Policy Focus

Understanding Income Inequality

RECIPES FOR RATIONAL GOVERNMENT FROM THE INDEPENDENT WOMEN'S FORUM

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WHAT YOU NEED TO KNOW

Americans have been hearing a lot from politicians about income inequality, but it's important to separate popular beliefs from proven realities. Popular beliefs include the following: (1) Middle-class incomes and living standards have largely stagnated since the late 1970s. (2) Social mobility has declined, and rising inequality is partly responsible. (3) Inequality is much worse in the United States than in Western Europe, and raising the top U.S. income-tax rates would change that.

Each of these beliefs deserves closer scrutiny. While there is certainly evidence of long-term wage stagnation, especially among less-skilled workers, broader measures of middle-class incomes and living standards reveal significant gains. Inequality has increased, but an exhaustive 2014 study concluded that intergenerational income mobility has been "extremely stable" for decades. Other research has likewise failed to show a serious connection between inequality and mobility, perhaps because the recent growth of American inequality has been driven by the top 1 percent of earners. If we look at inequality among the bottom 99 percent of households, U.S. and Western European levels are in the same ballpark — and America *already* has a more progressive tax system than the major European welfare states.

Bottom line: Income inequality per se is neither "bad" nor "good." Opportunity and mobility are far more important. The goal of U.S. policy should therefore be, not to soak the rich, but to promote the economic and cultural underpinnings of broad-based prosperity.

WHY YOU SHOULD CARE

Concerns about income inequality distort America's political debate in potentially harmful ways, such as by:

- **Justifying bad policies.** Leading left-wing economists have called for lifting the top income-tax rate to 70 percent or higher, and Democrats are pushing a minimum-wage hike that the Congressional Budget Office estimates "would reduce total employment by about 500,000 workers."
- **Fostering misconceptions about the fluidity of America's income distribution.** Between 1999 and 2007, nearly 58 percent of taxpayers in the bottom quintile of earners moved up to a higher quintile, as did more than 33 percent of taxpayers in the second quintile, according to former Treasury Department economist Robert Carroll. Over that same period, close to 38 percent of taxpayers in the top quintile dropped to a lower quintile.
- **Distracting us from the troubling rise in *cultural* inequality.** Marriage and parenting have become class markers. As Brookings Institution scholars Ron Haskins and Isabel Sawhill write: "There is not a more important divide between the middle class and the poor than the much higher share of middle-class children being raised by both parents."

We need sound policies to help improve the lives of all Americans.

MORE INFORMATION

The Real Story on Middle-Class Incomes

On September 16, the Census Bureau reported that America's inflated-adjusted median household income was lower in 2013 than it was in 1989, and that the total increase since 1979 had been less than 6 percent. Those are truly awful figures. They are also quite misleading.

When Census analysts measure "income," they measure pre-tax money income. In other words, they measure private cash income plus pre-tax government cash benefits (such as Social Security), thereby excluding the value of refundable tax credits, non-cash government transfers (such as Medicare), employer-provided fringe benefits (such as health insurance), and capital gains. They also fail to adjust for variations in household size, and use an inflation measure that, as Manhattan Institute scholar Scott Winship has written, "fails to fully account for the ability of consumers to substitute between goods and services as their relative prices change."

By contrast, the Congressional Budget Office (CBO) provides income data that use a superior inflation measure, are adjusted for household size, and account for refundable tax credits, non-cash transfers, capital gains, and all elements of labor income, including employer-paid health premiums.

CBO estimates that the size-adjusted increase in post-tax, post-transfer median household income from 1979 to 2011 was 47 percent. (The non-size-adjusted increase was 40 percent.) The respective gains in average income among the three middle quintiles of earners were 37 percent (second quintile), 35 percent (middle quintile), and 45 percent (fourth quintile).

To be sure, the Great Recession took a massive toll: As of 2011, the average income for each of those quintiles remained below its 2007 level. Labor-force participation among men aged 25 to 54 has fallen to all-time lows, and the U-6 unemployment rate was higher in October 2014 than it was at the apex of the financial crisis in September 2008. These are serious problems. But the long-term trajectory of middle-class incomes is still more encouraging than many people think.

Furthermore, income numbers tend to understate consumption gains. Indeed, economists Bruce Meyer of the University of Chicago and James Sullivan of Notre Dame estimate that the 2010 U.S. poverty rate as measured by consumption (4.5 percent) was 10.6 percentage points lower than the Census Bureau's official income-poverty rate (15.1 percent). In a related study, Meyer and Sullivan calculate that, from 1980 to 2011, the rise in income inequality (45 percent) was almost two and a half times greater than the rise in consumption inequality (19 percent) — and, moreover, "this much smaller percentage increase in consumption inequality started from a considerably lower base."

These are significant findings, because consumption is a more accurate barometer than income when it comes to capturing material prosperity and living standards.

Is Rising Inequality Hurting Social Mobility?

Even if income and consumption gains have been larger than commonly believed, it is still possible that rising inequality has stifled upward mobility. In a 2012 speech, then–White House economic advisor Alan Krueger unveiled the "Great Gatsby Curve," which purports to show a negative relationship between inequality and mobility. More recently, in a December 2013 address, President Obama declared that "alongside increased inequality, we've seen diminished levels of upward mobility."

However, in January 2014, economists from Harvard, UC-Berkeley, and the Treasury Department reported that, according to their analysis of U.S. children born between 1971 and 1993, intergenerational income mobility has been "extremely stable" for decades — even though inequality has increased. As the authors explained, the recent growth of American inequality has been driven by the top 1 percent of earners, and the income shares of the top 1 percent "are not strongly associated with mobility across countries or across metro areas within the U.S."

Other research has confirmed that rising inequality does not necessarily cause a reduction in social mobility — at least not in America. For example, after performing "the first systematic analysis of how inequality and mobility covary across contexts within the U.S.," University of Michigan sociologist Deirdre Bloome found "little evidence of a relationship between individuals' economic mobility and the income inequality they experienced when growing up." Even UC–San Diego sociologist Lane Kenworthy — who wants U.S. policymakers to build a Scandinavian-style welfare state — has conceded that local data "suggest little if any correlation between income inequality and relative intergenerational mobility."

One factor that *does* have a strong correlation with mobility is parenting. In fact, the same Harvard and UC-Berkeley economists who conducted the study mentioned above have also determined that, across the United States, "the strongest predictors of upward mobility are measures of family structure such as the fraction of single parents in the area."

For that matter, the decline of marriage has suppressed income growth and exacerbated inequality. Between 1980 and 2012, write scholars Robert Lerman of the Urban Institute and Brad Wilcox of the University of Virginia, the share of families with children headed by married parents dropped from 78 percent to 66 percent. Had the level of married parenthood stayed constant, Lerman and Wilcox estimate that "the growth in median family income would have been 44 percent higher." (They are referring to pre-tax money income.) Meanwhile, had family structure remained the same from 1979 to 2012, the growth of family-income inequality would have been reduced by nearly a third.

America vs. Western Europe

Family breakdown is a big reason the United States has less social mobility than many other wealthy democracies. "By 2010," notes American Enterprise Institute scholar Nicholas Eberstadt, "a child was more likely to grow up in a broken home in America than in practically any other Western society." At the same time, income inequality has been rising throughout the industrialized world: in the Anglosphere, in continental Europe, and even in Scandinavia. Indeed, between the mid-1980s and the late 2000s, the growth of inequality was larger in famously egalitarian Sweden than in the United States, according to a 2011 OECD study.

That study also confirmed that inequality is greater in America than in Western Europe. But, once again, we have to keep in mind that rising inequality in the United States has been fueled by the top 1 percent of earners. When Winship compared levels of inequality among the bottom 99 percent of households, before government redistribution, he found that U.S. inequality "is of the same magnitude as that of our rich-country peers in continental Europe and the Anglosphere." And while America has a lower aggregate tax burden (relative to GDP) than other advanced nations, its overall tax system is, in the words of USC tax expert Edward Kleinbard, "the most progressive in the developed world."

Thus, making our income-tax system even more progressive by raising the top rates would be unlikely to deliver a major revenue surge. Since the mid-1970s, the top federal rates on wage income and long-term capital gains have fluctuated significantly. Yet the amount of revenue generated by the individual-income tax has been remarkably consistent: According to CBO data, the annual average was 8.1 percent of GDP from 1974 to 1981, 8.2 percent of GDP during the 1980s, 8.1 percent of GDP during the 1990s, and 7.8 percent of GDP during the 2000s.

How to Increase Opportunity and Mobility

As University of Chicago economist John Cochrane puts it: "Inequality, by itself, is not a problem. Inequality is a symptom of other problems." The longstanding problems that have both intensified inequality and hampered social mobility include the collapse of marriage among Americans with lower levels of education; the spread of an underclass culture; the decline of high-paying low-skilled jobs; and the inadequacies of our K–12 public-school system.

The goal of U.S. policy should therefore be, not to soak the rich, but to promote the economic and cultural underpinnings of broad-based prosperity. That means promoting education, work, entrepreneurship, and marriage. We could start with the following five reforms: (1) increase support for apprenticeship programs, (2) mitigate the burden of occupational-licensing requirements, (3) improve and expand the Earned Income Tax Credit, (4) improve and expand the Child Tax Credit, and (5) reduce or eliminate the marriage penalties created by our tax and transfer policies.

Such reforms would help advance opportunity and mobility, which are far more important than inequality.

Inequality and Immigration

Economists are divided over the precise impact of immigration on U.S. wages. But it's safe to say that America's current system — which, through its emphasis on family reunification, effectively promotes mass low-skilled immigration — has exerted downward pressure on working-class incomes while exerting *upward* pressure on the official U.S. poverty rate. "From 1990 to 2013," notes *Washington Post* columnist Robert Samuelson, "Hispanics accounted for 57 percent of the 11.7 million increase in the number of people below the poverty line." And according to research from the Center for Immigration Studies, "Immigrants and their children accounted for 42 percent of the growth in Medicaid enrollment from 2011 to 2013."

The ideal immigration reform would create a system based more on skills than on family ties. Australia and Canada offer good models of how such a system might work. As UC–San Diego economist Gordon Hanson has observed: "A skills-based immigration policy would help to narrow the wage gap between high-skilled and low-skilled labor in the United States and reduce the fiscal burden on taxpayers."

WHAT YOU CAN DO

- **Get Informed:** To learn more about income inequality and social mobility, visit:
  - Independent Women's Forum
  - The Equality of Opportunity Project
  - The Manhattan Institute
- **Talk to Your Friends:** Help your friends and family understand these important issues. Tell them about what's going on and encourage them to join you in getting involved.
- **Become a Leader in the Community:** Get a group together each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.
- **Remain Engaged Politically:** Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

ABOUT THE INDEPENDENT WOMEN'S FORUM

The Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility.

IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.

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