Inequality of Income and Consumption: Measuring the Trends in Inequality from 1985-2010 for the Same Individuals

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Research indicates that during the 1980s economic inequality has increased in the United States (see Cutler and Katz (1991), Johnson and Shipp (1997), Krueger and Perri (2006)). Researchers, however, dispute which resource -- income or consumption -- should be used to measure economic well-being, and the extent of the change in inequality of well-being (Meyer and Sullivan (2007)). In fact, Meyer and Sullivan (2011) demonstrate that, during the past decade, income inequality has increased, while consumption inequality has decreased. The magnitude of the change in inequality depends not only on the choice of the resource used to measure inequality but also on whose inequality is measured, i.e., whether inequality is measured for individuals or households, or the young or the old (see Slesnick (2001), Meyer and Sullivan (2010), Attanasio et al. (2007)).

The dispute over whether income or consumption should be preferred as a measure of economic well-being is discussed in the National Academy of Sciences (NAS) committee report on poverty measurement (Citro and Michael (1995), p. 36). The NAS report argues:

> "Conceptually, an income definition is more appropriate to the view that what matters is a family's ability to attain a living standard above the poverty level by means of its own resources...In contrast to an income definition, an expenditure (or consumption) definition is more appropriate to the view that what matters is someone's actual standard of living, regardless of how it is attained. In practice the availability of high-quality data is often a prime determinant of whether an income- or expenditure-based family resource definition is used."

Although the NAS report chose to measure poverty in the U.S. using income, not everyone agrees that this was the appropriate resource to use. Some may believe that consumption is a preferable measure of well-being; however, obtaining an estimate of consumption from survey data is difficult because much of consumption is not reported in surveys. Others might argue for using a measure of disposable income, yet this measure could reflect large transitory components and, as a result, overstate the true measure of well-being (Greenspan (1996)). And both income and consumption are subject to measurement error. It may be argued that for many groups, e.g., welfare recipients and the self-employed, consumption may be a more reliable and accurate measure of permanent income than annual disposable income. Hence, choosing consumption rather than income or vice versa may, and indeed does, yield different results concerning inequality and the well-being of individuals and families.

We maintain that both consumption *and* disposable income should be used to analyze the level of and trend in economic well-being and inequality because both resource measures provide useful information by themselves and in combination with one another. We suggest that a better measure of economic resources can be obtained by using *both* the maximum and minimum of consumption and disposable income, rather than by using either one alone. Since the measure of permanent income may be independent of the relative ordering of disposable income and consumption, these other measures may provide a bounded estimate of permanent income.

In this paper, we use income and expenditure data from the Consumer Expenditure (CE) Survey to obtain various measures of income and consumption (see Johnson and Smeeding (1998)) from 1984 to 2010. This paper will examine a variety of income and consumption measures to illustrate their complementary nature as well as their differences. Although permanent income would be the preferred measure of economic well-being, obtaining an estimate of permanent income using cross-sectional survey data is difficult. For this reason, we suggest that using measures of both income and consumption – a maximum/minimum approach – provide useful information. That is, they are useful in determining which households may be better able to smooth consumption and in examining the cases when the measures provide similar or different results concerning the measurement of well-being. In addition, we may be able to obtain a better proxy for unobserved permanent income than we can when using either income or consumption alone.