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Income Inequality and the U.S. Tax System

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Income inequality has become a hot button topic of late. Two years ago, Thomas Piketty's book on the causes of income inequality rallied people on the left to call for more taxes on the wealthy. As the 2016 presidential election draws near, some candidates are talking about income inequality and the need for higher taxes on the rich in order to redistribute wealth and level the playing field. However, the rhetoric does not reflect some truths about inequality and the progressivity of the tax and benefits system today.

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Problems in Measuring Income Inequality. In order to measure the extent of inequality, it is important to accurately measure income. But this is not simple for several reasons:

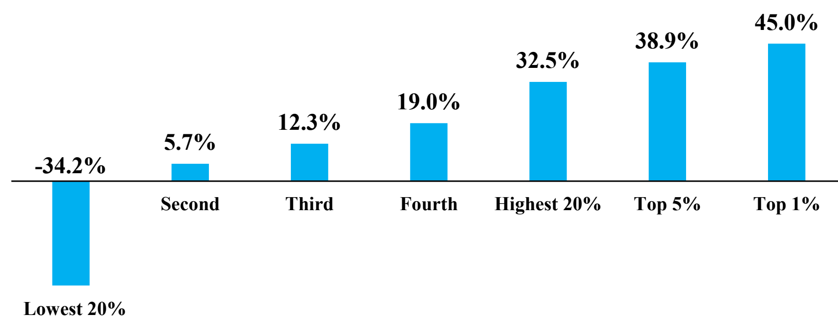
- Reported income usually does not include the value of benefits received by the poor, including Medicaid, food stamps, education grants, cash assistance and subsidized housing.
- Reported income does not include employer-provided benefits, such as health insurance, that carry an implicit value.
- Furthermore, income reporting in surveys can be inaccurate; for instance, according to the Federal Reserve Bank of New York, the self-employed underreport their income by an average of 25 percent.

Thus, using income to assess how people are doing in terms of well-being — having housing, food, transportation, health care and so on — is a poor way to distinguish the haves from the have-nots.

This has led some economists to consider consumption a better measure of well-being than income. If the gap between the rich and the poor is supposedly growing, would this have an effect on differences in their consumption? Researchers Bruce Meyer and James Sullivan analyzed income data from the Current Population Survey and consumption data from the Consumer Expenditure Survey from 2000 to 2011. Measuring the gap between the top 10 percent and the bottom 10 percent of earners, they found:

- Income inequality rose 19 percent from 2000 to 2011.
- Income inequality rose particularly sharply in 2003, and again from 2008 to 2011.
- Consumption inequality, however, was quite different. It rose slowly through 2005, but fell below the 2000 level by 2009 and remained there.

In other words, during the Great Recession, consumption inequality and income inequality moved in opposite directions. This is likely due to the fact that income transfers increased during the Great Recession. For example, the share of the population receiving food stamps (SNAP) rose from about 9 percent in 2007 to 14 percent in 2011. Additionally, consumption by the top 10 percent of earners declined from 2006 to 2009,



Source: Alan J. Auerbach et al., "U.S. Inequality, Fiscal Progressivity and Work Disincentives, National Bureau of Economic Research, Working Paper No. 22032, February 16, 2016.

as did the returns on their investments, such as stocks and real estate.

How Progressive Is the U.S. Fiscal System? Besides the debate over how to measure it, there is also debate over what should be done about inequality. (Many argue that nothing should be done about it because, in and of itself, inequality is not an urgent problem; but that issue is not addressed here.) Progressive policymakers often point to inequality as a reason to redistribute income from the wealthy to the poor through the tax code and benefit programs. How well does the current fiscal system do that?

Economists Laurence Kotlikoff, Alan Auerbach and Darryl Koehler examined this question using the 2013 Survey of Consumer Finances, the Current Population Survey and a highly detailed consumption-smoothing software program developed by Kotlikoff. Consumption-smoothing simply means that households attempt to maintain a constant standard of living throughout their lives; for instance, a couple will save money during their working years for future spending, so that they will not be destitute in retirement. Since nonwage assets are also taxed and can be income-producing (such as housing, capital gains and dividends), they are included in the profiles along with wages. Thus, they divided households into resource quintiles (fifths).

Considering all major federal and state tax and income transfer programs, Kotlikoff and his coauthors estimated lifetime net marginal tax rates and spending by age cohort. The results were surprising: The U.S. tax system is extraordinarily progressive — meaning that lower income households pay far fewer taxes as a share of their income than high-income households. In fact, low-income households actually have a negative net average lifetime tax rate — meaning they receive more in benefits over their lifetimes than they pay in taxes. For instance, for households headed by 40- to 49-year olds with different resources [see the figure]:

- The top 1 percent of households pay an average 45 percent tax rate on each dollar of remaining lifetime earnings.
- The top 20 percent of households pay a 32.5 percent tax.
- However, the bottom 20 percent of households pay a -34.2 percent tax rate — meaning they receive one-third more in government benefits than they pay in taxes.

In some age groups, the tax differences among households with varying resources are substantial. Consider the net marginal lifetime tax rates — the sum of taxes paid plus any reduction in government benefits when an individual earns an additional dollar. For the top 1 percent of 70- to 79-year olds, the net marginal lifetime tax rate is 26.8 percent, on average, while the net marginal lifetime tax rate for the bottom 20 percent of earners in the same age group is –700 percent, meaning they receive seven times as much in benefits as they pay in taxes over their lifetimes!

There are also differences in net marginal lifetime tax rates among households of the same age and resource groups. For example, for the second highest quintile of households by resources, for ages 40 to 49 years, the median net marginal lifetime tax rate is 47.4 percent; but within that cohort the minimum tax rate is –32.4 percent and the maximum tax rate is 78.8 percent!

Conclusion. According to Auerbach, Kotlikoff and Koehler, comparing incomes over one year without regard to age or lifetime resources and tax burdens is very misleading. This is because individual households' earnings and tax burdens tend to change over time. Moreover, factoring in welfare or entitlement benefits received throughout one's lifetime, spending inequality between the rich and the poor is far less drastic than is commonly believed.

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