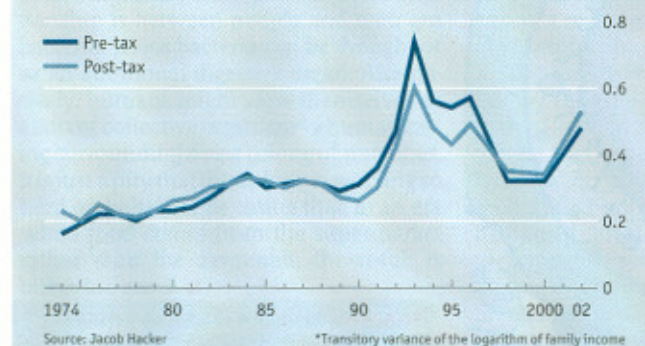


Economics focus | Shifting sands

Income volatility is less of a problem than America's Democrats think

The Hacker hypothesis

Fluctuation of income around its overall trend path*



AFTER more than a decade in the wilderness, America's Democrats took control of Congress on January 4th. Their arrival brings a new emphasis on economic policy. The Democrats believe they owe at least part of their election victory last November to voters' worries about financial insecurity. Those fears, it is argued, stem from a double squeeze on America's middle class. Most workers have seen few gains from the recent boom as profits have soared and inequality has widened. Yet their standards of living are more precarious than they used to be, because incomes have become more volatile and the country's social safety net has worn thin.

One of the most influential proponents of this view is Jacob Hacker, a political scientist at Yale, whose recent volume, "The Great Risk Shift", is becoming something of an intellectual handbook for many on the left. Mr Hacker argues that the defining economic shift of recent times has been the increasing instability facing American families. While income inequality—the gap between the highest and lowest earners—has risen sharply since the 1970s, income instability—the size of short-term income fluctuations—has gone up even more dramatically.

Examining surveys that track the fortunes of individuals over time, Mr Hacker reckons that short-term income volatility is three times higher than it was 30 years ago. On average, he claims, Americans have a 17% chance of seeing their family income drop by more than half from one year to the next, more than double the probability in the 1970s. The painful consequences of this instability are evident in higher bankruptcy rates and the rising numbers of home foreclosures.

According to Mr Hacker, the cause is a politically motivated shift of risk from the government and firms towards ordinary people. From the weakening of unemployment insurance to the demise of defined-benefit pensions, America's Republican politicians and its firms have wriggled out of the country's social contract. Fighting back against this "risk shift" should be the Democrats' priority, and the book suggests how—from health-care reform to a government system of "universal insurance" against sudden income loss. Some of the proposals have merit. But his premises that income volatility is undesirable, that it is excessive and that government (or rather Republican) policies bear much of the blame are, on close inspection, flawed.

For a start, rising instability of incomes is not necessarily a bad thing. A dynamic, mobile society is one in which people's

income varies a lot. Milton Friedman pointed out in 1957 that living standards should be affected only by permanent changes in their income. Short-term fluctuations could be smoothed out by borrowing and saving. The fact that household saving rates have plunged in the past three decades does not suggest Americans are terrified by the spectre of more variable incomes. More likely, the increased sophistication of credit markets, particularly the ability to extract equity from housing, has made temporary income instability easier to cope with.

Broader social trends, such as the rise of working women, have also affected the stability of family incomes. Women often take time off to care for children, thus (voluntarily and often temporarily) depressing a family's finances. These type of social shifts make it harder to compare today's typical family income volatility with that of the 1970s.

There is little doubt that Americans' incomes are more variable than they were a generation ago, but the story is a nuanced one. Mr Hacker's statistics are controversial. Peter Gottschalk, of Boston College, and Robert Moffitt, of Johns Hopkins University, were the first economists to disentangle how much of the rise in income inequality was due to long-term changes in earnings and how much to temporary instability. Their most recent report suggests that temporary earnings volatility rose sharply in the 1980s, fell in the 1990s and has risen again in recent years.

Nor is it clear that the social problems Mr Hacker cites, such as rising bankruptcy rates, have much to do with income instability. An analysis by Igor Livshits and James MacGee, of the University of Western Ontario, and Michèle Tertilt, of Stanford University, finds that growing income volatility cannot explain the big rise in the incidence of personal bankruptcy in the past three decades, from 1.4 per 1,000 workers in 1970 to 8.5 in 2002. It had far more to do with a falling cost of bankruptcy.

The consumer society

Instead, the evidence is that most people can cope with temporary income volatility. Although few statistics track changes in individuals' consumption over time, a study by Richard Blundell and Ian Preston, of University College London, and Luigi Pistaferri, of Stanford, compared the information from surveys of income with separate statistics on consumption patterns at different income levels. The economists concluded that, just as theory predicts, most people's consumption varies as permanent income changes, but barely responds to temporary shocks. Only poor people, who are less able to borrow, saw their consumption much affected by temporary changes in income.

And that is despite government policy, not because of it. Some programmes, such as unemployment insurance, have grown less effective. But from the Earned Income Tax Credit (a kind of negative income tax) to the expansion of public health-care schemes for children, America's public safety net has, in many ways, strengthened since the 1970s. George Bush's inclusion of a drug benefit in the public health-care system for retirees was one of the biggest such reinforcements. Government spending may not have assuaged the economic risks poor Americans face, but it has not worsened them. The "Great Risk Shift" is a snappy book title, just as promising workers greater "security" is an appealing political slogan. Unfortunately, neither stands up to much scrutiny. ■

* The sources for this article are listed online.