Community Perspective:
Widening Inequality Hurts us All

By Robert B. Reich

How did America go from the Great Depression of the 1930s to thirty years of what might be termed the Great Prosperity between 1947 and 1977? And from there, to thirty years of stagnant incomes and widening inequality, culminating in a Great Recession and one of the most anemic recoveries on record? It was no accident.

The Great Prosperity

During three decades from 1947 to 1977, America implemented the basic bargain – providing its workers enough money to buy what they produced. Productivity grew in tandem with wages. Labor productivity – average output per hour worked – doubled. So did median incomes. Expressed in 2007 dollars, the typical family's income rose from about $25,000 to $55,000. The bargain was cinched.

But here's the really interesting thing. We became more equal. The wages of workers in the bottom fifth grew 116 percent – faster than the pay of those in the top fifth (which rose 99 percent), and in the top five percent (86 percent). By the late 1940s, the nation was "more than halfway to perfect equality," as the National Bureau of Economic Research wryly observed. But as the economy grew almost everyone came out ahead, including those at the top.

The Great Prosperity also marked the culmination of a reorganization of work that had begun during the Depression. Perhaps most significantly, government increased the bargaining leverage of ordinary workers. They were guaranteed the right to join labor unions, with which employers had to bargain in good faith. By the mid 1950s more than a third of all workers were unionized. UAW president Walter Reuther, among others, explicitly invoked the basic bargain: "Unless we get a more realistic distribu-

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tion of America's wealth," he threatened, "we won't get enough to keep this machinery going." Employers relented, and the higher wages kept the machinery going better than ever by giving average workers more money to buy what they produced. (Non-unionized companies, fearing their workers would otherwise want a union, offered similar deals.) And because health and pension benefits were not taxed, big employers added ever more generous provisions.

Americans also enjoyed economic security against the risks of economic life – not only unemployment benefits but also, through Social Security, insurance against disability, loss of a major breadwinner, workplace injury, and inability to save enough for retirement. In 1965 came health insurance for the elderly and the poor (Medicare and Medicaid). Economic security proved the handmaiden of prosperity. In requiring Americans to share the costs of adversity it enabled them to share the benefits of peace of mind. And by offering peace of mind, it freed them to consume the fruits of their labors.

Government also widened access to higher education. The GI Bill paid college costs for those who returned from war. The expansion of public universities – whose tuitions averaged about four percent of median family incomes during the Great Prosperity in contrast to the 20 percent then demanded by private universities – made higher education affordable to the American middle class. Consequently, college enrollments surged. By 1970, seventy percent of the nation's four-year post-secondary students were in public universities and colleges. The federal government, especially the Defense Department, also underwrote a growing portion of university research, especially in the sciences.

Notwithstanding all this, the nation also found the time and money in these years to rebuild Western Europe and Japan – spending billions of dollars to restore foreign factories, roads, railways, and schools. The effort proved an astounding success. The years 1945 to 1970 witnessed the most dramatic and widely shared economic growth in the history of the world, which contributed to America's Great Prosperity. In helping restore the world's leading economies and thus keep communism at bay, the new global system of trade and assistance created vast new opportunities for American corporations – far richer, larger, and more technologically advanced than any other – to expand and prosper.

Government paid for all of this with tax revenues from an expanding middle class whose incomes were rising. Revenues were also boosted by those at the top of the income ladder whose marginal taxes were far higher than today's. The top marginal income tax rate during World War II was over 68 percent. In the 1950s, under Dwight Eisenhower, whom few would call a radical, it rose to 91 percent. In the 1960s, the highest marginal rate was around 70 percent. Even after exploiting all possible deductions and credits, the typical high-income taxpayer paid a marginal federal tax of over 50 percent. But contrary to what conservative commentators had predicted, the high tax rates did not hobble economic growth. To the contrary, they enabled the nation to expand middle-class prosperity and fuel growth.

America of that era still harbored vast inequalities, of course. The very poor remained almost invisible. Blacks were still relegated to second-class citizenship. Few women dared aspire to professions other than teaching or nursing. But such barriers would eventually weaken or disappear. And although the era also engendered a blandness, uniformity, and materialism that many found abhorrent, the Great Prosperity offered more Americans more opportunities to make whatever life they wanted more than ever before. It significantly expanded the portion of total income going to the middle class. And it proved that widely-shared income gains were not incompatible with widespread economic growth; they were, in fact, essential to it.

The Great Regression, 1980 to 2008

During the Great Prosperity of 1947-1977, the vast middle class received an increasing share of the benefits of economic growth. But after that point, the two lines began to diverge: output per hour – a measure of productivity – continued to rise. But real hourly compensation was left in the dust.

Contrary to popular belief, trade and technology have not reduced the overall number of American jobs. Their more profound effect has been on pay. Rather than be out of work, most Americans have quietly settled for lower real wages, or wages that have risen more slowly than the overall growth of the economy per person. Although unemployment following the Great Recession remains unusually high, jobs are slowly returning – but in order to get them, many workers have to accept lower pay than before. Trade and technology have driven a wedge between the earnings of people at the top and everyone else. The pay of well-connected graduates of prestigious colleges and MBA programs – the so-called "talent" who reached the pinnacles of power in executive suites and on Wall Street – has soared. But the pay and benefits of most other workers has either flattened or dropped. And the ensuing division has also made most middle-class American families less economically secure.

The real puzzle is why so little was done in response to these forces that were conferring an increasing share of economic growth on a small group at the top and leaving most other Americans behind. With the gains from that growth, the nation could, for example, have expanded our educational system to encompass early-childhood education and better equipped our public schools. It could have supported affordable public universities, created more job retraining, and better and more extensive public transportation.

In these and many other ways, government could have reinforced the basic bargain. But it did the opposite. Starting in the late 1970s, and with increasing fervor over the next three decades, it deregulated and privatized. It slashed public goods and investments – whacking school budgets, increasing the cost of public higher education, reducing job training, cutting public transportation, and allowing bridges, ports, and highways to corrode. It shredded safety nets – reducing aid to jobless families with children, and cutting unemployment insurance so much that by 2007, only 40 percent of the unemployed were covered. It halved the top income tax rate from the range of 70 to 90 percent that prevailed during the Great Prosperity to 28 to 35 percent; allowed many of the nation's rich to treat their income as capital gains subject to no more than 15 percent tax; and shrunk inheritance taxes that affected only the top-most 1.5 percent of earners. Yet at the same time, America boosted sales and payroll taxes, both of which took a bigger chunk out of the pay of the middle class and the poor than of the well off.

We allowed companies to break the basic bargain with impunity – slashing jobs and wages, cutting benefits, and shifting risks to employees (from you-can-count-on-it pensions to do-it-yourself 401(k)s, from good health coverage to soaring premiums and deductibles). Companies were allowed to bust unions and threaten employees who tried to organize (by 2010, fewer than eight percent of private-sector workers were unionized). And nothing impeded CEO salaries from skyrocketing to 300 times that of the average worker (from 30 times during the Great Prosperity), while the pay of financial executives and traders rose into the stratosphere. We stood by as big American companies became global companies with no more loyalty or connection to the United States than a G.P.S. satellite.

Most telling of all, Washington deregulated Wall Street while insuring it against major losses. In so doing it allowed finance – which until then had been the servant of American industry – to become its master, demanding short-term profits over long-term growth, and raking in an ever-larger portion of the nation's profits. Between 1997 and 2007, finance became the fastest-growing part of the U.S. economy. Two-thirds of the growth in the Gross National Product was attributable to the gains of financial executives, traders, and specialists. By 2007, financial companies accounted for over forty percent of American corporate profits and almost as great a percentage of pay, up from ten percent during the Great Prosperity.

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The Cause of Our Unraveling

Some argue America did so little because Americans lost confidence in government. They have cause and effect backwards. The tax revolts that thundered across America starting in the late 1970s were not so much ideological revolts against government – Americans still wanted all the government services they had before, and then some – as backlash against paying more taxes on incomes that had stagnated. Inevitably, government services deteriorated and government deficits exploded, confirming the public's growing cynicism about government's capacity to do anything right. Furthermore, the inflation of the 1970s wasn't due to government spending. It was the result of an eightfold hike in world oil prices engineered by the oil cartel and a drop in the value of the dollar. When inflation began to accelerate, federal spending was only one percentage point higher as a proportion of GDP than it had been in the first half of 1960s.

The real reason for the reversal of the pendulum was political. As income and wealth became more concentrated in fewer hands, politics reverted to what former Federal Reserve Chair Marriner Eccles described in the 1920s as when people "with great economic power had an undue influence in making the rules of the economic game." With hefty campaign contributions, and platoons of lobbyists and PR flacks, the rich pushed legal changes that enabled them to accumulate even more income and wealth – including tacit permission to bust unions, slash corporate payrolls, and reduce benefits; lower taxes for themselves; and deregulation of Wall Street. Since so much of their wealth depends on the performance of the stock market, they particularly wanted to free up the Street to put greater pressure on companies to perform. The plan worked. The Dow Jones Industrial Average took off – rising tenfold between 1980 and 2000.

Americans accepted the backward swing of the pendulum because they mitigated its effects. Starting in the late 1970s, the American middle class honed three coping mechanisms, allowing it to behave as though it was still taking home the same share of total income as it had during the Great Prosperity, and to spend as if nothing substantially had changed. Not until these coping mechanisms became exhausted in the Great Recession would the underlying reality be exposed.

Coping mechanism # 1: Women move into paid work. Starting in the late 1970s, and escalating in the 1980s and 1990s, women went into paid work in greater and greater numbers. For the relatively small sliver of women with four-year college degrees, this was the natural consequence of wider educational opportunities and new laws against gender discrimination that opened professions to well-educated women. But the vast majority of women who migrated into paid work did so in order to prop up family incomes, as households were hit by the stagnant or declining wages of male workers.

This transition of women into paid work has been one of the most important social and economic changes to occur over the last four decades. It has reshaped American families and challenged traditional patterns of child-rearing and child care. Its magnitude has been extraordinary. In 1966, twenty percent of mothers with young children worked outside the home. By the late 1990s, the proportion had risen to sixty percent. For married women with children under the age of six, the transformation has been even more dramatic – from twelve percent in the 1960s to fifty-five percent by the late 1990s.

Families seem to have reached the limit, however – a point of diminishing returns where the costs of hiring others to see to the running of a household or to take care of the children, or both, exceeds the apparent benefits of the additional income.

Coping mechanism # 2: Everyone works longer hours. By the mid 2000s it was not uncommon for men to work more than sixty hours a week, and women to work more than fifty. Professionals put in more "billable" hours. Hourly workers relied on overtime. A growing number of people took on two or three jobs, each demanding twenty or more hours. All told, by the 2000s, the typical American worker worked more than 2,200 hours a year – 350 hours more than the average European worked, more hours even than the typically industrious Japanese put in. It was many more hours than the typical American middle-class family had worked in 1979 – five hundred hours longer, a full twelve weeks more. Americans seemed to have reached a limit. Even if they can find the work, they can't find any more time.

Coping mechanism #3: Draw down savings and borrow to the hilt. After exhausting the first two coping mechanisms, the only way Americans could keep consuming as before was to save less and go deeper into debt. During the Great Prosperity the American middle class saved about nine percent of their after-tax incomes each year. By the late 1980s and early 1990s, that portion had been whittled down to about seven percent. The savings rate then dropped to six percent in 1994, and on down to three percent in 1999. By 2008, Americans saved nothing. Meanwhile, household debt exploded. During the Great Prosperity debt had averaged around 50 to 55 percent of after-tax income. That included what people owed on their mortgages. But starting in 1980 debt took off. In 2001, Americans owed as much as their entire after-tax income that year. By 2007, the typical American owed 138 percent of their after-tax income.

Americans borrowed from everywhere. Credit card solicitations flooded mail boxes; many American wallets bulged with dozens of such cards, all amassing larger and larger debt loads. Auto loans were easy to come by. Students and their families went deep into debt to pay the costs of college. But far and away, the largest borrowing was to buy homes. Mortgage debt exploded. As housing values continued to rise, homes doubled as ATMs. Consumers refinanced their homes with even larger mortgages and used their homes as collateral for additional loans. As long as housing prices continued to rise, it seemed a painless way to get additional money (in 1980 the average home sold for $62,000; by 2006 it went for $245,000). Between 2002 and 2007, American households extracted $2.3 trillion from their houses, putting themselves ever more deeply into the hole.

Eventually, of course, the debt bubble burst. With it, the last coping mechanism ended. Each of these mechanisms reached its inevitable limit. And when the debt bubble burst, most Americans woke up to a startling reality: They could no longer afford to live as they had been living; nor as they thought they should be living, given the growth in the economy; nor as they expected to be living, given how their pay used to grow when the economy grew; nor as they assumed they could be living, given the lavish lifestyles of people at the top of the income ladder.

The Future

The economic challenge ahead is to lift the means of middle-class Americans and reconstitute the basic bargain linking wages to overall gains – providing the vast American middle class with a share of economic gains sufficient to allow them to purchase more of what the economy can produce. One step toward reestablishing shared prosperity would be expanding the Earned Income Tax Credit. The EITC has not only helped reduce poverty but has increased the incomes of families most likely to spend that additional money, and thereby create more jobs. In 2011, the EITC was the nation's largest anti-poverty program. Over 24 million households received wage supplements. Given what's happened to middle-class incomes, the EITC should be expanded and extended upward. Under my plan, full-time workers earning $20,000 or below (this and all subsequent figures are in 2010 dollars) would get a wage supplement of $15,000. This supplement would decline incrementally to $10,000 for full-time workers earning $30,000; to $5,000 for full-time workers earning $40,000; and then to zero for full-time workers earning $50,000. Along with expanding the EITC, I'd recommend that marginal tax rates be lowered for the middle class. The income tax rates of full-time workers earning between $50,000 and $90,000 should be cut to ten percent of earnings, and of workers earning between $90,000 and $140,000 to 20 percent of their earnings.

The yearly cost to the federal government of expanding the EITC and reducing middle-class taxes would be approximately $634 billion a year (in 2010 dollars). This lost revenue could be replaced by a tax on fossil fuels (coal, oil, and gas), based on how many tons of carbon dioxide such fuels contain. The tax would be collected at the mine or port of entry for each fossil fuel, and would gradually rise over time in order to push energy companies and users to spew less carbon into the atmosphere. If initially set at $35 per metric ton of carbon-dioxide or its equivalent, such a tax would raise over $210 billion in its first year alone. By the time it reached $115 per ton, it would yield about $600 billion per year. The public wouldn't directly pay this tax, but would indirectly pay it to the extent the prices of goods rise in proportion to how much carbon is used in their production. For example, a tax of $115 per ton would add about $1 to the price of a gallon of gasoline and 6 cents per kilowatt-hour to the price of electricity. But if the revenues from the carbon tax went into an expanded EITC and lower taxes on the middle class, most Americans would still come out far ahead. A carbon tax has two additional advantages. It would push energy companies and businesses to invest in new ways to reduce greenhouse gases, and in lower-carbon fuels and products. This would prevent overall emissions from increasing beyond current levels. The tax will also boost aggregate demand.

The Great Recession has accelerated the structural change in the economy that began in the late 1970s. Large numbers of Americans will not be rehired unless they are willing to settle for lower wages and benefits. Eventually jobs will return, but if the trend continues, more people will be working for pay they consider inadequate, more working families will be at or near poverty, and inequality will have widened.

Nor will households be able to borrow as before. Lending standards have tightened, and bank regulators and new regulations will require prudence. Meanwhile, a large number of Americans are paying off, paying down, or walking away from trillions of dollars of outstanding loans – in a vast "deleveraging" of household finances that is likely to continue for years. At the same time, tens of millions of boomers are approaching retirement with nest eggs that have shrunk to the size of peanuts, and must save in earnest.

All this means less consumption as a proportion of the overall economy than before the Great Recession. Although consumers have to replace cars, appliances, and other things that run out or wear out or finally break down, and businesses have to replace inventories that become so depleted they have nothing left to sell or ship, a lasting recovery cannot be based on replacements.

Where will demand come from without a buoyant American middle class? Absent their spending, private investors have little incentive to buy new equipment or software, new commercial buildings or factories; entrepreneurs have little incentive to embark on new research and develop new products and services. Government can fill the gap for a time, but government cannot continue indefinitely to stimulate the economy with deficit spending or by printing money. Nor can we rely on exports to fill the gap. Exports will remain a relatively small proportion of our economy. Other economies – even the Chinese – are relying on net exports to maintain their employment. It is impossible for every large economy, including the United States, to become a net exporter.

Hence our underlying dilemma. As we should have learned during the Great Prosperity – the thirty years after World War II when America grew because most Americans shared in the nation's prosperity – we cannot have a growing and vibrant economy without a growing and vibrant middle class. CI

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