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Keeping up with the 1 percent

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By Chrystia Freeland

NEW YORK (Reuters) - We know now that trickle-down economics doesn't really work — the past decade in the United States has seen incomes at the very top soar, while the earnings of the middle class stagnated or declined. But a growing body of academic research is suggesting that this benign force's wicked stepsister, a phenomenon two economists have dubbed "trickle-down consumption," is having a powerful impact on the economy and politics of the United States.

The idea is that income inequality has a significant impact on the 99 percent: It drives the rest of us to consume more, whether we can afford to or not.

Robert H. Frank, an economist at Cornell University, is a pioneering student of this behavior who has been writing about the subject for nearly two decades, long before it became fashionable. Frank, who is the co-author of two economics textbooks with the Federal Reserve chairman, Ben Bernanke, believes that rising income inequality affects the rest of us through what he calls "expenditure cascades."

Rising income inequality, he notes, isn't just about the gap between the 99 percent and the 1 percent; it is also about growing differences across the income distribution, including at the very top. The result is that all of us see people we think of as our peers earning — and spending — a lot more. As a consequence, we find ourselves spending more, too.

"The main idea is that frames of reference are very local," Frank said. "Bertrand Russell said beggars don't envy millionaires, they envy other beggars who have a few more coins than they do. Expenditure cascades aren't because the poor want to emulate the rich."

Instead, he argues, each of us imitates those near us — and the result is a cascade of unaffordable consumption.

"There has been extraordinary growth in the 1 percent," Frank said. "Ordinary people don't want to emulate them, but what happens is that the people who are next to them want to emulate them, and so on. That social cascade ultimately explains why the middle-class home got 50 percent bigger in the past three decades." (Frank says that the average U.S. house went from 1,570 square feet, or 146 square meters, in 1970 to 2,300 square feet in 2007.)

This cascading increase in consumption can have what some of us might consider to be benign effects — everyone working harder and more women entering the workforce. But it can also have malign ones. In "Expenditure Cascades," a paper Frank wrote with Adam Seth Levine and Oege Dijk, the three show that more bankruptcies, a higher divorce rate and longer commutes all correlate with increased income inequality.

A draft study by two University of Chicago economists that is attracting a lot of attention in the academy supports this view. Marianne Bertrand and Adair Morse coined the term "trickle-down consumption," and in their paper of the same name they find that higher spending, bankruptcy and self-reported financial distress all increase if you live in a community with higher income inequality, compared with one with lower income inequality.

The concepts of "trickle-down consumption" and "expenditure cascades" help to explain one of the great mysteries of the past decade in U.S. politics and society. Income inequality has been on the rise since the late 1970s, but it is only since the financial crisis that it has gained any real traction in public life. That may be because increased consumption masked growing inequality. Retail therapy meant the 99 percent didn't notice that the 1 percent was pulling away.

Bertrand and Morse offer empirical evidence of an important explanation for why that was possible. In areas with higher income inequality, politicians were more likely to support measures to make consumer credit cheaper and more available. People weren't talking about inequality much before 2009, but they felt it. And, America being a democracy, the political system worked to soften it. Interestingly, because inequality grew at a time when overt redistribution was falling out of favor, politicians made it easier to borrow.

If you think the American middle class had too much debt before the crisis, and if you buy the notions of expenditure cascades and trickle-down consumption, the bad news is that the cycle may be about to start all over again. Ipsos MediaCT, a research firm, does a monthly poll of a group they describe as "the affluents," people with a household income of more than $100,000. Their February survey, released this week, showed this group is poised to hit the malls.

"We have seen for some time what people call frugal fatigue," said Steve Kraus, chief research and insights officer for Ipsos MediaCT. "Last month it jumped up from about a quarter to a third. They want to revisit the glory days of 2005 or 2006 when they could just buy something nice and treat themselves and not worry about it."

But credit is a lot tighter today than it was before 2008, so how will those who aren't affluent cope when consumption at the top again becomes conspicuous? The alternative to easy credit for the poor is higher taxes for the rich. Surprisingly, Kraus found that his affluent respondents were willing to pay up. Nearly 60 percent were in favor of higher taxes for the rich and nearly 40 percent sympathized with Occupy Wall Street.

"The past 40 years have been the best 40 years for rich people in the history of rich people," Kraus said. "There is a recognition that we've had a pretty good run and now something has got to be done."

Even at the very top, though, there turns out to be a class divide. Households with an income of more than $250,000 are far less supportive of higher taxes and more hostile to Occupy Wall Street.

"When you get to the really high-end folks, you get more of a strident conservative," Kraus said. "More of a crowd that says, 'Cut spending rather than raising taxes.'" Consumption may trickle down, but when it comes to the very top, ideas don't climb up.

(Editing by Jonathan Oatis)