Does inequality still matter?

For years, pundits and politicians lamented the growing income inequality in the U.S. But since Obama's election as president, silence has reigned. Did critics realize inequality is too complex for slogans? Or are they just hypocrites?

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Whatever happened to income inequality?

George W. Bush's last term was a golden age of the moralizing polemic decrying a widening income gap. Since then, this once paramount concern has completely evaporated. Yet if the question of income inequality was ever interesting or urgent, you'd think a transformative shock to the American economy would make it more urgent still. A wealth-obliterating disaster has put our economy in the dump along with the livelihoods of millions of lower-income Americans. So why have we stopped talking about income inequality?

First, it's useful to analyze what income inequality does and does not tell us. As I argue in a paper recently released by the Cato Institute, in a wealthy nation like the U.S. income is a poor measure of economic well-being and income inequality is an even worse measure of social justice. To capture the real gap in standards of living, we would need to look at the shifting patterns of consumption throughout entire lives, not at context-free snapshots of income at particular moments.

If we take a snapshot right now, for instance, in the thick of the downturn, we'll see the shortcomings of income inequality as a social gauge. The official data covering the financial crisis and the current recession won't roll in for some time, so the true story's not yet ripe to be told. But a glance at historical trends allows us to predict the general effect of the downturn with a fair degree of certainty.

In a widely-lauded 2003 paper that looked at trends in the income and wealth of high-income households from 1913–1998, economists Thomas Piketty and Emmanuel Saez showed that the earnings and accumulated wealth of the happy few at the top have dived with each recession, reducing their share of national wealth and income with each dip of the business cycle.

Salaries, bonuses, and hourly wages now make up a much larger part of the total income of those near the top of the earnings ladder than they did even 20 or 30 years ago, when high-income households depended much more heavily on gains from investments of capital. The ladies and gentlemen of leisure who live off inheritances have ceased to dominate the upper ranks of income. These days, the people who really rake it in invest long hours striving for high pay. "The working rich have replaced the rentiers at the top of the income distribution," as Piketty and Saez put it.

The way in which the working rich get paid has changed, too. The annual compensation of hedge fund jocks, Wall Street rainmakers, and corporate honchos is increasingly determined by performance-based bonuses, which have made the incomes of America's biggest earners increasingly sensitive to the vicissitudes of the market.

"High-income households are highly exposed to aggregate booms and busts," report Northwestern University economists Jonathan A. Parker and Annette Vissing-Jorgenson in a recent National Bureau of Economic Research working paper. They estimate that our current bust is hitting the income and consumption of households in the top 20 percent of income earners significantly harder than the households in the 80 percent below. And the higher up the distribution you go, the harder the hit is likely to be.

Let's assume then that the financial collapse and recession really have hit high-income households the hardest, resulting in a dramatic decline in income inequality. Is that a good thing? A disaster that leaves almost everyone worse off is no improvement—especially for low-income workers who have lost their jobs. Likewise, a stretch of economic progress that leaves almost everyone better off is hardly a disaster—even if income inequality rises in the process.

Income inequality can rise and fall for all sorts of reasons. Twenty-somethings just starting out and retired 70-somethings both earn a lot less on average than peak-earning 50-somethings. As the age profile of the population shifts, income inequality figures shift, too. So what? Consider another example. A generous immigration policy can widen the income gap in this country while at the same time reducing world poverty. That's good, if you ask me.

Income inequality can also rise as a side effect of injustice in our socio-economic system. But injustice should be rooted out because it is wrong, not because it widens the income gap as a side effect. If, just to take a wildly hypothetical example, the government has unjustly dumped loads of taxpayer money on Goldman Sachs, such a narrow allocation of public funds for private use should concern us for its own sake—not because Goldman's bountiful bonuses are likely to exacerbate income inequality.

A good hard jog and an oncoming heart attack may produce the same racing heartbeat. But the distinction matters. A mathematical abstraction like national income inequality is a similarly ambiguous symptom. We can slash the level of income inequality in an instant by slapping even higher taxes on big earners. Or we can slash the level of income inequality by falling into recession. But neither remedy addresses the real problem, which is persisting poverty, not income inequality.

The corruption of a political system in which crises are used to pay off the governing party's allies is also a real problem. The current silence about inequality—from news editors, pundits, and politicians alike—would be golden if only it were based on a grasp of the limited utility of income statistics in guiding us toward more effective and humane public policy. But that is not the case. Instead, it appears that the commentators who fretted over income inequality so publicly for so long have simply stopped worrying about it. Inequality, it seems, only matters when a Republican is in the White House.

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