CHAPTER 1

A Half Century of Incomes

WRITING about an economy is like writing about a river. The backdrop is the motion, a constant evolution with no beginning or end. The stories mix human effort and impersonal forces, sometimes working together, sometimes in opposition.

The chapters that follow trace the development of American incomes from the end of World War II through the late 1990s. During this time, our broadest economic goals have remained unchanged: a shared prosperity, the opportunity to progress over a career, the opportunity for our children to do better than we have done. In some decades, the economy has largely delivered these goals. In other decades, it has failed in different ways. When it fails, we develop policies to improve the economy's performance. Since the economy is constantly evolving, we solve existing problems, new problems surface, and the story continues.

The 1998 economy is a case in point. As this book was being finished in the spring of 1998, the nation was finishing the second decade of an experiment in free market economics to accelerate economic growth. The economy has always had markets, of course. Over time, better transportation and communication strengthened competition by knitting local U.S. markets into national markets and then into global markets. We also made conscious choices. Through the court-mandated deregulation of telephones, Jimmy Carter's deregulation of airlines, railroads, and trucking, and most powerfully, Ronald Reagan's philosophy of limited government, we embraced free markets as our main economic strategy much as we embraced Keynesian economics as our main strategy in the 1960s.

Three Economic Stories

How well has the free market experiment succeeded? The question has no single answer. In the summer of 1998, we could see three dif-

ferent economic stories. The most visible economic variables—inflation, unemployment, the government deficit—had all improved dramatically. Unemployment stood below 4.5 percent, the lowest in twenty-five years. Despite extremely tight labor markets, inflation was running at a very modest 2 percent per year. Interest rates were low. The government budget deficit—alarmingly large a decade ago—had temporarily vanished. Consumer confidence and U.S. stock markets were at record highs. All this was part of a business cycle peak—too sweet to last indefinitely—but it was a remarkable achievement.

A second story was the slow growth of average wages. From the close of World War II through 1973, average wages, adjusted for inflation, grew at 2 to 3 percent per year. Rapid wage growth was the basis of a mass upward mobility in which most workers saw big income gains over their careers. After 1973, average wage growth slowed dramatically. It remained slow even in the buoyant economy of the late 1990s.*

The third story was the high level of income inequality, a measure that has traced a long arc through this century. In the 1920s, the richest 5 percent of all families received about 30 percent of all family income.[1] Then, toward the end of the Great Depression, income inequality began a long decline. U.S. Census statistics, which understate the very highest incomes,† report that the income share of the richest 5 percent of families fell to 17.5 percent by 1947 and to 15.6 percent in 1969. Inequality stabilized through the mid-1970s but then began to grow. The income share of the richest 5 percent of families rose to 17.9 percent in 1989, and 20.3 percent in 1996—larger than in 1947. To put the matter in different terms, the top one-half percent of federal tax returns—about 560,000 returns out of 116 million—now report almost 11 percent of all adjusted gross income (AGI) tabulated by the Internal Revenue Service.‡

When you stand too close to this economy, you get a distorted picture. Think about recent sound bites: "The New Economy"; "An

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* From April 1997 through March 1998, one measure of hourly wages grew by a respectable 2 percent, adjusted for inflation, but this growth occurred in a labor market that most people judge too tight to sustain.

† Census statistics understate the highest money incomes by not counting income from capital gains and by not counting incomes over fixed reporting limits. In 1996, individual earnings above $1,000,000 were rounded down to $1,000,000 in census inequality calculations. Generally, similar limits apply to family and household incomes. These limits currently affect 75,000 to 100,000 households out of 100 million households.

‡ In the mid-1990s, there were about 100 million households versus 116 million tax returns but the two populations differ in important respects. Some households file multiple returns. Other households file no tax returns since their income is too low to require payment of federal income taxes—Jim Poterba, personal communication, (1998).

Economy As Good As It Gets"; "A Polarized Economy"; "An Information Economy"; "An Entrepreneurial Economy"; "A Downsized Economy." No one of these phrases tells the story because all of them are more or less true.

When you take a step back and see today's economy in historical perspective, certain facts become clear. In the first quarter-century after World War II—from 1946 to 1973—the economy grew very rapidly and achieved most of the nation's economic goals. In the quarter-century since 1973, the economy's performance has been much weaker. For reasons we will discuss—reasons largely beyond the reach of policy—average wage growth slowed sharply after the early 1970s. As a consequence, many of today's older workers have not seen significant income gains over their careers. If slow average wage growth continues, many young workers—particularly those who have not attended college—will not earn as much as their parents earned.

The conflicting trends we see around us mean that the economy *may* be entering a period in which it can once again generate broadly rising incomes. Whether or not the turning point occurs depends on three factors. One is the growth rate of labor productivity, the increase in output per hour of work. The second is the economy's level of skill bias, the degree to which new production processes, including expanded trade, favor better educated workers over less educated workers. The third is the quality of the nation's equalizing institutions: public and private education, the welfare state, unions, international trade regulations, and the other political structures that blunt the most extreme market outcomes and try to ensure that most people benefit from economic growth.

To anchor the discussion, I will focus on the evolution of the U.S. income distribution. The income distribution is a mirror of economic life and I will look less at the distribution's statistics than at the stories that explain the statistics—stories about people, places, industries, and jobs. The three abstract factors—productivity growth, skill bias, and equalizing institutions—will help tie the stories together. For example, in the 1950s the continuing mechanization of agriculture both made farming more efficient and displaced large numbers of farm laborers. Often, however, farm laborers could get on a bus to a city where they could find factory jobs at higher pay.* In other words, the 1950s economy was not skill-biased: Low-skilled workers displaced in one industry could get good jobs in another industry and so incomes automatically grew throughout the distribution.

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* Kevin Murphy (personal communication in 1993) points out that this was particularly true for blacks. Many of the agricultural jobs held by blacks in the 1940s were ultimately eliminated by mechanization. Yet black incomes rose substantially over the next thirty years as black men and women moved into other industries.

Today, the economy favors the better educated over the less educated. When computerization or international trade displaces a semiskilled worker, the move to a good job means acquiring the training to become a computer repairman or laboratory technician, a much harder move than getting on a bus. If these changes were occurring when productivity and the economy's wage level were growing rapidly, the skill bias would create a benign inequality in which less-educated workers got a little richer and well-educated workers got much richer. Until very recently, productivity and the economy's average wage have grown slowly and so many less-educated workers have taken absolute income losses.*

We cannot legislate the rate of productivity growth and we cannot legislate the level of skill bias in technological change and trade. That is why equalizing institutions are important. One of these institutions—quality education—is currently as popular as motherhood. Other institutions including unions and much of the welfare state are frequently described as ideas whose times have passed, obstacles to individual freedom and well-functioning markets. Today, when the unemployment rate is 4.5 percent, arguing against these institutions is provocative chatter. In the longer run, it is dangerous nonsense. People will not continue to support free market policies if they believe only others benefit. John Gray, a conservative political philosopher who would disagree with much in this book, makes the point well:

> [The philosophy of unfettered markets] maintains that only a regime of common rules, perhaps embodying a shared conception of rights, is required for the stability of market institutions and of a liberal civil society. This species of *liberal legalism* overlooks, or denies that market institutions will not be politically stable—at any rate when they are combined with democratic institutions—if they do not accord with widespread conceptions of fairness, if they violate other important cultural norms, or if they have too destructive an effect on established expectations.[2]

The Plan of the Book

The history that follows is divided into five parts. Chapters 2 and 3 contain an economic overview of the last fifty years. Chapter 2 describes the economy as it was immediately after World War II. Chapter 3 tells the economic story of the last five decades. The story

* During 1996 to 1997, productivity growth averaged 1.6 percent per year versus 1 percent per year over the previous two decades and 2 to 3 percent per year between 1947 and 1973. In chapter 8, I discuss the consequences if this higher rate is sustained.

centers on changes in labor productivity and changes in the average family's income—related topics. Since economic history is more than economics, noneconomic factors make appearances as well: politics, demography, the Civil Rights Revolution, and women's drive for equality.

Chapters 4 and 5 begin a discussion of inequality by focusing on the labor market and the distribution of earnings. Chapter 4 examines the economy's shift to a service society, and the argument that this shift is responsible for both rising inequality and a slowdown in growth. While there is some truth here, much of the argument is a case of mistaken identity. The real culprit in "deindustrialization" is a surge in skill bias that reduced opportunities for less-educated labor in all industries beginning in the early 1980s.

Chapter 5 looks inside manufacturing and services to examine the changing nature of work and pay. The chapter traces the evolution of the occupational distribution for both the whole economy and for different groups of workers—black women, white men, and so on. Using these data, I will assess three overlapping pictures of today's labor market. One is that today's economy has difficulty producing good jobs—stable work at good pay. The second is that earnings inequality is now tightly tied to genetic intelligence and is beyond the reach of policy. The third is that the labor market has become a winner-take-all market with most income gains concentrated among a very few individuals.

In chapter 6, I examine how income varies across geography and how these variations have changed over time. Over fifty years, the growth of national markets has made the nation's regions more alike while differences within regions—cities versus suburbs—have grown larger.

Chapter 7 describes changing living arrangements and the welfare state, a second pair of related topics. The welfare state, a major equalizing institution, has been based on a fairly constant set of assumptions for sixty years. Over the same sixty years, both living arrangements and the economy have changed substantially, with some of the changed living arrangements induced by welfare state programs. A constant welfare state in a changing world has created the current imperative for reform. It is straightforward to design reforms that either encourage individual initiative or ensure a decent income. The trick—a trick we have not mastered—is in constructing reforms that do both.

In chapter 8, I use the perspective of the previous chapters to reassess today's economy and sketch the policies we need if we are to continue to progress as a nation.

Notes on the Data

When my previous book, *Dollars and Dreams*, was published in 1987, it began with a statistical review of trends in average family and household incomes* and income inequality. Statistics on income and wealth are more familiar today, and so these statistics along with a definition of the gini coefficient—a standard measure of inequality—are now included as the appendix.

Two statistical issues deserve mention here, beginning with my sources. The bulk of the statistics in this volume come from the decennial census and the monthly *Current Population Survey*, both collected by the U.S. Bureau of the Census. These are the main income data available for historical studies,[3] but they contain some limitations. Most important, the census defines income as pre-tax money receipts, excluding capital gains. This definition misses the value of non-money income like Medicare and employer-provided health insurance. It misses the bite that taxes take from income. By excluding capital gains, it understates some incomes toward the top of the distribution. The appendix contains some examples of the differences made by these limitations. For most of what I discuss, the differences are not a problem. Where census statistics are inadequate for my purposes, I will supplement them with other data.

The second point involves the choice of a price index to adjust for inflation. This book traces the purchasing power of incomes and wages over the last fifty years. To do this, I must use a price index to translate historical dollar amounts into today's dollars. In recent years, a variety of reports have argued that standard government price indices—for example, the consumer price index (CPI)—overstate inflation.[4]

Unless otherwise noted, historical dollar amounts will be converted to 1997 dollars using the Bureau of Labor Statistics' chain-weighted personal consumption expenditure (PCE) deflator.† Observers agree that among government price indices, this recently revised index does the best job of measuring the inflation faced by the

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* In U.S. census data, a family is defined as a living unit inhabited by two or more people related by blood, marriage, or adoption. A household is simply an occupied living unit. Thus all families live in households but households also include persons living alone, unrelated roommates, and so on.

† An exception is the use of official federal poverty statistics. These statistics are based on the federal poverty standard, which is annually adjusted for inflation using the consumer price index.

typical consumer over the last five decades.* When I discuss changes in "real" income or "real" wages, I am referring to changes over time in dollar amounts that have first been corrected for inflation using this index.

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* Note that the choice of an inflation index does shape history. Statistics based on the chain-weighted PCE rather than the CPI will show less inflation between World War II and the present, greater gains of purchasing power over the same period, and a picture of the late 1940s which shows us poorer than we might believe. This last point follows from the fact that our history takes the purchasing power of today's dollar as a fixed reference point. If the growth of purchasing power since World War II was larger than we had previously estimated, it follows that purchasing power in the late 1940s must have been smaller than we had estimated.