Income Inequality in the US: Where did things go wrong?

The American Dream has a simple, yet optimistic mantra: the United States is a country that offers equal opportunities to all of its citizens, and through hard work and determination, anyone can achieve their highest aspirations. Millions emigrated to America for this exact reason. They wanted to escape oppression, corruption, and favouritism for the opportunity to start a new life in the prosperous United States.

But what happens when this dream vanishes in front of people's eyes? What if the wealth that has been accumulated throughout decades of hard work by the middle and lower classes is transferred to the richest few?

This is what has been observed in the United States for the past fifty years. During this time, the middle class, arguably the backbone of any economy, has seen its income grow at a slower rate than that of the upper class. While the income of the top 0.1% was less than fifty times that of the bottom 90% in 1960, this multiple is now steadily hovering around two hundred. Furthermore, the American recovery from the 2008 financial crisis has been alarmingly uneven, with the richest 20% of households being the only group to have increased its income in the years following the recession. Today, the United States is the most unequal country of all the G7 members. But why is this an issue?

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The effects of high inequality, both socially and economically, justify the undesirability of this phenomenon. A high degree of inequality erodes confidence in government and businesses, as they are seen to enable the transfer of wealth to the richest few. Furthermore, greater inequality damages social cohesion, as the top income earners are increasingly viewed as out of touch and exploitative. Increased crime rates have also been shown as positively correlated with income inequality. On the economic side, a high degree of inequality reduces the purchasing power of middle and lower earners, as their relative wealth against the top earners decreases as prices rise with inflation.

Why did this happen?

While the distribution of aggregate income has been deteriorating for the past few decades, it is the Federal Reserve's response to the 2008 financial crisis that has played a central role in exerting more pressure on the income groups that needed the most help. Since the outbreak of the Great Recession, the Fed has pursued an unprecedented loose monetary policy that has seen interest rates approach the lower bound of 0%.

This response by the Fed is understandable. With governments around the world severely constrained in terms of fiscal policy tools due to mounting debt levels, central banks have had to substitute for governments' lack of policy response by cutting interest rates. Lower interest rates are thought to be an engine for growth, as investment by firms through loans becomes much cheaper and easier to repay.

However, this statement can be flipped on its side by two counter-arguments. The first one involves equal access to cheaper debt by both large and small corporations. Large corporations have been able to take advantage of cheap loans to conduct research and development and streamline their production processes, undercutting smaller competitors. While this benefits consumers through cheaper retail prices, small business owners, who primarily belong to the middle class, have been pushed out of the competition by their larger counterparts.

The other negative effect of loose monetary policy affects households directly through the erosion of their savings. Low-interest rates push the interest rates on bank deposits down, meaning that households saving their money in banks see minuscule returns on their investment. In Japan, where interest rates have been negative for years, saving is a loss-inducing activity. Therefore, households have the incentive of spending any income instead of saving. This would have been acceptable if there was real economic growth that would have led to higher real wages. However, real wages in the United States have remained flat since 2001. Therefore, the Fed's policy response has prevented the middle class from fully recovering from the Great Recession.

Inequality was not always as high as it is now. In the post-war era, the country experienced its most equitable income distribution until the end of the 1970s. This was a period when the middle class was able to exploit lower interest rates, to finance the purchase of durable goods that significantly improved their relative position to higher earners through loans. Today, with household debt suffocating the middle class, loose monetary policy has become a barrier to creating a fairer society. With fiscal multipliers at high levels in areas such as the Eurozone, the case for fiscal policy is strong as pressure for expansionary policies needs to be alleviated from central banks.

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