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THE FUTURE OF THE PUBLIC SECTOR

A series on the long-term forces affecting U.S. social policy

Growing Income Inequality: Roots and Remedies

Edward M. Gramlich and *Mark Long*

American history goes in waves. The dominance of corporate interests during the Gilded Age of the late 1800s was succeeded by the socially conscious legislation of the Progressive Era. The stock market explosion of the Roaring Twenties was succeeded by the social insurance revolution of the New Deal.

The nation may now be on the crest of another big wave. Scores of articles have documented a major change in the income distribution, beginning in the late 1970s. Between 1947 and 1973, all incomes grew together; between 1973 and 1979, all incomes stagnated together. But from 1979 to 1989, the rate of income growth was highest for the top group and dropped steadily through the income distribution (see figure on page 2).

What has caused these trends? Numerous theories exist, but the balance of evidence seems to be tipping toward one explanation: growing returns to education.

This change is sufficiently startling that it has been examined and reexamined for confirmation. Even more of a gap in income growth among high and low segments of households along the income distribution was found when the Congressional Budget Office (CBO) resolved uncertainties in the Census reporting of capital income.[1] What the CBO found was that even within the top group, the highest growth was concentrated among the top 1 percent of households. The same trends hold for both labor and capital income and, despite considerable individual income mobility, for lifetime incomes.[2] Household wealth, with and without adjustments for public pension income such as Social Security benefits, has also experienced these trends.[3]

The same general trends are also visible in wage data for other developed countries, including Sweden, the United Kingdom, the Netherlands, France, and Canada.[4] Unlike the case in the United States, these increases have been accompanied by large rises in unemployment among lower income workers.

What has caused these trends? Numerous theories exist, but the balance of evidence seems to be tipping toward one explanation: growing returns to education.[5] The global economy is often fingered as the villain behind increasing economic inequality, but there is evidence that refutes this.[6] The share of trade in the U.S. economy did not make a precipitous leap in the 1980s (at the height of the growth in income inequality) but instead has been rising gradually over time. In any case, trade still represents only slightly over one-tenth of the U.S. economy, too small to have such pervasive effects on the entire wage distribution.

Was Public Policy to Blame?

An obvious candidate for blame is public policy. But are tax and transfer policies at fault for growing income inequality? The short answer is—not really. Is there something public policy can or should do to correct these tendencies? That answer, though unpopular in the current climate, is yes.

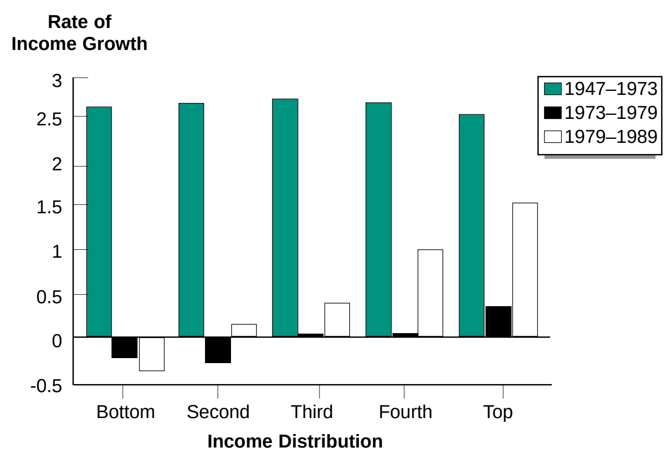
Since the greatest movement toward inequality occurred in the 1980s during the Reagan administration, it is tempting to link this problem to the trickle-down economics then espoused by the White House. Tempting, but by and large, inaccurate.

Public policy affects the distribution of income most obviously through tax and transfer policies. Income and corporate taxes are moderately progressive, while transfer policies are very progressive. To assess *how* progressive, CBO analysts computed the distribution of income before and after all federal taxes and transfers in 1990, using the Gini coefficient. This coefficient ranges from zero to one, with zero denoting full equality. They found that federal taxes and transfers were moderating inequality by accomplishing substantial redistribution. In 1990, the Gini coefficient before all taxes and transfers were taken into account was .523. The post-tax transfer Gini was .463, a drop of 11.5 percent, even near the end of three Republican presidential terms.

Further calculations reveal a potentially larger role for the tax and transfer policies of the 1980s in contributing to today's income inequality. To illustrate, in 1980, before Ronald Reagan assumed office, federal taxes and transfers reduced the pre-tax/transfer Gini by 16.5 percent, from .473 to .395. Over the decade of the 1980s, however, massive changes raised the pre-tax/transfer Gini from .473 to .523. Were tax/transfer policy to have lowered the Gini coefficient by the same percentage in 1990 as in 1980, the resulting Gini would have been .437 in 1990, rather than .463 (the actual post-tax/transfer Gini for 1990 as quoted above). Judged in this stricter manner, it appears that federal tax and transfer policies in the 1980s did contribute to widening inequality.

But not so fast. It turns out that the major policy change responsible for reduced income redistribution was a rise in Social Security payroll taxes in the middle of the decade. Measured in the short term, higher Social Security taxes are regressive because they are assessed only on the first $62,500 of wage income. In the long run, however, the Social Security program provides a substantial amount of internal redistribution. Low-wage workers may have paid more Social Security taxes (proportionate to their wages) than did high-wage workers during their working years, but will get these taxes back upon retirement, with a reasonable rate of return. Social Security taxes should therefore be disregarded when computing Gini coefficients. That done, we are then back to the observation that, over the 1980s, public policy had almost no net effect on the distribution of income. The 1980s saw a big shift away from equality in the distribution of income before taxes and transfers, federal policy effected some redistribution in 1980, and did the same, in roughly similar amounts in present value and percentage terms, in 1990.

Income Growth, 1947–1989, By Income Quintile



Source: Current Population Survey.

Furthermore, adjusting for in-kind benefits such as Medicaid and Food Stamps—which are not counted in Census incomes but for which federal spending grew rapidly in the 1980s—indicates that the federal government may even have ameliorated the distribution of income over the decade.

Should Policy Be Changed?

The next question is normative. Whatever tax and transfer policies *did* do to the distribution of income over the 1980s, perhaps they *should* do more.

One policy change would involve taxes and transfers. Taxes could be made more progressive, and transfer payments more generous. It will not escape notice that both suggestions run counter to movements now sweeping Washington.

On the tax side, heated debate revolves around the "flat tax." This has been proposed by Congressman Richard Armey (R.-Texas) and the Kemp Tax Commission (not to mention former Republican presidential candidates). Versions of the flat tax vary, but most are combinations of a consumption tax and flat or non-increasing marginal tax rates that effectively reduce progressivity in the marginal rate schedule.

Many economists favor moving to some type of consumption tax. Eliminating progressivity in marginal rates, however, is a different matter. Since there is simply no way to replicate the present distribution of income tax payments without some progressivity in the rate structure, all conceivable flat tax programs—at least if they merely replace current income taxes—would involve a significant further shift to inequality in post-tax incomes.

On the transfer side, attempts to balance the federal budget and limit entitlement spending have been directed at trimming, not increasing, transfer payments. The issues here are broad, ranging from the degree to which states versus the federal government should be expected to design and pay for welfare benefits, to appropriate incentives for Medicare and Medicaid health providers to control service costs. However these complex and politically sensitive issues shake out, it is clear that cutting entitlement spending will raise inequality.

One promising vehicle for reducing income inequality could be an improved version of the Earned

Income Tax Credit. The EITC is a wage subsidy for workers from low-income families who have low wages. This makes it a more efficient low-wage subsidy than the minimum wage, which benefits all low-wage workers whether or not they are from low-income families (and many are not). Offering the wage subsidy as a tax credit to needy workers also helps sidestep the employment reductions that can result from minimum wage policies. The EITC has many virtues, but as presently constituted presents some problems of enforcement. If ways could be found to improve administration of wage subsidies, it might be possible to extend such subsidies further into the wage distribution.

The trends in pre-tax, pre-transfer income are so striking that even large government interventions may not fully offset them. In the long run the most important thing government at all levels can do to address inequality involves education.[7] Studies of pre-school education have shown that programs like Head Start can more than pay their way for low-income preschool children. Studies of higher education indicate positive investment returns for students, particularly now that wages paid to highly educated people have risen so dramatically. It is harder to observe and measure returns to investment in elementary and secondary education. But it is almost impossible to imagine that this nation cannot create well-designed programs to boost school achievement and college attendance for low-income, disadvantaged students, many of whom are now attending poor and overcrowded elementary and secondary schools.

There are caveats to viewing education as a panacea. Numerous studies indicate that simply throwing money at public schools will not work. Programs must be well-designed and have sensible incentives built into them. Also, even well-designed education programs can only be effective over time. They will not cause a significant improvement in the income distribution by, say, the year 2000. Even so, improving educational levels, especially for those at the bottom, will work against the trend toward increasing income disparities.

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Notes

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