



A DEEPER LOOK AT INCOME INEQUALITY

AN ANALYSIS OF THE CBO'S LATEST STUDY ON HOUSEHOLD INCOME DISTRIBUTION AND
RECOMMENDATIONS FOR POLICYMAKERS

November 17, 2011

KEY POINTS:

- The question for policymakers is not how best to redistribute a shrinking economic pie. The focus ought to be on increasing living standards, expanding economic opportunity, and promoting *upward mobility* for all.
- Conventional wisdom on government's role in inequality often has it backwards: tax reforms have resulted in a *more progressive* federal income tax; government transfer payments have become *less progressive* (due in large part to growing entitlement payments to wealthier seniors).
- Rather than further divide Americans, there is growing bipartisan consensus to target corporate welfare, to income-adjust entitlement programs, and to reform the tax code by removing loopholes and lowering barriers to growth.

The Congressional Budget Office (CBO) recently released a study on changes in the distribution of household income in America from 1979 to 2007.¹ This study has added fuel to an intensifying debate in Washington and across America over income inequality – what causes it, how do government policies affect it, and what should policymakers do about it?

The primary means by which government policy directly affects income inequality is through the redistribution of wealth via taxes and transfer programs such as Social Security, Medicare, and Medicaid. Therefore, it is not surprising that views on inequality have colored recent debates over debt and deficit reduction, since most deficit-reduction proposals involve changes to tax rates and transfer programs.

As policymakers evaluate competing approaches to deficit reduction, it is important that the impact of past policy changes are properly understood. This is especially true if deficit reduction efforts aim to maximize economic growth, opportunity, upward mobility, and prosperity for *all* Americans – rather than just to change the distribution of a shrinking economic pie.

The following House Budget Committee report is organized as follows:

I.	Summary of CBO's Study.....	2
II.	Understanding Income Inequality in Context.....	3
III.	The Impact of Government Policy on Inequality.....	9
IV.	Successfully Addressing the Problem.....	14

¹ Congressional Budget Office. *Trends in the Distribution of Household Income from 1979 to 2007*. October 2011. <http://cbo.gov/doc.cfm?index=12485> (referenced throughout)

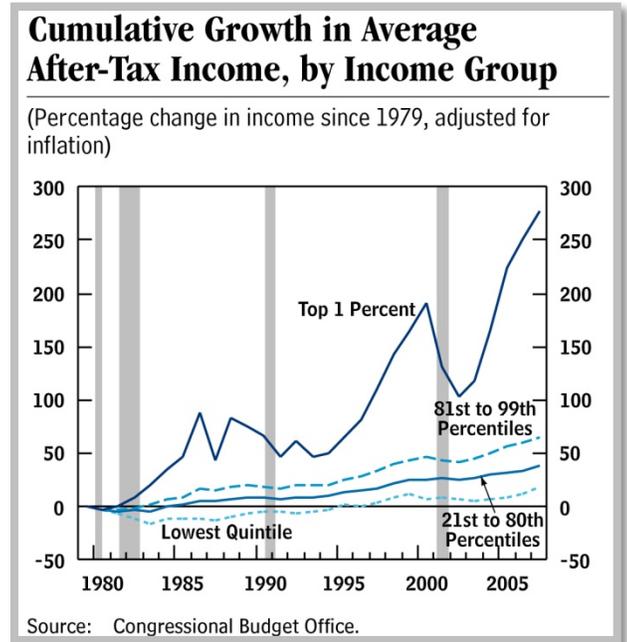
Summary of CBO's Study

At the request of Senate Finance Committee Chairman Max Baucus and then-Ranking Member Chuck Grassley, the CBO examined the distribution of household income in the United States from 1979 to 2007. These endpoint years allowed for a comparison between periods of similar economic activity – i.e. they were both years before major recessions. The CBO's central conclusion is that inequality among income groups has increased notably over this period.

Figure 1

One key metric in the study is after-tax, after-transfer household income, which the CBO refers to as "real after-tax income." This adjusts income for inflation, government transfers received (i.e. Social Security, food stamps, unemployment insurance, Medicare, etc.) and taxes paid. Real after-tax income is used as a proxy for economic well-being. Next, the study divides the population into fifths, or "quintiles," based on this definition of income.

Considering the population as a whole, real average after-tax household income in the United States grew by 62 percent over this 30-year period. After-tax median income (half of the population is above the median, half is below) grew by 35 percent. But the trend of absolute gains across all income levels was not the focus of the study. Instead, the CBO sought to analyze the *distribution* of these income gains and their uneven growth over time.



Between 1979 and 2007, real average after-tax income grew by 275 percent for the top 1 percent. Average after-tax household income for the lowest quintile increased by significantly less, growing by 18 percent over the period studied (see Figure 1).

Similarly, the highest quintile's share of after-transfer, after-tax income grew from 43 percent in 1979 to 53 percent in 2007. The top 1 percent's share more than doubled from 8 percent to 17 percent. By contrast, the income shares of all other quintiles shrank over this period. For instance, each of the middle three income quintiles saw their shares of after-transfer, after-tax income decline by 2 to 3 percentage points over this period (see Figure 2).

Figure 2

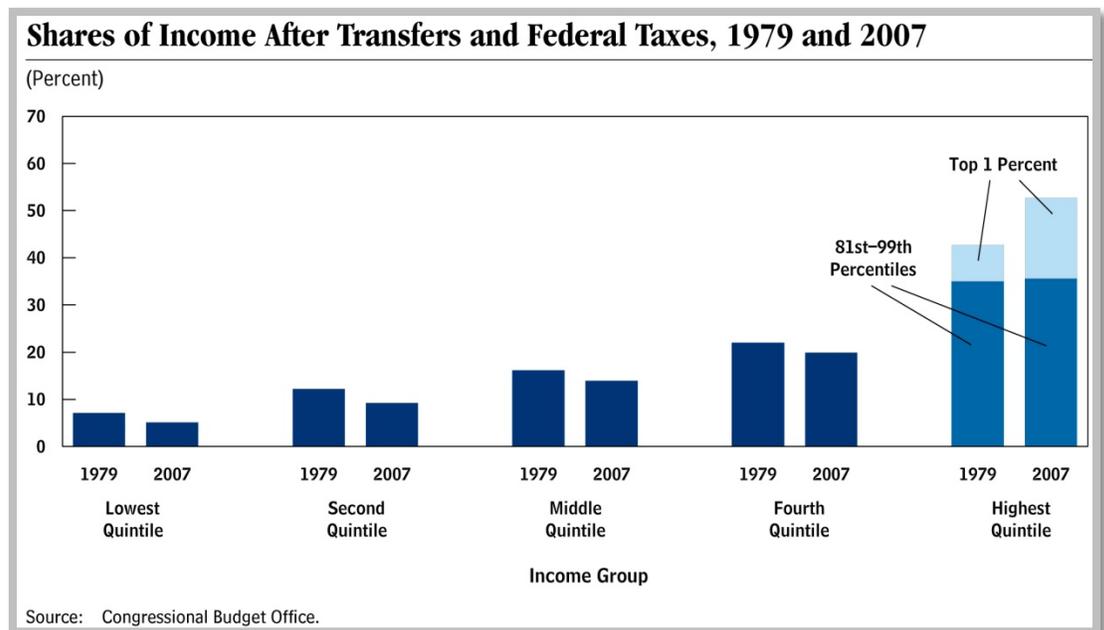


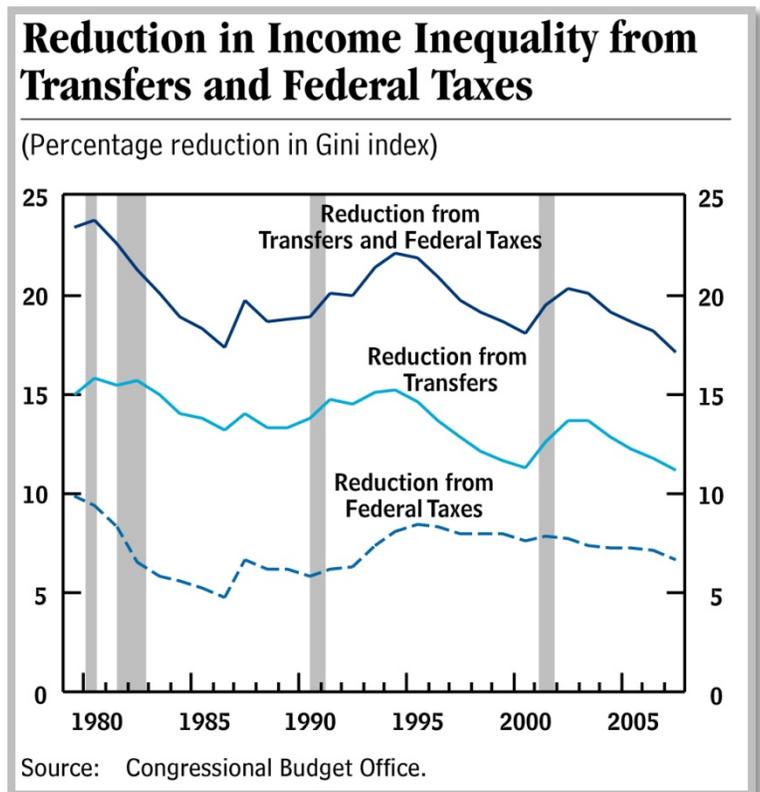
Figure 1 shows that the past few recessions in the United States have tended to temporarily reduce the income gap between rich and poor as those at the top of the distribution scale have seen the most significant income reductions in the wake of each downturn. In these cases, of course, the increase in income equality was overshadowed by lower economic growth and fewer opportunities for everyone.

One underreported conclusion from the CBO study is that shifts in government transfers and federal taxes have contributed to *increasing* inequality over time. Both taxes and government transfers remain progressive, but the *equalizing effect* of transfers and taxes on household income was smaller in 2007 than it was in 1979 (see Figure 3).

Figure 3

This is mainly because the distribution of government transfers has moved away from households in the lower part of the income scale. For instance, in 1979, households in the lowest income quintile received 54 percent of all transfer payments. In 2007, those households received just 36 percent of transfers.

This shift reflects a growth in programs that focus on the elderly population and are not for the most part income-adjusted, such as Social Security and Medicare. In other words, the structure of some of the nation's largest entitlement programs has decreased the share of government transfer payments going to lower-income households and directed an increasing share of government spending to wealthier seniors. According to the CBO's findings, this trend, accelerated by the retirement of the baby-boom generation, contributes to an increase in inequality.



The tax system has also become slightly less of an equalizing factor today than it was in 1979. The composition of federal taxes changed between 1979 and 2007, as less-progressive payroll taxes grew faster than more-progressive income taxes. The average payroll tax rate was slightly higher at the end of the period, while the average individual income tax rate was slightly lower.

The CBO identified a variety of factors that may explain *why* income gains at the top of the distribution have outpaced those in the middle and bottom of the distribution over this period. For instance, the CBO cites “technical innovations that have changed the labor market for superstars (such as actors, athletes, and musicians), changes in the governance and structure of executive compensation, increases in firms’ size and complexity, and the increasing scale of financial-sector activities.”

Understanding Income Inequality in Context

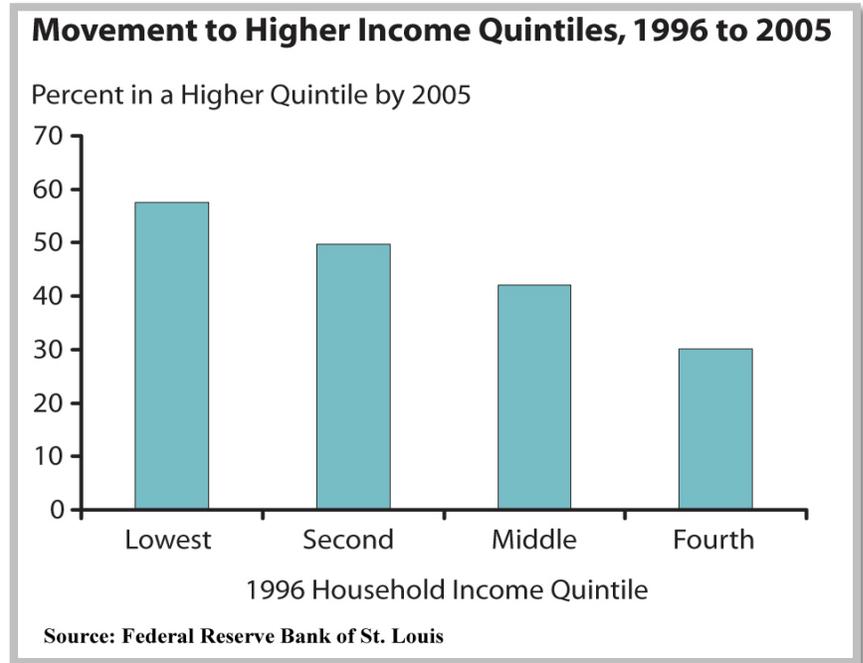
In attempting to draw conclusions from the CBO study, particularly in terms of how it might inform policy prescriptions, it is useful to contextualize the analysis, acknowledging the limitations that the CBO placed on the scope of its study, as well as alternative interpretations of similar data. Recent commentary on this issue often draws sharply divergent conclusions based upon legitimate differences regarding how to frame the challenge. Proper context can help advance a more informed debate on how society can best secure the natural rights of all citizens to freely pursue their happiness.

Income Mobility

Figure 4

The CBO took static snapshots of the income distribution at two different points in time, in this case 1979 and 2007. In examining these snapshots, it is clear that real income has grown significantly more for those at the upper end of the distribution than for those at the lower end over the past 30 years.

Yet the CBO concedes that the dynamism of the American economy is not properly captured by this analytical approach. It is not the case that individual households remained fixed in the income distribution over this period. The CBO readily points this out: The study “does not reflect the experience of particular households. Individual households may have moved up or down the income scale if their income rose or fell more than the average for their initial group.”



This is an important distinction, as considerable empirical evidence has made clear that there is a *significant* amount of movement across income quintiles over time – in other words, there is a lot of income mobility in the U.S. economy. A person working his or her way through college in a relatively low-paying job in year one, for instance, may have climbed into a much higher earnings level by year five. Comparing the low-income point in year one with that same low-income point in year five does not speak to this particular individual’s experience, because the individual has moved up over that time. As the Federal Reserve Bank of St. Louis puts it, since “incomes are not constant over time, the same households do not necessarily remain in the same income quintiles. Thus, comparing income quintiles from different years is a proverbial apples-to-oranges comparison because the households compared are at different stages in their earnings profile.”²

Dynamic studies attempt to solve this “snapshot analysis” problem by tracking income movements in the *same* household over time. One such recent analysis in the *National Tax Journal* examined individual tax returns from 1996 to 2005 and found that about 58 percent of households that were in the lowest income quintile in year one had moved up to a higher income segment ten years later.³

Similarly, about half of families in the second-lowest income quintile had moved up to a higher income point at the end of ten years (see Figure 4). This dynamic works both ways. The same study showed that nearly 40 percent of households in the top 10 percent of the income distribution had slipped to a lower income segment by 2005. A host of other studies confirm the fact that income mobility over time is quite high. For instance, a study by economists at the Federal Reserve Bank of Minneapolis showed that 44 percent of families in the lowest income quintile in 2001 had moved up to a higher income point by 2007, while 34 percent of those in the highest income segment had moved down.⁴

² Garrett, Thomas A. “Income Mobility.” *Economic Synopses*. No. 15, 2011. <http://research.stlouisfed.org/publications/es/11/ES1115.pdf>

³ Auten, Gerald and Geoffrey Gee. “Income Mobility in the United States: New Evidence from Income Tax Data.” *National Tax Journal*. Vol. LXII, No. 2, June 2009 [http://ntj.tax.org/wwtax/ntjrec.nsf/F95CooD9840D35F2852575F40047B159/\\$FILE/Article%2005-Auten\(F\).pdf](http://ntj.tax.org/wwtax/ntjrec.nsf/F95CooD9840D35F2852575F40047B159/$FILE/Article%2005-Auten(F).pdf)

⁴ Díaz-Giménez, Javier et al. “Facts on the Distributions of Earnings, Income, and Wealth in the United States: 2007 Update.” *Federal Reserve Bank of Minneapolis Quarterly Review*. Vol. 34, No. 1, February 2011. <http://www.minneapolisfed.org/research/qr/qr3411.pdf>

While household income mobility is high in the United States, other studies have attempted to gauge economic mobility by looking at a different measurement. Rather than looking at the movement of individuals or households over time, these studies measure the likelihood that a child will do better than his or her parents and then compare these statistics among developed countries. According to one such study by the Economic Mobility Project, by this measurement, economic mobility is higher in other developed nations than it is in the United States.⁵

However, in a recent article for *National Review*, the Brookings Institution's Scott Winship – a former research manager for the Economic Mobility Project – explained that the problem illustrated by these studies is not a lack of mobility between middle- and upper-income groups in America. Rather, it is mobility from the very bottom up – especially for young men – where the United States lags behind. A variety of factors associated with entrenched poverty reduce mobility for this income group. Winship writes that children of unwed mothers, for example, are less likely to escape from the bottom of the income distribution than other children. Winship's analysis details the tragedy of broken families and minority groups that are disproportionately remaining at the bottom of national income distribution. "Simply put, two-thirds of black children experience a level of neighborhood poverty growing up that just 6 percent of white children will ever see," Winship writes.⁶

This analysis shines light on a particularly vexing problem for those policymakers who wish to improve upward mobility in the United States. But it also highlights another limitation in the CBO's study – by failing to distinguish between mobility and inequality, policies aimed at the latter can impair the former. Redistributive welfare programs can impede upward mobility by creating dependency, yet welfare reforms that reduce dependency and promote work appear in the CBO's analysis as zero-sum deductions from government efforts to reduce income inequality (see "Welfare reform" below). Omitting the incentives to work that were built into the successful welfare reforms of the 1990s results in an analysis that fails to capture how such reforms actually affected mobility.

Income mobility is important because it implies that longer-term income, or "lifetime income," is more equal than what is observed in annual snapshots. Studies that rely on "snapshot income" and ignore income mobility can give an incomplete picture of trends in inequality.

Data and Demographics

Like most studies, the CBO's adjusts its household income data for the effects of inflation over time. But it turns out that the particular price index used to calculate inflation-adjusted, or "real" income can make a big difference in the overall distribution results. Northwestern University economist Robert Gordon believes that the official consumer price index (CPI) that is often used to calculate real income in inequality studies has a persistent upward bias. Reliance on CPI fails to account for the fact that many lower-income individuals consume a basket of goods whose prices have declined significantly over recent decades. If the CPI has an upward bias, studies that utilize this imperfect metric will show a *lower* increase in real income over time for the lower-income groups. Gordon argues that the size of this upward bias distorts income gains by roughly 38 percent over the past 30 years.⁷ In other words, according to the Gordon, standard real income calculations understate real gains for the lower segments of the distribution by as much as 38 percent over this time period.

⁵ Sawhill, Isabell and John E. Morton. Economic Mobility: Is the American Dream Alive and Well? Economic Mobility Project. May 2007. <http://www.economicmobility.org/assets/pdfs/EMP%20American%20Dream%20Report.pdf>

⁶ Winship, Scott. "Mobility Impaired." *National Review*. November 14, 2011.

⁷ Pethokoukis, James. "Shining More Light on Income Inequality Myths." American Enterprise Institute. November 1, 2011. <http://blog.american.com/2011/11/shining-more-light-on-income-inequality-myths/>

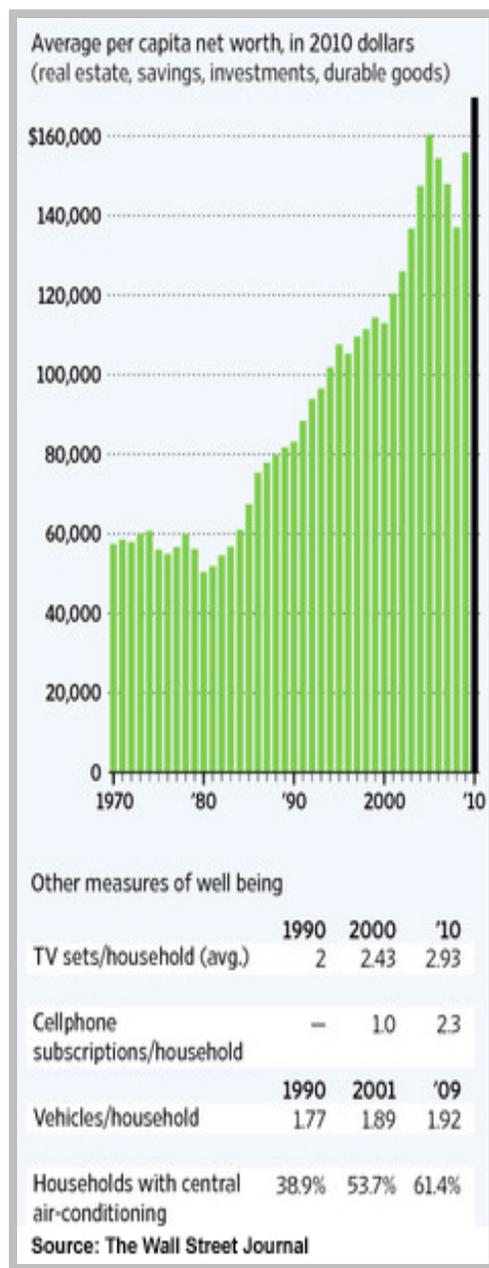
Figure 5

Gordon's research leads him to conclude that since 1993, as a result of significant decreases in relative prices for most basic goods, cost-of-living disparities for the majority of the U.S. population have held remarkably constant.⁸ Christian Broda of the University of Chicago also finds that the prices of goods disproportionately consumed by lower-income households have been declining rapidly in recent years. Using a corrected price index to calculate growth in earnings, Broda and colleagues estimate that the lowest 10 percent have seen a 30 percent real wage gain from 1979 to 2005.⁹

Apart from more accurate measures of inflation, other analysts caution that demographic patterns have a large influence on inequality results. For instance, the size of the typical American household has been shrinking over the past half century, moving away from the once-ubiquitous married-couple household to single-parent or so-called "non-family" households. Fewer children are being born, fewer parents are getting married, and fewer couples are staying married.¹⁰ This shift to smaller households with fewer earners, by itself, will tend to increase inequality.

Household demographics also go a long way toward explaining observed inequality at any one point in time. University of Michigan economist Mark Perry illustrated this point using the latest Census data for 2010. Those figures show that nearly three-quarters of households in the highest income quintile included individuals in their prime earning years, compared to less than half for households in the lowest quintile. In addition, 77 percent of households in the top quintile had at least one adult working full time, whereas only 17 percent in the lowest quintile did.

Perry summed up his view that household demographics have much to do with income inequality: "American households in the top income quintile have almost five times more family members working on average than the lowest quintile, and individuals in higher-income are far more likely than lower-income households to be well-educated, married, and working full-time in their prime earning years. In contrast, individuals in low-income households are far more likely to be less-educated, working part-time, either very young or very old, and living in single-parent households."¹¹



Relative Inequality vs. Absolute Well-Being

Comparing just incomes over decades can also obscure the fact that broad living standards in the United States have risen sharply throughout its history. Average per capita net worth, for instance, has risen threefold over the

⁸ Gordon, Robert J. "Misperceptions About the Magnitude and Timing of Changes in American Income Inequality." NBER Working Paper No. 15351. September 2009. <http://www.nber.org/papers/w15351>

⁹ Broda, Christian et al. "The Role of Prices in Measuring the Poor's Living Standards." *The Journal of Economic Perspectives*. Volume 23, Number 2, Spring 2009. <http://www.ingentaconnect.com/content/aea/jep/2009/00000023/00000002/art00005>

¹⁰ U.S. Department of Commerce. Bureau of the Census. "Projections of the Number of Households and Families in the United States: 1995-2010." Current Population Reports. April, 1996. <http://www.census.gov/prod/1/pop/p25-1129.pdf>

¹¹ Perry, Mark J. "Income Inequality Can Be Explained by Household Demographics." American Enterprise Institute. October 21, 2011. <http://blog.american.com/2011/10/income-inequality-can-be-explained-by-household-demographics/>

past 30 years (see Figure 5). In a recent article in *The American Interest*, Tyler Cowen of George Mason University reframed the income inequality problem by looking not only at changes in income levels, but also at changes in what that income can purchase.¹² Measures of “personal well-being” – comfort and convenience, access to new technology, low-cost goods, etc. – indicate dramatic advancements in living standards for citizens across all income groups. The average U.S. household, for instance, today owns nearly three TVs, over two cell-phone subscriptions and nearly two cars.

These consumer goods, which were once considered luxuries only available to the wealthy, if they existed at all, are now available to the overwhelming majority of Americans. An article in the *Christian Science Monitor* a few years back, citing Census data, showed “an ever-growing material prosperity, with formerly high-dollar luxury items now commonplace in even poor households.”¹³

Cowen pointed to this phenomenon as evidence that inequality of personal well-being has *fallen* over the past hundred years and likely over the past twenty years too. A century ago, the average American lived a life that was dramatically different, in terms of what he or she could experience and obtain, from an elite like Rockefeller. In many important respects, the difference between ultra-elites and average Americans is less pronounced today. Cowen compared his own situation to that of Bill Gates: “I have access to penicillin, air travel, good cheap food, the Internet and virtually all of the technical innovations that Gates does... by broad historical standards, what I share with Bill Gates is far more significant than what I don’t share with him.” An exclusive focus on relative inequality neglects the important measurement of absolute well-being.

To note these facts is not to discount the painful fact that millions of Americans are materially impoverished, or that the ranks of the poor have grown with the recession and the sluggish, jobless recovery. Yet measures of inequality that look only at income, and not at disparities in the absolute well-being of households across the income distribution, can often do a poor job of diagnosing the challenges of Americans struggling to make ends meet. Most Americans would likely place a higher priority on ensuring that lower-income citizens have greater access to higher living standards, as opposed to devoting their efforts to restricting the income growth of higher-income citizens.

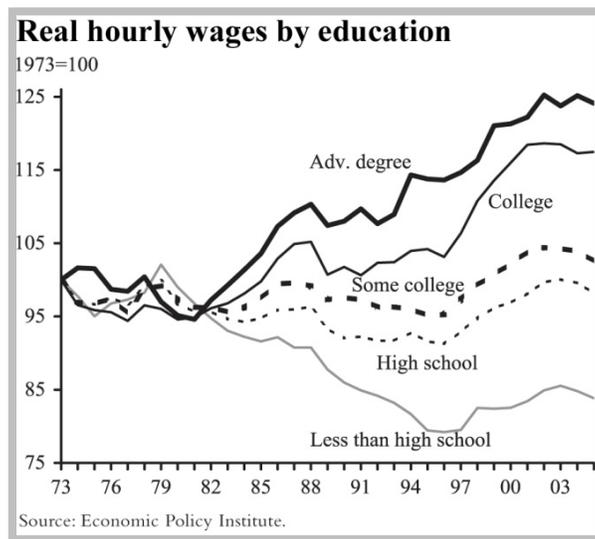
Figure 6

Income Inequality and Economic Trends

The causes of income inequality are multidimensional and often difficult to trace and measure with precision. At its root, the issue is inextricably linked to the wider economic forces that have shaped the United States and the global economy over the past several decades.

In the nearly 30 years covered by this CBO study, the pace of technological change, particularly in computers and related technology, has been rapid.

These new technologies have diffused throughout virtually all segments of the economy, fundamentally changing the skill set sought by many employers and even the nature of work itself. This change has favored individuals with the skill sets to best leverage that technology. This trend is evident in the so-called “wage premium” for individuals with college and advanced degrees relative to those with just high school degrees and below (see Figure 6).



¹² Cowen, Tyler. “The Inequality that Matters.” *The American Interest*. January/February 2011. <http://www.the-american-interest.com/article.cfm?piece=907>

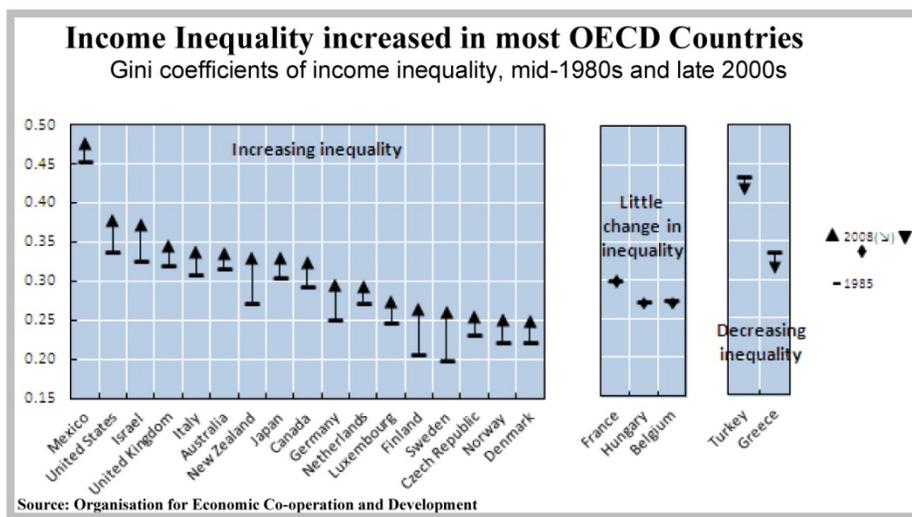
¹³ Trumbull, Mark. “Poverty Now Comes With a Color TV.” *The Christian Science Monitor*. January 2006. <http://articles.moneycentral.msn.com/Investing/Extra/PovertyNowComesWithAColorTV.aspx>

This premium has jumped since 1980, underscoring the increasing returns on education in the modern economy. Increased trade and globalization has also played a role in widening earning and income gaps because, like new technology, it has tended to reduce demand for lower-skilled workers in the United States while raising demand for higher-skilled workers. The United States tends to export goods with a heavy skilled labor component while importing goods produced by lower-skilled workers.¹⁴ This is the comparative advantage profile of a highly developed economy, and it has shaped various segments of the domestic labor market and relative wages. The trend is most evident in the U.S. manufacturing sector. The U.S. economy has generally shifted away from lower-skilled manufacturing, such as the apparel and textile industry, and towards a service sector that requires a high-skill, high-intellect workforce.

Technology and trade are obviously two economic forces that have contributed to dislocations and relative wage inequalities in recent decades. But it is also true that these same forces, which have exponentially increased access to consumer goods and services, have been hugely beneficial for the living standards of citizens across all income levels. These economic trends have also contributed to increased inequality in most other advanced industrial economies around the world, not just the United States (see Figure 7). In fact, of the few countries that have seen *decreasing* inequality over the past thirty years, one of them, Greece, is in the midst of a severe debt crisis and is teetering on the edge of economic collapse. This underscores the point that increased equality does not always mean better economic outcomes for all.

Figure 7

Many economists caution policymakers against overly simplistic, short-sighted efforts to correct perceived inequalities in the marketplace for fear of doing more harm than good. Ken Rogoff of Harvard recently argued that market forces such as technology and globalization have the capacity to eventually “exert a stabilizing role” in the economy and could actually put a check on some of the income inequalities witnessed today.¹⁵



For instance, technology may be leveraged to “commoditize” education so that many Americans could easily access at least primary college courses. That diffusion of education could in turn impact income inequality. Rogoff says that some commentators are too quick to cite growing income inequality as evidence of the need for governments “to intervene radically in markets to restore social balance.” He disagrees, pointing out, “Yes, we need genuinely progressive tax systems, respect for workers’ rights, and generous aid policies on the part of rich countries. But the past is not necessarily prologue: given the remarkable flexibility of market forces, it would be foolish, if not dangerous, to infer rising inequality in relative incomes in the coming decades by extrapolating from recent trends.”

Furthermore, when looking at past periods of U.S. history when households experienced relatively less income inequality than they do today, it is important to be clear about why this was so. The late 1970s were a time of rising inflation and stagnating economic growth. Income inequality was lower, but poor economic policies – such as strict regulations that reduced competition in certain industries and labor policies that enabled unions to

¹⁴Yellen, Janet L. “Economic Inequality in the United States.” *FRBSF Economic Letter*. Number 2006-33-34, December 1, 2006. <http://www.frbsf.org/publications/economics/letter/2006/el2006-33-34.pdf>

¹⁵Rogoff, Kenneth. “Technology and Inequality.” *Project Syndicate*. July 6, 2011. <http://www.project-syndicate.org/commentary/rogoff82/English>

command above-market wages for their members – also contributed in part to the economic difficulties Americans experienced at that time.

Going back further, since the 1950s and '60s, an advance toward greater individual freedom and a decrease in institutionalized discrimination has increased competition in the labor market, as large numbers of individuals from previously discriminated-against groups joined the workforce. For instance, between 1950 and 2005, the labor force participation rate for adult women nearly doubled. At the same time, as former Cato Institute Vice President for Research Brink Lindsey noted in a recent essay, “the range of jobs open to women expanded enormously,” growing to include those high-paying managerial and professional occupations that had previously been closed to women. Lindsey pointed out that the addition of women to the labor force has increased the number of dual-income households, which has had an especially pronounced effect at the top of the income distribution. This incidentally contributed to growing income inequality, as millions of empowered women assumed greater control over their work and family decisions. As Lindsey put it, “There is no morality tale here. Economic institutions improved, and social norms improved, but as a result incomes diverged.”¹⁶

The Impact of Government Policy on Inequality

The CBO also looked at the effect of taxes and transfer payments on income distribution. Other government policies, such as labor laws and trade barriers, can also affect income distribution, but these effects are indirect and difficult to isolate, and the CBO did not look at them in this study.

Taxing income and redistributing it through government transfer programs is the primary means by which government policy affects income distribution. While the combined effect of taxes and transfers is to reduce inequality, the CBO found that the relative effect of government policies on inequality was less pronounced in 2007 than it was in 1979.

After analyzing various changes in taxes and transfer programs over the period studied, the CBO came to the following conclusions:

- **Overall spending on transfer programs relative to income growth remained constant over the period studied.** The CBO found that “the amount of government transfer payments... relative to household market income was relatively constant from 1979 through 2007.”
- **The share of transfer payments going to middle- and upper-income households increased.** The CBO found that “Rapid growth in Medicare, which is not means-tested... tended to shift more transfer income to middle- and upper-income households.”
- **Welfare reform reduced transfer payments to lower-income households.** Payments declined as welfare recipients were encouraged to move from welfare to work, and as means-tested, work-contingent support programs (such as the Earned Income Tax Credit) were added to the tax code.
- **Federal income taxes actually “became slightly more progressive,” while payroll taxes “became slightly less progressive.”** The U.S. tax system as a whole became less progressive, as the composition of federal revenues shifted from income taxes to payroll taxes.

To better understand these trends, it is useful to separate them into two categories: changes that resulted from government action and changes that resulted from government inertia.

¹⁶ Lindsey, Brink. “Paul Krugman’s Nostalgianomics: Economic Policies, Social Norms, and Income Inequality.” The Cato Institute, 2009. <http://www.cato.org/pubs/wtpapers/Nostalgianomics.pdf>

Government Action

Welfare reform: According to the CBO's study, one contributing factor to the declining share of transfer payments going to lower-income households was the decline in spending on Aid to Families with Dependent Children and its successor, Temporary Assistance for Needy Families, relative to market income. These relative declines occurred as a result of bipartisan efforts in the late 1990s to transform cash welfare by encouraging work, limiting the duration of benefits, and giving states more control over the money being spent.

At the time, opponents of these reforms charged that the reform effort would cause large increases in poverty and despair. Instead, the exact opposite occurred. These reforms cut welfare caseloads in half against a backdrop of falling poverty rates, falling child poverty rates, low unemployment, and rising income for the lowest quintile. In fact, over the period studied by the CBO, the lowest quintile's income gains were most pronounced after the passage of the 1996 welfare reform law (see Figure 1 on page 2).

As a result of methodology limitations in the CBO's study, this successful welfare reform effort appears to have reduced government's role in making the distribution of income more equal, but it does not follow that welfare reform caused income inequality to get worse. In many cases, welfare checks were replaced by paychecks. The CBO report states that its analysis does not account for the incentive effects of changes to taxes or transfer programs. In the case of welfare, that means that the analysis does not account for the sea change in the incentive structure of the program that led large numbers of welfare recipients to escape the grip of government dependence in favor of gainful employment and independence.¹⁷

Creation of new means-tested entitlements/tax credits: Also, as the CBO's study notes, the decline in transfer payments to low-income families with children was largely offset by increased spending on other means-tested programs and tax credits. In the late 1990s and early 2000s, Congress created a number of new means-tested entitlements (such as the State Children's Health Insurance Program) and tax credits (such as the Earned Income Tax Credit, or EITC, and the Child Tax Credit, or CTC) that raised the after-tax income of lower-income households.

The EITC and the CTC are refundable credits, meaning that if a taxpayer's credit exceeds his or her tax liability, he or she receives the balance of the credit in the form of a payment. The CBO notes that an increase in the refundable portion of these credits largely took the place of cash welfare spending, as government income-support programs migrated to the tax code and became tied to work status.

The increase in these credits was also partially responsible for the observed increase in the progressivity of the federal income tax over the period studied. The CBO study noted that "The lowest income quintile has a negative average federal tax rate because, as a group, households in that quintile qualify for more in refundable tax credits than they owe in income taxes before the credits are applied."

Other income-tax changes: In 1979, the top marginal federal tax rate was 70 percent, and the share of federal income taxes paid by the top 1 percent was 18.3 percent. By 2007, the top marginal federal tax rate had fallen to 35 percent – yet the share of federal income taxes paid by the top 1 percent was 39.5 percent.¹⁸

Put another way, over the period covered by the CBO's study, the top marginal federal tax rate was cut in half, and the share of taxes paid by the top 1 percent more than doubled. Much of this increase was attributable to rising incomes for the top 1 percent (see "Rising incomes" below), so that the total amount of income exposed to

¹⁷ Gabe, Thomas. *Trends in Welfare, Work and the Economic Well-Being of Female-Headed Families with Children: 1987–2005*. Washington, DC: Congressional Research Service. 2007.

¹⁸ Congressional Budget Office. "Average Federal Taxes by Income Group." June 2010. <http://www.cbo.gov/publications/collections/collections.cfm?collect=13>

the top rate was rising even as that rate was falling, and this rise is partly responsible for the increase in the progressivity of the federal income tax.

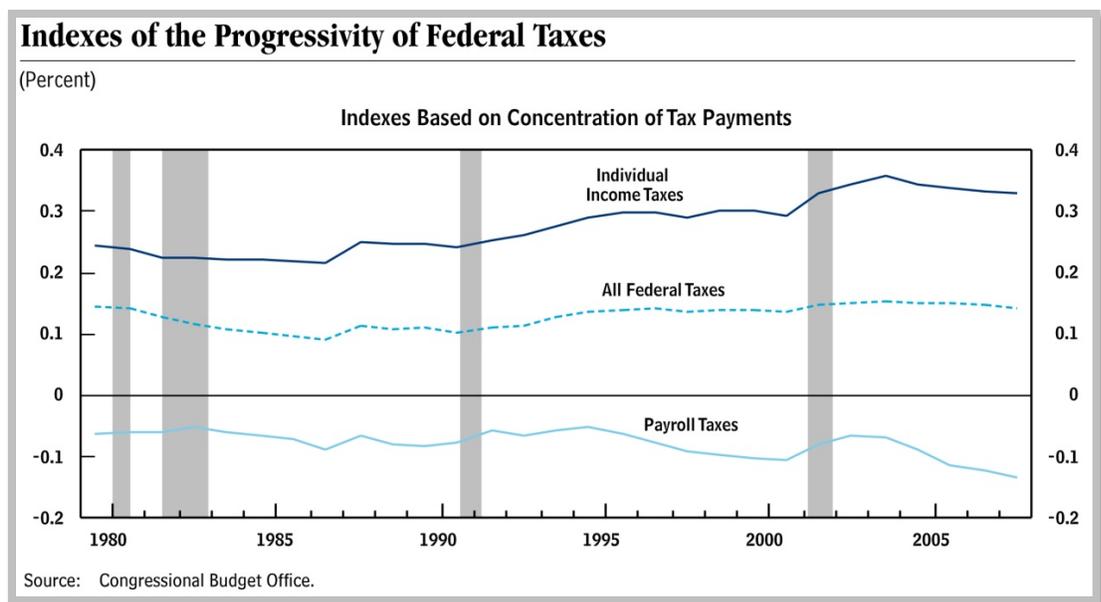
But policy changes were also partly responsible. For instance, the CBO found that average federal tax rates declined for all quintiles over the period studied, but, “The decline... was largest for those in the lowest income quintile, primarily because of increases in the earned income tax credit.” As mentioned above, these increases served to make the federal income tax more progressive.

Another policy-related increase in the progressivity of the federal income tax occurred after the Tax Reform Act of 1986 (see Figure 8). According to the CBO, “The average federal income tax rate for the 1 percent of the population with the highest income... rose following enactment of the Tax Reform Act of 1986,” despite the fact that the 1986 law slashed the top rate from 50 percent to 28 percent. This is primarily because the 1986 reform broadened the tax base by eliminating numerous deductions and tax shelters primarily used by high-income households to reduce their tax liabilities.

- The 1986 tax reform not only raised the *average* federal income tax rate for the top 1 percent, but it also generated more revenue than anticipated despite being initially scored as a revenue-neutral reform. The economist Martin Feldstein of Harvard studied a sample of individual tax returns for more than 4,000 taxpayers and found that “the actual experience after 1986 showed an enormous rise in the taxes paid, particularly by those who experienced the greatest reductions in marginal tax rates” (a.k.a. “the rich”).¹⁹
- Feldstein concludes that this is because reductions in *marginal* income tax rates increased returns on hard work, investment, and entrepreneurial risk-taking, so that the average taxable income for top ratepayers rose between 1985 and 1988 by 45 percent. Meanwhile, the share of individual income tax liability for the top 1 percent grew from 21.2 percent to 26.6 percent over the same period.²⁰

Figure 8

The 1986 tax reform, by cutting top rates and broadening the base, caused the average federal income tax rate paid by the top 1 percent to go up; average federal income tax rates for the bottom 80 percent to fall; and the burden of the federal income tax to shift from the bottom 80 percent to the top 20



percent, especially the top 1 percent. At the same time, the incentive effects of lower rates produced a rise in taxable income and an increase in federal income tax revenues.

¹⁹ Feldstein, Martin. “The Tax Reform Evidence From 1986.” *The Wall Street Journal*. October 24, 2011. <http://www.nber.org/feldstein/wsj10242011.pdf>

²⁰ Congressional Budget Office. “Average Federal Taxes by Income Group.”

The results of this successful reform illustrate the folly of looking only at what is happening to tax rates when analyzing the distributional effects of pro-growth tax policy. Lowering tax rates while eliminating shelters that are overwhelmingly used by upper-income taxpayers results in a more progressive federal income tax overall, while creating the kind of economic growth that allows all income groups to prosper while incidentally bringing in more revenue to the government.

Payroll-tax changes: As the federal income tax was getting more progressive, the payroll tax was moving in the opposite direction (see Figure 8). And as changes in tax policy were reducing the share of federal revenue derived from (more progressive) income taxes, they were simultaneously increasing the share derived from (less progressive) payroll taxes.

In the 1980s, the cap on earnings subject to the Social Security payroll tax rose due to previously legislated increases, and – facing a crisis in the financing of Social Security – Congress accelerated previously scheduled increases in the tax rate to bring more revenue into the system. Then, in the 1990s, Congress first increased and then eliminated the cap on earnings subject to the Hospital Insurance payroll tax (which is used to finance a portion of Medicare).

These changes increased the share of federal revenue derived from payroll taxes, which had the effect of decreasing the progressivity of the federal tax system as a whole. The Social Security payroll tax is less progressive than the federal income tax, because it only applies to earned income, and it does not apply to income earned above a set cap (\$106,800 in 2011). Therefore, higher-income households pay a lower average rate than lower-income households because a large portion of their earnings are above the cap and a larger fraction of their income comes from sources other than earnings.

Although the Social Security payroll tax is less progressive than the income tax, it is not normally considered in isolation from the benefit structure of Social Security. The payroll tax was instituted as a financing mechanism for Social Security and as a form of forced saving tied to the receipt of benefits upon retirement. However, Social Security benefit formulas are progressive, with those at the lower end getting a higher return on the taxes they paid and those on the higher end getting a smaller return. So Social Security is a progressive program on balance, even though the tax component of the program is not.

Over time, as Social Security's finances have deteriorated, policymakers have attempted to patch the program with repeated increases in both the payroll tax rate and the cap on taxable earnings. Since its creation in 1935, the payroll tax has been increased 13 times, and the cap on taxable earnings has been increased 26 times.²¹ Former Democratic U.S. Rep. Timothy Penny has called this "a vicious cycle of overextension followed by raised taxes."²²

Ultimately, policymakers have three choices if they wish to increase the progressivity of health and retirement security programs: They can continue to chase unsustainable spending with increases in the payroll tax rate and the taxable maximum; they can make benefit formulas more progressive so that less help is going to wealthier seniors who don't need it; or they can implement a combination of the two. The first approach makes the tax component more progressive but creates a drag on economic growth by increasing marginal tax rates. It also raises questions of intergenerational equality, as more income is transferred from younger generations to older ones. By contrast, the second approach reduces the deadweight loss associated with government income transfers while strengthening these programs for those who need them most.

²¹ Penny, Timothy. "Please, Not Another Payroll Tax Hike." The Cato Institute. February 20, 1998.

http://www.cato.org/pub_display.php?pub_id=5944

²² Ibid.

Government Inertia

Figure 9

Demographic changes: Even though Social Security benefits are progressive, neither Social Security nor Medicare is means-tested and the cohort that is eligible for these programs is the second-wealthiest cohort by age in the United States.²³ This cohort has grown faster than the population overall, and the resulting demographic change has reduced the share of transfer payments received by lower-income households while increasing the share received by middle- and upper-income households.

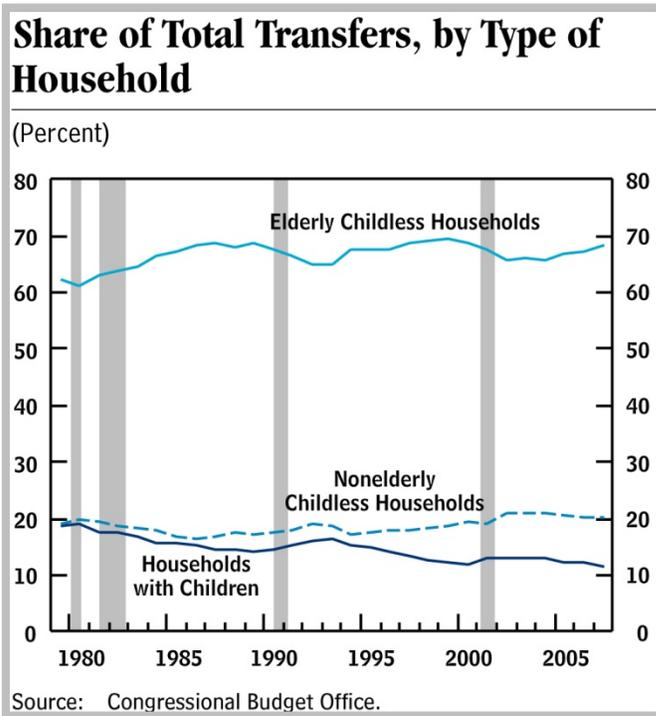
According to the CBO, “Because outlays on programs focused on the older population (such as Social Security and Medicare) have grown faster than outlays on other transfer programs, the share of transfers received by elderly childless households has likewise increased” – from 62 percent in 1979 to 68 percent in 2007 (see Figure 9).

This large increase in spending on non-means-tested programs for a relatively well-off demographic was less a result of explicit government actions than a combination of demographic and health care cost factors. A fixed retirement age, a lengthening of life expectancy, the retirement of the baby-boom generation, and rapidly rising health care costs worked in concert to reduce the overall progressivity of government transfer payments during the period studied.

Gene Steuerle of the Urban Institute has written about the way in which the structure of our entitlement programs invariably leads to generational inequities. He has shown that the “lifetime benefits” of Medicare and Social Security for average households have far outstripped the taxes those households actually paid in to support these programs, leaving them on a path to bankruptcy for future generations. For instance, Steuerle estimates that an average-wage couple retiring in 1980 paid in about \$200,000 (2010 dollars) in Medicare and Social Security taxes but received total benefits of nearly \$600,000. Likewise, an average wage couple retiring today will get total lifetime benefits that are \$200,000 higher than their taxes paid.²⁴ The structure of our entitlements has virtually guaranteed that future generations will face higher taxes, lower benefits, or both. As Steuerle explains, “not only does this current structure (of entitlements) lead to more borrowing from abroad, it saddles future generations with most of the costs.”²⁵

Rising health-care costs: The rising cost of health care exacerbated this trend. As the CBO put it, “Rapid growth in Medicare, which is not means-tested (in other words, not provided to people based on a test of need determined by their income and assets), tended to shift more transfer income to middle- and upper-income households.”

Though some of the growth in Medicare spending during the period studied is the result of the demographic changes mentioned above, the majority of the growth is due to increases in per capita Medicare spending that



²³ Federal Reserve. 2007 SCF Chartbook. http://www.federalreserve.gov/econresdata/scf/files/2007_SCF_Chartbook.pdf

²⁴ Steuerle, C. Eugene and Stephanie Rennane. “Social Security and Medicare Taxes and Benefits Over a Lifetime.” The Urban Institute. June 2011. <http://www.urban.org/UploadedPDF/social-security-medicare-benefits-over-lifetime.pdf>

²⁵ Steuerle. “My View.” January 10, 2011. <http://crfb.org/blogs/my-view-gene-steuerle-3>

occurred as a result of rising health care costs.²⁶ Specifically, the CBO determined that the fungible value of Medicare benefits (a Census Bureau estimate of the value of the benefits to recipients) increased from 1.3 percent to 3.2 percent of market income over the period studied, reflecting a rise in the per capita cost of providing the benefit.

The growth in the fungible value of the Medicare benefit was not distributed evenly among income groups, but rather tilted toward the middle- and upper-income groups, in part because lower-income groups rely more on Medicaid. For the lowest-income quintile, the fungible value of the Medicare benefit as a share of household income nearly doubled, from 7.1 percent to 14.1 percent. But for the middle quintile, it more than quintupled, from 0.9 percent to 4.7 percent. For the fourth quintile (those households making between \$42,202 and \$60,557), it quadrupled, from 0.5 percent to 2.1 percent. This disparity in the distribution of per capita Medicare spending, driven primarily by rising health care costs, also contributed to the decline in the progressivity of transfer payments observed by the CBO.

Rising incomes: The CBO's analysis of changes in the tax system's progressivity captures two important changes that came about as a result of rising incomes over the period observed, rather than any specific policy change. Rising incomes, particularly at the top of the income distribution, tended to increase the progressivity of federal income taxes while simultaneously decreasing the progressivity of payroll taxes.

As incomes at the top rose, the amount of income subject to the top federal rate went up, shifting the burden of the federal income tax to higher-income households. This phenomenon, combined with steadily falling average federal income tax rates for the bottom 80 percent of households, led to an increase in the progressivity of federal income taxes.

Also, as incomes at the top rose, the amount of income exempt from the Social Security payroll tax went up, lowering the average payroll tax rate for higher-income households. This phenomenon, combined with legislated increases in payroll tax rates, led to a decline in the progressivity of payroll taxes.

For the most part, these changes in the progressivity of the tax system did not occur due to government action, but rather because incomes at the top of the distribution were rising and thus affecting average tax rates.

Successfully Addressing the Problem

Answering the normative question of what policymakers should do to address income inequality must begin with a more precise understanding of the problem. There are two divergent approaches to the question policymakers should be asking:

1. Is the problem simply that some households make more than others, in which case policymakers should be focused on closing this income gap by any means at their disposal, indifferent as to whether government policies aimed to close relative inequality result in lower absolute levels of income?
2. Or is the problem that incomes for households in the middle- and lower-quintiles are not rising fast enough, in which case policymakers should focus first and foremost on creating the conditions for income growth and job creation?

In the first case, the questioner presupposes that the economy is a fixed pie, and the government's role is to more equitably slice the pie for citizens. Given this premise, the solution seems simple enough: An aggressively redistributive program of taking more from households at the top of the income distribution and increasing

²⁶ U.S. Department of Health and Human Services. Centers for Medicare and Medicaid Services. *2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*. May 13, 2011. <https://www.cms.gov/reportstrustfunds/downloads/tr2011.pdf>

transfer payments to households in the middle and lower quintiles would do the job. The incentive effects of large marginal tax rate increases and government transfers indicates that the result of such an agenda would be much slower economic growth and lower incomes for all – but this should not bother a policymaker who thinks that increasing absolute levels of income is a secondary concern compared to the greater priority of reducing relative levels of income inequality.

If, on the other hand, the goal should be to expand the economic pie for all groups, while making sure that lower- and middle-income households are enjoying the gains, then policymakers must be mindful of the trade-offs between policies that enhance the redistributive power of government versus policies that promote economic growth. The policy recommendations that follow assume that the goal is to promote upward mobility, increase broadly shared economic growth, and ensure that more and more Americans are able to freely earn their success.

Reform Social Security and Medicare

The CBO's finding that Medicare and Social Security are directing an increasing share of government transfer payments toward retired individuals who are in middle- and upper-income households touches on a key element of the federal government's larger budget challenge. Absent fundamental reform, our entitlement programs – coupled with interest payments on the debt – are on a path to consume the entire federal budget. As demographics and runaway health-care costs bankrupt these programs, younger generations face the prospect of severely reduced benefits when they retire in the coming decades, or prohibitively high taxes to pay for the unreformed programs, which would in turn sink the economy.

A much less discussed form of inequality is the growing gap between old and young, with younger Americans on the hook for the trillions of dollars of unfunded liabilities that will be required to finance benefits promised to elderly Americans. And as we increasingly fund these programs with borrowed money, we are increasingly relying on foreign sources to finance our debt. Today, nearly one-half of our debt is held by foreigners, with China being our largest foreign creditor.

The younger generation is already starting from a tough position. Fresh Census data shows that the wealth gap between the elderly and the young has reached an all-time high as households over 65 have net wealth that is 47 times higher than households under 35.²⁷ This wealth gap has *doubled* since 2005, fueled by the economic recession. Demographers think that this gap could be as wide as it has ever been, even in those times that pre-date government records.²⁸ The looming entitlement crisis, with younger Americans responsible for financing the shortfall, promises to worsen this trend.

A prudent course of action for policymakers would be to advance sensible reforms to the unsustainable benefit structure of these programs so that government is giving less help to households that need it least. For Social Security, the Bowles-Simpson Commission on Fiscal Responsibility and Reform laid the groundwork by outlining reforms that would reduce the growth in benefits for higher-income workers. Contrary to false attacks, these reforms would not cut benefits; in fact, all benefits would continue to grow at least as fast as inflation. And, with the exception of high-income individuals, benefits would grow even faster than inflation. The Bowles-Simpson proposal would also modernize the special minimum benefit to ensure a higher benefit for the poorest seniors, thus helping to target Social Security benefits to those who most rely on the program.

For Medicare, the House-passed budget, *The Path to Prosperity*, proposed no changes for those 55 and older, but for future generations, it proposed a premium-support system that provides more help for the poor and the sick, and less help for the wealthy.

²⁷ Yen, Hope. "US wealth gap between young and old is widest ever." Associated Press. November 7, 2011.

http://www.boston.com/news/nation/washington/articles/2011/11/07/us_wealth_gap_between_young_and_old_is_widest_ever/

²⁸ Ibid.

Policymakers should also reform these programs to account for demographic realities. The Bowles-Simpson proposal indexed the eligibility age to increases in longevity. The House-passed budget proposed a similar reform for Medicare by gradually raising the age of Medicare eligibility from 65 to 67, beginning in 2022.

Finally, policymakers must address the rising health care costs that are imposing increasing burdens on all income groups, but especially on those in the middle of the income distribution. Health-care cost inflation is driven by the overutilization of services, dramatic underpayments, and massive inefficiency – and the primary driver of all three is the open-ended structure of government’s subsidization of health care. From the open-ended tax exclusion for employer-sponsored health insurance, to open-ended fee-for-service Medicare, to a perverse matching system in the federal-state Medicaid program, government policies remain the key contributor to health inflation. Promoting choice and competition and putting patients in charge of how their health care dollars are spent will force providers to compete against each other on price and quality.

Enact pro-growth tax reform

The CBO’s finding that the progressivity of the federal income tax increased after the nation’s last round of fundamental tax reform is an encouraging sign for those policymakers who favor enacting another round of reform today. As tax rates fell over the period studied, the share of the federal tax burden borne by the top 1 percent increased dramatically – and the sharpest increase came after the 1986 law closed the loopholes that many wealthy individuals used to shelter their income from taxation.

The nation is long overdue for the kind of fundamental tax reform that broadens the tax base while lowering tax rates. When President Reagan left office in 1989, there were only three tax brackets, with a top rate of 28 percent. Reagan’s tax reforms proved to be a cornerstone of the unprecedented economic boom experienced during the final two decades of the 20th Century. But over time, additional brackets, credits, and carve-outs have grown on the tax code like weeds. In the last ten years alone, there have been nearly 4,500 changes made to the tax code.

The current individual tax code has six brackets, with a top rate of 35 percent (which is set to climb to nearly 40 percent after the end of 2012). Meanwhile, the corporate income tax rate is also 35 percent – the second-highest rate in the developed world, putting U.S. companies and jobs at a disadvantage in an increasingly competitive world economy.

Reorienting the tax code with pro-growth incentives would not only increase economic growth and allow all Americans to share in a larger pie – it would also make the tax code more progressive, as income at the top end of the distribution that was formerly parked in tax shelters would go from being taxed at zero percent to being taxed at the top marginal rate.

Conclusion

While entitlement reforms and pro-growth tax reforms speak directly to the CBO’s findings, policymakers must do more to promote broadly shared prosperity and economic growth. Streamlining job training programs, as proposed in the House-passed budget, would give more workers access to the kinds of mid-career educational programs that would help them keep up in a fast-moving, 21st Century global economy. Encouragement for school voucher programs would help lower-income parents find the educational alternatives that would help their children escape from failing public schools. And ending corporate welfare programs would strike a blow against a form of inequality that has unfortunately grown more pervasive over the past several years – an inequality that is based on political influence and bureaucratic favoritism.

Above all, policymakers should be mindful of the traditional American commitment to equality of opportunity. In the United States, all citizens have the right to rise. Policymakers should dedicate themselves to removing any and all barriers to upward mobility, while preserving the right of every American to make the most of his or her talents and dreams.

Using the government's taxing and spending power to try to equalize incomes may not produce the intended result and could seriously weaken America's traditional strength: individual freedom and responsibility in a market economy, combined with a secure safety net for society's most vulnerable.

To the extent that debates about inequality shape the national discussion about the threat we face from ever-rising debt, policymakers should be mindful of the CBO's findings that inequality grows when government grants income support to those who don't need it, and it recedes when the tax system is made fairer, flatter, and more competitive. Reforming the tax code and entitlements would not only go a long way toward putting the budget on the path to balance and the economy on the path to prosperity; these reforms would also help promote upward mobility and equal opportunity for all Americans – core tenets of the American Idea.

*This document was prepared by the Republican staff of the Committee on the Budget, U.S. House of Representatives.
It has not been approved by the full committee and may not reflect the views of individual committee members.*