



# *Policy Note*

---

2015 / 4

## WHEN A RISING TIDE SINKS MOST BOATS: TRENDS IN US INCOME INEQUALITY

PAVLINA R. TCHERNEVA

Do the majority of Americans share in the benefits of economic recoveries? Does a rising tide, as we are often told, lift all boats? *Growth for Whom?* (Tcherneva 2014a) shows changes in the share of income growth captured by different cohorts during economic expansions (see Tcherneva 2014b for further analysis). It turns out that in the postwar period, with every subsequent expansion, a smaller and smaller share of the gains in income growth have gone to the bottom 90 percent of families. Worse, in the latest expansion, while the economy has grown and average real income has recovered from its 2008 lows, all of the growth has gone to the wealthiest 10 percent of families, and the income of the bottom 90 percent has fallen. Most Americans have not felt that they have been part of the expansion. We have reached a situation where a rising tide sinks most boats.

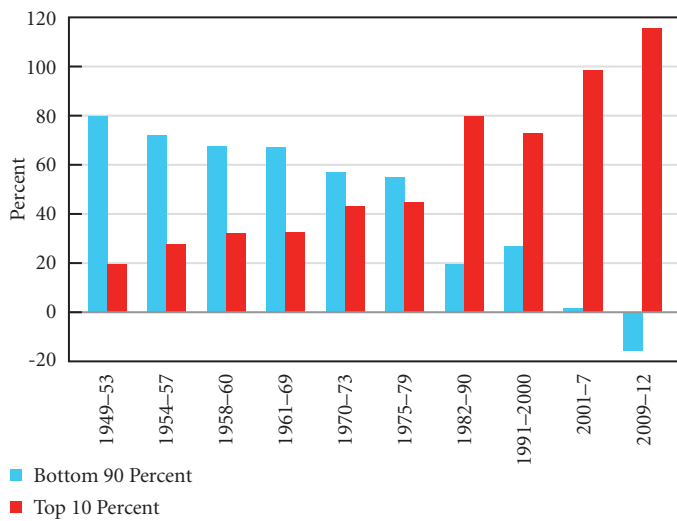
This policy note provides a broader overview of the increasingly unequal distribution of income growth during expansions, examines some of the changes that occurred from 2012 to 2013, and identifies a disturbing business cycle trend. It also suggests that policy must go beyond the tax system if we are serious about reversing the drastic worsening of income inequality.

---

Research Associate PAVLINA R. TCHERNEVA is an assistant professor of economics at Bard College.

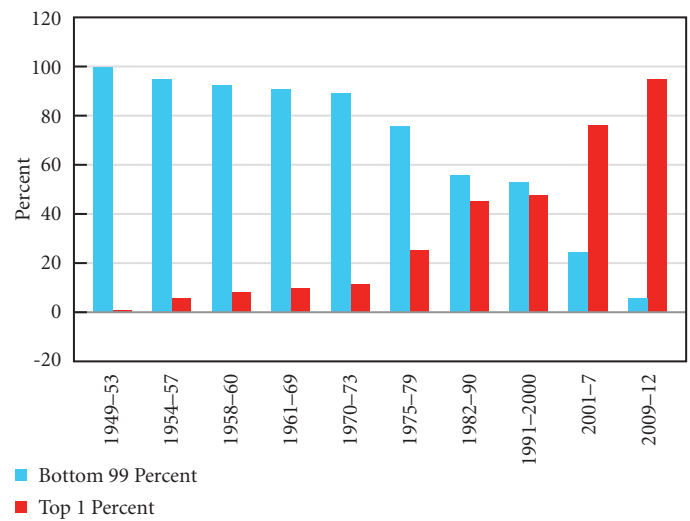
The Levy Economics Institute is publishing this research with the conviction that it is a constructive and positive contribution to the discussion on relevant policy issues. Neither the Institute's Board of Governors nor its advisers necessarily endorse any proposal made by the author.

**Figure 1 90 Percent vs. 10 Percent: Distribution of Average Income Growth during Expansions (including capital gains)**



Sources: Author's calculations based on Piketty/Saez data and NBER

**Figure 2 99 Percent vs. 1 Percent: Distribution of Average Income Growth during Expansions (including capital gains)**



Sources: Author's calculations based on Piketty/Saez data and NBER

### Growth and Inequality: 1949–2012, including Capital Gains

The figures in this policy note are based on Piketty and Saez data (2003; updated in 2015), which measure real average market income before taxes and transfers. Market income includes wages and salaries, entrepreneurial income, dividends, interest, rents, and capital gains (data excluding capital gains are presented below). For Figures 1 through 7, the x-axis shows expansion periods only (from trough to peak year), as defined by NBER business cycle data.

Thomas Piketty (2014) and many other scholars have illustrated the rapid worsening of US income inequality since the 1970s. Coupling these findings with those in Figure 1 suggests that the way we grow the economy erodes the income distribution (business cycle data are also presented later).<sup>1</sup> As the economy grows, the wealthy are getting a bigger and bigger slice of the income pie, perpetuating a vicious cycle where inequality breeds more inequality.

And not all wealthy families are created equal. Decomposing the top 10 percent further, we can see that during the latest expansion, from 2009 to 2012 (the data are updated to 2013 below), the top 1 percent captured 95 percent of the growth pie (Figure 2), whereas the 0.01 percent captured 32 percent (Figure 3). A stunning one-third of all income growth has gone to a tiny sliver of the wealthiest families in the United States.

### Growth and Inequality: 1949–2013, including Capital Gains

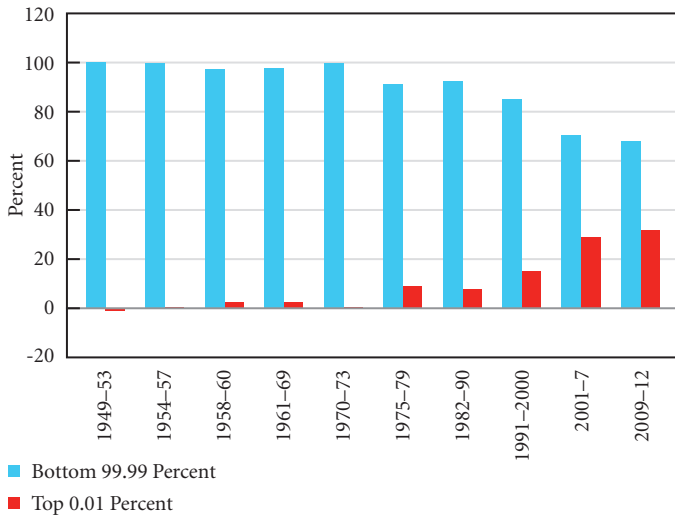
Updating Figure 1 with the latest 2013 data illustrates the exact same trend (see Figure 4).

When we look at the wealthiest cohorts, however, the data seem to indicate a slight shift in trend. When comparing Figures 2 and 3 to Figures 5 and 6, it would seem that there has been an improvement in the way gains from growth are shared by the bottom 99 percent and 99.99 percent.

This is in part due to a number of tax changes that occurred in 2013. The data in these graphs are pretax, pretransfer, but changes in tax rates affect the way income is reported on a tax return. For example, in 2013, a series of Bush-era tax cuts expired. For the wealthiest 2 percent of taxpayers, ordinary income is now taxed at 39.6 percent, instead of the earlier rate of 35 percent. Also, taxpayers in that bracket now pay 20 percent on long-term capital gains and qualified dividends, instead of the lower Bush-era tax rate of 15 percent.

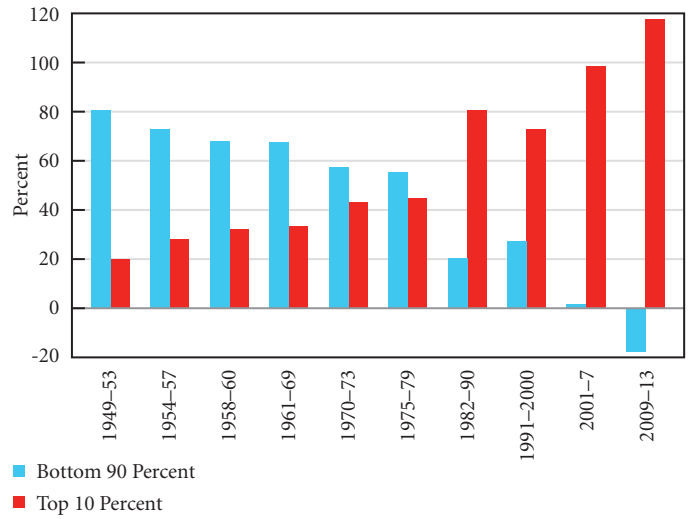
When comparing the two most recent estimates of real average income for the top 1 percent and top 0.01 percent, one notices that there was a spike in reported income for 2012 in the latest estimate (compared to what was initially reported). This indicates that the ultrarich are pulling income forward and reporting it in the 2012 tax return, when the preferential tax treatments were still in effect. In a sense, preliminary estimates

**Figure 3 99.99 Percent vs. 0.01 Percent: Distribution of Average Income Growth during Expansions (including capital gains)**



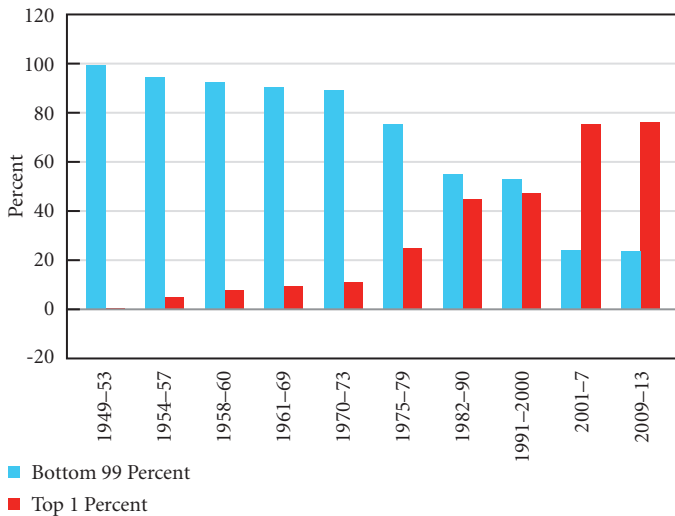
Sources: Author's calculations based on Piketty/Saez data and NBER

**Figure 4 90 Percent vs. 10 Percent: Distribution of Average Income Growth during Expansions (including capital gains)**



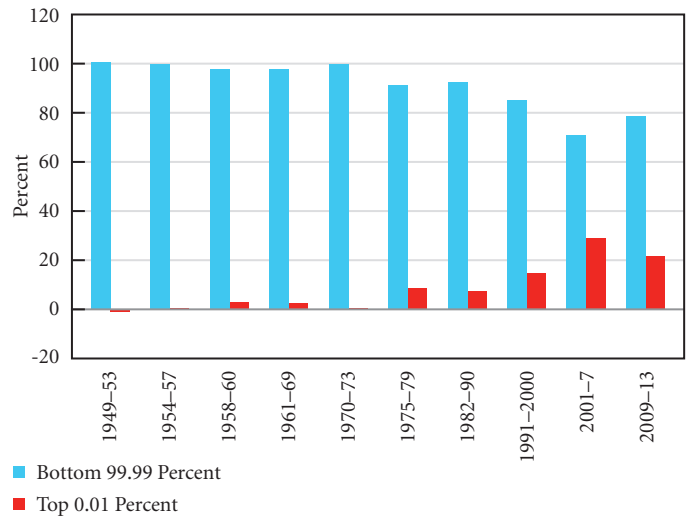
Sources: Author's calculations based on Piketty/Saez data and NBER

**Figure 5 99 Percent vs. 1 Percent: Distribution of Average Income Growth during Expansions (including capital gains)**



Sources: Author's calculations based on Piketty/Saez data and NBER

**Figure 6 99.99 Percent vs. 0.01 Percent: Distribution of Average Income Growth during Expansions (including capital gains)**



Sources: Author's calculations based on Piketty/Saez data and NBER

of 2013 income are “too low” (Saez 2015). Thus, the 2013 tax changes have likely triggered an improvement in the income distribution, due to the way the wealthy are reporting their income.

This statistical improvement is misleading for another reason. Consider what has happened to the incomes of the bottom 99 percent of families in the meantime. Average real income for the bottom 99 percent, which fell after the crash—from \$50,400 (2007) to \$47,000 (2008)—continued falling during the expansion, to \$44,300 (until 2011). It finally showed a small uptick in 2012, to \$44,900, but in 2013 it remained essentially flat. Thus, any “improvement” in the income distribution is not due to improvements in the well-being of the bottom 99 percent of households.

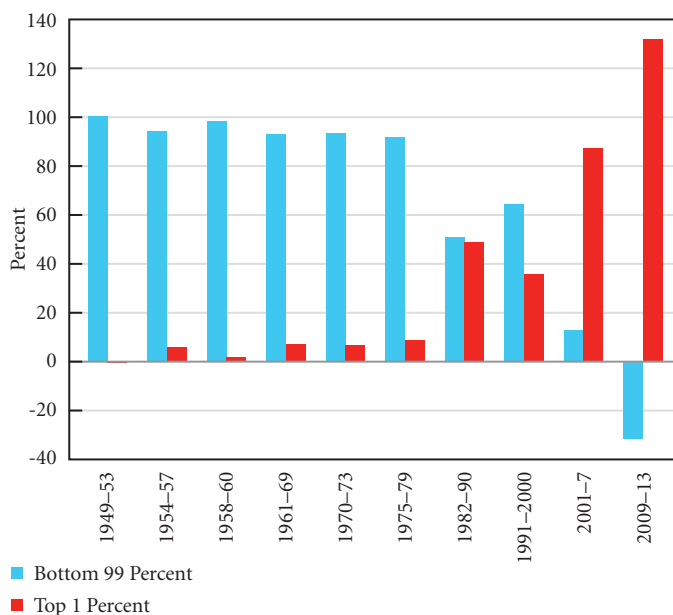
Since the wealthy have greater discretion over the size of their income (a greater proportion of their income is composed of capital gains) and can elect to realize these gains at different times, one might want to examine what happens to the distribution of income growth once capital gains are excluded. To be sure, capital gains are a crucial component of income for the wealthy, and any analysis that excludes them will be limited in scope. Because capital gains can be taken as a lump sum in a given year, looking at tax return data is not an ideal way of examining them. A much better method would be to annuitize them (as in Wolff and Zacharias 2009). Nevertheless, considering the income growth distribution once capital gains have been excluded can provide some insights.

### Growth and Inequality, 1949–2013, excluding Capital Gains

During 2009–13, the wealthiest 1 percent of families captured more than 100 percent of the income growth (Figure 7). That means that market incomes of the bottom 99 percent, excluding capital gains, fell during the 2009–13 expansion (from average real income of \$44,000 in 2009 to \$43,800 in 2013). The same is true for the bottom 90 percent, whose average real incomes fell from \$31,600 in 2009 to \$30,980 in 2013, while the incomes of the wealthy 10 percent rose.

Comparing Figure 5 to Figure 7 (including and excluding capital gains, respectively, for the 99 percent and 1 percent), one notices that the distribution of income growth appears less unequal when capital gains are included. At first, this may seem like a counterintuitive result. What the data illustrate is that, even though capital gains are a very small share of income for

**Figure 7 99 Percent vs. 1 Percent: Distribution of Average Income Growth during Expansions (excluding capital gains)**



Sources: Author’s calculations based on Piketty/Saez data and NBER

the bottom 99 percent of families (only about 2 percent of their income comes from capital gains), they are the difference between a shrinking income and a marginally growing income for those families.

Without capital gains, average real income for the bottom 99 percent fell by \$127 from 2009 to 2013, but including them it rose by a meager \$451. For the rich, however, average incomes grew with or without capital gains, even though the latter make up a proportionately larger share of income for the wealthy (between a quarter and a third of their income) and capital gains contributed \$91,444 to their average income growth. In essence, the bottom 99 percent are counting on their very small capital gains to keep themselves afloat, because their shrinking wages are not doing the job.

### Economic Cycles and Inequality

Piketty’s work demonstrates that income inequality has been worsening rapidly over the last four decades. The figures above illustrate the same trend for all consecutive expansions since the 1970s: the majority of the growth has gone to the wealthy. For that period, we can therefore conclude that even if the wealthy lose disproportionately more of their income as the economy

enters a recession, they must more than make up their losses when the economy expands. The data below corroborate this conclusion.

We can examine changes in real income over the economic cycle in two ways. The first is to consider what happens during the business cycle—that is, from peak GDP to subsequent peak—as reported by the NBER (Figure 8). Real incomes, however, rise, fall, and recover at a somewhat different pace from GDP. So we can also consider the income cycle by identifying actual peaks in the real income data from Piketty and Saez (2003; updated 2015). In other words, by looking at income cycles, we can also answer the question “When real income falls and recovers from one peak to the next, who gains?” (Figure 9). The GDP cycle and real income cycle data do not correspond perfectly to each other but they are very close. In either case, what is notable is that the trend toward greater inequality is even more apparent over the entire economic cycle (GDP or income). Worse, since the '70s, the incomes of the rich have recovered almost immediately after a downturn by capturing the overwhelming majority (and sometimes all) of the income growth that occurs in the period spanning only one year after the peak of the income cycle to the subsequent peak (Figure 10).

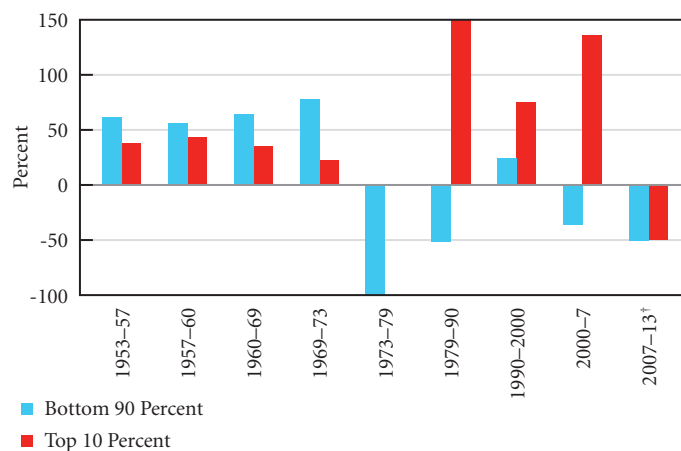
The GDP and income cycle charts (Figures 8 and 9) confirm that, after the '70s, the wealthy capture most of the income growth in most economic cycles. Especially troubling is that during each of the last two periods, the incomes of the bottom

90 percent have shrunk (including or excluding capital gains). One must interpret the 2007–13 period with caution. Average incomes have still not recovered their 2007 highs, and the decline was about equally shared between the bottom 90 percent and top 10 percent of households. Nevertheless, this last period does not show the full picture, because the business cycle is not yet complete. Thus, we cannot draw too many conclusions yet about the distribution of income growth during this cycle.<sup>2</sup>

Consider, however, what happens to the distribution of income growth from one year after the peak of the income cycle until the subsequent peak (Figure 10). It shows a surprising trend. Since the '70s, when we look at the period beginning only *one* year after a downturn, the cycle delivers between 78 percent and 107 percent of the income growth to the wealthiest 10 percent of families.

Observe several periods. From 1973 to 1979, the incomes of the wealthy barely grew (Figure 9). But if one examines what happened beginning one year after the peak of that income cycle (Figure 10), one notices that during 1974–79 they captured 93 percent of the income growth. In other words, though their losses in that first year were large, they recovered all of those losses through the remaining years by capturing virtually all of the growth for that period. Furthermore, since 1973, the bottom 90 percent of households have experienced declining real incomes during four out of the five income cycles (Figures 8 and 9). Finally, during the last period, from 2007 to 2013,

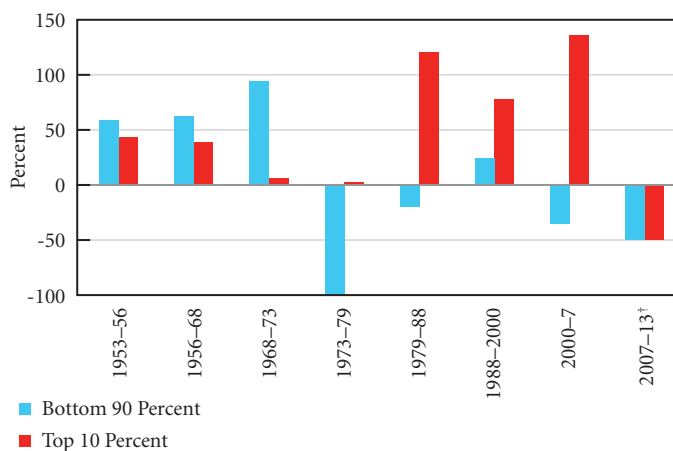
**Figure 8 90 Percent vs. 10 Percent: Distribution of Income Gains during GDP Cycles (peak to peak)**



† Incomplete GDP cycle

Sources: Author’s calculations based on Piketty/Saez data and NBER

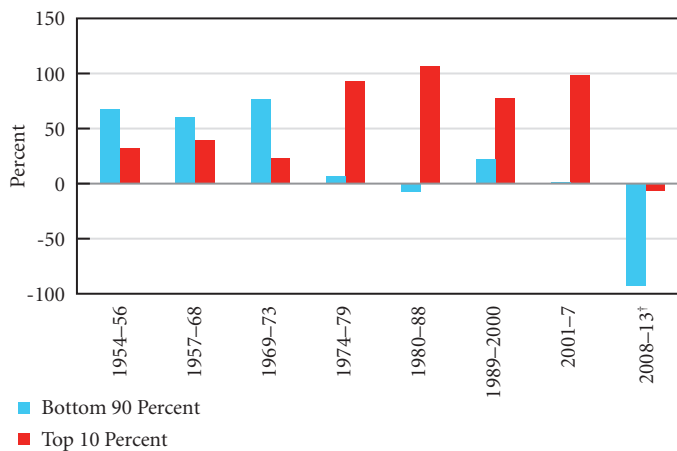
**Figure 9 90 Percent vs. 10 Percent: Distribution of Income Gains during Income Cycles (peak to peak)**



† Incomplete income cycle

Sources: Author’s calculations based on Piketty/Saez data

**Figure 10 90 Percent vs. 10 Percent: Distribution of Income Gains One Year after the Peak of an Income Cycle to Subsequent Peak**



† Incomplete income cycle

Sources: Author's calculations based on Piketty/Saez data

average real income in the economy shrank, and those losses were shared about equally between the bottom 90 percent and top 10 percent (Figures 8 and 9). But during 2008–13 (Figure 10), income for the bottom 90 percent fell proportionately more than that for the wealthiest 10 percent, meaning that incomes of the latter turned around more rapidly (even though they are still below their 2007 highs). Indeed, during 2009–13, real average income for the wealthiest 10 percent of households rose by 12 percent (not shown), while that for the bottom 90 percent was still falling. To recap, this quick turnaround in the incomes of the wealthy has been the norm for the majority of economic cycles since the mid-'70s.

The economic cycle data again confirm that the *way we grow* recovers the incomes of the top 10 percent first.

### An Important Culprit: The Shift in Government Policy

The trends illustrated above are neither an accident nor inescapable. Indeed, during the Golden Age of American capitalism, the majority of economic growth was shared by the majority of families. As Hyman P. Minsky (1992) argued, there are many varieties of capitalism, some more stable than others—and, we can add, some more equitable than others. In the immediate postwar era, when government prioritized pro-employment and pro-wage policies, growth brought

shared prosperity. Wages were rising in lockstep with productivity, public investment and public works were still a standard government response to downturns, the financial sector took only 7–15 percent of total corporate profits (compared to 30 percent today, after peaking at over 40 percent in the early 2000s), and long-term unemployment was a small share of total unemployment. The focus on pro-employment and pro-wage policies slowly weakened, but after the '70s the shift was decisive—away from labor markets and toward top marginal tax rates and financial markets.

Trends in income distribution are largely underwritten by the policy regime in place. In no small measure, they are shaped by the method used to stimulate economic growth; by the *direction* of government spending and tax policy, for instance. When policy began prioritizing the reduction in top marginal tax rates (i.e., Reagan-style trickle-down economics) in place of an employment- and wage-led strategy, a growing economy began favoring the incomes of the ultrarich, by design. And when stabilization policies began focusing on recovering the banking and financial sectors first, households whose incomes were tied to stock market performance (i.e., wealthy families disproportionately benefiting from stock options, bonuses, capital gains, and dividends) experienced faster income growth than the rest.

Most families still get their incomes from wages and salaries, which are derived from increasingly anemic and precarious labor markets. And indeed, since the '70s, in virtually every consecutive expansion, lost payrolls have taken longer and longer to recover. The abandonment of the goal of tight full employment has unsurprisingly meant that incomes of those who depend on employment, wages, and salaries would be the last to grow (if at all). When jobless recoveries became the norm and wages and salaries remained stagnant, the families who counted on them shared few, if any, of the benefits from expansions (Tcherneva 2014b).

### Changing Directions: Refocusing Policy to Tackle Inequality

John Maynard Keynes ([1936] 1973) famously said that the two outstanding faults of economic society were the failure to secure full employment and the arbitrary and inequitable distribution of income. I have argued (Tcherneva 2014b) that the failure to solve the first problem (achieve tight full employment at decent wages for all) has contributed to the worsening of the

second (income inequality). A policy orientation that pursues chock-full employment and decent wages can go a long way toward lifting the floor and filling the middle, delivering shared prosperity.

When we look exclusively to the tax system for policy solutions to inequality, we miss this more important piece of the puzzle. Returning to a more equitable variety of capitalism requires far more than just rolling back regressive tax cuts; it requires resuscitating and modernizing those labor-market-focused policies left behind by the shift to a trickle-down, financial-sector-driven policy regime. Redesigning the tax structure alone will not do the job. Aggressive increases in top marginal tax rates will reduce incomes at the top and thereby improve the income distribution, but more extensive progress will not be made until steps are taken to ensure that incomes at the bottom and the middle rise faster than those at the top. This can be achieved by refocusing policy on labor markets—including a mechanism that links wage increases to productivity gains, prioritizes decent work for decent pay, commits to pay equity, reexamines comparable worth policies, and, importantly, implements an effective employment safety net at living wages for all. These are policies that would ensure that (1) the incomes of the vast majority of people grow rather than shrink in expansions and (2) the majority of the gains from growth go to the majority of families.

## Notes

1. I examine why growth in the United States has increasingly brought income inequality in Tcherneva (2014a and 2014b).
2. To account for the 2013 tax return reporting aberration in the data discussed above, I average the 2012 and 2013 income data in Figures 8-10.

## References

- Keynes, J. M. (1936) 1973. *The General Theory of Employment, Interest and Money*. In D. E. Moggridge, ed. *The Collected Writings of John Maynard Keynes*, Vol. 7. London: Macmillan.
- Minsky, H. P. 1992. “The Capital Development of the Economy and the Structure of Financial Institutions.” Prepared for the session “Financial Fragility and the US Economy,” Annual Meeting of the American Economic Association, New Orleans, January 2–5.
- Piketty, T. 2014. *Capital in the Twenty-First Century*. Cambridge: Harvard University Press.
- Piketty, T., and E. Saez. 2003. “Income Inequality in the United States, 1913–1998.” *Quarterly Journal of Economics* 118, no. 1 (February): 1–39. (Tables and Figures updated to 2013 in Excel format, January 2015.)
- Saez, E. 2015. “Striking It Richer: The Evolution of Top Incomes in the United States.” (Updated with 2013 preliminary estimates.) UC Berkeley, January 25.
- Tcherneva, P. R. 2014a. *Growth for Whom?* One-Pager No. 47. Annandale-on-Hudson, N.Y.: Levy Economics Institute of Bard College. October.
- . 2014b. “Reorienting Fiscal Policy: A Bottom-up Approach.” *Journal of Post Keynesian Economics* 37, no. 1 (Fall): 43–66. Draft version first published as Working Paper No. 772, Levy Economics Institute of Bard College, August 2013.
- Wolff, E., and A. Zacharias. 2009. “Household Wealth and the Measurement of Economic Well-Being in the United States.” *The Journal of Economic Inequality* 7, no. 2 (June): 83–115. Originally published as Working Paper No. 447, Levy Economics Institute of Bard College, May 2006.