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First Trust

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Monday Morning Outlook

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Not So Unequal, After All

When it comes to income inequality, conventional wisdom says that it's been getting worse for a long time. Productivity is going up, but middle-class incomes are stagnating. The rich are getting richer and the poor are getting poorer. You've heard it over and over again. Many free market economists have argued against the conventional wisdom, only to be dismissed as out of touch. But, an incredible new paper from Northwestern Professor Robert Gordon, a pillar of the "mainstream" academic establishment, says maybe they are right and have been for a long time.

With productivity growth up an average of 2% annually in the past 30 years, but real (inflation-adjusted) median household income up only 0.3%, many say that the middle-class has been ripped-off. But Gordon says that correcting a few basic statistical problems eliminates almost all the gap between these figures.

First, in the past generation, the number of people per household has declined, as has the number of hours per worker. In other words, median *household* income has not kept pace with actual increases in hourly income on an individual basis.

Second, the 2% growth rate of productivity only refers to the private sector. With 17% of the workforce in the government, where productivity growth is zero, economy-wide productivity (private plus public sector) has lagged behind.

Third, Gordon shows that the inflation measure the government uses to adjust incomes (the Consumer Price Index) is typically higher than the inflation measure used to adjust output for productivity calculations (the GDP deflator).

Correcting for these factors eliminates 90% of the gap between productivity and middle-class household incomes.

Gordon then goes on to show that, with one important exception, any skewing in the income distribution stopped in the early 1990s, maybe even earlier. The reason other analysts have missed this is that they assume inflation is the same for every income group. But inflation for people with lower incomes has been *lower* than inflation for everyone else.

Call it the Wal-Mart Effect. There are certain kinds of items that make up a much larger share of the budget for the poor than for the middle class and upscale – clothing, for example. And prices for these items have not increased as much as overall inflation. There are also geographic differences. Inflation has been higher where incomes are higher – that is on the East and West coasts versus the Heartland. That said, we would not be surprised if the higher inflation we anticipate in the next few years – an inflation that may raise commodity prices relative to service prices – will send this process into reverse.

The exception about inequality, Gordon says, is that even though 99% of earners have stayed in the same economic position relative to each other, the top 1% of earners have increased their incomes relative to the other 99%.

But this is largely the result of more widespread use of performance-based pay systems in Corporate America. In 1993, the Clinton Administration limited the deductibility of regular paychecks for highly-paid workers. As a result, stock options became more ubiquitous and total pay rose with the market value of companies. In other words, government prodding may have led to the situation, not the free market.

Obviously, in a democracy, inequality matters. When people feel left behind, populism expands and freedom comes under attack. In that sense, Gordon's recent paper is important. Political demagoguery about inequality just had a huge hurdle put in front of it by an academic economist that cannot be argued with on politics alone.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-27 / 9:00 am	Consumer Confidence - Oct	53.5	**51.1**		53.1
10-28 / 7:30 am	Durable Goods - Sep	1.0%	**2.3%**		-2.6%
7:30 am	Durable Goods (Ex-Trans) - Sep	0.8%	**0.4%**		-0.3%
9:00 am	New Home Sales - Sep	0.440 Mil	**0.441 Mil**		0.429 Mil
10-29 / 7:30 am	Q3 GDP Advance	3.2%	**4.0%**		-0.7%
7:30 am	Q3 GDP Chain Price Index	1.3%	**2.3%**		0.0%
7:30 am	Initial Claims - Oct 24	525K	**529K**		531K
10-30 / 7:30 am	Personal Income - Sep	0.0%	**0.0%**		0.2%
7:30 am	Personal Spending - Sep	-0.5%	**-0.5%**		1.3%
9:00 am	Chicago PMI - Oct	48.7	**50.8**		46.1
8:45 am	U. Mich. Consumer Sentiment	70.0	**70.0**		69.4