

America's Struggling Lower Half

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As a society gets richer, the living standards of its households should rise. Justice needn't require that the poorest benefit the most; equal rates of improvement may be good enough. Indeed, we might not mind too much if the best-off benefit a bit more than others; a little increase in income inequality is hardly catastrophic.¹ But in a good society, those in the middle and at the bottom ought to benefit significantly from economic growth. When the country prospers, everyone should prosper.

In the period between World War II and the mid-to-late 1970s, economic growth was good for Americans in the middle and below. Figure 1 shows that as GDP per capita increased, so did family income at the 50th percentile (the median) and at the 20th percentile. In fact, they moved virtually in lockstep. Since then, however, household incomes have become decoupled from economic growth. As the economy has grown, relatively little of that growth has reached households in the middle and below. Incomes in the lower half haven't stagnated or declined. They've risen. But they've risen very slowly relative to the economy.

Why has this happened? And how can we do better going forward?

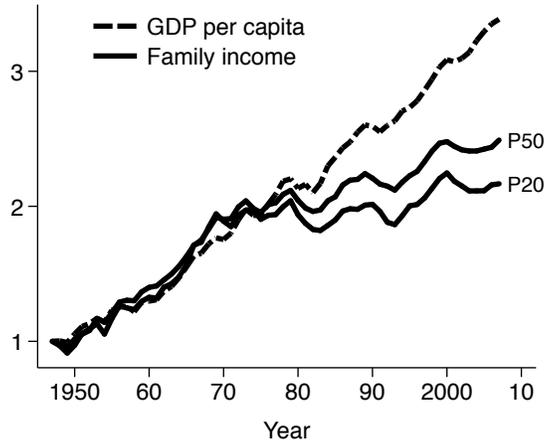


Figure 1. GDP per capita, P50 family income, and P20 family income

P50 is the 50th percentile (median) of the income distribution; P20 is the 20th percentile. Each series is displayed as an index set to equal 1 in 1947. The family income data are posttransfer-pretax. Inflation adjustment for each series is via the CPI-U-RS. Data sources: Bureau of Economic Analysis, "GDP and the National Income and Product Account Historical Tables," table 1.1.5; Council of Economic Advisers, *Economic Report of the President*, table B-34; Census Bureau, "Historical Income Tables," tables F-1 and F-5.

WHY HAS THIS HAPPENED?

Households in the lower half of the income distribution have two principal sources of income: earnings and net government transfers. Earnings is money from paid employment. Net government transfers are cash and near-cash benefits a household receives from government programs minus taxes it pays. From the 1940s through the mid-to-late 1970s, the most important source of growth in incomes for working-age Americans came from rising wages.² But employment and net government transfers also rose. The story has been very different since the 1970s.

Figure 2 shows inflation-adjusted median earnings for a person working full-time year-round since 1979. The trend has been nearly flat. The key to rising wages during the post-WW2 golden age was that many American firms faced limited product market competition, limited pressure from shareholders to maximize short-run profits, and significant pressure from unions (or the threat of unions) to pass

on a "fair" share of profits to employees. Each of these three institutional features is gone. Moreover, a host of additional developments now push against wage growth: technological change, stagnant educational attainment, the shift of employment from manufacturing to services, a more general trend away from middle-paying jobs, a rise in less-skilled immigration, growing prevalence of winner-take-all labor markets, a shift toward pay for performance, and minimum wage decline. Our only period of nontrivial wage growth in the past generation was the late 1990s. The key seems to have been a tight labor market.³ The unemployment rate in those years dipped below 4%, the lowest rate since the 1960s.

Employment is the other potential source of rising earnings. The United States has a set of institutions and policies that in theory should be relatively conducive to rapid employment growth: a low wage floor, limited labor market regulations, relatively stingy government benefits, and comparatively low taxes. Up to the turn of the century we were comparatively successful. As figure 3 shows, during the 1980s and 1990s the employment rate among 25-to-64-year-olds rose by 7 percentage points. This was better than what many other rich nations achieved during those two decades.⁴ Some commentators took to referring to our economy as the "great American jobs machine."

But in the 2000s the bloom fell off the rose.⁵ The early years of recovery after the 2001 recession featured feeble job growth, and things didn't improve much after that. By the peak year, 2007, the employment rate had not yet recovered to its 2000 level. And during the subsequent economic crash virtually all of the progress of the 1980s and 1990s was erased.

Government transfers include money from Social Security, unemployment compensation, disability payments, the Earned Income Tax Credit, Food Stamps, Temporary Assistance to Needy Families, and several other programs. (The value of services such as health care and education isn't included.) As our nation grew richer in the decades following World War II, we increased the (inflation-adjusted) value of many of these benefits and added some new ones. Figure 4 shows that in recent decades there has been little increase.

So the story since the 1970s is this: Wages in the lower half have barely risen. Employment has increased, and this has been an im-

portant help, but it hasn't done enough. Net government transfers, like wages, have risen only slightly. This is what lies behind the very slow income growth for American households in the bottom half.

Yet perhaps there is no alternative. Maybe the economic shifts that have taken place in rich countries such as ours — globalization, heightened competition, computerization, manufacturing decline — make it unlikely or impossible for more than a little economic growth to trickle down to households in the middle and lower parts of the income distribution.

To assess this possibility, we can look at the experiences of other rich nations during the past generation. Have they suffered the same decoupling of household income growth from economic growth?

Some have, but many haven't. In fact, in quite a few other affluent countries we observe a relationship between economic growth and household income growth that looks like what we saw in the United States in the 1950s, 1960s, and the early part of the 1970s. Figure 5 shows per-year growth in lower-half household income since the 1970s in the United States and sixteen other rich nations for which comparable data are available. Our slow rate of income growth is more the exception than the rule.

Part of the difference we see among these countries is due to differing rates of economic growth. Ireland and Norway, in particular, had exceptionally fast growth. But if we set aside those two nations, most of the difference across the countries is accounted for by differences in the degree to which economic growth reached households in the lower half — the degree to which growth trickled down.⁶

Figure 6 breaks this down a bit. It shows the contribution to household income growth from earnings and from net government transfers. This calculation can be done for twelve of the seventeen countries. Here I separate households in the bottom quarter of the income distribution from those in the lower-middle quarter (together these make up the lower half). Among households in the bottom quarter, rising household income came mostly from increases in net government transfers. Among those in the lower-middle quarter, rising income owed to improvement in both earnings and net government transfers.⁷ In the U.S., neither increased much. That's why we see the decoupling between economic growth and lower-half household income growth in figure 1.

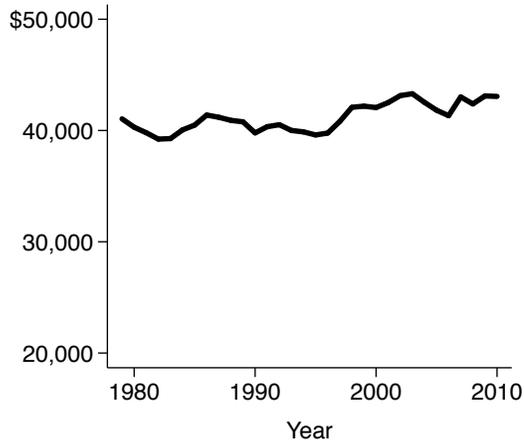


Figure 2. Median wage

Median annual earnings among persons employed full-time year-round. Inflation adjustment is via the CPI-U-RS. The vertical axis does not begin at zero. Data source: Census Bureau, "Historical Income Tables," table P-38, using Current Population Survey data.

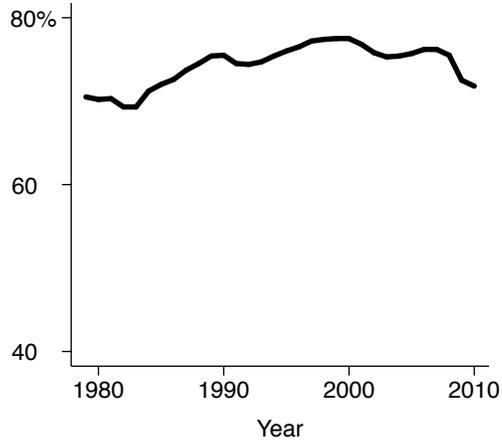


Figure 3. Employment rate

Employed share of persons age 25 to 64. The vertical axis does not begin at zero. Data source: OECD.

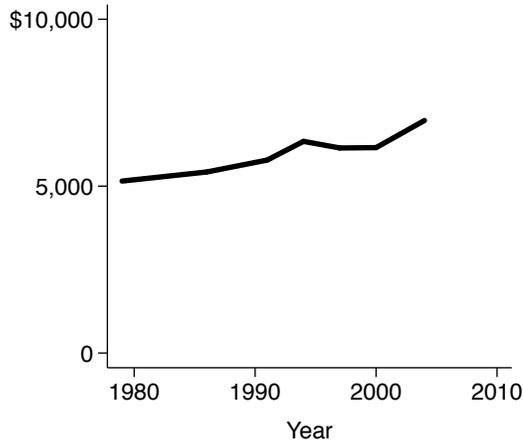


Figure 4. Average net government transfers received by households in the lower half of the income distribution

Net government transfers = cash and near-cash transfers received minus taxes paid. Inflation adjustment is via the CPI-U-RS. Data source: Luxembourg Income Study.

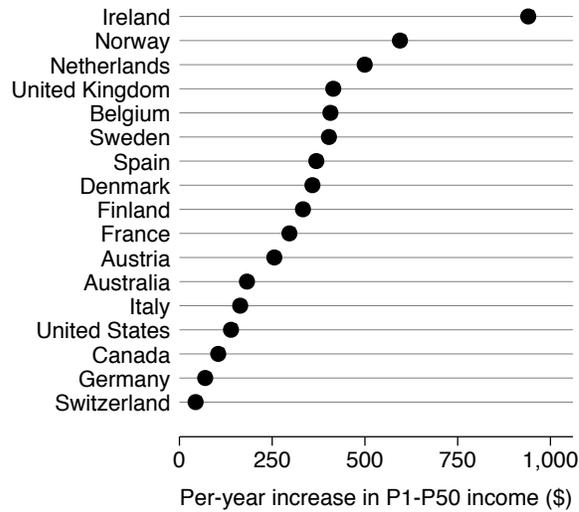


Figure 5. Average yearly increase in posttransfer-posttax income in households in the lower half, 1979-2005

Per-year change in average posttransfer-posttax income among households below the median. Incomes are adjusted for inflation using the CPI and converted to U.S. dollars using purchasing power parities. Data source: Luxembourg Income Study.

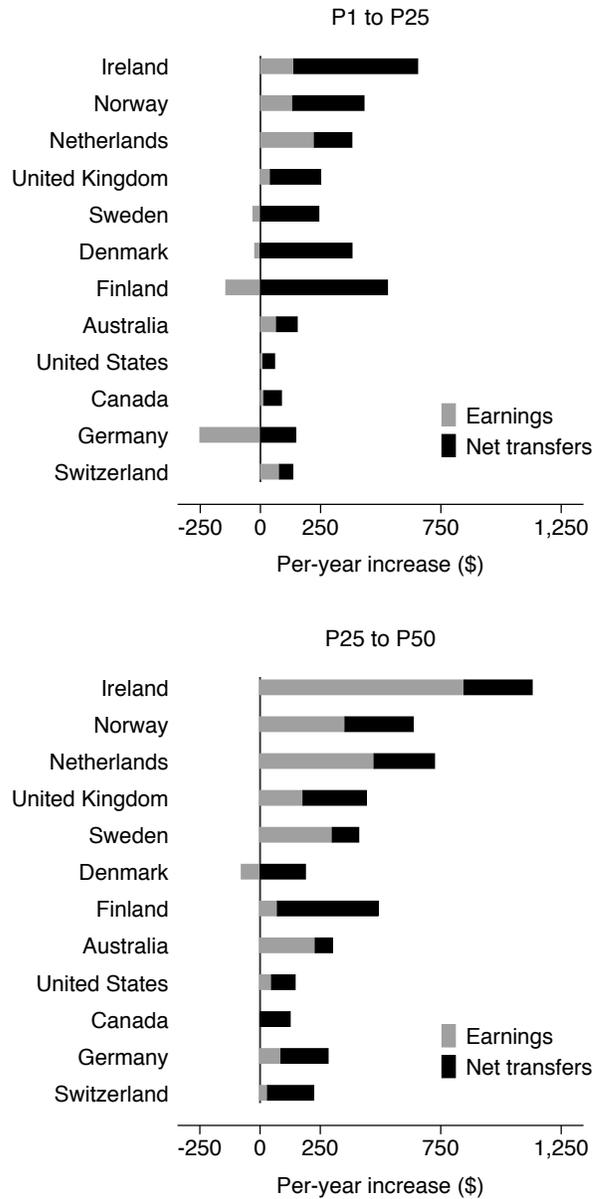


Figure 6. Average yearly increase in earnings and in net government transfers in households in the lower half, 1979-2005

Earnings and net transfers are adjusted for inflation using the CPI and converted to U.S. dollars using purchasing power parities. Data source: Luxembourg Income Study.

HOW CAN WE DO BETTER GOING FORWARD?

What are our prospects for a better outcome going forward? Begin with wages. I'm very pessimistic about the likelihood of a return to rising wages in the lower half. So many forces push against wage increases that even if we manage to address one or two, we might make only a small dent.

As I noted earlier, the one encouraging period in the past generation was the late 1990s. A low unemployment rate is what mainly separates these years from the rest of the past three decades. It would be good to repeat this. But I fear it won't happen. If and when our unemployment rate gets near 4% again, I suspect the Federal Reserve will be less willing than it was in the late 1990s to resist stepping on the brakes. The Fed chair at that time, Alan Greenspan, held interest rates low despite opposition from other Fed board members, who were concerned about potential inflationary consequences of rapid growth, rising wages, and the internet stock market bubble. Greenspan took this stance in part because his belief in the self-correcting nature of markets led him to worry less than others about the bubble. In light of the painful consequences of the 2000s real estate bubble, I doubt the Fed will take that approach again for quite some time.

One clearcut way to ensure a rise in wages for at least some in the bottom half is via the minimum wage. We should increase the minimum a little from its current level of \$7.25 an hour. More importantly, the minimum wage should be indexed to inflation. This wouldn't ensure that it keeps up with growth of the economy, but it would at least guarantee that it doesn't lag relative to prices.

What about employment? As of 2010, about 85% of prime-working-age males and 70% of prime-working-age females were employed. We may see no further increase among prime-age men, but among women and the near-elderly (age 55-64) there is substantial room for growth.

How can we do it? First, adequate demand is essential. When our economy finally emerges from the aftermath of the great recession, it may struggle in the absence of a 1990s- or 2000s-style stock market or housing bubble to fuel consumer spending. Rising living standards in developing nations should help by boosting American exports, and government job creation can enhance domestic demand. But this is a

significant question mark going forward. Second, good-quality affordable early education is a smart strategy for facilitating women's employment. Third, we would do well to sharply expand provision of individualized assistance for those who struggle in the labor market. This is expensive, but it helps.⁸ Fourth, government can directly promote job creation by subsidizing private-sector job growth and by creating public-sector jobs.⁹ One candidate is green jobs.¹⁰ Another is helping-caring services, including provision of information. Finally, we can do better at making low-end jobs pay well enough to be attractive. The key tools are the minimum wage and the Earned Income Tax Credit.

Even if we do return to sustained employment growth, there is a limit to how far that can take us in boosting household incomes, because the employment rate has a ceiling. If and when most working-age adults are in employment, we won't be able to raise household incomes by adding more. We would then have to rely on wage growth. Suppose I'm correct in my pessimism about the prospects for wage growth going forward. What then?

One useful strategy is expansion of public goods, services, spaces, and mandated free time — from childcare to roads and bridges to health care to vacations and paid parental leave. This expands the sphere of consumption for which the cost to households is zero or minimal. It lifts the living standards of households directly, and it frees up their limited income for use in purchasing other goods and services.¹¹

Second, we ought to begin thinking about a government program that can compensate for stagnant or slowly-rising household income in a context of robust economic growth. Think of it as decoupling insurance.¹² One way to do this would be to extend the Earned Income Tax Credit well up into the middle class and to tie (index) it to average compensation.¹³ This would give all households that have at least some earnings a bit of additional money, in many instances a few thousand dollars. And because average compensation tends to rise in sync with GDP per capita,¹⁴ it would help to restore the link between growth of the economy and growth of household incomes.¹⁵

WILL BIGGER GOVERNMENT HARM THE ECONOMY?

A number of the things we could do to ensure that American households in the lower half benefit more from economic growth would require an increase in government expenditures. But if government gets bigger, will our economy suffer?

It's easy to understand why some think so. An increase in taxes reduces the financial incentive to work harder or longer, invest in more skills, start a new company, or expand an existing one. And when governments provide goods and services, they inevitably waste some resources, particularly when they face no competition.

But that's too simplistic.¹⁶ The incentive effect of higher taxes can also work in the other direction; if tax rates go up, I may work more in order end up with the same after-tax income I had before. Moreover, some of what government does helps the economy.¹⁷ When it protects safety and property and enforces contracts, it facilitates business activity. Enforcement of antitrust rules enhances competition. Schools boost human capital. Limited liability and bankruptcy provisions encourage risk taking. Affordable high-quality childcare increases parental employment and boosts the capabilities of less-advantaged kids. Child labor restrictions, antidiscrimination laws, minimum wages, job safety regulations, consumer safety protections, unemployment insurance, and a host of other policies help to ensure social peace.

There surely is a point — a tipping point — at which more government taxing and spending begins to harm the economy. But where is that point? Are we near it? Already past it?

Jon Bakija and Peter Lindert have examined this issue in much greater detail. Let me add one additional piece of evidence.

A useful measure of the size of government is government revenues as a share of GDP. Data for the United States are available going back to the early 1900s. These data include the federal government and state and local governments. Most of the revenues, though not all, are from taxes. The first chart in figure 7 shows that revenues rose from the 1910s through the 1990s and then leveled off. All told, government revenues increased by approximately 25 percentage points, from less than 10% of GDP to around 35%.

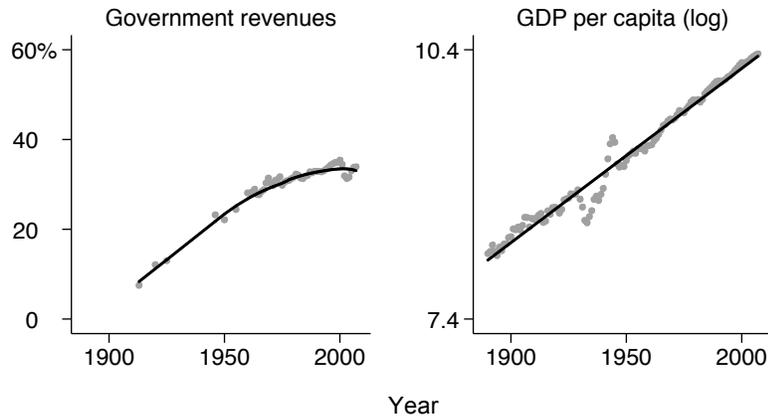


Figure 7. Government revenues and economic growth in the United States

Government revenues: Government revenues as a share of GDP. Includes all levels of government: federal, state, and local. The line is a loess curve. Data sources: for 1960-2007, OECD; for 1946-55, *Economic Report of the President*, 2011, tables B-79, B-86; for 1913-25, Vito Tanzi, *Government versus Markets*, Cambridge University Press, 2011, pp. 9, 92 (with a minor adjustment). GDP per capita: Natural log of inflation-adjusted GDP per capita. A log scale is used to focus on rates of change. The vertical axis does not begin at zero. The line is a linear regression line; it represents a constant rate of economic growth. Data source: Angus Maddison, www.ggdc.net/maddison/historical_statistics/vertical-file_02-2010.xls.

The second chart in the figure shows GDP per capita all the way back to 1890. I display the data in log form in order to focus on the rate of growth. The straight line drawn in the chart represents what the data would look like if the economic growth rate had been perfectly constant. The actual data points hug this line. Despite occasional slowdowns and speedups, the rate of per-capita GDP growth in the United States has been essentially constant for the past 120 years.¹⁸ We've gone from being a country with relatively small government to one with medium-size government, and in the course of doing so we've suffered no slowdown in economic growth.¹⁹

Now let's look at two big-government countries: Denmark and Sweden. Figure 8 shows trends in government revenues and in economic growth for these two nations. In both, government revenues jumped sharply, especially in the decades after World War II. Revenues stopped rising around 1990, flattening out in Denmark and falling back a bit in Sweden. Just like the United States, these two coun-

tries have had a virtually constant rate of economic growth since the late 1800s. A very large increase in the size of government didn't knock either country off its steady-state growth path.

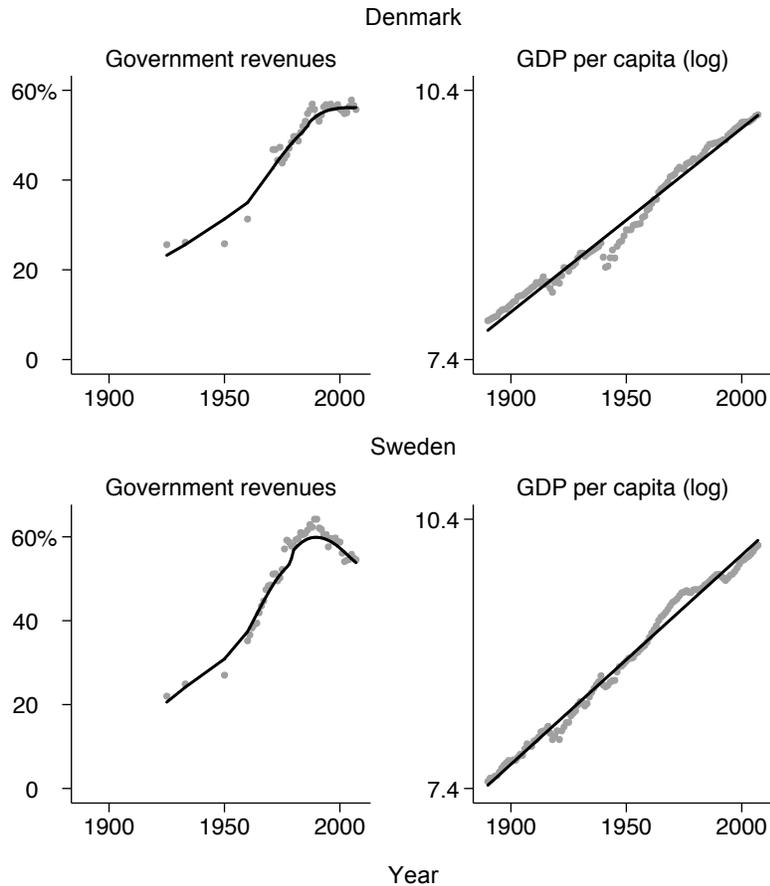


Figure 8. Government revenues and economic growth in Denmark and Sweden

Government revenues: Government revenues as a share of GDP. Includes all levels of government: central, regional, and local. The lines are loess curves. Data sources: for 1960-2007, OECD; for pre-1960, Vito Tanzi, *Government versus Markets*, Cambridge University Press, 2011, table 13.2 (with a minor adjustment). GDP per capita: Natural log of inflation-adjusted GDP per capita. A log scale is used to focus on rates of change. The vertical axis does not begin at zero. The lines are linear regression lines; they represent a constant rate of economic growth. Data source: Angus Maddison, www.ggd.net/maddison/historical_statistics/vertical-file_02-2010.xls.

One possible exception is Sweden around 1990. At the end of the 1980s government revenues in Sweden reached 65% of GDP. Shortly thereafter the country had a severe economic downturn. By 1995 revenues had dropped to 60% of GDP and the economy returned to its long-run economic growth path. The onset of the early-1990s crisis owed mainly to deregulation of Swedish financial markets and to the government's pursuit of fiscal austerity during the downturn. But given the coincidence in timing, it could be argued that government taxing and spending at 65% of GDP is too high. Maybe that's correct. If we follow that logic, however, then we should conclude that 60% of GDP, the level of government revenues when the Swedish economy returned to solid growth, is not too high.

When the United States is compared to countries such as Denmark and Sweden, a common objection is that the latter are small and homogenous.²⁰ But the point here isn't to compare or contrast these countries. The point is that developments over time within each of the three countries tell a similar tale. In each, government taxing and spending rose substantially — in the United States to about 35% of GDP, in Denmark and Sweden as high as 60% — with no apparent impact on economic growth.

One might still object that only a small, homogenous nation can have a *big* government without hurting economic growth. The story would be that a large heterogeneous nation such as the U.S. can do just fine with a rise in government up to 35% of GDP, but beyond 35% economic growth will begin to slow down. It's conceivable that this is true. But the story is based on assumption rather than evidence, so there is reason for skepticism.

The historical record doesn't give us full and final answers to questions about the impact of government size on the health of the economy. But it strongly suggests that America hasn't reached the tipping point. Indeed, we're very likely well below it.

NOTES

1. Rawls 1971.
2. Mishel and Shierholz 2012.

3. Bernstein and Baker 2003.
4. Kenworthy 2008.
5. For more discussion, see Kenworthy 2011.
6. Kenworthy 2011.
7. For a more detailed discussion, see Kenworthy 2011.
8. Ben-Galim and Dal 2009.
9. Freeman and Gottschalk 1998.
10. Apollo Alliance 2008.
11. Kenworthy 2011, ch. 7.
12. This is similar in spirit to the idea of "inequality insurance" proposed by Robert Shiller. See Shiller 2003, ch. 11.
13. Reich 2010 offers a similar proposal.
14. Pessoa and Van Reenen 2012.
15. To be effective, the EITC needs to be coupled with a rising minimum wage. Without a wage floor, an earnings subsidy may lead to reductions in low-end wage levels, which will offset the improvement in income achieved by the subsidy. This can happen in two ways. First, if the subsidy succeeds in pulling more people into work, the increase in competition for jobs will put downward pressure on wages. Second, regardless of labor supply, employers will be tempted to incorporate the value of the subsidy into the wages they offer. For more discussion, see Kenworthy 2011, ch. 5.
16. Huang 2012; Bartlett 2012; Saez, Slemrod, and Giertz 2012.
17. The list of relevant citations here is lengthy. A good start is Polanyi 1944; Stiglitz 1989; Madrick 2009.
18. Jones 1995.
19. This line of reasoning follows Stokey and Rebelo 1995; Myles 2000.
20. Tanzi 2011.

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