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TAXES AND INEQUALITY

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I. Introduction

The creation of the individual and corporate income taxes was largely motivated by concerns about equity.[1] At the turn of the 20th century, the federal government relied on regressive tariffs and excise taxes for most of its financing. Progressive Democrats and Republicans rallied around the new income tax and the amendment enabling the new legislation was quickly ratified by the required three-fourths of states. Initially, the individual income tax was a 1-percent levy on the incomes of the very wealthy, but the US entry into World War I vastly increased federal revenue needs and the income tax rate rose dramatically.

For its first 30 years, the income tax remained a "class tax," only affecting a small sliver of the population with very high incomes. World War II vastly increased the federal government's revenue needs and the innovation of payroll tax withholding made the income tax into a "mass tax," affecting most working people in the country. Nonetheless, the income tax has remained progressive: it claims a much larger share of income from those at the top than at the bottom of the income distribution. And, indeed, the income tax now serves as an important income supplement for low-income working families.

Some argue that the need for a highly progressive tax has never been greater. Economic inequality has been rising since the 1970s and is now at levels not seen since the eve of the Great Depression. Myriad factors have contributed to this trend, including rising returns to higher education, technological change, increased globalization, the declining role of unions and other institutions, the evolution of a winner-take-all society where top performers earn much, much higher rewards than those near the top, and the erosion in the real value of the minimum wage.

While the ideal response to extreme inequality is to try to deal with underlying impediments to success, it is clear that the tax system can play an important role in mitigating economic inequality, especially in the short- to medium-term. The question for economists is what the cost of progressive taxation is—i.e., how much *can* the income tax reduce inequality. The question

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[1] Need footnotes for historical motivations.

for policymakers is how much the tax system *should* reduce inequality given those costs and social values and fairness.

This paper examines trends in economic inequality and the role of the tax system in reducing it. Section II provides an historical and international perspective on inequality. Section III looks at the role of taxes in mitigating inequality and how that has changed over time. Section IV considers what economists call optimal taxation—the trade-off between the gains to social welfare from a more equal distribution of incomes and the costs of using the tax system to reduce inequality primarily from diminished economic incentives. Section V discusses the important role that the income tax now plays in providing a safety net. The last section offers some concluding observations.

II. Trends in inequality

If people all had equal abilities to earn income, a simple flat tax would be fairest option, but that has never been the case. Although there are significant differences in the choices people make to work, save, pursue higher education, and in the kinds of jobs they're willing to take, the larger differences occur in an individual's intelligence, inheritance, and luck. Some people are born smart, rich, good-looking, or with the ability to jump very high or throw a baseball very fast.

Those differences manifest themselves in a highly skewed distribution of income, and the skew in favor of the rich seems to be growing over time. Data collected by economists Thomas Picketty and Emmanuel Saez show that, in 2007, the top 1 percent of households earned almost 24 percent of all income for the first time since 1928 (see figure 1).[2] The income share of the top earners plummeted during the great depression falling to around 10 percent in the 1950s, 1960s, and 1970s before rising steadily starting in the 1980s. A similar pattern applies to the highest-income 1 in 1,000 households. Their share of income reached an all-time record of 12.3 percent in 2007.

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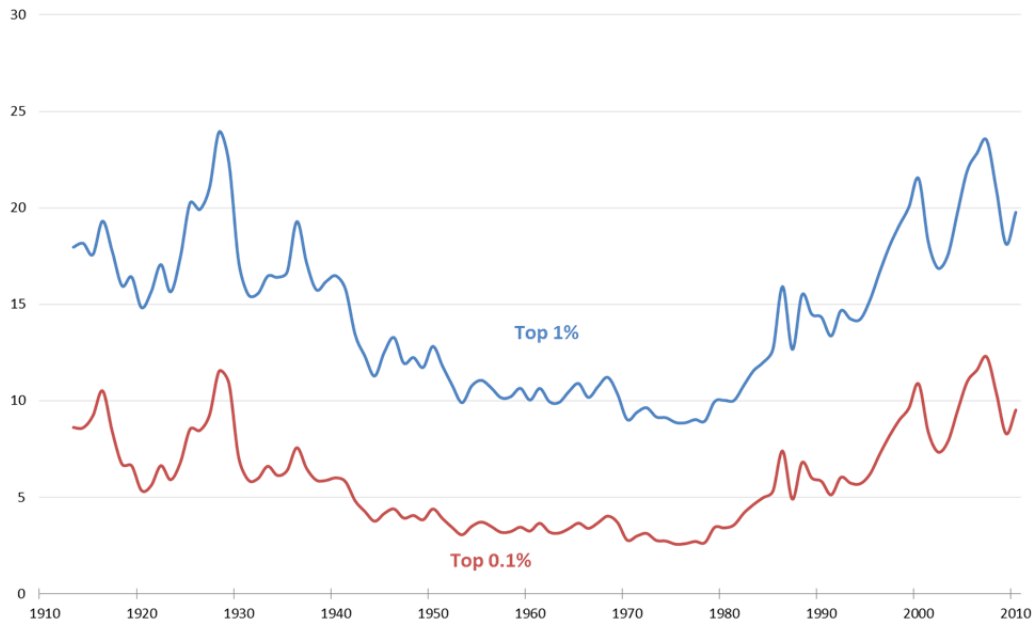
[2] The original time series published in Thomas Picketty and Emmanuel Saez (2003) has been periodically updated on Saez's website. See http://elsa.berkeley.edu/~saez/TabFig2010.xls.

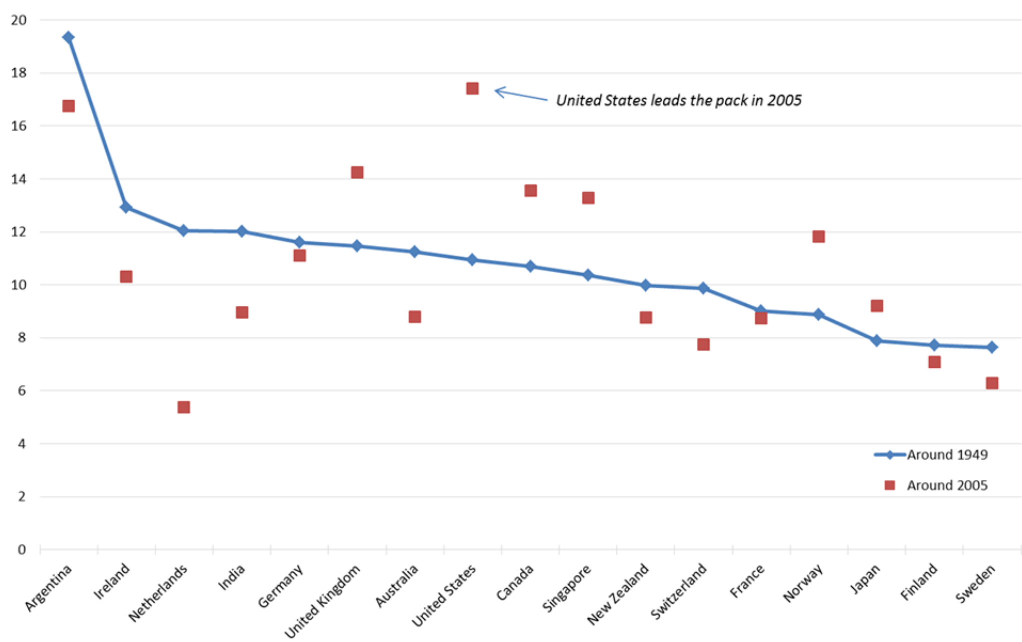
Figure 1. Income Share of Top 1% and Top 0.1%, 1913-2010



Source: Picketty and Saez (2003), with updates from http://elsa.berkeley.edu/~saez/TabFig2010.xls.

Tony Atkinson, Picketty, and Saez (2011) report that while income inequality in the United States was once quite moderate by an international standard, it is now among the highest in the developed world. (See figure 2.)

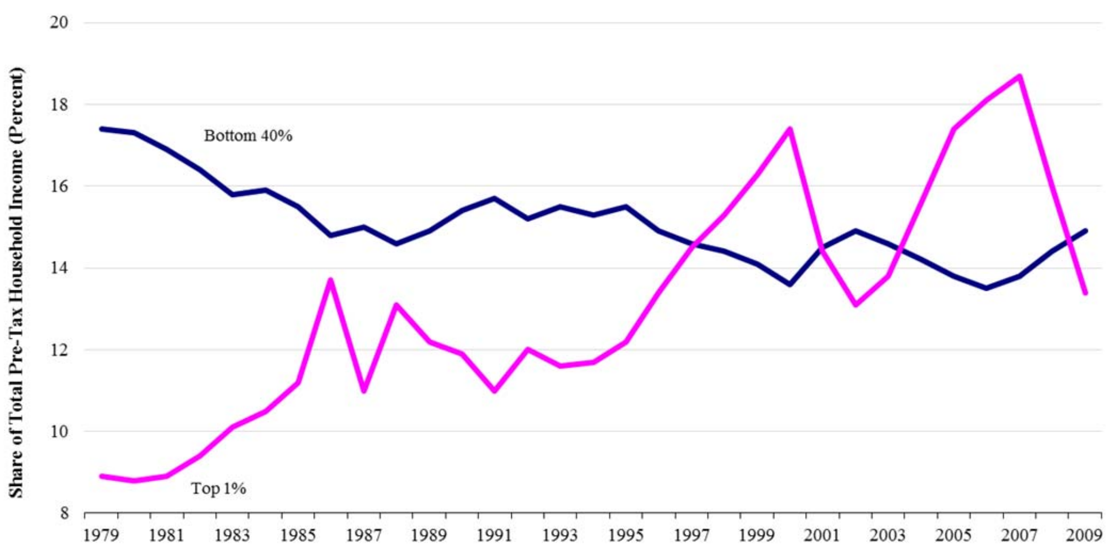
Figure 2. Top Income Shares in Selected Countries, in Percent, 1949 vs. 2005



Source: Atkinson, Piketty, and Saez (2011).

Looked at another way, data from the Congressional Budget Office (2011) show that the top 1 percent of households received about 9 percent of income in 1979, compared with almost 19 percent on the eve of the Great Recession in 2007 (figure 3). The bottom 40 percent received 17 percent of income in 1979, but their share dropped below that of the top 1 percent in the late 1990s; they received about 14 percent of pre-tax income in 2000. The income share for the bottom 40 percent exceeded that at the top in succeeding years, but then fell short until the Great Recession leveled incomes somewhat in 2007. This, however, is likely to be a transitory phenomenon.

Figure 3. Share of Pre-Tax Income Earned by the Top 1% and Bottom 40%
1979 to 2009

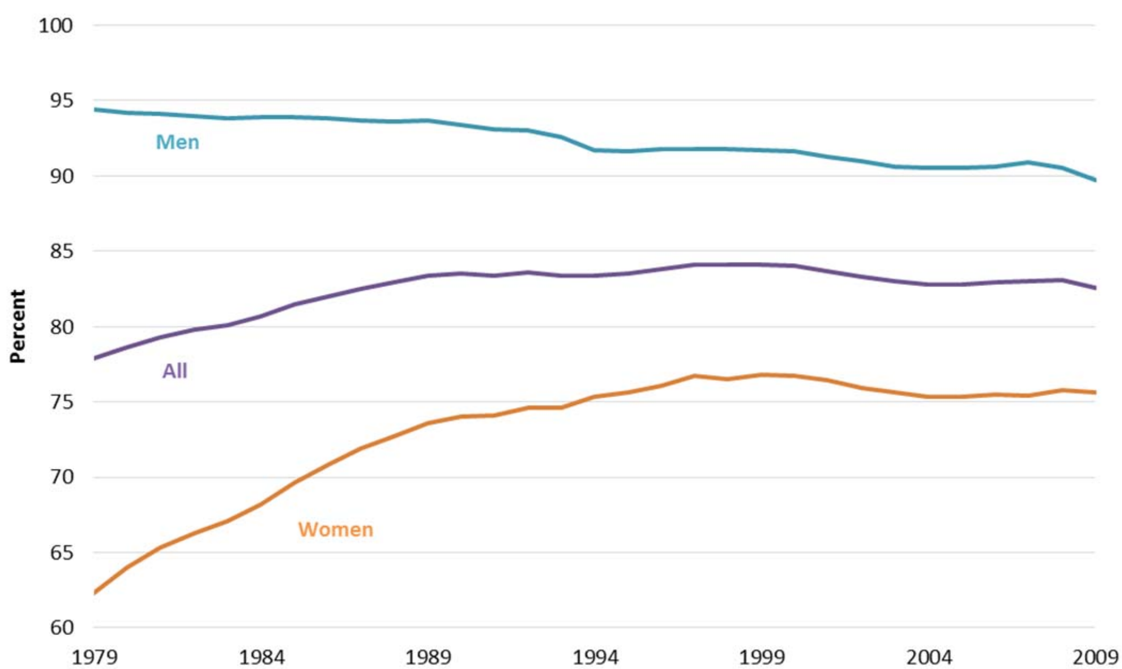


Source: Congressional Budget Office

Income inequality is clearly worsening, and the trend appears likely to continue. Explanations for rising inequality include the decline in the power of labor unions, increased immigration, and the effects of international trade and the growth in information technology (Goldin and Margo 1992). Despite remarkable gains in labor productivity, the benefits of those gains have mostly accrued to the highest-income 10 percent. All other income classes have seen their wages grow more slowly than productivity. Economists Ian Dew-Becker and Robert Gordon (2005) attribute the increasing skew in earnings to "the economics of superstars," which richly rewards the top performers relative to others who are nearly as productive.

Increased inequality has *not* arisen because the middle class has become a bunch of slackers. Indeed, the opposite seems to be the case. Women between the ages of 25 and 54 are 20 percent more likely to be working outside the home now than they were in 1979, and there has been only a modest decrease in labor force participation among men of the same age (figure 4). Sociologists Michael Hout and Caroline Hanley (2003) found that married women with children increased their average time at paid work by nearly half between 1979 and 2001, and married women without children worked over 25 percent more hours each week in 2001 than in 1979. Together, married parents increased their hours worked by more than 10 percent, whether they had children or not.

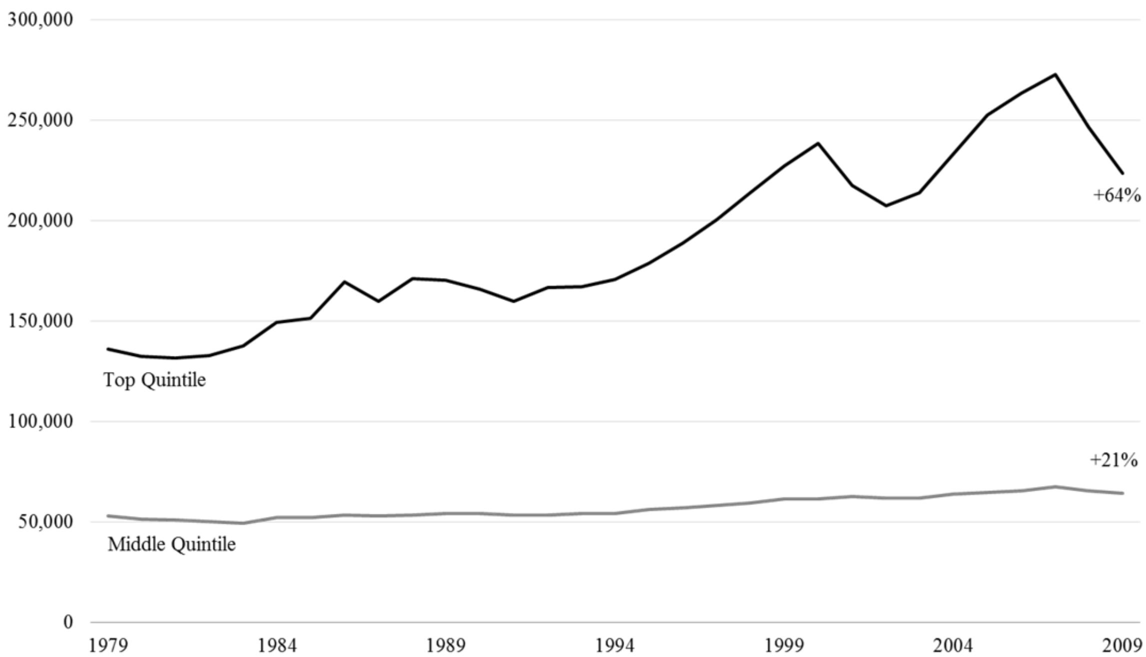
Figure 4. Civilian Labor Force Participation Rate by Gender, Age 25-54, 1979-2009



Source: Bureau of Labor Statistics

The average American family is working harder than ever but, except at the top of the income scale, its income does not reflect the extra effort. Between 1979 and 2009, average income for households in the middle quintile rose less than 1 percent a year, climbing just 21 percent after adjusting for inflation (figure 5). In contrast, households in the top quintile saw their average income double between 1979 and 2007. The recession cut their incomes significantly, but it was still 64 percent above the 1979 level.

Figure 5. Average Pre-Tax Household Income
Middle and Top Income Quintiles, 1979-2009



Source: Congressional Budget Office

III. The tax system and inequality

The federal tax system reduces economic inequality because, overall, it is progressive. It reduces the after-tax incomes of high-income people by proportionately more than the incomes of lower-income people. Figure 6 illustrates how the tax system has historically diminished income disparities. In 1979, the bottom four quintiles (80 percent) of the income distribution earned 55 percent of pre-tax income and the top quintile earned the other 45 percent. Over time, the higher-income households earned an ever larger share of pre-tax income. In the late 1980s and first half of the 1990s, the two groups approximately split total income in half; in 1996, the top 20 percent pulled ahead and the gap has tended to widen since then (although the 2000 and 2007 recessions both temporarily narrowed the gap).

Figure 6. Pre- and After-Tax Shares of Household Income for the Top 20 and Bottom 80 Percent, 1979 to 2009

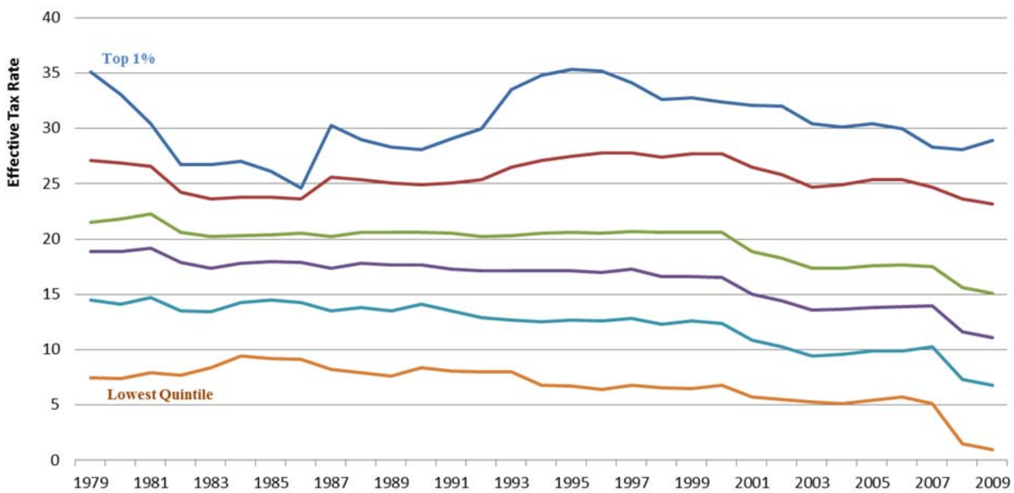
Source: Congressional Budget Office data and author calculations

The right-hand panel in figure 6 shows how taxes change that comparison. Until 2000, the bottom 80 percent always received a larger share of after-tax income than the top 20 percent. The stock market surge in the late 1990s, which pealed in 2000, and the capital gains tax cuts in 1997 and 2003 and the ordinary income tax rate cuts started in 2001 allowed the top quintile to overtake the bottom four-fifths in 2000 and again in 2005-2007. Nonetheless, after-tax income is significantly more equally distributed than pre-tax income.

In 1979, the difference in shares of after-tax income was 16 percentage points, compared with a 10 percentage point difference in the share of pre-tax income. In 2009, taxes reversed the division from a 1.6 percentage point advantage in pre-tax income for the top quintile to a 5.6 percentage point advantage in after-tax income for the bottom 80 percent.

The CBO data also show how the progressivity of the tax system has changed over time. In 1979, the richest 1 percent of tax units paid about 37 percent of their incomes in taxes to the federal government, compared with 19 percent for the middle quintile and 8 percent for the lowest income quintile (figure 7). The Reagan tax cuts in the early 1980s reduced taxes dramatically for the highest income earners and by lesser amounts for other income groups. The exception was people in the bottom 20 percent, who actually paid more because of the payroll tax increases enacted to extend solvency of the Social Security system. Tax changes enacted by President Clinton and the first President Bush restored the federal tax system to the level of progressivity achieved in the early 1980s, although a cut in taxes on capital gains, enacted in 1997, reversed that pattern for very high income families. Expansions in refundable tax credits (the earned income tax credit, and, in this decade, the child tax credit) have reduced the tax burdens on low- and middle-income households since the mid-1980s. The dramatic increase in incomes of higher income workers in the late 1990s contributed to an increase in effective tax rates for the top two quintiles, since a progressive tax system collects larger and larger shares of income in taxes when income growth exceeds inflation. Symmetrically, the drop in income in 2001 reduced average tax bills, but the tax cuts enacted since 2001 had a far larger impact.

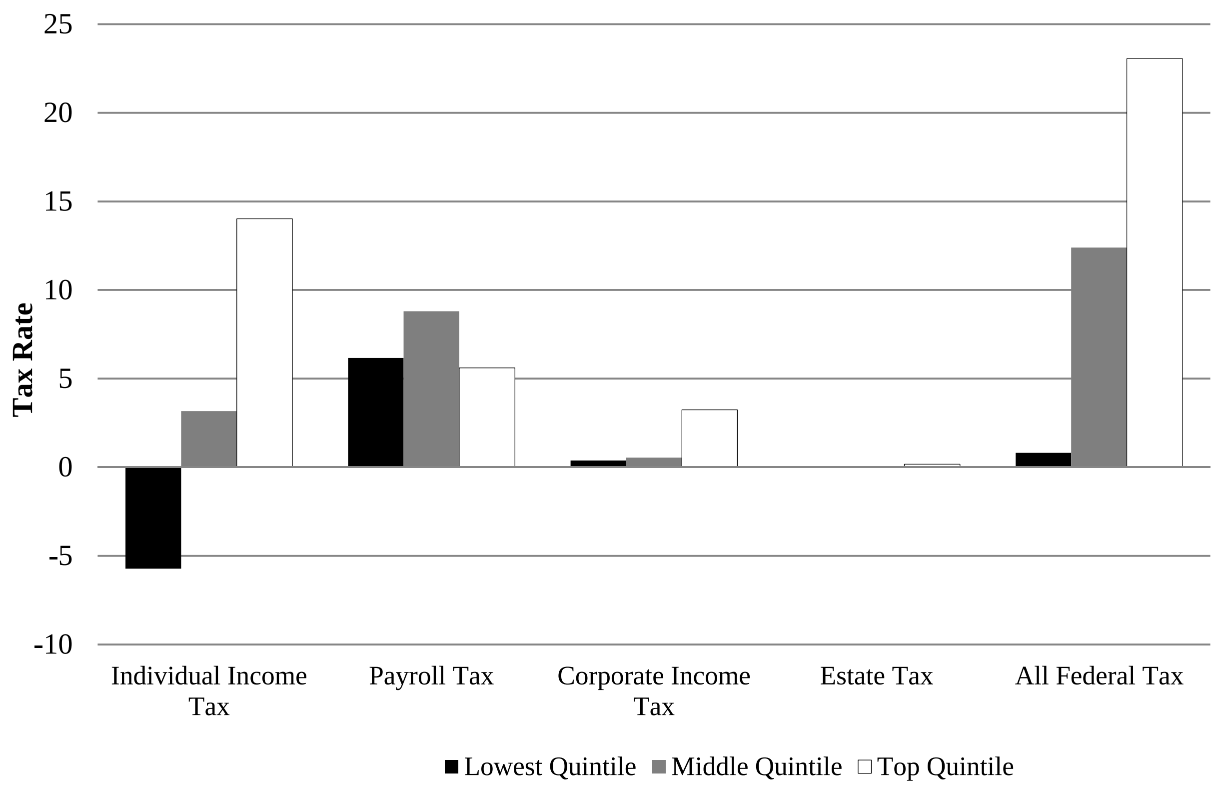
Figure 7. Effective Federal Tax Rates by Quintile and Top 1% 1979 - 2009



Source: Congressional Budget Office

The federal tax system is an amalgam of progressive and regressive taxes. The individual and corporate income taxes and the estate tax are highly progressive (figure 8). Because of the refundable tax credits, individual income tax burdens are actually negative for the lowest-income households, meaning that they get a refund in excess of taxes paid. The middle quintile paid only about 3 percent of income in income taxes while the top quintile paid an average of 14 percent. Corporate income taxes are a much smaller source of revenue, but most of them are also borne by high-income households (under the assumption that the tax falls on owners of capital). And the estate tax—the smallest source of revenue shown in the figure—is entirely borne by very high income tax units.

Figure 8. Average Tax Rates by Cash Income Quintile and Type of Tax, 2011



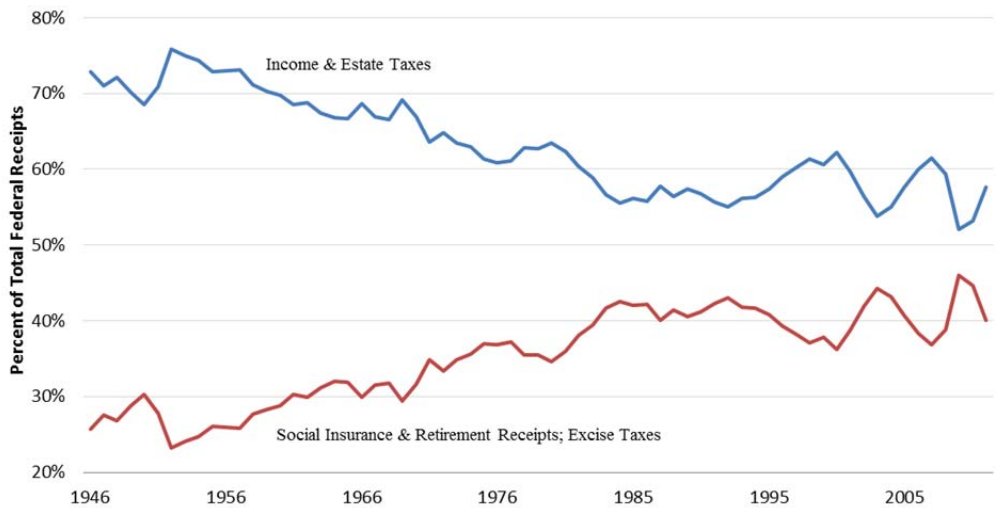
Source: Tax Policy Center Table T11-0100.

Payroll taxes and excise taxes (not shown) are regressive, however. The payroll tax is regressive for two reasons. First, only wages are subject to the tax and wages are almost all of income for low- and middle-income households, but only a fraction for very high-income families. Second, the Social Security tax, which is more than 80 percent of payroll taxes for most people, only applies to earnings up to an annual cap. Above that level, no additional Social Security tax is due. Thus, the tax declines as a fraction of wages for high-income earners. In consequence, payroll taxes are a smaller share of income for the top 20 percent than they are for the bottom 80 percent. Excise taxes (not shown) are also regressive because expenditures on goods subject to the taxes—alcoholic beverages, cigarettes, gasoline, tires, etc.—make up a larger share of income for lower-income people than for those with higher incomes.

Nonetheless, despite these regressive components, the overall federal tax system remained largely progressive in 2011. The top quintile paid 23 percent of income in tax, compared with 12 percent for the middle quintile and less than 1 percent for the lowest-income group.

The tax rates shown in figure 8 understate the longer-run shifts in the composition of taxes. As noted, the increase in payroll tax rates enacted in the early 1980s raised tax burdens disproportionately on lower-income households. Over a longer period, the change in composition of taxes has been even more dramatic. After World War II, progressive income and estate taxes composed more than 70 percent of federal receipts, while regressive payroll and excise taxes accounted for only about 26 percent of receipts (figure 9).[3] By 2011, the regressive taxes made up over 40 percent of receipts while progressive taxes accounted for less than 58 percent.

Figure 9. Composition of Federal Receipts by Source, 1946 to 2011

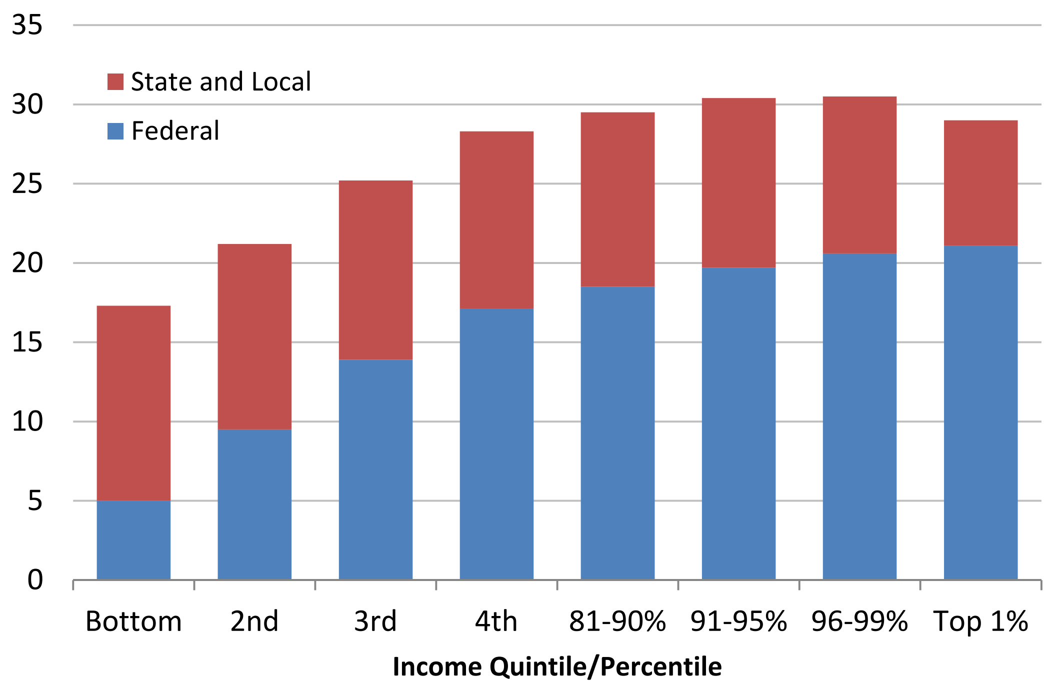


Source: Office of Management and Budget. Federal Reserve deposits are excluded from total receipts; Customs duties and fees and other miscellaneous receipts are not shown.

[3] The components in figure 9 do not add up to 100 percent because customs duties, fees, and other miscellaneous receipts are excluded.

Finally, it should be noted that a complete assessment of tax burdens must include state and local taxes, which constituted about 40 percent of total taxes in 2009. State and local governments rely much more heavily on regressive taxes, such as sales taxes, than does the federal government, and state income taxes often assess tax liability on households near, or even below, the poverty line. Robert McIntyre (2011) has shown that when state and local taxes are included, the overall tax system is much less progressive. (See Figure 10.)

Figure 10. Federal and State Taxes as Percent of Income, 2011



Source: McIntyre (2011))

IV. How Progressive Should the Tax System Be?

Three questions must be answered to determine the ideal shape of the tax rate schedules. First, how much revenue does the government need? It seems obvious to me that when the economy is doing well, revenues should be close to the level of spending. That certainly does not imply a balanced budget every year or even necessarily over the business cycle, but it does rule out large persistent deficits as we have experienced over the past decade.[4] That said, there is a strong argument for running deficits while the economy remains weak, because raising taxes or cutting spending reduces aggregate demand and could plunge the economy back into recession. That argument holds with special force now when monetary policy appears to be near its limits. And, even when the economy is at full employment, there might be an argument for a modest deficit if much of government spending is in the form of investments that pay returns over many years. On the other hand, if the government is accumulating obligations without adequately funding them, there might be an argument for running surpluses.

Second, how broad or narrow will the tax base be? Currently, the income tax code includes around a trillion dollars of tax subsidies or tax expenditures. The exact number could be larger or smaller depending on what is considered a tax expenditure, but they are quantitatively quite significant. Most economists' preference would be to eliminate or reform many tax expenditures so that rates can be kept as low as possible while still meeting distributional and revenue objectives. Every recent tax reform, dating back at least to the proposals made by President Bush's tax reform commission, would significantly scale back tax expenditures and use at least some of the savings to cut income tax rates.

Third, how should the tax burden be distributed? The answer to this question balances normative considerations reflecting social values against the economic incentive effects of higher tax rates. Less well understood is the fact that progressive taxation provide a kind of insurance whose value offsets to some extent the negative incentive effects.

A. Top tax rates are low by historical standards.

Although higher than they were in the immediate aftermath of the Tax Reform Act of 1986, top tax rates are now (and were during the Clinton Administration) lower than at any time between 1932 and 1986. (See Figure 11.) While it is possible that the economic costs of taxation have grown since 1986—for example, because the technology of tax avoidance has improved—it is unlikely that returning tax rates to their levels in 2000 would entail a large economic cost.

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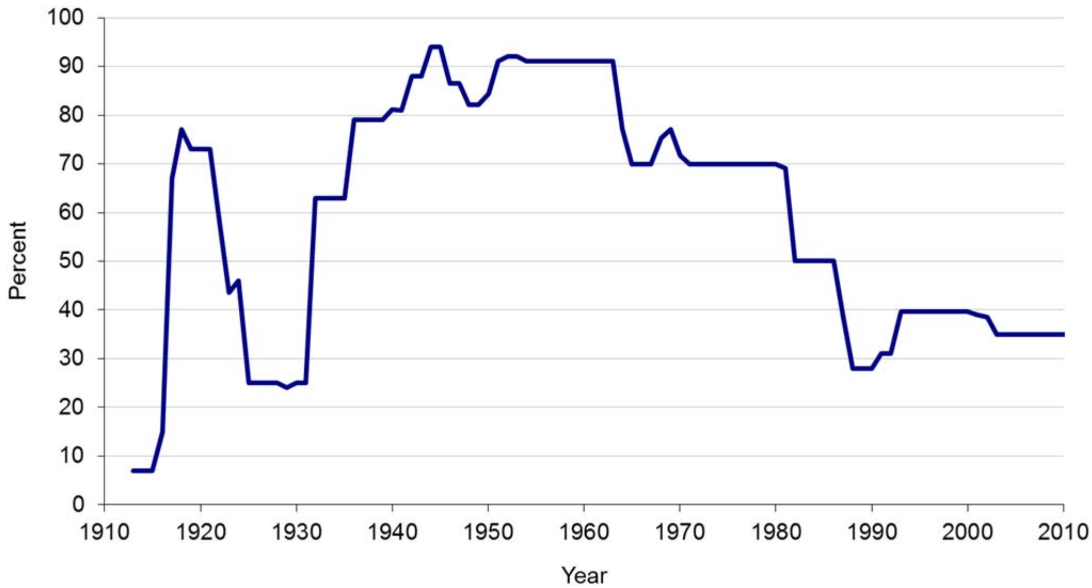
[4] For a nice exposition of the factors driving deficit policy, see Douglas Elmendorf and N. Gregory Mankiw (1999).

Despite predictions that the economy would collapse in 1993 when tax rates increased, economic growth was quite robust until 2000. And notwithstanding forecasts that the Bush tax cuts would turbocharge the economy, growth was anemic throughout the last decade (even before the Great Recession). This certainly does not prove that economic growth is independent of tax rates, but it suggests that, at least at current tax levels, other factors are more important.[5]

Figure 11. Top Marginal Individual Income Tax Rate, 1913-2012



Source: Tax Policy Center

Thomas Hungerford (2012) attempted to control for other macroeconomic factors that might have driven economic growth in a time series analysis. He concluded that "changes over the past 65 years in the top marginal tax rate and the top capital gains tax rate do not appear correlated with economic growth. The reduction in the top tax rates appears to be uncorrelated with saving, investment, and productivity growth. The top tax rates appear to have little or no relation to the

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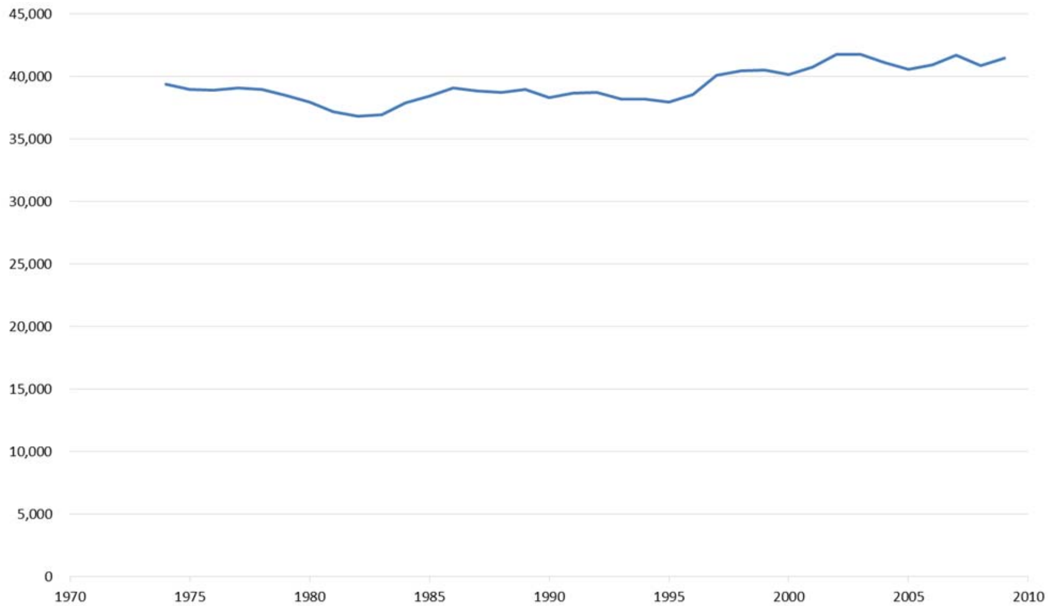
B. The stagnation of middle class income

There is great concern about the tremendous harm caused by the financial meltdown and ensuing recession, but the middle class in the United States has experienced almost no income growth for the past 30 years. Incomes by a variety of measures have grown barely faster than inflation. For example, figure 12 shows that median earnings for full-time, full-year workers grew by only 0.15% per year from 1974 to 2009 after adjusting for inflation. Some point out that total compensation has grown faster because most workers still get health insurance at work and the cost of health insurance has far outstripped inflation. But I doubt that workers perceive more economic gain when it's explained that almost all of their pay increases have gone to pay for increasingly expensive health insurance.

Figure 12. Median Earnings for Full-Time, Full-Year Workers, in 2009$, 1974-2009



Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements.

C. Extreme inequality and the risk of a populist revolt

Economists can't help but marvel at the magic of the capitalist system. It is unsurpassed for producing great abundance at low cost, but it doesn't guarantee that the benefits will be widely shared. President Kennedy's famous metaphor is not robust. A rising tide doesn't necessarily lift all boats.

While I view this as undesirable in its own right, I'd argue that even those who do not care about inequality *per se* should be concerned about this trend. If the bottom 60 or 80 of the population feel like they're not getting their fair share, that could lead to a populist revolt. Voters might be tempted to support populist calls for trade restrictions, more regulation, or throwback policies like a return to the gold standard. Any of those responses could be extremely detrimental to economic growth. For that reason, those who benefit most from the current system have an incentive—completely beyond any notion of altruism—to try to mitigate extreme inequality in ways that entail less economic cost.

To be sure, the best approach is to provide more economic opportunities, such as better and more affordable education, but not everyone can or should go to college. The income tax plays an important auxiliary role. It's second best because it adjusts outcomes rather than opportunities, but equalizing opportunity is simply impossible.

D. The Cost of Progressive Income Taxation

A progressive income tax does a number of things. It mitigates inequality, provides a form of insurance, and weakens economic incentives. The first point is obvious. A schedule of rising tax rates means that high-income people pay a much larger share of their income in taxes than lower-income people.

The insurance aspect of progressive taxation is less well understood. With taxes, government becomes a kind of partner—albeit an involuntary one. When taxpayers do well, they pay a lot of tax. When things go badly, they pay less (or even get a net subsidy). Even a flat tax reduces the variance of after-tax returns (since the government takes on a fraction, t, of any gain or loss, where t is the tax rate), but a progressive income tax allows for a higher level of consumption when things go badly than a flat tax system that raised the same amount of revenue. Effectively, it provides insurance in the case of bad luck. (And, just like real insurance, it also provides less incentive to avoid bad outcomes—a cost that I discuss below.) To the extent that the income distribution reflects luck, most of us would prefer a system that smooths after-tax incomes (for the same reason that we buy insurance).

Economist Hal Varian (1980), who developed the theory of taxation as insurance in a seminal paper, argued that this aspect of taxation might justify especially high tax rates on people with very high incomes—say over $1 million per year. The logic is that incomes that high must have a substantial luck component. It is not plausible that people reach that level of income simply by working especially hard or saving more much than their neighbors. To the extent that very high incomes derive from factors outside taxpayers' control, taxing those incomes at high rates might have little or no effect on their behavior. However, that theory did not account for the possibility of tax shelters that may be especially attractive to those with high incomes.

As noted, the obvious downside of progressive taxation is that it weakens economic incentives. However, most economic evidence suggests that taxpayers' real responses to the individual income tax are small. One might expect high tax rates to deter work and saving, but in fact, the effects are ambiguous. On the one hand, a higher tax rate reduces the reward to both activities. (Economists call this the substitution effect.) On the other hand, by making taxpayers feel poorer, taxes can ironically provide an incentive to work or save more. (This is called the income effect.) For example, a taxpayer whose living expenses are inflexible may need to work harder to make ends meet when take-home pay falls. Someone saving for retirement needs to save more to reach a target level of retirement income if the after-tax rate of return declines. The overall response of both work and saving to taxation is the sum of the substitution and income effects. Empirically, the total response appears to be very small or even zero on average. Surely some people work or save less when taxes go up, but others choose to work or save more.

There are two parts to the labor supply response: participation and hours. Evidence suggests that hours worked is not very responsive to tax rates, but participation (the decision of whether to work or not) is somewhat more sensitive, especially for second earners and those with low incomes. Recent policies tend to encourage participation in both groups. Marriage penalty relief enacted over the past 10 years reduces the marginal tax rates facing many second earners, providing more incentive to enter and stay in the work force. The earned income tax credit and the refundable portion of the child tax credit are contingent on earnings providing a strong incentive for low-income people to enter the work force. Without earnings, they cannot claim the credits.

As for those with very high incomes, their labor supply is unlikely to be very responsive to taxation. Otherwise, people earnings millions of dollars a year would be working hundreds or thousands of times as hard as people with moderate incomes, which is implausible. One theory of wage inequality at the top is the "winner take all" model, which suggests that the people at the very top echelons earn many times as much as people who are quite talented, but a rung below. This suggests that the penalty to slacking off, even a little bit, would be much more than could be effected by taxation. Compare the salaries of vice presidents with CEOs, triple-A baseball players with major league starters, summer stock actors with Broadway stars. It seems highly unlikely that top performers would slack off in response to higher taxation. And, as noted earlier, luck plays a larger role in the incomes of the super-rich than the rest of us. Overall, evidence suggests that their labor supply is insensitive to tax rates.

However, there are other ways to skirt tax liability, legally and not, and those appear to be more responsive to taxation. Those responses are not typically as economically costly as real responses. If a corporate executive chooses to squirrel away a few hundred thousand dollars in deferred compensation, there may be a loss to the Treasury but there's unlikely to be much of an effect on the real level of economic activity. However, if that executive invests in complex tax shelter arrangements, those might entail a real cost to the economy for several reasons. First, some of the kinds of investments that make good tax shelters would make no sense absent tax considerations. As a result, capital may be allocated to less productive investments than it would without the tax incentives. Second, the kinds of people who invent complex tax shelters could otherwise be doing productive work. Their work on shelters, as inventive as it might be, does nothing to make us more competitive or produce goods and services that real people might want to buy. So tax avoidance is wasteful.

In some cases, the avoidance might actually reflect Congress's priorities. For example, if I decide to save more for retirement to avoid tax, presumably that's exactly what Congress had in mind when it created tax-free retirement accounts. Those incentives are stronger at higher tax rates. And some people might decide to take a chance on starting a business because it is a good way to avoid tax. Businesses can deduct expenses that employees can't, and many of them choose not to report all the income that the IRS thinks should be taxed. Both legal avoidance and shadier evasion activities are more profitable at higher tax rates. If you want to encourage people to go into business for themselves, raising tax rates would provide a boost.

However, to the extent that tax shelters become more prevalent at high incomes, the economic cost of raising top rates will increase at the same time that the revenue yield diminishes. The best ways to address this problem are to eliminate loopholes that enable tax avoidance and raise the likelihood of detection and penalties for illegal tax evasion. And the biggest loophole is the lower tax rate on capital gains, as I discuss in the next section.

There is an upper bound on productive tax rates—in the sense that higher rates could actually reduce revenue (an effect made famous by Arthur Laffer and his napkin). A survey by economists Peter Diamond and Emmanuel Saez (2011) estimated that the revenue-maximizing federal income tax rate was "conservatively" 48 percent assuming the existing tax base and could be as high as 76 percent if the tax base were much broader. Evidence from other studies also suggests that current rates are safely below the unproductive level.

The "right" rate ultimately depends on spending. After the economy recovers, government should be paid for (although small deficits might be justifiable as I explained earlier). If the low marginal tax rates lead to larger deficits, even if the lower rates boost the economy in the short run, the much higher tax rates required to pay back the debt with interest in the future will entail a far bigger economic cost than setting rates at the level required to tame deficits and keeping them there. Studies by the nonpartisan staffs of the JCT, CBO, and Treasury (all under Republican appointees) reached this conclusion. Policymakers must figure out what government needs to do and, after the economy has recovered from this nasty recession, pay for it. That will probably require higher tax rates or significant tax reform.

E. Tax Rates on Capital Gains

A key element in the progressivity of the tax system—and the debate about how progressive it should be—is the tax treatment of capital gains. Long-term capital gains (those on assets held at least one year) and qualifying dividends are taxed at a top rate of 15 percent. By comparison, the top tax rate on other income is 35 percent. If Congress does nothing, the rates on gains will increase to 20 percent in 2013 and the top rate on dividends will return to 39.6 percent. Moreover, the Affordable Care Act included a surcharge on investment income of 3.8 percent, which would raise the effective rates to 24 and 44 percent.

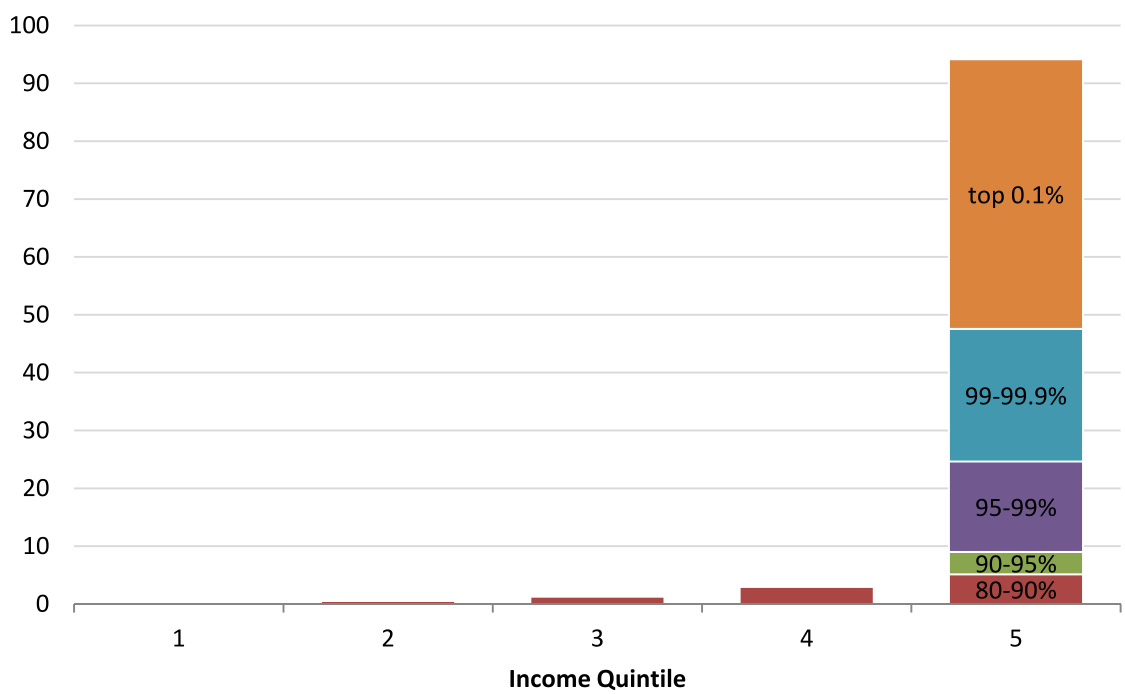
While long-term capital gains have been taxed at lower rates than other income for most of the history of the income tax, dividends have only been taxed at a lower rate since 2003. The argument for a lower dividend tax rate is that corporation income is already taxed at the company level. Taxing the dividends again corresponds to double taxation. A similar argument is often made to justify lower capital gains tax rates. However, the lower rate is a very imperfect offset. While some corporations pay a lot of tax, some are able to use tax breaks to significantly reduce their effective corporate tax rate.

The ideal adjustment for corporate double taxation — at least from the economist's perspective — would be to "integrate" the individual and corporate taxes. In other words, corporate income would be allocated to shareholders and taxed at individual rates. For technical reasons, however, this is much easier said than done.

While double taxation is a plausible rationale for tax breaks on corporate capital gains and dividends, the lower tax rate also applies to non-corporate capital gains. Burman (2012) explains why these arguments are incomplete or overstated and how, as long as top ordinary income tax rates are not too high, a large preference for capital gains can do more harm than good.

The benefits of a capital gains tax preference are extremely concentrated among those with very high incomes. In 2010, the highest-income 20 percent realized more than 90 percent of long-term capital gains according to the Tax Policy Center. (See Figure 13.) The top 1 percent realized almost 70 percent of gains and the richest 1 in 1,000 households accrued about 47 percent. It is hard to think of another form of income that is more concentrated by income.

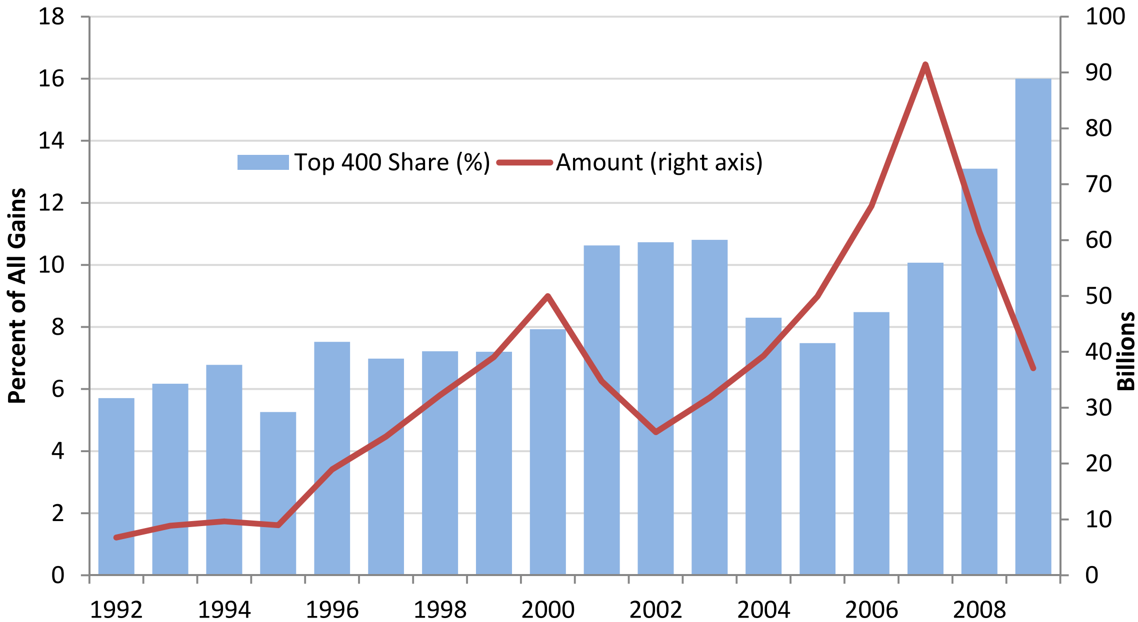
Figure 13. Percent Distribution of Long-Term Capital Gains, by Income Quintile, 2010



Source: Tax Policy Center, http://www.taxpolicycenter.org/T09-0490

The concentration of capital gains has also been growing over time. The IRS has published aggregate data from the income tax returns of the highest-income 400 taxpayers from 1992 to 2009. In 2009, the "fortunate 400" had adjusted gross incomes of at least $77 million. That small group, which corresponded to 0.00028 percent of taxpayers, realized 16 percent of all gains ($37 billion). (See Figure 14.) That share is an all-time high because, even though ultra-high income households' capital gains fell in 2009, the capital gains of other less well off taxpayers fell even more. But Figure 14 shows that the trend toward increased concentration has tended to increase over time.

Figure 14. Share of Capital Gains and Total Amount Realized by 400 Highest-Income Taxpayers, 1992-2009



Source: Internal Revenue Service (2012).

Based on surveys (e.g., Pew Research Center, 2011), a majority of Americans favors a more progressive tax system. A higher level of progressivity could be achieved without raising top ordinary income tax rates by reducing or eliminating the capital gains tax preference. (This approach was taken in 1986 and proposed by the Bowles-Simpson debt reduction commission.) Alternatively, if capital gains tax rates are to be kept low, it will be very difficult if not impossible to cut top income tax rates as part of tax reform while satisfying the public's preferences with respect to the distribution of tax burdens.

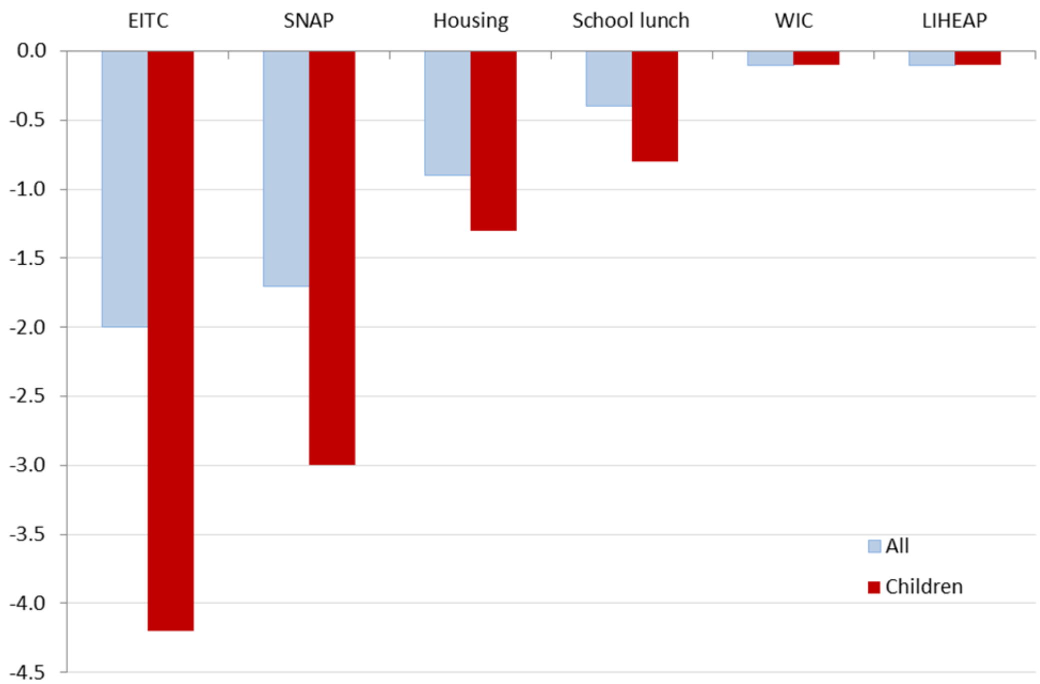
V. The Income Tax and the Social Safety Net

The economic discussion of optimal taxation generally concludes that raising the after-tax incomes of low-income families is socially desirable if the costs in terms of incentive effects are not too great. However, some commentators and at least one presidential candidate have expressed alarm about the nearly 50 percent of families that do not pay income tax, so I am uncertain about whether helping low-income working families and retirees should be considered a widely held policy objective.

A couple of observations: First, many of these people are retirees and most of the rest are low-income working families, many of whom receive refundable credits. Only workers get back more than they owe in income taxes as work is a requirement for claiming the credits. While low-income working families might be exempt from the income tax, they pay payroll taxes. (Payroll taxes are bigger than income taxes for most workers.) As I noted above, encouraging low-income people to work reduces the distortions created by the income tax. In addition, connection to the labor force is important for building job skills (human capital) as well as maintaining personal dignity.

A broader point is that the income tax is now a critical component of the safety net. The Census Bureau (Short 2011) recently developed a new alternative measure of poverty that accounts for the effect of tax and transfer programs on poverty levels. (Astonishingly, under the standard measure of poverty, non-cash transfer programs and tax credits can't reduce poverty because they are not counted in families' incomes.) Under the broader measure, the single most effective program at reducing poverty in 2010 was the Earned Income Tax Credit (EITC). It reduced overall poverty rates by 2 percentage points and the child poverty rate by 4.2 percentage points. (See Figure 15.) Overall, this single program cut child poverty by more than 20 percent. It encourages work and helps a significant fraction of working families and children escape poverty.

Figure 15. Effect of Selected Anti-Poverty Programs on Poverty Rates in 2010



Source: Kathleen Short, "The Research Supplemental Poverty Measure: 2010," US Census, Current Population Reports, P60-241, November 2011.

While the EITC and other tax provisions helping low-income working families, such as the child tax credit, could certainly be simplified, any reform should reflect the fact that many low-income families and children rely upon the tax code as a safety net.

Moreover, most of us receive more from government than we pay for. That's a consequence of the skewed income distribution and progressive tax rates. How much is a robust national defense, research on life saving medicines and basic science, national highways and parks, food safety, air traffic control, the legal system, etc., worth? The only difference between us and the low-income "lucky duckies" (so called by the Wall Street Journal, 2012) is that only some of our benefits are claimed on income tax returns. Many are supplied by traditional government programs.

However, it is potentially problematic for half of Americans to think that government is free. One solution might be to clarify the division between tax obligations and government programs, which are currently commingled on income tax returns. Every year, the IRS could send taxpayers a statement letting them know what they paid in income and payroll tax before subsidies (tax expenditures) as well as the value of those tax subsidies. This would make a few things clear. People might discover that they pay much more in tax than they think, although they get a portion of it back after jumping through the hoops required to claim exclusions, deductions, and credits. Some might decide that they'd rather pay less tax and jump through fewer hoops. (That is, tax reform might become a more attractive option.)

Some might be surprised to see how little they benefit from tax breaks. For example, some homeowners are thrilled that they get to deduct their mortgage interest, charity, and taxes, but many have total deductions not much bigger than the standard deduction. Their mortgage interest is only a benefit to the extent that it (plus the other itemized deductions) exceeds the standard deduction. If that excess is only a few hundred dollars and they're in the 10 or 15% bracket, they might not save enough money to pay for a nice dinner out.

And some people might notice that the IRS is not just in the tax collection business, but in the business of administering 200 or so extraneous public programs. A little thought might suggest that some of those programs are not worth the cost and some others might be better run through traditional agencies that can better administer them.

VI. Conclusion

Economic inequality is rising and the trend is unlikely to abate anytime soon. The income tax serves an important role in reducing income disparities and it has also become an integral element of the social safety net. Nonetheless, the income tax cuts enacted in the last decade have largely served to reduce the progressivity of the income and the nation is likely to be celebrating the centenary of the individual income tax with a rousing debate about whether this is a good or a bad thing.

A key issue surrounds the economic cost of redistribution. Optimal tax theory involves balancing the costs of taxation against the benefits of a less skewed distribution of income. If the costs of taxation are high, then the optimal degree of progressivity is likely to be quite modest. If the costs are low, then the income tax can mitigate inequity with only modest costs to the overall economy.

Much of the debate has surrounded the issue of whether to raise top individual income tax rates, and, as I explain above, the economic cost of higher tax rates is likely significantly smaller than supply siders would have us believe. However, an even better option would be to achieve equity goals primarily through broadening the tax base, and especially taxing capital gains more like other income. The differential in tax rates between capital gains and other income is a prime driver of inefficient tax shelter activity. It entails economic costs through the misallocation of capital into investments especially conducive to providing tax shelter and labor into activities that pay in the form of capital gains (and into designing complex tax shelters). Moreover, capital gains are highly skewed towards high-income taxpayers. Taxing capital gains, combined with cuts in other tax expenditures, might allow for cuts in income tax rates while maintaining or even enhancing progressivity.

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