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Income Inequality May Take Toll on Growth

By ANNIE LOWREY

WASHINGTON — Income inequality has soared to the highest levels since the Great Depression, and the recession has done little to reverse the trend, with the top 1 percent of earners taking 93 percent of the income gains in the first full year of the recovery.

The yawning gap between the haves and the have-nots — and the political questions that gap has raised about the plight of the middle class — has given rise to anti-Wall Street sentiment and animated the presidential campaign. Now, a growing body of economic research suggests that it might mean lower levels of economic growth and slower job creation in the years ahead, as well.

“Growth becomes more fragile” in countries with high levels of inequality like the United States, said Jonathan D. Ostry of the International Monetary Fund, whose research suggests that the widening disparity since the 1980s might shorten the nation’s economic expansions by as much as a third.

Reducing inequality and bolstering growth, in the long run, might be “two sides of the same coin,” research published last year by the I.M.F. concluded.

Since the 1980s, rich households in the United States have earned a larger and larger share of overall income. The 1 percent earns about one-sixth of all income and the top 10 percent about half, according to statistics compiled by the respected economists Emmanuel Saez of the University of California, Berkeley and Thomas Piketty of the Paris School of Economics.

For years, economists have thought of such inequality in part as a side effect of policies that fostered the country’s economic dynamism — its tax preferences for investment income, for instance. And organizations like the World Bank and the I.M.F., which is based in Washington, have generally not tackled inequality in the world head on.

But economists’ thinking has changed sharply in recent years. The Organization for Economic Cooperation and Development this year warned about the “negative consequences” of the country’s high levels of pay inequality, and suggested an aggressive series of changes to tax and spending programs to tackle it.

The I.M.F. has cautioned the United States, too. “Some dismiss inequality and focus instead on

overall growth — arguing, in effect, that a rising tide lifts all boats," a commentary by fund economists said. "When a handful of yachts become ocean liners while the rest remain lowly canoes, something is seriously amiss."

The concentration of income in the hands of the rich might not just mean a more unequal society, economists believe. It might mean less stable economic expansions and sluggish growth.

That is the conclusion drawn by two economists at the fund, Mr. Ostry and Andrew G. Berg. They found that in rich countries and poor, inequality strongly correlated with shorter spells of economic expansion and thus less growth over time.

And inequality seems to have a stronger effect on growth than several other factors, including foreign investment, trade openness, exchange rate competitiveness and the strength of political institutions.

For developing economies, the channels through which inequality might drag down growth seem clear. Inequality might foster political instability and lead to violence and economic destruction, for instance, a theme that fits for Arab Spring countries, like Egypt and Syria.

For the United States, such channels are now the subject of intense research interest, with economists examining whether and how the gap between the rich and the poor fueled the recession and what it might mean.

In the last few years, research by the Brookings Institution, the I.M.F. and dozens of economists at top research universities has started to coalesce into a compelling narrative.

Starting in the 1970s, earnings were squeezed for low- and middle-income households. They borrowed to improve their standards of living — buying bigger houses than they could afford and using those houses as piggy banks. Families bet that housing prices would keep rising, making a three-bedroom outside Phoenix a safe store of wealth. But the housing bubble collapsed, and took the rest of the economy with it.

Research by Raghuram Rajan of the University of Chicago has also underscored the importance of deregulation. "Starting in the early 1970s, advanced economies found it increasingly difficult to grow," he wrote this year. "The shortsighted political response to the anxieties of those falling behind was to ease their access to credit. Faced with little regulatory restraint, banks overdosed on risky loans."

Thus, inequality might help explain the recession and the sluggish recovery after it. But now, economists and policy experts are facing the thorny and politically freighted question of what the United States' inequality might mean over the next several years.

The recession seems to have cemented the country's income and wealth inequality, not reversed it. The top 10 percent earn a larger share of overall income than they have since the 1930s. The

earnings of the top 1 percent took a knock during the recession, but have bounced back. In contrast, the average working family's income has continued to decline through the anemic recovery.

The distribution of wealth has become more concentrated as well. The lower income a family earns, the more wealth they tend to hold in their housing. Housing values have plummeted, and are not expected to recover for years if not decades. At the same time, many bond prices have soared and stock prices have performed well, aiding the upper-income households that tend to hold investments.

A new study by the left-of-center Economic Policy Institute, a research group in Washington, has found that the top 1 percent of households now hold a larger share of overall wealth than the bottom 90 percent does.

Policy experts and politicians across the political spectrum — including President Obama and Mitt Romney — argue that restoring the middle class will be crucial to driving growth. But they disagree sharply on the proper policies to do so, particularly when it comes to taxes and government transfer programs.

"What worries me is the idea that we're in a vicious cycle," said Joseph E. Stiglitz, a Nobel laureate in economics who has studied inequality extensively. "Increasing inequality means a weaker economy, which means increasing inequality, which means a weaker economy. That economic inequality feeds into political economy, so the ability to stabilize the economy gets weaker."

Rea S. Hederman, an economist at the right-of-center Heritage Foundation, a Washington research group, said that "the problem is that the policies that encourage growth also encourage inequality," citing the preferential tax rates for investment income as an example. "That means redistributing income is going to restrict growth."

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