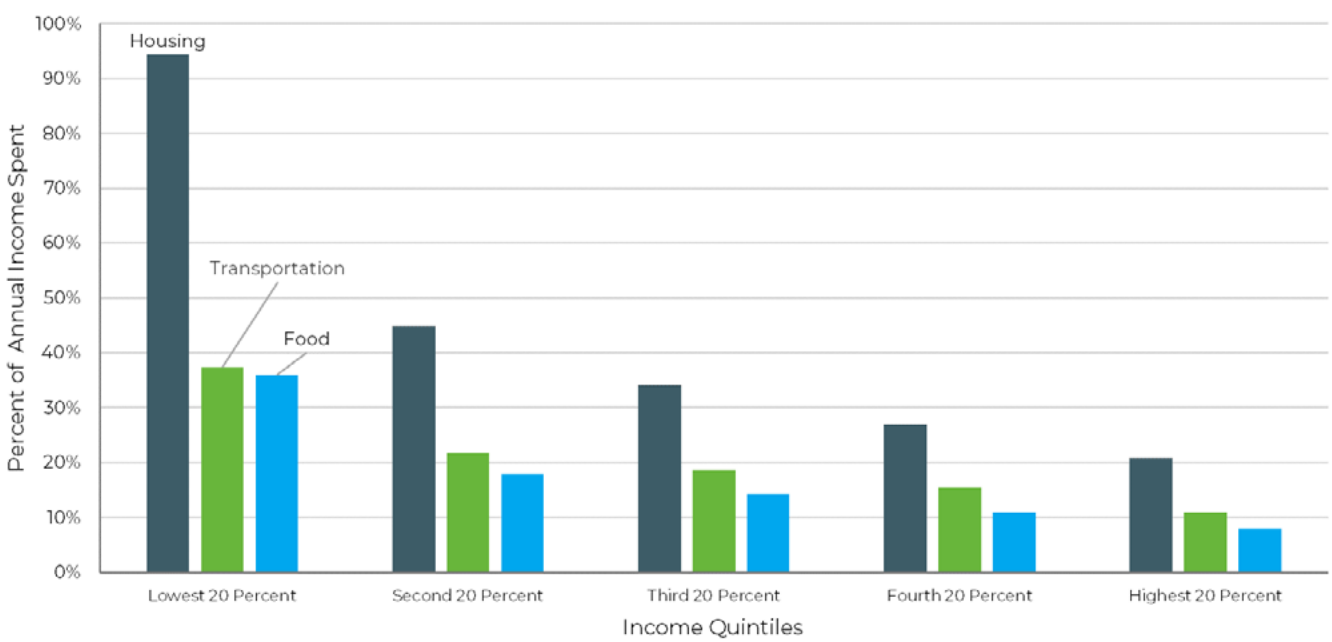
High inflation affects any individual who holds or spends money by reducing the purchasing power of their dollars, but it is especially harmful for poor and middle-class Americans. Global polling from researchers at the World Bank and

International Monetary Fund found that individuals who self-identify as very poor have a 10.5 percent higher probability of naming inflation as a top national concern than those who identify as rich. The researchers also found that rising inflation is associated with increasing poverty rates.

Similarly, research from the Federal Reserve Bank of Cleveland finds that inflation reduces poor individuals' lifetime consumption opportunities more than their wealthier counterparts, and research from the Federal Reserve Bank of New York finds that gasoline prices are the main reason why urban and rural households experience inflation differently. In other words, inflation reduces poor Americans' quality of life, and rising gas prices specifically increase the cost of living for poor Americans living in rural areas much more than for richer Americans.

To determine how inflation is affecting low-income Americans today, it is helpful to examine the main drivers of current inflation relative to lower-income Americans' normal consumption patterns. In October, increases in housing, transportation, and food prices were the largest contributors to the 6.2 percent annual increase in CPI. Within those categories, the cost of hotels, used autos, and gas are experiencing some of their largest annual increases to date as demand for travel rises—increasing 25.5 percent, 26.4 percent, and 49.6 percent, respectively. Unsurprisingly, lower income households spend a larger portion of their incomes on items in all three of these categories, and the difference is stark.

Figure 1: Average Annual Expenditures as a Percentage of After-Tax Income, by Income Quintile, 2019



Source: Bureau of Labor Statistics (BLS) Consumer Expenditure Survey, 2019

Figure 1 shows U.S. consumer units' (i.e. households) spending patterns on housing, transportation, and food across various income levels. Annual spending is shown as a percentage of annual income after taxes, which includes government transfers. Of note, spending among the lowest 40 percent of households exceeded their after-tax income during the year. According to BLS, this is likely driven by individuals, like students and retirees, who draw on savings or borrowing to fund their expenses. However, additional evidence suggests that it may be the result of individuals at the low end of the income distribution underreporting government income assistance and other welfare benefits.[3]

In 2019, the lowest-earning 20 percent of U.S. households spent over 4.5 times more of their income on housing and food than the highest-earning 20 percent, and nearly 3.5 times more on transportation. Households in the middle of the income distribution—those making on average $56,000 per year—also spent proportionally more than the highest-income households, spending 64 percent more of their income on housing, 69 percent more on transportation, and 77 percent more on food. Within these categories, the most striking differences in spending patterns were on shelter[4] (high earners spend 12 percent of their incomes vs. 57 percent for low earners), food at home (4 percent vs. 23 percent), and gas (2 percent vs. 8 percent).

In addition to spending a larger share of their income on essentials, such as housing and food, lower-income families also tend to consume more foreign-made goods than higher-income Americans (think of all of the low-cost imported consumer goods sold by Amazon, Wal-Mart, and Dollar General). These goods are also experiencing rapid price increases, which is disproportionately hurting lower-income Americans. Elevated consumer demand for imports and ongoing supply chain issues drove up import prices by 9.2 percent as of September— much more than the 5.4 percent annual increase in overall CPI that month.

Inflation is a defining piece of the post-COVID economic recovery. While some argue that there should be no concern over today's rising prices because they are simply the consequence of a strong economic rebound, the evidence suggests that inflation is depressing economic growth and harming poor Americans the most.

Jackie Benson
Senior Economist

ENDNOTES

1. Author's calculations, nominal wages by income level were retrieved from the Bureau of Labor Statistics "Usual Weekly Earnings of Wage and Salary Workers" releases and adjusted to real dollars using the Consumer Price Index for All Urban Consumers.
2. Research from Bruce D. Meyer, Wallace K. C. Mok, and James X. Sullivan finds that the Consumer Expenditure Survey produces the lowest government assistance reporting rates of five major nationally representative surveys because it asks participants to recall detailed consumption and income data over a relatively longer period of time. They also find that underreporting rates have been increasing over time.
3. Shelter is a category defined by the Bureau of Labor Statistics that measures the services that housing units provide their occupants. It's two main components are: (1) rent of primary residence, and (2) owners' equivalent rent of residences.

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