Economic Inequality

By John C. Goodman, April 25, 2023

Resolved: The United States federal government should substantially increase fiscal redistribution in the United States by adopting a federal jobs guarantee, expanding Social Security, and/or providing a basic income.

How Much Inequality Is There?

Most measures of income inequality ignore differences in age. As a result, they end up comparing 20-year-olds (just starting out in life) with 80-year-olds (living off of a lifetime of saving). These measures also ignore the effects of our fiscal system (taxing and spending by government). And they ignore the lifetime effects of fiscal policy (people with low earnings today get more of their pre-retirement wages replaced by Social Security in the future).

The most accurate estimates of inequality (ones that avoid the mistakes just mentioned) are produced by Boston University Professor Laurence Kotlikoff and his colleagues. In fact, *the Kotlikoff model is the only model that accurately measures true inequality in our fiscal system.*

Here is an overview. As an example of what correct measurement tells us, Kotlikoff segments the population according to the amount of resources (wealth) they have at their disposal over the course of a lifetime:

> Take 40-49-year-olds. Those in the top 1 percent of our resource distribution have 18.9 percent of our net wealth but account for only 9.2 percent of the spending. In contrast, the 20 percent at the bottom (the lowest quintile) have only 2.1 percent of all wealth but account for 6.9 percent of total spending.
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> This means that the poorest are able to spend far more than their wealth would imply, even though they are far short of the 20 percent they would spend, if spending were fully equalized.

Bottom line: there is far less inequality than what conventional measures tell us.

See [Kotlikoff's technical study] with the very latest results on inequality.

Some Surprising Facts about Welfare and Poverty in the U.S.

Here is a summary:

- The U.S. welfare state has almost eliminated poverty in this country – when poverty is properly measured.
- Over the last 75 years, income inequality has actually gone down, not up.

- Since the end of World War II, income has steadily risen for every income group – with the greatest increase among the bottom fifth of the income ladder.
- Over half of the U. S. population gains very little from working because the U.S. fiscal system provides untaxed transfer benefits for those who don't work that are greater than their after-tax income would be if they did work.

For an impeccably researched book that backs up these findings with overwhelming evidence, consult *The Myth of American Inequality* by Phil Gramm (the former U.S. senator), Robert Ekelund, and John Early.

See this overview by John C. Goodman.

A Surprising Finding about The U.S. vs. Europe

Fact: The U.S. has the most progressive fiscal system among all developed countries.

Most people think that the typical European country has a larger welfare state than the U.S. does. That belief is true. What is not true is the belief that these systems are mainly funded by taxes on the rich. To the contrary, they are mainly funded by taxes on the middle class.

The typical European family pays more of its income in taxes than the typical American family. In return, they get more

benefits from the state. These are mainly “social insurance” benefits.
A possible reason: It’s easier to get public support for social insurance in a homogeneous population (where people are more likely to think of their neighbors as extended kin) than in a heterogenous population (where people are more likely to think of their neighbors as foreigners).

Although the U.S. has less social insurance, it nonetheless engages in more redistribution from rich to poor than the typical European country.

The U.S. has the most progressive tax system in the developed world – by far.

See this overview and this technical study.

What’s Wrong with Current Methods of Redistribution?

A lot.

The marriage tax. Academic studies find that marriage stabilizes relationships, improves children’s outcomes and helps adults develop labor market skills. In general, marriage is correlated with economic well-being. One study reports that married couples’ average per capita wealth is more than twice that of two similar people who never married.

Kotlikoff and his colleagues (again, using taxes and welfare benefits over people's lifetimes) find that young adults with low- or middle-income jobs pay a heavy price if they marry. Specifically, when higher tax rates are combined with a reduction in welfare/entitlement benefits, the economic loss from marriage is equal to between one-and-a-half and two years of income, on average.

Take two people between the ages of 26 and 40:

- If both individuals earn $10 an hour, getting married will lower their lifetime income by more than $70,000, on average.
- If they earn $15 an hour, the lifetime losses will climb to more than $107,000.
- At $20 an hour, their loss will be more than $142,00.

Note that these are only averages. Some couples face marriage burdens that are much higher. In the worst case, researchers discovered, getting married has a lifetime cost that is equal to 20 years of income! This occurs when marriage makes a family's income too high to qualify for Medicaid, but too low to qualify for an Obamacare subsidy in states that have not expanded Medicaid.

This helps explain why couples earning $100,000 a year are twice as likely to be married as people earning $26,000 or less.
Technical study. Nontechnical summary.

In a new book, Two-Parent Privilege: How Americans Stopped Getting Married and Started Falling Behind, University of Maryland economist Melissa S. Kearney makes the case that:

- Two-parent families are beneficial for children.
- The class divide in marriage and family structure has exacerbated inequality and class gaps.
- Places that have more two-parent families have higher rates of upward mobility,

If more redistribution is channeled through existing entitlement programs, the transfers could create more inequality, not less.

Disincentives to work. Kotlikoff and his colleagues have produced the most accurate estimates available of the combined tax and entitlement penalties for working. For example, if you earn a dollar today, you will pay income and payroll taxes on that dollar in the current year. You may also lose entitlement benefits in the current year. That dollar will also affect your future Social Security benefits. If you save part of your dollar (as the average household does), you will face additional income and capital gains taxes in future years. Further, the earnings on your savings will affect the taxes on your Social Security benefits and your Medicare premiums in the years of your retirement.

[If all this sounds horribly complicated, it is. Thankfully, Kotlikoff and his colleagues have done the heavy lifting for us. Kotlikoff also has an online financial planning calculator people can use to learn the lifetime effects of current-period decisions.]

When all is said and done, here is the question: When you earn a dollar, how much of that dollar do you get to keep, considering all the ways the government can tax it or reduce entitlement benefits based on it, for the rest of your lifetime? Alternatively, what fraction of the dollar will you lose to the government's fiscal policies? The latter is your net (lifetime) marginal tax rate.

The authors write:

> Our findings are striking. One in four low-wage workers face marginal net tax rates above 70 percent, effectively locking them into poverty. Over half face remaining lifetime marginal net tax rates above 45 percent.

The richest 1 percent face a high median lifetime marginal tax rate of roughly 50 percent. That means the poorest income-earners are facing tax rates almost as high and often much higher than the very rich.

Technical study.

Eating your own seed corn. Advocates of redistribution are usually very unclear about where the money they want to redistribute would come from. The least-bad source of funds would be from a progressive consumption tax – one that taxes only consumption (not income or wealth) and taxes the rich at a higher rate. That would lead to less consumption by the rich and more by the poor. But this is rarely ever proposed.

Instead, redistributionists often talk of taxing corporations. That would take money out of the capital market. They also often advocate taxing the investment income of the rich – for example, by taxing unrealized capital gains or by imposing a "payroll tax" on investment income. Bottom line: they would take savings and investment funds away from people who save and invest and give it to people who would use those funds to consume.

Most wealthy people consume only a small fraction of their income and wealth. The rest of it is invested. Warren Buffet, for example, is one of the world's richest men. But he is notoriously frugal in his personal consumption. He spends less than $4 a day on breakfast. That's less, we suspect, than breakfast costs for the average high school debater.

If we increase taxes on Buffett, he is still going to eat breakfast. Those higher taxes will come from funds he otherwise would leave in the capital market.

What's wrong with that?

Capital market funds are what makes it possible to build new buildings, produce new machinery, and invent new and more sophisticated tools of production. All of that raises worker productivity – which results in higher wages. Without any capital, we would all still be scrounging around in the forest for roots and berries.

Capital is essential to economic growth. (It's no accident that rich countries have a lot of it and poor countries have very little.) And economic growth is the most powerful anti-poverty program ever discovered. In the last quarter century 1.1 billion people, about one-seventh of the world's population, have been lifted out of extreme poverty. Economic growth made that possible. Without capital investment, that growth would not have occurred.

Reducing a country's capital stock and using the funds for consumption instead is like eating our seed corn. It would reduce our growth rate in the process. While today's poor would consume more, tomorrow's poor would have to consume less than they otherwise would.

On why it's a bad idea to tax wealth, see John Goodman, Why a Billionaire Tax Could be Bad for You.

Here are a short essay and video on the importance of economic growth.

The Economic Costs of Redistribution

They can be quite large.

Case study: the Biden economic plan. When he was running for president in 2020, Joe Biden proposed an economic plan that incorporated many of the measures mentioned above. It included a higher corporate income tax, higher taxes on unrealized capital gains and investment income for high-income earners, among other measures. Much of the Biden economic plan also found its way into Democratic proposals in Congress – although most of the proposals have not passed and become law so far.

The most thorough economic analysis of Biden's plan was produced by Professor Kotlikoff, although his results were similar to the findings of economists using other models. He writes:

> The package would **increase** lifetime spending across all age cohorts by 1.2 percent among the bottom fifth of the income distribution and by 0.7 percent in the second-to-lowest fifth … while **reducing** spending by 2.3 percent in the top fifth, by 3.9 percent among the top 5 percent, and by 5.9 percent among the top 1 percent.

Thus, the Biden plan would definitely redistribute income (and therefore consumption) from rich to poor. However, because taxes on financial capital reduce the physical capital stock and lead to less production in future years, there would be a negative impact on the economy as a whole that would affect everyone. Kotlikoff and his colleagues write:

> The long-run loss to the U.S. capital stock is roughly 6 percent and the long-run decline in output is roughly 2

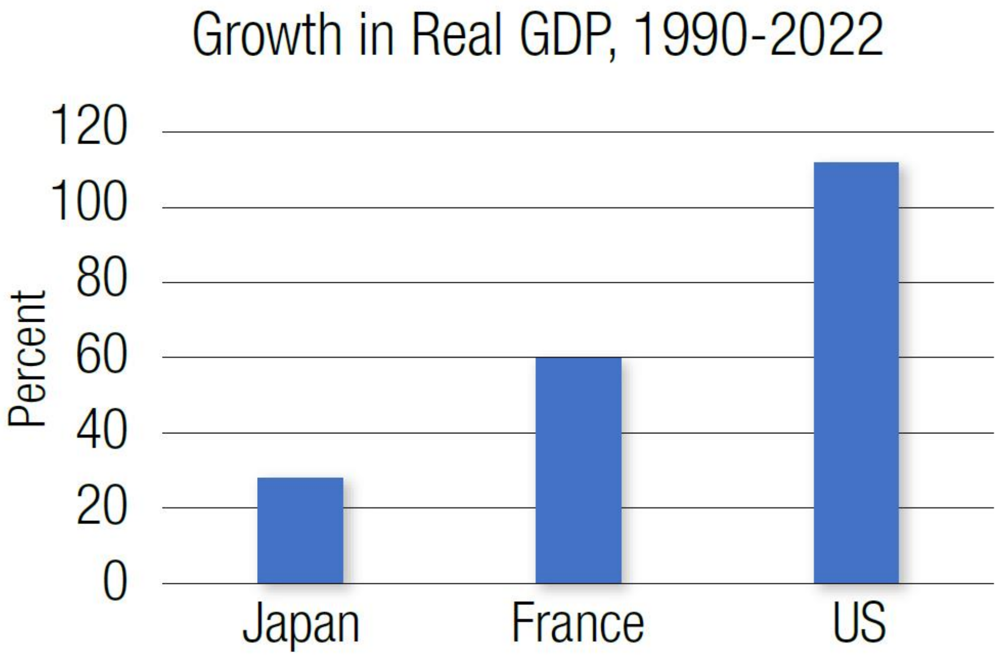
> percent. [There is] a roughly 2 percentage-point reduction in wages of U.S. workers, with a larger reduction in the wages of high-skilled workers.

Roughly speaking, for **every dollar increase** in the spending power of people in the bottom 40% of the income ladder, middle-income workers would experience a **six-dollar decrease** in wages.

The "Leaky Bucket" problem. More generally, any time the government transfers money from one group to another, we run into Arthur Okun's "Leaky Bucket Theorem." The theorem says that when you take money from Peter and give it to Paul, you affect the incentives of both Peter and Paul – leading to a lower level of well-being for the two combined.

For example, the tax on Peter encourages Peter to produce less (because there is smaller reward for producing) and to engage in tax avoidance and tax evasion activities. At the same time, the gift to Paul encourages Paul to work less (because part of his income is now provided without working) and to change his behavior in other ways that increase his eligibility to be a recipient of funds.

The Leaky Bucket Theorem may explain why the United States had more substantial economic growth over the last two decades than European and other developed countries. (See the graphic.)



Source: The Economist, April 21, 2023.

While European countries do not redistribute more funds from rich to poor than the U.S. does, they do redistribute more within the middle class. Middle-income families pay higher taxes and get more benefits from government than U.S. families do.

This may be why they also produce less over time.

Understanding the U.S. Welfare System

History. The percentage of the population living below the federal poverty level fell almost continuously throughout the 20th century. The reason: economic growth – which is the greatest force for eliminating poverty the world has ever known. That trend was broken with the passage of a group of programs called the "War of Poverty" in 1965. Although the economy kept on growing, for the next six decades the official poverty rate stagnated, varying between 11% and 15% of the U.S. population – even though spending on poverty reduction totaled $22 trillion in the war on poverty's first 50 years. The poverty rate stood at 11.6 percent in 2021.

Why the poverty rate remains so high. There are two reasons: (1) the Census Bureau measures poverty by counting only money income, but (2) almost all poverty spending has been on non-money benefits. Historically, the U.S. welfare system has given very little cash to poor people. Almost all the money is spent on non-cash goods and services.

For example, Medicaid money goes to doctors, hospitals and the health care infrastructure; food stamp (Supplemental Nutrition Assistance) money goes to agribusiness; housing money goes to real estate interests; education money goes to the education bureaucracy; etc. And, of course, these interests lobby for even more spending, while poor families don't tend to lobby for anything.

Since the official measure of poverty ignores non-cash benefits, there is almost an unlimited amount that can be spent eliminating poverty with no success at all. On the receiving end, poor families can qualify for dozens of means-tested programs so long as they avoid earning very much cash income (or so long as they fail to report their cash earnings).

An entire welfare/poverty industry exists, with trillions of dollars changing hands. And this could continue forever – with no apparent improvement in the war on poverty as long as the government spends on non-cash benefits and the beneficiaries avoid earning cash income.

The role of non-cash welfare benefits. Over the past 50 years, the value of taxpayer-funded transfer payments to the poorest 20 percent of American households has risen from an average of $9,677 to $45,389 in real terms. If we count non-cash benefits dollar-for-dollar as income, what does the poverty picture look like?

Phil Gramm and his colleagues estimate the real poverty rate would be near 2.5% – leaving out mainly the homeless and those afflicted with mental illness and drug addiction.

One problem with this approach is how to value the in-kind benefits. Should it be from the point of view of the giver (i.e., these are things we want people to have, regardless of what the recipients think) or should we value them from the point of view of the beneficiary?

Studies show that low-income families place a value on Medicaid that is between 20% and 40% of its actual cost. In other words, if you offered these families a choice of Medicaid enrollment or as little as one fifth of the cost of Medicaid in cash, they would take the cash.

This is why Amy Finkelstein, one of the nation's top health care economists, advocates giving families cash (say in the form of a Health Savings Account) instead of Medicaid.

To what extent does welfare cause poverty? In most peoples' minds, the alternative to welfare is work. In a study for the Goodman Institute, Peter Ferrara showed that as of 2018, a single mother working full-time at the minimum wage would have an income above the poverty level – almost regardless of how many children she had. That is because she would be helped by two tax measures – the child tax credit and the earned income tax credit.

Of course, in today's full employment economy, "low wage" workers are earning a lot more than the $7.25 federal minimum wage. In 2022, for example, the average wage nationwide for fast food workers was $17.22.

But regardless of the wage, a working mother risks losing her Medicaid enrollment, her housing subsidy and other means-tested benefits. She could be economically less well-off than if she stayed home.

What if there were no welfare state? There would probably be very little poverty today. From the end of World War II until 1965, there was a continuous, almost unbroken decline in the percent of people living in poverty in the U.S.

Phil Gramm and his colleagues show that poverty would have been eliminated by around 1984/85. (*The Myth of American Inequality*, Figure 3-1, p. 36.) Except for the homeless and those with mental illness or drug addiction we would have stopped talking about poverty roughly four decades ago.

Do We Have Too Much Redistribution Already?

As the above example shows, government tax policy already makes it possible for people to escape poverty by working. But our fiscal system appears to give people the opportunity to enjoy an even better life style by avoiding work altogether.

Gramm and his colleagues write that, since the War on Poverty started in 1965, the labor force participation of the bottom one-fifth of households – who now receive more than 90 percent of their income from government – has dropped from 70 percent to 36 percent.

It's not hard to understand why. Gramm et al. adjust for taxes, transfers (again, counting non-cash benefits as dollar-for-dollar income), and the number of people living in each household. Then they divide households into quintiles, based on earned income. The finding: the bottom fifth of households, based on earned income, had an average income of $33,653 per capita. The second and middle fifths, based on earned income, had $29,497 and $32,574, respectively.

Those with the least earned income have more actual income than those in the next two higher quintiles!

The average household in the bottom fifth (based on earned income) received 14 percent more income than the average second-fifth household and 3.3 percent more than the average middle-income household.

Does Anyone Really Care about Inequality?

Other than intellectuals, it's not clear that they do. Given a choice between living among people who earn about the same income they do, or immigrating to a place where almost every one earns more than they do, millions of people worldwide are showing that they prefer the latter.

Gallup says that 750 million people worldwide would immigrate if they could, and 158 million place the U.S. at the top of their list. This is the case even though most all of them would start out at the bottom of the income ladder.

If people reveal their true preferences through their actions, inequality is not perceived as a bad thing by most people. To the contrary, it's perceived as a good thing.

Better Ways to Reduce Inequality Other than Redistribution

- Promote school choice

- Reduce occupational licensing
- Reduce zoning restrictions that prevent low-cost housing
- Make most non-cash benefits independent of income
- Give families cash instead of in-kind benefits

Finally, Surprising Facts About the Approach of the Two Political Parties to the Question of Inequality.

See these two articles:

Why do Progressives Support Democrats? Part I

Why do Progressives Support Democrats? Part II