Economic Trends

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SPENDING LEVELS OF RICH AND POOR

Surprisingly, the gap hasn't grown

It's somewhat of a puzzle. In recent decades, income inequality in the U.S. has increased sharply as the highest-paid Americans have pulled further ahead of middle- and low-income families. Many families have seen scant real income growth. Yet these trends have sparked little public outcry.

AN INEQUALITY PUZZLE

GAPS IN INCOME HAVE WIDENED SHARPLY, BUT NOT IN SPENDING

▲PERCENT OF LOW-INCOME FAMILY LEVELS

*HIGH-INCOME FAMILIES ARE THOSE AT THE 90TH INCOME PERCENTILE (HOUSEHOLDS JUST BELOW THE TOP 9%); LOW-INCOME FAMILIES ARE THOSE AT THE 10TH PERCENTILE (JUST ABOVE THE BOTTOM 9%). **AFTERTAX

Data: Dirk Krueger and Fabrizio Perri

Observers attribute this subdued reaction to the public's abiding faith in the American dream of upward mobility. But a study by Dirk Krueger of Stanford University and Fabrizio Perri of New York University points to another possible factor. To their surprise, the two economists found that the rise in income inequality has hardly affected Americans' relative living standards.

Between the early 1970s and the late 1990s, they report, the average aftertax incomes of high-wage households surged from five times that of poor households to nine times. Yet the study shows that the consumption ratio of rich to poor families—their outlays on food, clothing, cars, housing, and other goods and services—stayed at roughly 3 to 1.

How could this happen? The study suggests that rising volatility of income caused by job instability is partly responsible. While richer households have responded to the volatility by saving more of their income, middle- and low-income households have done the opposite. They have borrowed more to enable them to maintain their living standards during bad patches.

Krueger and Perri deem this a positive development, an example of how the credit markets have met the needs of our evolving capitalist system. In fact, consumers' enhanced ability to borrow mitigated the recent downturn.

But there's a potential downside. Survey data indicate that, even with low interest rates, one out of nine families with debts in 2001 were devoting over 40% of their incomes to debt service, and the number has climbed since then. Families that borrow during income declines tend to take longer paying off debts and to amass fewer savings for retirement.

The key question, then, is whether the New Economy will enhance the long-term income growth of middle- and lower-income families enough to offset their increased propensity to take on debt. If it doesn't, more people may face retirement with reduced savings—and income inequality could yet jeopardize the remarkable stability of America's relative living standards.

INFLATION VS. UNEMPLOYMENT

Which makes folks more unhappy?

Monetarists have long argued that the Federal Reserve's mandate to combat both inflation and unemployment should be revised to focus policy solely on inflation. Judging by a forthcoming study in the journal *International Finance*, however, such a shift might not sit well with the body politic.

In the study, based on data from some 280 surveys conducted in the U.S. and Europe from 1973 to 1998, political economist Justin Wolfers of Stanford University analyzed how people's views of their overall happiness are affected by present and past levels of inflation and unemployment. He found that a rise in joblessness is substantially more troubling to people than accelerating inflation—even when the period of unemployment is short-lived.

Wolfers' analysis indicates that a one-percentage-point rise in unemployment causes as much unhappiness as a five-point increase in inflation. Fluctuations in the jobless rate are also unsettling.

In sum, the prospect of declining job security worries folks a lot more than rapidly rising prices. The policy implications for Fed Chairman Alan Greenspan, says Wolfers, are clear: Keep an eye on both inflation and unemployment, but "when the trade-off for achieving greater employment stability is just a little more inflation instability, the gain in the public's happiness suggests it's worth it."