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Matthew P. Drennan, *Income Inequality: Why it Matters and Why Most Economists Didn't Notice*, Yale University Press, 2015, 168 pp. $37 Hardcover.

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Abstract. Matthew P. Drennan, Income Inequality: Why It Matters and Why Most Economists Didn't Notice (Yale University Press, 2015) deserves significant notice. The author focuses on theoretical approaches that might have shown the causes of income inequality with main attention to the theory of consumption, where the mainstream of the economics profession, after some attention earlier, turned away from inequality as a causal factor after the 1950s. He documents that turn, and suggests directions for a new theory. He gives brief mention to policy suggestions, but mainly concerns himself with causal issues on which policy would have to be based. Matthew Drennan has been a Visiting Professor of Urban Planning, Luskin School of Urban Affairs, UCLA since 2004. He is an Emeritus Professor, City and Regional Planning, Cornell University.
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1. Introduction

M.P. Drennan's Income Inequality: Why It Matters and Why Most Economists Didn't Notice (Yale University Press, 2015) is really good. It starts from a problem, and identifies a cause in mainstream macroeconomic theory – what economists care about, their inner beliefs. Drennan's focus, the theory of consumption, is plausibly even the core of the core.

As Drennan reminds us, at one time the theory of consumption was at the center of macroeconomics. In introductory courses one learned about national income accounts and propensity to consume and how it related to Gross National Product. Consumption was important: if you learned anything, you learned that relationship and its symbolic expression: Y = C + I + G. There was some beauty in that, the attraction of seeing the whole as the sum of the parts. It was one reason that many were attracted to the field.

No longer, it seems. Later, as Drennan lays it out, economists stopped thinking too much about the larger issues of consumption and the average propensity to consume. In particular, they avoided the question of relative consumption among the classes, and the effects of inequalities.

There had been some attention to this aspect of consumption in the past. Malthus had worried about excess savings – i.e. restraints on consumption in

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general would be a drag on the overall functioning of the economy. Ricardo debated this, but Keynes, a century later, revived Malthus' concern, predicting that with a rise in prosperity, consumers would save enough to constrain investment and depress the whole economy. Keynes even gave some attention to income inequality: reducing it would soften any reductions in consumption arising from aggregate growth (Drennan p, 4; 74).

But inequality disappeared from mainstream theory. Post WW2 prosperity did not bear out Keynes' concern that per capita consumption (the "average propensity to consume", or "APC") would fall with rising incomes. Along with this was the idea that growth would largely cancel concerns about inequality: Simon Kuznets had posited a U shaped trend of inequality rising, but then falling over time as the collective gains of industrial production made possible social legislation and redistributive effects. And, finally, based in part on mid-century data, theorizing about consumption emerged that swept away the Keynesian approach, while making no note of inequality issues.

This theoretical position lasted longer than the data disputing the relevance of inequality. Milton Friedman had led the way with *A Theory of the Consumption Function* (1957), which simply assumed APC to be constant over time. Friedman and others elaborated by asserting, in the face of increases in the APC, that these were temporary: what mattered for consumption decisions was "permanent" changes in consumption, thus eliding further investigation of distribution. [i]

But, Drennan writes: "Around 1985, something strange began. After a long period of stability… the APC began a long-term rise…" [p. 5] Consequently, Friedman's observations "…of declining income inequality and stable saving rate (which infer a stable APC) are not true for the period 1984-2007…" [p. 90]. The crux of Drennan's argument is the observation that, when inequality in fact rose after the 1950s, mainstream economists had no theoretical basis to deal with it.

One result was that when the economy crashed in 2007, economists and policy makers were able to identify proximate causes, but missed the more fundamental problems of unsupported consumption. What they saw were (1) unusually low interest rates after 2000; (2) relaxed borrowing standards if lenders; and (3) the housing price bubble. [p. 1]

But Drenan identifies a fourth factor that caused the 2009-2011 recession. Inequality had risen over several decades, and Drennan writes:

> The story here is that increasing consumer indebtedness, which supported consumption until the crash in 2008-09, was driven by the pressure for most households to maintain consumption in the face of stagnant income as income inequality relentlessly rose for thirty years or so. That debt-supported expansion of consumption became unsustainable after 2007 once house prices tumbled. [p. 3]

But mainstream theory would not see this. Its main assumptions, established in a period of stable propensity to consume, did not anticipate change caused by an increased rate of consumption led by the lower and middle portions of the income distribution. The average propensity to consume had not appreciably changed. But the average was only maintained because middle and lower income families had access to debt financing that -when the housing bubble burst and jobs and income declined- they could not sustain.

2. Theory

Drennan stops short of advocating policy in any detail, even though his analysis has relevant implications for policy. In a brief passage, Drennan endorses some of the policy prescriptions of Piketty, Krugman, Pierson and Hacker: a simple focus on public works spending would do great good. [ii] But his main focus is on economic theory, which he sees as having failed policy. He ends the argument about theory making the point that mainstream economics has indeed ignored inequality:

> Counting articles, published in the most prestigious economic journals form 2009 through 2013, very few are about income inequality or income distribution generally, based on their titles… [The] total of twenty-six articles about income distribution or income inequality over five years [2009-2013] amounts to less than 2 percent of the 1561 articles published in those journals. That certainly indicates lack of interest and perhaps some hostility. [78]

Drennan then cites a review of Thomas Piketty's book Capital in the Twenty-first Century: "Some economists (not to mention politicians) tried to shout down any mention of inequality at all. 'Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution,' declared Robert Lucas Jr., of the University of Chicago, the most influential macroeconomist of his generation, in 2004." [p. 78] [iii]

Thus Drennan makes the point about where the mainstream stood. But he does not explain it. He gives hints. He shows where omissions occurred in the literature. He suggests antecedents for an alternative theory:

> A revised theory of consumption must… replace the representative rational consumer… with a realistic distribution of consumers with heterogeneous preferences by income, age, race and so on subject to rational choices (buying appreciating assets early) as well as irrational choices (buying appreciating assets late) and facing incomplete markets (some risks not insurable). Looking back to Keynes and to behavioral economics can inform the effort to develop a revised theory of consumption. A revised theory may be messy, inelegant, and ugly. The current theory is tidy, elegant, and beautiful, but it is only true some of the time. [p. 110]

3. Policy

Drennan backs away from policy questions. He seems to think, at least for this book: "Fix the theory first." This is reasonable.

Still, someone needs to drop the other shoe. It will also be important to consider, alongside what Drennan has done, what he is not doing. Like others who have looked at the problem, he ends with a question: "Why have today's economists failed to jettison the mainstream theory of consumption in the face of so much evidence to the contrary?" This seems, finally, too polite a question.

Notes

i Drennan presents the Keynesian position and later displacement in summary on pp. 3-5, and in detail in pp. 73 ff. including the Kuznets U-curve and the "Friedman-Modigliani-Brumberg paradigm" which displaced Keynes in mainstream economics. Friedman, Milton 1957. National Bureau of Economic Research. Princeton, NJ: *A Theory of the Consumption Function*, Princeton University Press; and Modigliani, Franco, & Richard Brumberg. 1954. Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data. *In* K. K. Kurihara, ed., *Post-Keynesian Economics*, pp. 3-45. New Brunswick, NJ: Rutgers University Press.

ii Drennan, after mentioning brief examples of policy options, writes: "This book does not address how to fix rising income inequality through public policy. However, it does address the possible causes of rising inequality." [p. 5-6]. On policy, he cites several whats providing detail: Krugman, Paul. 2012. *End This Depression Now!* New York: W W Norton; Hacker, Jacob S., and Paul Pierson. 2010. Winner-Take-All Politics: Public Policy, Political Organization, and the Precipitous Rise of Top Incomes in the United States. *Politics and Society* 38(2): 152-204; and Piketty, Thomas. 2014. *Capital in the Twenty-first Century.* Cambridge, MA: Belknap Press of Harvard University Press.

iii Krugman, Paul. Why We Are in a New Gilded Age. *New York Review of Books*, May 8. 2014. Drennan also cites Mankiw's response to Joseph Stiglitz' assertion of rising inequality: "there is no good reason to believe that rent seeking by the right is more pervasive today than it was in the late 1970s." Mankiw, N. Gregory. 2013. Defending the One Percent. *Journal of Economic Perspectives* 27(3):21-34. But, Drennan writes: "But there is a good reason. The top marginal tax rate was around 70 percent in the late 1970s. It has since been lowered a few times and well as raised and is now 39.6 percent. That means any successful rent-seeking effort by those in the top tax bracket today has an after-tax payoff almost double the size of a similar one in the 1970s." [p. 33].

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