PROJECT SYNDICATE

Democratic Inequality

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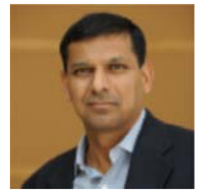
CHICAGO – Why did the household savings rate in the United States plummet before the Great Recession? Two of my colleagues at the University of Chicago, Marianne Bertrand and Adair Morse, offer an intriguing answer: growing income inequality.

Bertrand and Morse find that in the years before the crisis, in areas (usually states) where consumption was high among households in the top fifth of the income distribution, household consumption was high at lower income levels as well. After ruling out a number of possible explanations, they concluded that poorer households imitated the consumption patterns of richer households in their area.

Consistent with the idea that households at lower income levels were "keeping up with the Vanderbilts," the non-rich (but not the really poor) living near high-spending wealthy consumers tended to spend much more on items that richer households usually consumed, such as jewelry, beauty and fitness, and domestic services. Indeed, many borrowed to finance their spending, with the result that the proportion of poorer households in financial distress or filing for bankruptcy was significantly higher in areas where the rich earned (and spent) more. Were it not for such imitative consumption, non-rich households would have saved, on average, more than $800 annually in recent years.

This is one of the first detailed studies of the adverse effects of income inequality that I have seen. It goes beyond the headline-grabbing "1%" debate to show that even the everyday inequality that most Americans face – between the incomes of, say, typical readers of this commentary and the rest – has deep pernicious effects.

Equally interesting is the link that the study finds between income inequality and pre-crisis economic policy. Republican Congressmen from districts with higher levels of income inequality were more likely to vote for legislation to expand housing credit to the poor in the years before the crisis (almost all Democrats voted for such legislation, making it hard to distinguish their motives). And the effect of spending by the rich on non-rich households' spending was higher in areas where house prices could move more, suggesting that housing credit and the ability to borrow against rising home equity may have supported over-consumption by the non-rich.



Raghuram Rajan

Raghuram Rajan is a professor of finance at the University of Chicago's Booth School of Business. He previously served as the International Monetary Fund's youngest-ever chief economist, and was Chairman of India's Committee on Financial Sector Reforms. He is the author of *Fault Lines: How Hidden Fractures Still Threaten the World Economy*.

I was most fascinated, though, by the difference in legislators' response to inequality now and in the past. In a study of the congressional vote on the McFadden Act of 1927, which sought to boost competition in lending, Rodney Ramcharan of the US Federal Reserve and I found that legislators from districts with a highly unequal distribution of land holdings – farming was the primary source of income in many districts then – tended to vote against the act. More inequality led legislators, at least in that case, to prefer less competition and less expansion in lending. And we found that counties with less bank competition experienced a milder farmland boom, and therefore a smaller bust in the years before the Great Depression.

The obvious lesson to be drawn from these episodes is the importance of unintended consequences. In the early twentieth century, a congressional district's rich landowners were likely to own the local banks as well, or to be related to, or friends with, bank owners. They benefited from limiting competition and controlling access to finance.

Representatives voted on behalf of their districts' powerful interests. They preferred less competition in credit markets not out of concern for the unwitting farmers, but in order to defend powerful lenders' profits. It worked, but an unintended collateral effect was to protect these districts from getting carried away by the financial frenzy.

Why did twenty-first-century legislators behave differently? The cynical, and increasingly popular, view is that they were again voting their pocketbooks – all financial legislation in the run-up to the 2008 crisis was supposedly driven by the financial sector's appetite for more customers to devour with teaser loans and dubious mortgages.

But, if voting was influenced by the financial sector, the supposed party of the plutocrats, the Republicans, should have voted in unison for the bill. Instead, they split on the basis of whose non-rich constituents were more desirous of obtaining finance. Twenty-first-century legislators seemed to be more democratic, responding to their voters' possibly misguided wishes, rather than primarily to powerful financial interests.

Indeed, once the unintended consequences of their actions – more financial duress for the non-rich after the crisis – became clear, Bertrand and Morse show that the legislators in unequal districts moved against the financial sector to protect their constituents, voting to set limits on interest rates charged by "payday" lenders (who lend to over-indebted lower-income borrowers at very high interest rates). Of course, such legislation will have unanticipated consequences, which future studies will unearth, but the intent behind it cannot be doubted.

We should not come away from these episodes thinking that expanding access to finance is bad. In general, expanding access is beneficial (just not before a crisis!), but finance is a powerful tool that has to be used sensibly. Access is good; excess is bad.

But there is a more important point: while there are many gaps between the intent and consequences of legislation, legislators do seem ultimately to care more about their less-moneyed constituents than they did in the past. Democracy is stronger. In these cynical times, that is encouraging.

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