[RS1]

Where has the American Dream Gone?

A look into Income Inequality Cycle in the United States~~America~~

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Economics Thesis

Abstract:

This paper will examine three main causes of income inequality in the United States: Taxes, Financialization, and the Social Changes in the 20th century. These three trends, while not the entire cause of increasing income inequality in the United States~~America~~, give a well-rounded picture of a multi-faceted issue. My aim is to distinguish and define the existence of an "inequality cycle" the first

series of which concluded before the 1970's, and in which we currently find ourselves at the second peak in recorded history.

Second Draft

Introduction

Politicians, pundits and armchair analysts all have their answer as to why the middle class is struggling.. Unfortunately it is often a cloudy partisan banter aimed at the other side of the aisle. What if the shifting middle class was a result of many factors, pushing and pulling members of the middle class sometimes for better, oftentimes for worse? This topic is an important one; the middle class is the consumer class, driving the modern economy with ~~its spending~~its spending choices. Without the middle class, the United States would be brought to its knees. Despite this importance, we are constantly hearing about the disappearance of the middle class, and what a struggle it is for members to make ends meet. This struggle of the middle class is indicative of the increasing income inequality in the United States

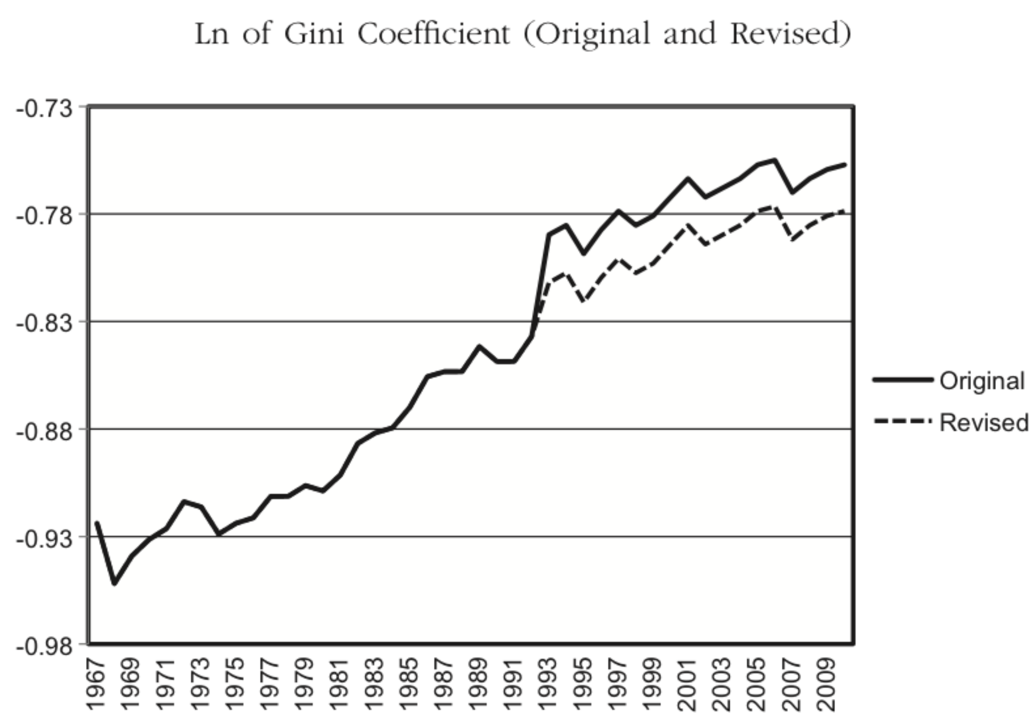


Figure 1
Source: Van Arnum, B. M., & Naples, M. I. (2013).

Figure 1 illustrates the increasing Gini coefficient, which is a measure of income inequality devised in 1912 by Corrado Gini. The lower the Gini coefficient, the lower the level of income inequality. As you can see from the above graph, the Gini coefficient has only risen since the 1960's. This pattern of increasing inequality is what I am attempting to explain in the following paper. From the Central Intelligence Agency's World Factbook list of countries' Gini Coefficients, the United States ranks 41st most unequal, with a coefficient of *45.0* in 2007. By contrast, the most unequal country on the list, Lesotho, has a coefficient of *63.2*, and Sweden, with the most equal distribution of income has a coefficient of *23.0* ("Country Comparison : Distribution of family income - Gini index", 2014).

In this paper I will argue that the increasingly unequal redistribution of income in the United States has been caused by the tax system, social change, and the financialization of the modern economy. It is important to note that the United States is not the only country that has a disparity problem.~~; I will touch on some of the literature that has been written on some other countries for comparison's sake.~~

I will begin the paper with a historical review of income inequality in America. This review will include opposing views - both new and old - on the history and reasoning for the existence of Income Inequality. I will examine the time periods before and after WWII, as it is important to see how the United States has recovered and changed from large scale human events in history. This time period is interesting to look at because there was increasing inequality before WWII and decreasing inequality until the 1970's when inequality began to increase again. I will be examining~~looking at~~ the potential for an inequality cycle, and what factors help and hinder the natural progression of that cycle. I will also look into how taxes have changed in the last century, and what that has done to help and hurt those who find themselves in the upper tax brackets. Much of my focus in the history section will be on the upper class, as it is imperative to understand how the ranks of the rich have grown in order to look at how the middle class has changed beneath them.

The second part of my paper will be an assessment of which economic factors may push the classes farther apart, specifically since the 1970's, when there is a clear change of the Gini coefficient from decreasing inequality to a sharp increase that continues today. I will also examine some of the suggestions experts have given to shrink the income gap. Finally, I will conclude with a recommendation of my own, summing up what could be done to benefit everyone on the class ladder.

In the next section I will outline three ideas surrounding inequality, two ~~well-known~~familiar and one slightly obscure, in order to set the stage for a conversation about income inequality. One is based on the thinking of a well-known social and economic philosopher, one is imperative to thinking about inequality as a generational idea, and the third is going to be helpful in my later model.

Marxist View

The Marxist view of inequality is that it is a necessary part of capitalism. In this view, workers are substituted for capital inputs, as workers are no longer needed to grow profits. This decrease in the number of workers demanded pushes wages lower. And, since productivity has increased and there is less demand for labor, there are increased profits and the upper, or capitalist class, sees an increase in wealth. This, in turn, causes an income disparity between the upper and lower classes, leading to clear, and~~but~~ expected income inequality (Wood, 1988[RS2]).

This is the story of the first industrial revolution, before World War Two. As companies began to specialize production, and the wealthiest families continued to gain wealth and power, there was less need for workers in the factories. The inequality peaked before the Great Depression, when labor was at its most discounted during the industrial revolution. Inequality only fell in the aftermath of the Great ~~Gepression~~Depression because the wealthiest classes had lost a large portion of their accumulated wealth. This is how the Marxist view contributes successfully to the explanation of income inequality. As we will see in the coming sections, this notion of unskilled workers being left behind to fend for themselves is a common one in the cycle of inequality.

Access to Education

Education is the backbone of our modern economy, or so we have been taught to believe. Education surely is part of the inequality picture; as the large move to high school graduates from 1910-1940 showed, skilled labor is invaluable to a growing, shifting economy. The G.I. Bill gave hundreds of thousands of young men the opportunity to go to college in exchange for service in the military, further training the workforce in skilled labor. This training, and the preparation of a whole generation of workers for skilled labor in the factory and in the office helped drive inequality down further in post World War Two the United States (Becker & Murphy, 2007).

This theory is going to be increasingly important to my argument-moving forward. Education clearly plays a significant role in the outcome of one’s income status in the short- and long-terms. The higher the education levels, usually the higher threshold for earnings, with few exceptions like those college dropouts who started certain technology firms; this has been true throughout the history of the world. This is one reason why women have been held back with respect to earnings; only in relatively recent history has education for women become commonplace in our society.

Kuznets Curve

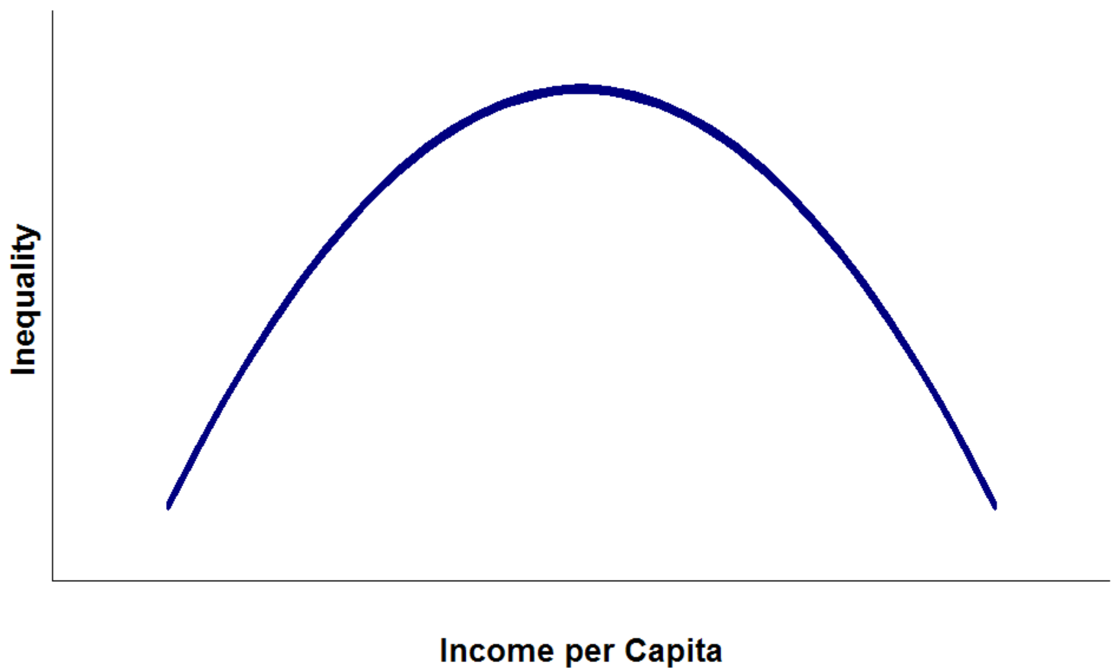


Figure 2
-Source: Wikipedia

In order to verse oneself in the theories and the body of work done on the topic of Income Inequality, one must be familiar with what is known as the *Kuznets Curve*. Simon Kuznets, in 1955, suggested that income inequality, when graphed over time, is in the shape of an inverted U. Kuznets noted that as the economy developed (in the late 19th and early 20th centuries) income inequality would rise, flatten out, and then decline as the developed incomes of the upper classes were caught up to by the advancing middle and lower classes. Kuznets explained this because of the shift from agricultural jobs to urban ones, and the associated higher income associated with urban jobs. Kuznets used these initial findings to challenge the economic community to delve further into why income distribution changes over time. While Kuznets' explanation was a simple one, it opened the eyes of many people to the gap that existed. It is, however, important to note that after Kuznets published these findings in 1955, the income inequality graph changed dramatically to favor the widening of the gap. That will be discussed further in the upcoming historical review.

A Brief History of Taxes in the United States

19th Century – 1932: In a complete discussion of taxes and income inequality it is important to talk about progressive taxation, that is, the taxation of different amounts based on one's income and holdings. During the 19th century the only progressive taxation was the property tax, but it was at very low levels so it did not prevent the rich from amassing fortunes during the late 19th century (Piketty, 2003). In 1909 the first Corporate Tax was passed. In 1913, the US imposed its first income tax; in 1916 the estate tax was introduced, and then in 1921, after ~~the first~~ World War One, the United States saw its first tax cuts. From 1929-1932 the Great Depression waged economic war on America, and then in 1932 taxes were raised in order to bring in revenue for the government, which it so desperately needed (IRS, 2014).

1933-Present: The Revenue Act of 1942 raised income taxes on most Americans, but also created deductions for expenses related to medical and investment purposes. The Economic Recovery Tax Act of 1981 saw huge tax cuts under Ronald Reagan. He cut all tax brackets by 25 percent and had to take back a few of his tax cuts in 1984, as inflation dropped by more than was necessary. Then again in 1986, the top tax bracket was lowered from 50 percent to 28 percent; the corporate tax rate was also slashed from 50 percent to 35 percent. Then in 1993, due to such large deficits, the Clinton administration raised taxes. The year 2001 saw more tax cuts under George W. Bush, and continued tax breaks for an increasing list of reasons. The Bush era tax cuts have been extended, since they were set to expire in 2010 (IRS 2014). *

Tax on Capital Gains: The maximum amount paid on long term gains in the United States has fluctuated quite a bit, and it is essential to see the path of taxes on capital gains in order to understand the path of income inequality in America. In 1954, the maximum tax rate on capital gains was 25 percent, the tax maximum reached its peak in 1978 at 39.875 percent, and in 2009 it rested at an all time low of 15.35 percent, remaining at that level today (Tax Policy Center, 2012). *

*See Figure 3~~2~~ for a timeline of taxes.

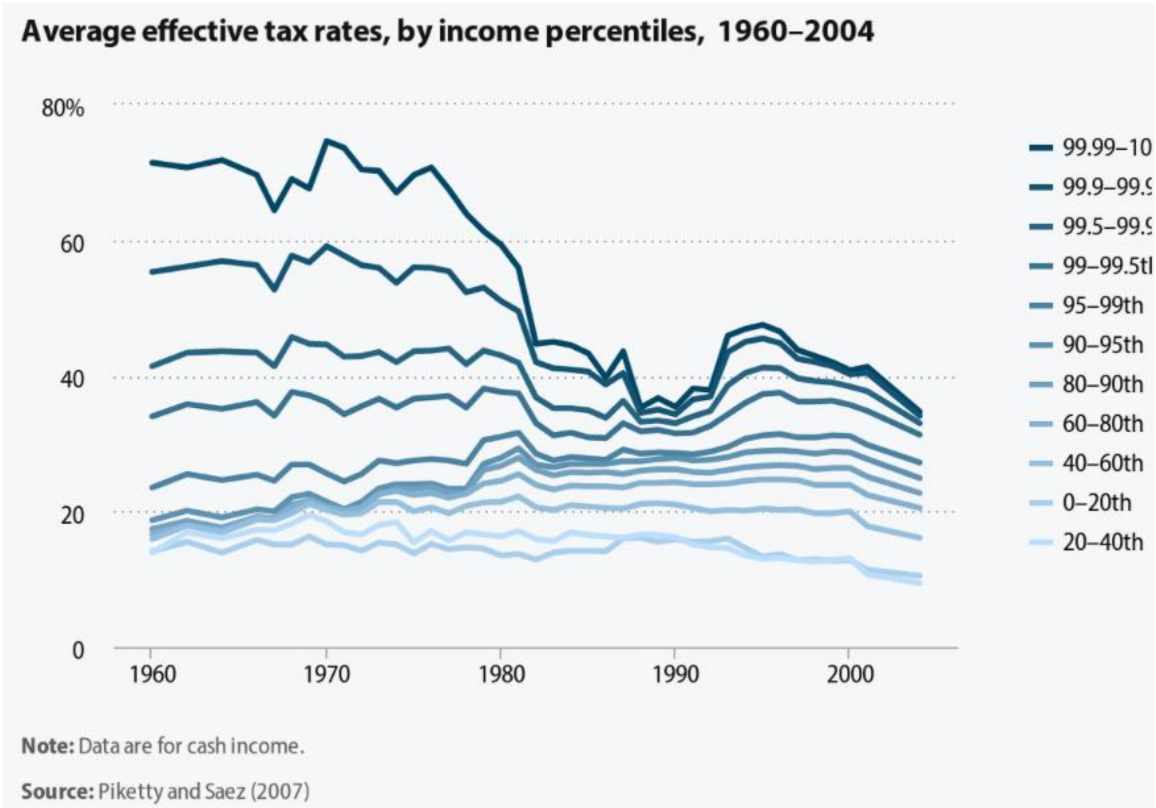


Figure 3

Pre WWII Inequality Trends

This section is going to focus on the sociopolitical climate and history preceding World War Two, that is: the Great Depression, Prohibition, World War One, and the establishing of the United States as a world economic player, while comparing it to the time period directly following the war. Piketty and Saez looked at income tax return data from 1913 to 1998 (see Figure 4) and found that the top decile income share increased until the beginning of The Great Depression dipped a small amount and then returned to its high in 1933 before finally slumping off in 1939 as World War Two picked up (2003). Kuznets states that in the years following World War Two, using an average from the years 1944, ‘46, ‘47, and 1950, income distribution is relatively equal, with the shares of the lowest quintiles growing, and the shares of the top quintile shrinking to more average levels by his standards (1955). This observation by Kuznets, while it does straddle World War Two ~~WWII~~, is interesting to look at since it is the basis for his *Kuznets Curve* pictured in Figure 1~~I~~ above. This is where he believes inequality is beginning to shrink.

The pre-World War Two era is an important one to look at because it is the period of time in the United States where governmental innovation was taking place. The government was stretching its taxation limits and introducing taxes on virtually every aspect of life in a country founded on the idea of no taxation. This period also showed that tax cuts, like the ones that occurred in the 1920's are not the answer. Taxes needed to be raised in 1932 because so many people were falling into the lower progressive income tax brackets due to the depression. But without people paying taxes, the government had no revenue, which was needed to pull the country out of depression. You may draw parallels to the 2001 Bush tax cuts and the following crash in 2008, but be careful of blaming the financial crisis on taxes alone as will become clear in my following discussion of financialization. See Figure 7 for trends in income inequality since 1920.

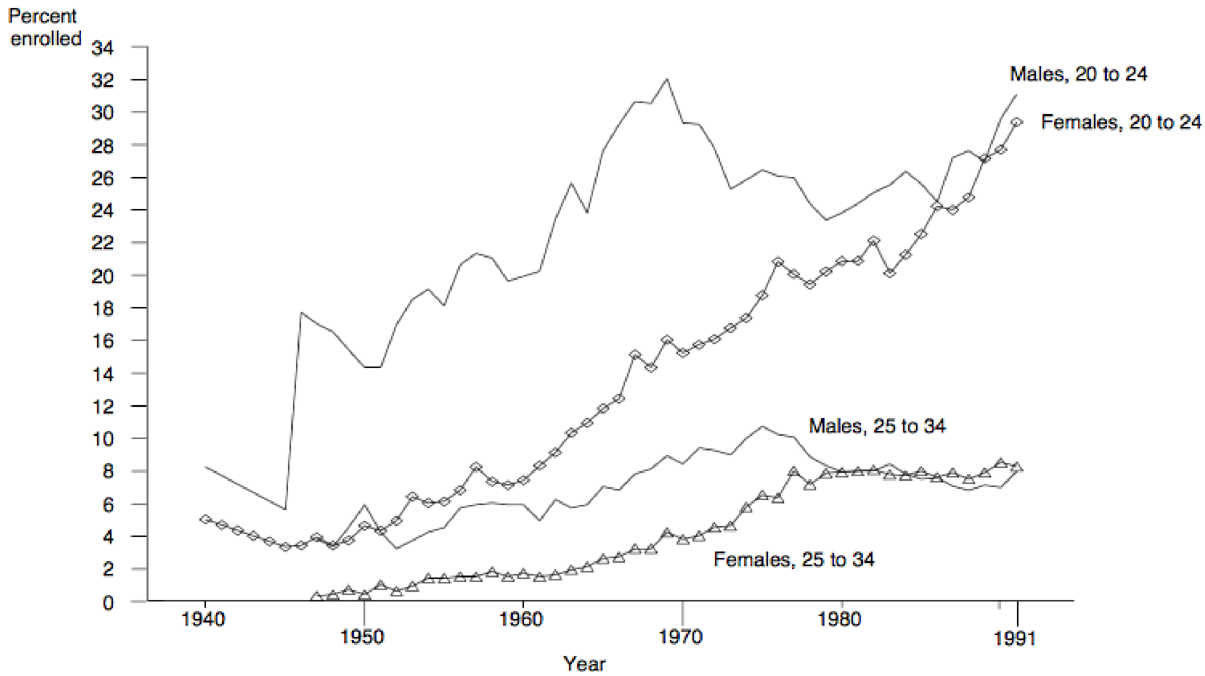
Financialization

Financialization is many things, but for the its use in this paper it can be defined as the increase to the share of gross domestic product (GDP) as contributed by the financial sector (Van Arnum, Bradford M. 2013). Although financialization truly began in the 1980's, one must not forget the time periods that we are jumping past: the 50's, 60's and 70's saw a shift in the culture of American homes. Women moved from the kitchen to the office, men moved from the factory floor to the floor of the stock exchange. The whole country began to transition from creating tangibles to creating ideas and products that spanned the globe. The United States spread itself around the world in this time period. With banks in the 1980's reoriented to short term gains to appease fickle stockholders inclined to revolt,, the long term safety of the financial sector was left by the wayside (Van Arnum, Bradford M. 2013). This financialization, according to Van Arnum, adds to income inequality in the following way: because of the movement of capital to financial markets and the pressure put on firms for short term profits, real growth slowed, firms downsized and grew theirprofits, in turn compensating executives for the maximization in shareholder return. This widened the income gap due to the downsizing of the workforce, and the upsizing of top-level employee's salaries (2013). In the conclusion, Van Arnum states that income inequality can be traced back most clearly to the financialization of the United States and the reduction of the minimum wage relative to the economy's ability to compensate (Van Arnum, Bradford M. 2013). Both Van Arnum and Bradford found that unemployment and the minimum wage had the largest correlations with the Gini coefficient, and increases in the finance sector and the presence of a college education contributed to unemployment as well (2013). It is interesting to note that the government largely sets the minimum wage, and unemployment is a result of firms maximizing their resources in the short term. The two largest factors in inequality as found by Van Arnum and Bradford could be changed with a change in governmental and corporate thinking. They did, however, find that the decline of unions and labor force participation had no statistically significant effect on inequality (Van Arnum, Bradford M. 2013). Hand in hand with financialization, how society has changed over the last 100 years has played an equally important role part in trends in inequality.

Social Change

The third of my reasoning's for the existence of the income inequality cycle is the social change that has occurred in the last century. I choose to go into detail on social change last, as it is largely set up by financialization and the tax changes that have been brought about as a result. It is also interesting to specifically look at the social changes of the 1970's in conjunction with taxes and financialization as this is the time period where inequality and income trends change direction, as can be seen in Figures 4 and 6.

One of the most profound changes that occurred in the 20^{th} century was the advent of women as an equal force in the workplace. Women entered the workforce in increasing numbers for two main reasons: a man's sole income was not enough to support the family; or, because the demand for labor was so great that it offset the opportunity cost of not working, and taking care of children and the home. The 20^{th} century also saw the heterogeneity of education. Specifically by the 1970's the mass movement to higher education had reached its peak (see Figure 4) (Snyder, 1997). After this, the number of enrolled males dropped off sharply. This also coincides with the end of the Vietnam War, which saw a Cultural Revolution taking place among the youth of America. It is interesting to note that, even though the number of enrolled men aged 20 to 24 tapers off during the early 1970's, the number of females 20 to 24 continues to rise until the end of the century.



SOURCE: U.S. Department of Commerce, Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970; and* Current Population Reports, Series P-20, *School Enrollment - Social and Economic Characteristics of Students*, various issues.

Figure 4.

The largest factors in the cultural and social change during the 20th century, for the importance of this paper, have~~s~~ to be the shift in education, and the addition of women to the workplace.

Top Income Trends

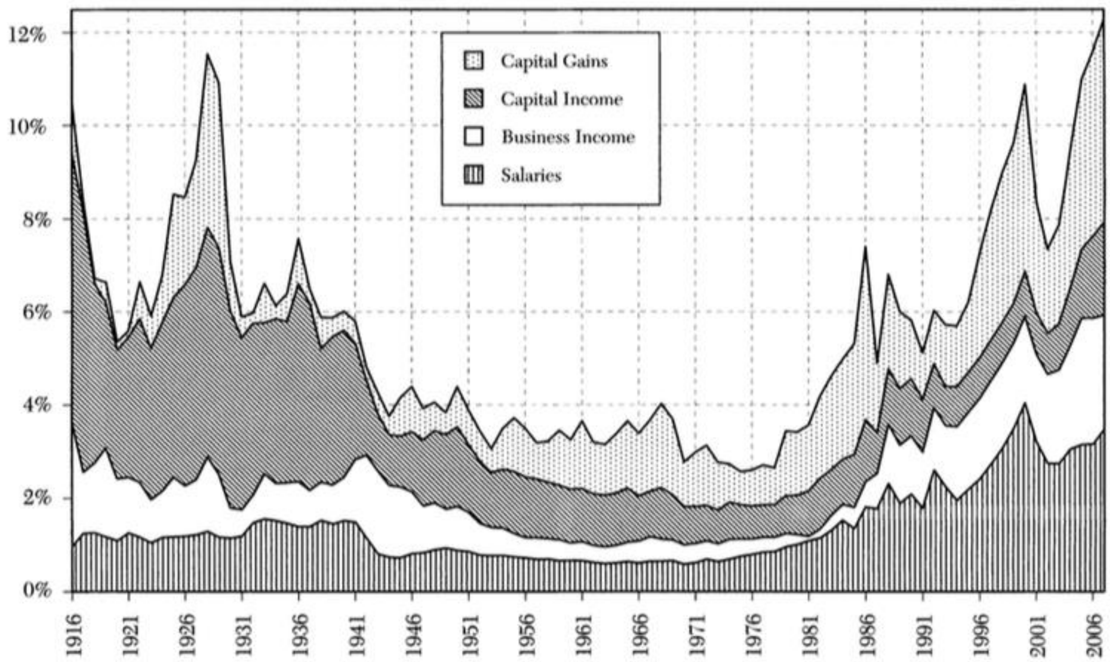


Figure 5. The Top 0.1 Percent Income Share and Composition 1916-2007.
Source: Piketty and Saez (2003), series updated to 2007.

In order to look at the middle class it helps to know the state of the upper echelons of the country as well. The share of the top 10 percent wage earners has gone on quite a journey throughout the 20th and early 21st centuries. The share of the top 10 percent peaked in 1928, just before the Great Depression, and then fell steadily until the 1940's when it leveled off after World War Two. Then with the tax cuts of the 1980's it has been on a steep increase ever since, reaching its height of nearly 50 percent in 2007 (Atkinson, Piketty, & Saez 2011). The share of the top 0.1 percent from 1976 to 2007, as depicted in Figure 3, has more than quadrupled from a level of 2.6 percent to 12.3 percent (Atkinson et al., 2011). What is interesting to note about Figure 3, is that while the income share of the top 0.1 percent has recovered to its pre-depression levels, and even surpassed them, a larger share of the income is made up of salaries, and less in capital income (Atkinson et al., 2011). Another important finding by Atkinson, et al. is that of historical global inequality, which shows that the story is much the same in other countries, although the United States always remains at the top in terms of largest share to the top percentiles (2011). This brings the picture of inequality into the global perspective. While we may feel it at home, income inequality is a worldwide phenomenon that has been developing around us for more than a century, aided by many factors, interconnected and intertwined.

Consumption and the Effects of Taxation

There is limited research on inequality in the middle-income percentages of the country. But the middle class is the consumer class so it is helpful to see the parallels that can be drawn from the variations in consumption as a representation for how the middle class has felt the changes in inequality. This is what Kruger and Dirk looked into as well, however they found that the there was little to no effect felt by the middle class, due in large part to the increase in consumer credit, as you can see from Figure 5 (2006).

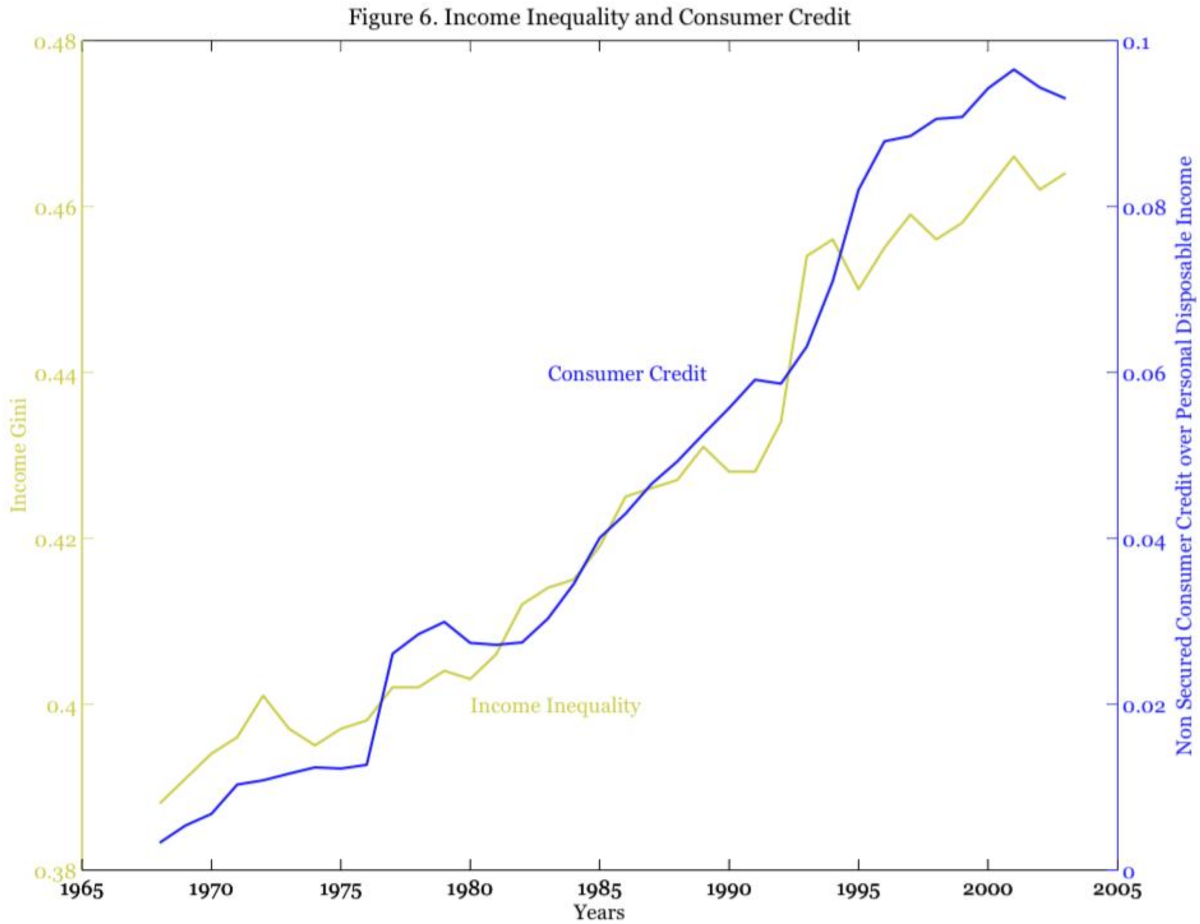


Figure 6
Source: Krueger, Dirk 2006

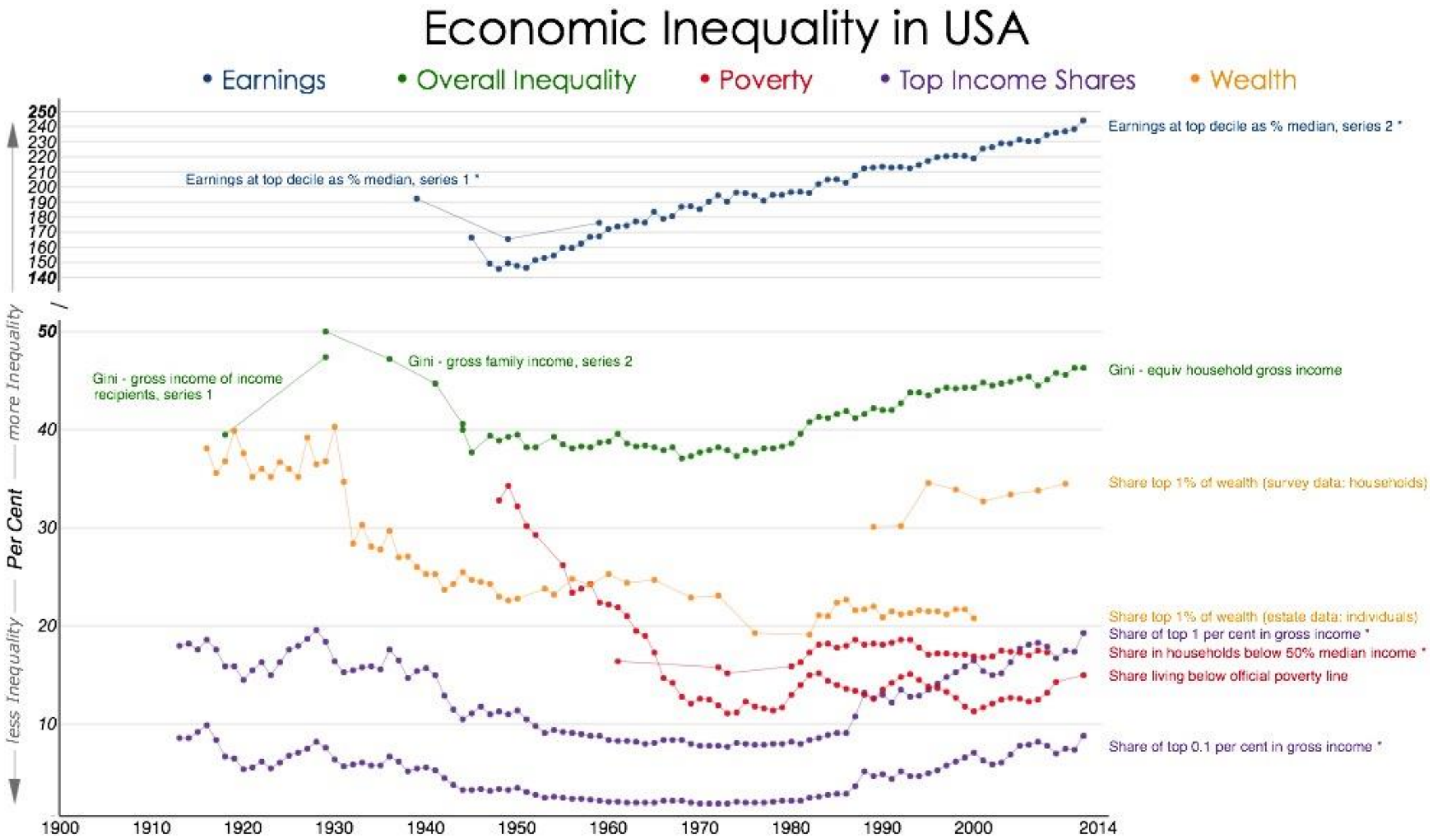
It is clear from the above graphic and from the Gini coefficient that has been used as a tool throughout this paper, that since the 1960's there has been a constant increase in the inequality experienced in the United States. It is interesting that Kruger and Dirk found that there really was no effect on consumption, in large part because of the amount that people are willing to put on credit lines. The emergence of larger and larger credit lines is, beginning in the 1960's, financialization in its most simple form. From there, credit only grew. Unfortunately, the data was from before 2007, but it would be provide insight if we were able to see if the financial crisis interrupted the trend toward greater credit debt. With credit cushioning the consumer's feeling and experience of inequality, has that aspect of the middle class been maintained? The members of the middle class propped up by their many credit lines and refinancing options, are apparently still able to support the economy by consuming at a level that masks the true effects of income inequality. If they are able to stay above their debt, they don't have to feel the pain of their lower income

When specifically looking at taxation in the 1980's, Auten and Carroll found that taxation had a statistically significant effect on income inequality (1999). Auten and Carroll looked at data from before and after the Tax Reform Act of 1986 in order to draw their conclusions. It is interesting to note that they also found non-tax factors contributed to the rising inequality and specific spike in the 1980's (Auten, Carroll 1999). These findings support my narrative of a multi-factor causation for the increase in income inequality.

So far we can see that it is a combination of multiple factors contributing to the rise in income inequality. Financialization and the changes to taxation in the 20th century lead the way for a more complete explanation.

Inequality Cycle

The inequality cycle actually represents something different from what it might mean in many other circumstances. For the purposes of this paper, the inequality cycle is the cycle that has already completed one revolution during the 20th century, and the United States is at a point once again where the cycle can begin again. The first cycle we saw began during the industrial revolution, with inequality peaking before the Great Depression and sloping off until the 1970's. As you can see in Figure 7 The Kuznets curve follows its normal progression until the 1970's when it appears to reverse and inequality begins to rise again. Much as the industrial revolution caused inequality to rise in the 1920's, the technological revolution has driven inequality to higher levels in the 21st century. What is interesting about where we are in the cycle right now is that we are at the same level of inequality as the last peak of the Kuznets curve. This begs the question: will our cycle be higher, or will we soon find a way to push our inequality trend in the other direction?



Source: A.B. Atkinson and S. Morelli (2014)
Figure 7

Limitations

It would be a disservice to my topic if I did not discuss the limitations of my research and the topics that I did not delve into fully. First, I did not create any economic models to solve the so-called income inequality problem that we are facing at this point in time. While I would like to give one simple solution, the problem, as you the reader can tell from the above meta-analysis, is incredibly complex. Secondly, I chose to focus on only three variables that I found to have correlation to trends in income inequality, but correlation does not equal causation, so there are certainly many more variables that have contributed to the increase in income inequality.

Conclusion

As stated above, I chose to only focus on three main points in the analysis of income inequality in America. Taxes, Financialization, and the social changes that occurred during the 20th and early 21st centuries have contributed greatly to the status of income distribution in America.

Where will we go from here? That is the question that I now stand to answer, based on my research and my understanding of current trends. In my non-professional opinion, the most effective change will come from a threefold shift in our society. These shifts are aligned with my three main points. These ideas are contingent on the thought that we want to change the inequality trends outlined in this paper. To begin, I believe society will need a major shift in the mindset of the masses, whether that is the “cultural revolution” of my generation and those in the generation before mine or not, our attitudes need to shift toward a greater sense of responsibility for all levels of society. Secondly, the financialization of the United States received a large shock in 2007, but the system of short-term gains is not sustainable and is not desirable in the long run.

And finally, our taxes are too low. The decrease in education, taxes and the drastic changes to the financial system have put us at this peak of inequality. For things to ~~change,~~change education must become more accessible, taxes must be raised in order to support public works projects, society should~~is going~~ to go through a shift, and the financial system that reinforces the structures that keep inequality strong must not continue. The first step is recognizing that inequality exists and that in the long run, it does not lift the United States up. The United States is built on the principle of the pursuit of happiness, and equality is essential to that dream being realized.

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