Does Growing Inequality Harm the Middle Class?

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Presidential aspirants since Ronald Reagan have urged us to ask whether we’re better off now than we were four years ago. At any time from 1945 to the early 1970s, the answer for most Americans would have been a resounding yes. Throughout that period, incomes grew at about 3 percent a year for families up and down the income ladder.

Today, however, this question is more difficult to answer. Although the top 1 percent of earners now have roughly twice as much purchasing power as in 1979, the real earnings of families in the middle have scarcely grown since then. The conventional wisdom has long been that such growth in the income gap between the rich and the middle class is a bad thing. But that view is now under challenge. Some revisionists, respected economists among them, invoke the Pareto criterion to argue that inequality doesn’t really matter so long as no one ends up with less in absolute terms.

Using income levels to measure the well-being of individual families, these inequality optimists argue that since the rich now have much more money than before and the middle class doesn’t have less, society as a whole must be better off.

Yet “having more income” and “being better off” do not have exactly the same meaning. I will argue that changes in spending patterns prompted by recent changes in the distributions of income and wealth have imposed not only important psychological costs on middle-income families, but also a variety of more tangible economic costs.

Recent Trends in Inequality

The period from the end of World War II until the early 1970s was, as noted, a time of balanced income growth in the United States. In the ensuing years, however, the pattern of income growth has been dramatically different. In the first row of Table 1, for example, notice that for families in the bottom 20 percent of the income distribution, real incomes actually declined by more than 4 percent from 1978 to 1988.

The third row of the table indicates that the real incomes of families in the middle quintile grew by less than 10 percent during the same 20-year period (a growth rate of less than one-half of one percent per year). But while the real incomes of middle-class and poor families were stagnant or declining, families with the highest earnings experienced much bigger gains than in the immediate post-war decades. Thus real
incomes jumped more than 40 percent for families in the top quintile between 1978 and 1998, while those for families in the top 5 percent jumped by more than 68 percent.

The result has been a significant shift in the overall distribution of earnings among American families. Table 2, for example, shows how the shares of total earnings have evolved for the different groups between 1978 and 1998. Note that the lowest three quintiles each had a significantly smaller share of the national income in 1998 than in 1978, while the share of the fourth quintile was essentially unchanged. But note in the final two rows of the table that the share of the top quintile rose more than 15 percent, and the share of the top 5 percent rose more than 57 percent.

Recent earnings growth has been even greater for those higher up the income ladder. Indeed, those near the top have taken home paychecks that might have seemed unimaginable just two decades ago. For example, though no American CEO earned as much as one million dollars in 1978, Disney's CEO Michael Eisner took home more than $665 million in 1997 (including gains from exercising his stock options). According to Business Week's annual executive compensation surveys, CEOs of large U.S. corporations earned 42 times as much as the average worker in 1980, but earned 419 times as much in 1998.

Recent decades have also witnessed dramatic growth and increased concentration of personal wealth. Only the richest one percent of Americans have seen their wealth holdings grow significantly since 1983, and the combined wealth of this group now exceeds the combined wealth of Americans below the 90th percentile (Wolff, 1998). The Forbes Four Hundred—the celebrated list of the 400 richest people in America—included 243 billionaires in 1998, up from 170 just a year earlier. In 1982 the list contained just 13 billionaires—five of them children of Texas oil tycoon H. L. Hunt. Together the Forbes 400 are now worth more than $1 trillion—nearly one-eighth of the national income of the United States, and more than the national income of China, a country of more than 1 billion people.

The recent gains in wealth have not been confined to those who were already worth hundreds of millions. For example, more than four million American households had a net worth of at least $1 million in 1998, 20 percent more than in 1995. 274,000 households had a net worth of at least $10 million in 1998, up from 190,400 in 1995 (Wolff, personal communication based on Federal Reserve Surveys of Consumer Finances).

Not long ago, most of us knew of people with such wealth only by reading about them in the media. Today, most of us can count one or more of these people among our high school or college classmates. That wealth of this magnitude has been achieved by so many is one of the truly remarkable achievements of the modern American economy. But it is an achievement that has come at a steep price.

DO RELATIVE LIVING STANDARDS MATTER?

Few commentators deny that real economic hardships confront families in the lowest quintile of the income distribution. These families, after all, now have lower real incomes than they did in the 1970s, and many fall well below the official poverty threshold. But these families are not my focus in this essay. Rather, my concern is with how conditions have changed for families in the middle. The incomes of these families are now slightly higher in real absolute terms than they were two decades ago, but substantially lower in relative terms.

How could these families be economically worse off? I will consider two possible ways. First, I will examine how the capacity of material goods to deliver satisfaction, in purely psychological terms, depends heavily on the context in which those goods are consumed. I will then discuss a variety of more tangible ways in which a family's economic welfare might be adversely affected by the spending of others.

THE PSYCHOLOGICAL COSTS OF INEQUALITY

Most of us were taught from an early age not to worry about how our incomes compare with the incomes of others. This sensible advice stems from the observation that since there will always be others with more, focusing closely on income comparisons can't help but generate reasons to feel unhappy.

But suppose you were faced with a choice between the following hypothetical worlds:

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<td>Bottom 20 percent</td>
<td>5.4</td>
<td>4.6</td>
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<td>Second 20 percent</td>
<td>17.7</td>
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<td>Middle 20 percent</td>
<td>17.6</td>
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<td>Fourth 20 percent</td>
<td>24.2</td>
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<tr>
<td>Top 5 percent</td>
<td>43.1</td>
<td>44.0</td>
<td>47.3</td>
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<tr>
<td>Top 5 percent</td>
<td>15.1</td>
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Source: Census Bureau, http://www.census.gov/hhes/income/histinc/n92.html
The absolute standard of living in the United States today is of course vastly higher than it was in Adam Smith’s 18th century Scotland. Yet Smith’s observations apply with equal force to contemporary industrial societies. Consider, for instance, The New York Times report of the recent account of the experiences of Wanda Williams, a middle-class student from a low-income family in a highly prosperous community in Illinois. Both of Wanda’s parents are employed at low-wage jobs, and the family lives in a trailer park where their bus picks her up each morning.

Watching classmates strut past in designer clothes, Wanda Williams sat silently on the yellow school bus, wearing a cheap belt and rummage-sale slacks. One boy stepped and yanked his thumb, demanding her seat.

“Move it, trailer girl,” he sneered.

It has never been easy to live on the wrong side of the tracks. In the economically robust 1980s, with sprawling new houses and three-car garages sprouting like cornstalks on the Midwestern prairie, the sting that comes with scarcity gets rubbed with an extra bit of salt.

To be without money, in so many ways, is to be left out.

“I told this girl: ‘That’s a really awesome shirt. Where did you get it?’” said Wanda, explaining that she knew it was out of her price range, but that she wanted to join the small talk. “And she looked at me and laughed and said, ‘Why would you want to know?’”

A lanky, soft-spoken girl with large brown eyes, Wanda pursed her lips to hide a slight smile that got her the nickname Rabbit, a humiliation she once begged her mother and father to avoid by sending her to an orthodontist.

For struggling parents, keenly aware that adolescents agonize over the social pecking order, the styles of the moment and the face in the mirror, there is no small sense of failure in telling a child that she cannot have what her classmates take for granted.

“Do you know what it’s like?” asked Wanda’s mother, Veronica Williams, “to have your daughter come home and say, ‘Mom, the kids say my clothes are tacky,’ and then walk off with her head hanging low.” [Johnson, 1998, A1]

An adolescent in 18th-century Scotland would not have been much embarrassed by having a slight overbite, because not even the wealthiest members of society wore braces on their teeth. In the intervening years, however, rising living standards have altered the frame of reference that defines an acceptable standard of cosmetic dentistry. On what ground might we argue that inequality’s toll on individuals like Wanda Williams is unimportant because it occurs in psychological rather than explicit monetary terms?
MORE TANGIBLE COSTS OF A WIDENING INCOME GAP

Increased spending at the top of the income distribution has not only imposed psychological costs on families in the middle, it has also raised the cost of achieving many basic goals. Few middle-income parents, for example, would be comfortable knowing that their children were attending below-average schools. Yet the amount that any given family must spend to avoid that outcome depends strongly on the amounts that others spend. In particular, the quality of public schools in America is closely linked to local property taxes, which in turn depend on local real estate prices. The upshot is that people cannot send their children to a public school of even average quality if they buy a home in a school district in which house prices are well below average.

The relationship between school quality and housing prices creates a problem for middle-income families, because the average new home built in the United States today, which has some 2,500 square feet of living space, is roughly 50 percent larger than the average new home built in 1970. Thus today's middle-income family cannot send its children to schools of average quality unless it carries a much larger mortgage than its counterparts in 1970.

Incomes are higher and the consumption demands of children are greater. The process begins when higher incomes prompt top earners to build larger homes. Perhaps your parents didn't care whether your neighbors had bigger houses than theirs. Yet many people do care about relative home size, and when top earners build 20,000 square-foot houses, others just below them find their own 10,000 square-foot houses no longer adequate. This process of comparison repeats itself all the way down the income ladder.

If an average earner can't buy his neighbor's larger house, couldn't he simply buy the same size house that average earners bought in 1970? Yes, but then he would have to send his children to below-average schools. Rather than do that, he might prefer to buy the bigger house, even if he doesn't care about the extra space. Worse still, he might end up buying an existing, 1,500-square-foot house whose price has been bid up sharply because of its location in a good school district.

Increased spending at the top also imposes other costs on those below. A soccer mom who buys a typical 3,000-pound sedan will incur risks that didn't exist in the 1970s, since she must now share the road with 6,000-pound Lincoln Navigators and 7,000-pound Ford Excursions. In self-defense, she may want to spend more for a bulkier vehicle.

Consider, too, how increased spending at the top affects how much one must spend on a professional wardrobe. Suppose that you have been unjustly accused of a serious crime and are looking for an attorney to represent you. Your choice is between two lawyers who, so far as you know, are identical in all respects except these: One wears a threadbare polyester suit off the rack and arrives at the courthouse in a 15-year-old, rust-eaten Chevy Citation, while the other wears an impeccably tailored sharkskin suit and drives a new BMW 740i. Which one would you hire? Remember, you are not looking for a friend, but for a competent attorney.

DOES GROWING INEQUALITY HARM THE MIDDLE CLASS?
 SIGNALING AND THE UTILITARIAN CASE AGAINST INEQUALITY

Utilitarians have long argued against income inequality on the grounds that the marginal utility of income is typically smaller for a wealthy person than for a poor person. In their view, transferring $1,000 of income from a rich person to a poor person is justified because the extra happiness experienced when the poor person received the money would far outweigh the decline in happiness experienced when the rich person gave it up. Although some have objected to this argument, saying that no one knows for sure how gains and losses affect the well-being of people in different circumstances, most people accept that an extra dollar generally means more pressing demands for a poor person than for a rich person.

Indeed, many top earners spend their money in ways that, from the perspective of the non-rich, appear to generate little impact at all. Consider, for example, Patek Philippe’s Calibre ‘89, perhaps the most remarkably elaborate and accurate mechanical watch ever built. With its $2.7 million price tag, this particular timepiece is purchased only by persons of extreme wealth. Among its many features—"a gyroscope that turns about once each minute, whose purpose is to offset the distortionary effects of the earth’s gravitational field. Yet despite its formidable engineering wizardry, the Calibre ‘89 is actually less accurate than a battery-powered quartz watch costing less than $20. The earth’s gravitational field, it turns out, doesn’t affect the accuracy of an electronic watch.

Accurate or not, top-of-the-line mechanical wristwatches are selling briskly. A Patek Philippe watch priced at $45,000, for example, is available only on back order, and sales of watches costing more than $2,000 are growing at almost 13 percent a year. The men who purchase these mechanical wristwatches (women almost never buy them) often own several, which contrasts with them a problem: Although the watches are self-winding, they will stop if put aside for a few days. So the person who owns several of these watches must often reset each one before wearing it.

One could hardly expect men of means to tolerate such a problem for long. And sure enough, there is now a ready solution. On display in Asprey & Garrard showrooms in Manhattan on Fifth Avenue, discerning buyers will find a finely tooled calf-skin-leather-covered box with a golden clasp, whose doors open to reveal six mechanical wristlets that rotate just often enough to keep the mechanical wristwatches they hold running smoothly. The price? Only $5,700.

The utilitarian argument for limiting inequality is strengthened considerably by the observation that these and other similar purchases are driven in part by their functions as signals—both of ability and of the importance of specific relationships.

"It’s all about who has what," said William Unger, a Madison Avenue retailer, as he described a conversation he had overheard between two men, each wearing a five-figure wristwatch. "The friend sees his friend has a [Patek Philippe] Fagoda, and those are people who have a certain intuitions; they know how much things cost. They ascertain what a guy’s capability or monetary status is by looking at his watch. They know if he’s a player. Or they think they know." (Quoted by Kuczynski, 1998, 3).

In an environment in which signal strength depends on relative expenditure, little would be sacrificed if all spent less on expensive wristwatches and birthday gifts.
acute respiratory distress each year and save more than 15,000 lives. The EPA proposed drew intense and immediate political fire, and bills were introduced in both houses of Congress to repeal the new standards, which have yet to be implemented.

Although overall spending on public education has not declined relative to historical norms, here, too, important inputs have not kept pace. For example, the national average starting salary for primary and secondary school teachers fell from 118 percent of the average salary of college graduates in 1963 to only 97 percent in 1994, a period that saw a significant decline in the average SAT scores of people who chose public school teaching as a profession. And although we know that children learn more effectively in smaller classes than in larger ones, we have offered fiscal distress as the reason for allowing class sizes to grow steadily larger during that same period.

Drug treatment and prevention programs have also been heavy casualties of recent budget slashing. These programs not only work, they are also cheap, especially in relation to the enormous costs they prevent. A Rand Corporation study estimated that every $1 spent on cocaine prevention and treatment programs saves $7 in future law-enforcement and health-care expenses.

We have slashed funding not only for services that benefit middle- and upper-income families, but also for hospitals that serve the poor, the Head Start program, the school lunch program, homeless shelters, and a host of other low-overhead programs that make life more bearable for our neediest citizens. We cut these programs not because they did not work, not because they destroyed incentives, but because the median voter feels he cannot afford them. And that fact, in large part, is a consequence of the growing income gap.

TIME FOR A TAX CUT?

In the summer of 1999, both houses of Congress voted for a bill that would have slashed personal income taxes in the United States by almost $500 billion, a measure that was not enacted only because Congressional leaders could not muster the votes to override President Clinton’s veto. As the Republican Party’s 2000 presidential nominee, George W. Bush proposed an even larger tax cut. A disproportionate share of the tax relief granted under these measures—45 percent under the House plan, 30 percent under the Senate version, and percentages in the same range for the Bush proposal—would go to the wealthiest one percent of households, those currently earning more than $300,000 a year.

In their defense of these proposals, tax-cutters claim the moral high ground. “It’s a matter of principle,” says Bill Archer, chairman of the House Ways and Means Committee, “to return excess tax money in Washington to the families and workers who sent it here.” “Tax cuts should go to taxpaying,” said Texas Senator Phil Gramm, explaining why his proposal would deliver most of the tax reductions to those with the highest incomes.

Archers, Bush, Gramm and other tax-cut proponents have built their case on the proposition that money spent in the private sector is almost always used more responsibly than money spent by bureaucrats. This claim has at least surface plausibility. The Pentagon’s $7.6 billion coffee maker may have been an aberration, yet private fire companies often deliver comparable protection at half the cost of their municipal counterparts.

Would tax cuts like the ones proposed provide budget relief for cash-strapped American families? Their initial effect would be to stimulate still further private spending by the upper-income families whose tax liabilities would decline the most. But for the reasons just discussed, higher spending by these families would set in motion a chain of additional spending by other families, all the way down the income ladder. Accordingly, the tax cutter’s promise of relief for American families in financial distress is largely illusory. Most of these families feel pressure not because they’re poor in any absolute sense, but because they’re trying to match consumption standards that are beyond their reach. In the wake of a tax cut, struggling middle-class families would simply have to meet tougher standards.

Proponents of smaller government argue that if we let the government spend more money, there will be more waste. This is true, of course, but only in the trivial sense that there would be more of everything the government does—good and bad—if public spending were higher. The solution favored by many opponents of government waste, epitomized in the Proposition 13 movement in California, is to starve the government. But as Californians have belatedly recognized, this remedy is like trying to starve a tapeworm by not eating. Fasting does harm the tapeworm, sure enough, but it harms the host even more. Residents of the Golden State, who once proudly sent their children to the nation’s best schools, now send them to some of the worst.

The physician treats an infected patient by prescribing drugs that are toxic to the parasite but not to the host. We might consider a similar strategy for attacking government waste. As a first step, we could insist that our representatives enact the campaign finance reform legislation currently before Congress—an action that, by itself, would do more to eliminate government waste than all the budget slashing of the recent past. Yet many of our leaders advocate tax cuts to curb government waste even as they vote against laws that would prevent them from accepting campaign contributions from special interests whose government subsidies they support.

There is no free lunch. Money that could be used to finance a tax cut could also be used to restore public services that deliver good value for our money. We must choose. Tired slogans about government waste are no substitute for informed debate about the relative merits of these alternatives.

CONCLUSION

Although middle-class families now enjoy slightly higher real incomes than in the 1970s, they also exhibit more widespread symptoms of personal financial distress and reduced willingness to support basic public services. An important cause of both changes, I have argued, is the increased spending spawned by extremely rapid growth in the income and wealth of top earners.

We are in the early stages of a technological revolution that promises to increase the income and wealth gaps still further. (Frank and Cook, 1995). If that happens, middle-class families will find it still harder to save, and still harder to scrape to-
gather down payment on a house in a good school district. Their
commutes will continue to grow longer, along with their reluctance to support essential services. Savings rates will continue to decline.
These problems merit serious attention from economists. But to think con-
structively about them, we must be prepared to relax our traditional assumption that absolute income is the only important economic determinant of welfare.

NOTES
1. For an extended discussion of recent cutbacks in basic public goods and services, see chapter 4 of my 1999 book.
2. As Slicher (2006) suggests, however, questionable accounting procedures undermine many of the examples purporting to show that private contractors have lower costs than government service pro-
viders.

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CAN RESCHEDULING EXPLAIN THE NEW JERSEY MINIMUM WAGE STUDIES?
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INTRODUCTION
In a recent and storied paper, David Card and Alan Krueger (1994) claim to find evidence that the 1992 New Jersey minimum wage hike raised the level of employment in fast food restaurants in that state (although not significantly by conventional statistical standards). In response, David Neumark and William Wascher (2000), using data on payroll hours, claim to show employment declined in the New Jersey restaurants. While both teams loosely characterize the labor input in terms of "full-
time equivalent employees", the Card-Krueger data set includes the number of work-
ers and the Neumark-Wascher data set (with the exception of a subsample described in more detail below) includes the total number of hours. A major issue in this on-
going debate, which now includes a reply from Card and Krueger (1999), has been the quality of the respective data sources. This paper focuses instead on a reschedul-
ing hypothesis, according to which both studies may be right.
Firms have the option of cutting back on labor services either by laying off work-
ers or by reducing the length of the scheduled workweek. Since total payroll hours are the product of the number of workers and their average workweek, it is alge-
braically possible for the number of workers to remain constant while weekly hours per worker (and thus total payroll hours) decline.1 To explore this rescheduling scenario, we present a simple model of the demand for workers and weekly hours per worker that shows why a wage increase could, in principle, induce firms to hire more work-
ers, (consistent with Card and Krueger's finding) while reducing the workweek. In this model, the firms' total demand for hours will decline (consistent with Neumark's and Wascher's finding). The model is then tested in the data sets that these two research teams have made available where the rescheduling hypothesis receives some support.2

In their original study, Card and Krueger (1994) conducted a telephone survey of fast-food restaurants before and after the New Jersey minimum wage went into ef-
fect. The survey asked for the number of employees on the payroll, the starting wage, and other relevant data. Card's and Krueger's analysis of these data showed that employment (measured by the number of workers) in New Jersey restaurants in-
creased by more than employment in restaurants in contiguous counties in Pennsyl-
vania, although the difference was not statistically significant. Their methods and

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