Title: Does Income Distribution Matter for Effective Demand? Evidence from the United States

Author: Christopher Brown, Arkansas State University

Abstract

Some Post Keynesians hold the view that a protracted increase in income inequality is likely to dampen the aggregate propensity to consume and hence effective demand. However, the post-1973 era in the United States appears to present strong contrary evidence to the hypothesis that income distribution matters for effective demand.

The purpose of this paper is twofold: (1) To investigate the empirical relationship of income inequality to the consumption/ income ratio using data for the U.S.; and (2) To identify and explain a set of factors that have tended to countervail the potentially restraining influence of rising income mal-distribution on the growth of household spending in the U.S.

The paper will employ the Granger-Sims method and cointegration tests to discern the linkage between a measure of income inequality (the Theil index) and consumption expenditure using monthly U.S. data for the period 1967-2000.

The argument is made that the combined influence of the following factors has been so great as to more than offset the negative impact exerted by the sharp increase in income inequality on the aggregate propensity to consume: (1) Product innovation and structural change of the economy; (2) Growth of spending by 16-24 year olds; (3) Liberalization of social attitudes toward credit use; and (4) Widened credit availability.

Product innovation and structural change boost the aggregate propensity to by supplying new outlets for consumer spending power. The increasing participation of 16-24 year olds in the circular flow of economic activity, both as suppliers of low wage labor services and as consumers, is a noteworthy development of the post-1973 era in the U.S. Cross sectional analysis indicates that the ratio of spending to income is higher for this age group than any other.

The argument is made the much wider availability of consumer credit, in combination with a generally reduced reticence on the part of households to use credit to finance consumption expenditures, is the single most important factor in explaining the observed secular rise in the spending to income ratio.