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Has Inequality Really Increased?

It is well documented that the gap between the richest and poorest Americans, in terms of earnings and income, has become wider over the last 25 years. But it is less well known that, despite this increase in "income inequality," the range of consumption among individuals has changed very little. Although in terms of income the households close to the bottom or in the middle have not been able to keep up with households in the upper brackets, on average the lower income group has been able to maintain its spending habits. This is the key finding in **Does Income Inequality Lead to Consumption Inequality? Evidence and Theory** (NBER Working Paper No. 9202) by **Dirk Krueger** and **Fabrizio Perri**.

By one measure, inequality of aftertax labor income has increased by 25 percent in the 1972-98 period. Yet consumption inequality has risen less than 2 percent. What's happened, the authors explain, is that higher-income Americans have been saving more of their income. This may be explained by an increase in income volatility in the United States: that is, a household that is prosperous in one year may have far less income in another year. So, as a precaution, the well-to-do families will save more of their income.

At the other end of the income scale, households attempt to maintain their living standard by borrowing more with credit cards, auto loans, or other means. The lower-income families are also subject to instability in their incomes. Rather than staying in one job for decades, many workers have been changing jobs more frequently, voluntarily or involuntarily. So, some households will pile up debts for years; others may find well-paid jobs and pay off some of their debts.

Credit markets in the nation have responded to these trends by finding more sophisticated ways to use the savings of upper-income households to make loans to those in the middle or the bottom of the income scale, thereby mitigating the impact of income inequality on the consumption of food, clothing, housing, and so on. The ratio of aggregate consumer credit to disposable income in the last 40 years was flat until the mid-1970s, and then showed an upward trend. In effect, the rich are transferring resources to the poor — on a loan basis.

"This development was the crucial factor for the divergence between income and consumption inequality in the last 25 years," the authors conclude, and add: "...the distribution of current income might not measure well how economic well-being is distributed among households in the U.S."

One element in this picture is that the inequality of both income and consumption between groups — say those with college education and those with high school or less — has increased, revealing that credit markets could not reduce consumption differences between permanently richer and permanently poorer households. But if one looks within such groups, income inequality has increased significantly while consumption inequality has actually decreased slightly, revealing an important role of credit markets in reducing consumption fluctuations in response to temporary income changes.

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— David R. Francis