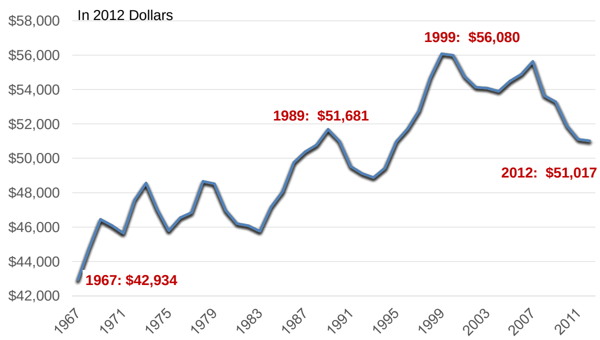
Income Growth and Inequality

Income inequality has increased dramatically in the U.S. over the last three decades. Economic growth has not translated to shared prosperity. In the aftermath of the recession, millions of people remain unemployed or underemployed, greatly exacerbating the problem. Does the growing gap between the wealthy and everyone else deserve our attention? If so, what should we do about it?

Income inequality can be socially destabilizing. It is difficult to preserve a functioning democracy if prosperity is not broadly shared. Income inequality perpetuates societal divides, erodes social mobility, and can lead to intergeneration transfer of poverty. This flies in the face of the American dream that one can advance through hard work and ingenuity. Although there are many reasons for the growing gap in income inequality, this discussion will focus on structural changes that have occurred in the labor market that favor the most highly skilled workers.

U.S. Median Household Income 1967-2012



Source: U.S. Census Bureau

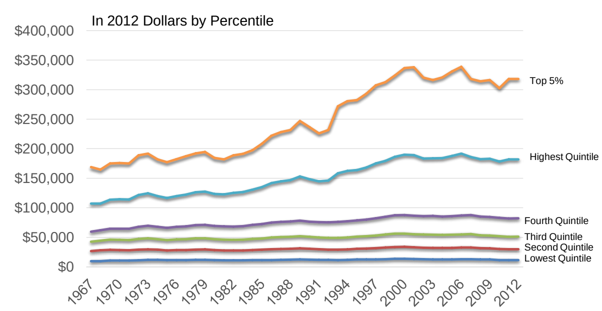
The recession may be long over, but the recovery has yet to reach every corner of the economy. In 2012, the U.S. median household income (adjusted for inflation) was slightly less than it was in the late 1980s and 9% below its peak in 1999. The "good" news is the precipitous decline that began in 2007 (before the recession) appears to be leveling out. Incomes were basically flat in 2011 and 2012.

Note: This definition of income reflects before tax cash income and does not account for changing tax burdens and the impact of income sources that do not take the form of cash (e.g. employer provided healthcare).

Declines in real income have not affected all Americans equally. Since 1967, incomes for the lowest quintile have grown by 19.5% and by 20.3% for the middle quintile. Meanwhile, incomes for the highest quintile increased by 69.8% and for the top 5% of income earners by 88.2%.

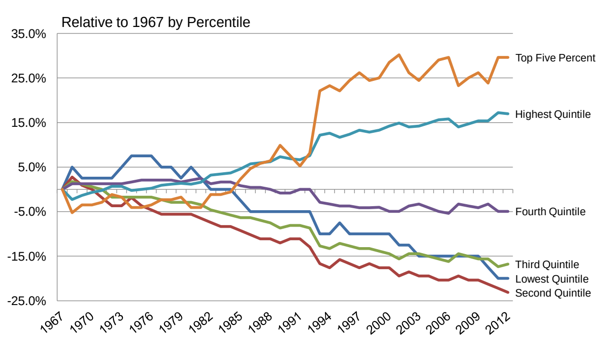
Between 2007 and 2012 (recession and recovery), incomes declined for almost all households, falling by 10.9% for the lowest quintile, 7.5% for the middle and by 2.2% for the highest quintile. Incomes for the top 5% were unchanged.

U.S. Mean Household Income 1967-2012



Source: U.S. Census Bureau

Change in Share of Total Income in U.S. 1967-2012

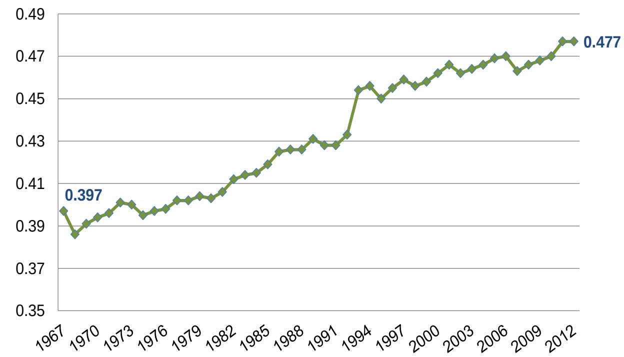


Source: U.S. Census Bureau

Another way to look at how well American households are faring is to examine the distribution of income. This chart shows the change in the share of income going to each quintile. Although the bottom quintile saw its share of income increase during the 1970s, the gains were quickly erased in the 1980s. Since then, only the highest quintile and the top 5% have seen their share of income increase, while the share of income going to everyone else has declined.

The Gini Index is a measure of income inequality. The Gini Index varies between zero and one. A value of one indicates perfect inequality where only one household has any income. A value of zero indicates perfect equality where all households have equal income. Since 1967, the Gini Index for the United States has been rising, meaning the distribution of household income has become more unequal. In 2012, out of 136 countries the United States was the 41st most unequal, just ahead of Uruguay but behind the Philippines (*The World Factbook, CIA*). By state, in 2011, Wyoming had the most equal distribution (.4081) of household income, while New York was most unequal (.5033). Ranking fifth in terms of inequality, California (.4812) was not far behind, and above the national average.

Change in Gini Index of Inequality, for the U.S.1967-2012



Source: U.S. Census Bureau

Similar to the rest of the United States, incomes in California declined across the spectrum during the recession and inequality increased. However, compared to the rest of the nation, incomes in California declined even more at the bottom while incomes at the top declined less.

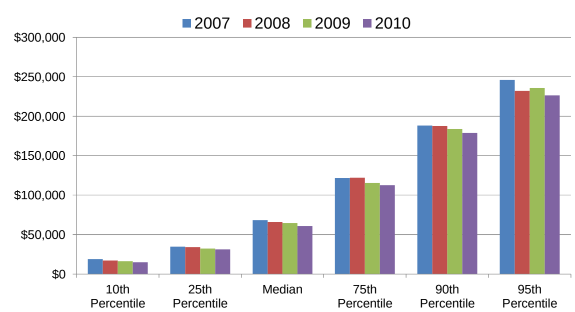
During the recession, the unemployment rate in California spiked at 12.4%, the duration of unemployment rose and many who were working, saw their hours cut or could only find part-time work. Recent research suggests that underemployment as opposed to declining wages was the primary cause for the decline in incomes during and after the recession. Additionally, the slow recovery has limited demand for labor and suppressed wage growth. Thus, policies that promote job creation and especially full-time employment may be a more effective tool for raising incomes than focusing on wage rates.

Over longer term, the trend of growing inequality is in part the result of structural changes in the labor market that have favored the most highly skilled workers over everyone else. A second, related trend, is the polarization of job opportunities. Job opportunities in high-skill high-wage occupations are expanding at one end, while jobs in low-skill low-wage occupations are expanding at the other end. Opportunities for middle-skill workers have diminished, pushing many former white-collar workers into lower-paying service jobs.

Since the mid-1970s, individuals with the highest levels of education (more than 16 years) have experienced a steady increase in wages. Persons with a bachelor's degree or some college are also earning more, but nowhere near their counterparts with an advanced degree. On the other hand, individuals with a high school diploma or less suffered a decline in real wages in the 70s and 80s; wages rebounded slightly in the 90s but have been stagnant ever since.

This suggests the most relevant issue for public policy is the growing gap between individuals with high skill levels and the rest of the population. To close that gap we need policies that focus on the disparities across education and skills, and on ways to upgrade the earnings capacity of the majority of Americans.

California Family Income Growth 2007-2010



Source: Public Policy Institute of California

A particularly alarming symptom of the income gap is the growing fissure in educational achievement as measured by math and reading test scores. While the racial gap has declined, the differences in performance between high and low-income students are widening. Kids at the top have advantages that are simply out of reach for kids at the bottom. Disadvantaged children are reaching college without the skills to persevere and graduate – the result is a growing gap in college completion.

There are a number of policies needed to address these problems. Reforms to the tax code or increases in the minimum wage may be part of the solution, but the nation also needs polices that promote education and skills acquisition across the broadest possible section of the population. This issue goes beyond questions of fairness, right and wrong. The ability of the United States to compete and prosper in a global economy depends on its willingness to make investments that will enable all Americans to have the skills and ability necessary to compete in the global labor market.