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# Inequality and the Deficit

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## **INEQUALITY AND THE DEFICIT**

Stephen B. Cohen<sup>1</sup>

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### **ABSTRACT**

*The enormous increase in economic inequality in the United States should play a central role in public discourse about the federal deficit. This essay reviews statistical evidence of trends in the distribution of income and wealth in the United States. The evidence demonstrates a dramatic increase in economic inequality. The gap between the rich and poor, and between the rich and the middle class, is today wider than at any other time in the past four decades.*

### **I. INTRODUCTION**

The enormous increase in economic inequality in the United States should play a central role in public discourse about the federal deficit. President Barack Obama and congressional Republicans agree that the deficit must be reduced dramatically but disagree profoundly on how to do it. Republicans favor lower taxes on the wealthiest Americans, increased defense spending, and draconian cuts in entitlement programs, such as social security and Medicare. The President would repeal tax breaks for the wealthiest, cut defense spending, and preserve, to the extent possible, entitlement programs for lower and middle-income groups. There is consequently a profound difference in how they would allocate the burden of deficit reduction among economic classes.

The case for the President's approach depends partly on the claim that economic inequality has increased dramatically and that deficit reduction must not aggravate this increase. The President, however, has explained neither the factual basis for the claim that inequality has increased, nor the magnitude of increased inequality.

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In his losing battle not to extend the Bush tax cuts to the wealthiest Americans until the end of 2012, for example, the President only repeated generalities about inequality and did not provide specific and detailed factual support for the claim that inequality has mushroomed. Without specific and detailed explanation of the facts, it will be difficult to marshal public support for spending cuts and tax increases that do not aggravate the massive increase in inequality over the last forty years.

This essay reviews statistical evidence of trends in the distribution of income and wealth in the United States. The evidence demonstrates a dramatic increase in economic inequality. The gap between the rich and poor, and between the rich and the middle class, is today wider than at any other time in the past four decades.

## II. CENSUS BUREAU ESTIMATES OF AFTER-TAX INCOME

Income can be measured either before taxes or after taxes. In principle, however, differences in income, or income inequality, ought to be ultimately judged on the basis of income *after* rather than before taxes. It is only income after taxes that individuals can freely spend. Moreover, income inequality before taxes may decrease, remain the same, or increase after tax, depending on the degree to which the tax burden is progressive, proportional, or regressive.

The U.S. Census Bureau has provided estimates of the distribution of after-tax income shares from 1980 to 2001.<sup>2</sup> This twenty-two-year period is important for two reasons. First, it included the longest period of sustained peacetime growth in U.S. history, along with historically low rates of

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<sup>2</sup> U.S. Census Bureau, Table RDI-3: Share of Aggregate Before and After Tax Income Received by Each Fifth and Top 5 Percent of Households: 1980 to 2001, <http://www.census.gov/hhes/www/income/data/historical/measures/rdi3/html>. The Bureau stopped providing such distributional estimates for years after 2001, apparently for political reasons. The dramatic increases in inequality would have made it more difficult to justify the 2001 federal income tax reductions that disproportionately benefited the top of the income scale.

unemployment and inflation.<sup>3</sup> Second, although economic growth during this period was unprecedented, the growth did not benefit all economic classes to the same degree. The upper classes reaped most of the gains. The rising tide lifted the biggest boats most of all and did little to help all others.<sup>4</sup>

The Census Bureau's after-tax income estimates are derived from monthly surveys of 50,000 respondents.<sup>5</sup> Income is determined on the basis of the household, defined as including "all people who occupy a housing unit," whether related or unrelated.<sup>6</sup> The Bureau's definition of before-tax income includes a wide variety of cash receipts (many of which are not subject to taxation) including the following: earnings, unemployment compensation, workers' compensation, social security, supplemental security income, public assistance, veterans' payments, survivor benefits, disability benefits, retirement income, interest, dividends, rents, royalties, educational assistance, alimony, child support, and financial assistance from outside the household.<sup>7</sup>

The taxes subtracted from before-tax income to arrive at an after-tax income figure include federal and state income taxes, payroll taxes, and state and local real property taxes.<sup>8</sup> In addition, the after-tax income figures include

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<sup>3</sup> U.S. President, Economic Report of the President, pp. 3, 19-21 (2001), [http://www.gpoaccess.gov/usbudget/fy02/pdf/2001\\_erp.pdf](http://www.gpoaccess.gov/usbudget/fy02/pdf/2001_erp.pdf).

<sup>4</sup> In Frankfurt, Germany, President John F. Kennedy said, "As they say on my own Cape Cod, a rising tide lifts all the boats." John F. Kennedy's Address in the Assembly Hall at the Paulskirche in Frankfurt, Published Papers, p. 519 (June 25, 1963), <http://www.presidency.ucsb.edu/ws/index.php?pid=9303&st=&st1=#axzz1HouLXFcb>.

<sup>5</sup> U.S. Census Bureau, Current Population Survey (CPS), <http://www.census.gov/cps/>.

<sup>6</sup> U.S. Census Bureau, Current Population Survey (CPS) - Definitions and Explanations, <http://www.census.gov/population/www/cps/cpsdef.html>.

<sup>7</sup> *Id.*

the substantial direct cash payments provided to lower income households by the earned income tax credit.<sup>9</sup>

Using this data, the Census Bureau calculates the shares (that is, proportions) of total after-tax income held by each of five percentile ranges of households ranked in ascending order from those with the lowest to the highest incomes.<sup>10</sup> The Bureau also makes an additional calculation of the share of after-tax income held by the 96th to the 100th percentile, the richest 5% of all households. From 1980 to 2001 (the last year for which figures are currently available from the Census Bureau), the shares of after-tax income received by households in each category decreased or increased as follows:

<u>PERCENTILE</u>	<u>1980 SHARE</u>	<u>2001 SHARE</u>	<u>CHANGE</u>
1 <sup>st</sup> -20 <sup>th</sup>	4.9%	4.4%	-10%
21 <sup>st</sup> -40 <sup>th</sup>	11.6%	10.4%	-10%
41 <sup>st</sup> -60 <sup>th</sup>	17.9%	16.3%	-9%
61 <sup>st</sup> -80 <sup>th</sup>	25.1%	24.0%	-4%
81 <sup>st</sup> -100 <sup>th</sup>	40.6%	44.9%	+10%
96 <sup>th</sup> -100 <sup>th</sup>	14.1%	18.2%	+29%

The data indicate a dramatic increase in income inequality. The share of after-tax income received by the richest one-fifth of all households increased, while the shares of after-tax income received by all other household categories declined. At the top of the income scale, the share of the richest 5% of households rose the most. The lion's share of the increase in the top quintile went to households, which themselves were at the top of that top quintile.

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Once the raw data has been assembled, it needs to be organized in order to judge the degree of economic inequality. As a first step, households are arranged in rank order from poorest to richest. This ranking is then divided into equal percentiles. Each percentile's share of society's total income or wealth is then computed. Year-to-year changes in the relative shares of income held by different percentiles can then be observed.

### III. LIMITATIONS OF THE BUREAU'S AFTER-TAX INCOME DATA

The Census Bureau emphasizes several limitations of this measure of after-tax income. First, most noncash benefits are excluded. Thus, neither the value of government goods and services nor imputed income from property is included. Second, capital gains, whether realized or unrealized, are not counted at all. Third, because the Census Bureau relies on the responses of those surveyed, its income figures are vulnerable to underreporting.<sup>11</sup>

Different limitations in the definition and measurement of income have different impacts across income classes. In the aggregate, these biases may cause the degree of economic inequality to be overstated or understated for any given year. Nevertheless, if the biases have not had significantly different effects from one year to another, then they should not affect conclusions about whether inequality has increased or decreased over time.

However, over the period from 1980-2001, the effects of excluding government goods and services and capital gains have probably changed. Government in-kind programs benefiting the poor contracted, while stock market values and therefore capital gains (which accrue primarily to top income groups) rose considerably over the period as a whole. An uncounted component of the income of lower classes declined, while an uncounted component of the upper classes increased. Therefore, this data on after-tax income shares from 1980-2001 probably understates the actual increase in income inequality.

### IV. GINI COEFFICIENTS AND INCOME DEFINITIONS

In order to facilitate comparisons, economists have devised a single index number, the Gini Coefficient, which provides a summary measure of the degree of economic inequality.<sup>12</sup> The Gini Coefficient measures the overall deviation of

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<sup>11</sup> U.S. Census Bureau, *supra* note 5.

<sup>12</sup> To derive this figure, economists graph the cumulative percent of the population (the x-axis) against the cumulative percent of the income or

the actual distribution of income from perfect income equality: the higher the Gini Coefficient, the greater the deviation from perfect equality and therefore the more unequal the actual distribution of income.

For the years 1979-2003, the Census Bureau has published Gini Coefficients for fifteen alternative definitions of household income.<sup>13</sup> The definitions differ in the degree to which they account for taxes, government transfers, noncash benefits, and imputed income from property. For example, Definition 1 is the least comprehensive. It includes only money income, excluding capital gains, and is calculated before taxes. Definition 15 is the most comprehensive. It includes realized capital gains, noncash government transfers, and imputed income from housing and is calculated after taxes.

For each of these fifteen different income definitions, without exception, the Gini Coefficient rose during the period from 1979 to 2003. For example, the Gini Coefficient for Definition 1 (the least comprehensive) increased from .403 to .450 and for Definition 15 (the most comprehensive) from .352 to .390.

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wealth held by that percent of the population (the y-axis), producing a line known as a Lorenz curve. To provide a frame of reference, a line is drawn to represent perfect economic equality. Under perfect economic equality, the two percentages would always be equal. One percent of the population would receive 1% of the income, 2% of the population would receive 2% of the income, and so on. Thus, the graph showing perfect economic equality would comprise a straight line drawn at a 45-degree angle. In the real world of economic inequality, the cumulative share of the population is always greater than the share of income that it receives. As a result, the real world Lorenz curve deviates from the diagonal line. The greater the deviation from the diagonal line, the greater the deviation from perfect economic equality. The Gini Coefficient is the ratio of the area between the 45-degree line (representing perfect equality) and the Lorenz curve (showing the cumulative percent of income or wealth held by that percent of the population) over the entire area under the diagonal line. Thus, the greater the deviation from equality, the greater the area between the two lines, and therefore the higher the Gini Coefficient.

<sup>13</sup> U.S. Census Bureau, Table RDI-5: Index of Income Concentration (Gini Index), by Definition of Income: 1979 to 2003, <http://www.census.gov/hhes/www/income/data/historical/measures/rdi5.html>.

In addition to Gini Coefficients for income of *households*, the Census Bureau calculates Gini Coefficients for before-tax money income (exclusive of capital gains) of *families*.<sup>14</sup> For this purpose, a family is defined as “a group of two or more people related by birth, marriage or adoption and residing together.”<sup>15</sup> The Gini Coefficient for family income before-taxes increased from .365 in 1980 to .443 in 2009.

These Gini Coefficients demonstrate that trends in income inequality are the same for a broad range of different definitions of income. The data all point consistently in the same direction. Whether income is measured before tax or after tax, whether income includes or excludes various kinds of nonmarket items, and whether income is determined on a household or family basis, economic inequality in the U.S. increased substantially during the last two decades or so of the twentieth century.

#### V. ADJUSTING FOR HOUSEHOLD AND FAMILY SIZE

The Census Bureau data for income shares and Gini Coefficients do not take into account the *number of people* residing within the household or family unit. However, smaller units need less income to achieve a given standard of well-being. Therefore, if the average size of a household or family varies with the unit’s income, the data will either exaggerate or understate the degree of economic inequality for any given year.

For example, suppose that in a given year, higher income families include more members on average than all other families. The data for that year will exaggerate the relative advantage of the average higher income family whose income must be shared by more members than in smaller families. Conversely, suppose that, in a given year, poor families have more members on average than

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<sup>14</sup> U.S. Census Bureau, Table F-4: Gini Coefficients for Families, by Race and Hispanic Origin of Householder: 1947 to 2009, <http://www.census.gov/hhes/www/income/data/historical/families/index.html>.

<sup>15</sup> U.S. Census Bureau, *supra* note 6.



others. The data for that year will understate the relative disadvantage of the average poor family whose income must be shared by more members.<sup>16</sup>

Provided such differences in average family size do not vary significantly from one year to another, they should not affect conclusions about whether inequality has increased or decreased over time. However, if lower and middle class families are becoming relatively smaller (or larger) than wealthy families, then the data will overstate (or understate) increases in economic inequality.

To correct for differences in family size, the Census Bureau employs yet another measure of economic inequality: the ratio of actual family income to income at the poverty threshold. The poverty thresholds vary to reflect both the number of family members and economies of scale in supporting those members.<sup>17</sup> The higher the ratio of actual income to the income at the poverty threshold, the greater the family's economic well being. The Census Bureau organizes the data to show the average income to poverty threshold ratios for five different ranges based on percentile rankings.<sup>18</sup> The table below displays the changes in such ratios between 1980 and 2001:

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<sup>16</sup> Appendix K, in House Comm. on Ways and means, 103d Cong., 1st Sess., Overview of entitlement Programs: 1993 Green Book—Background Material and Data on Programs Within the Jurisdiction of the Comm. on Ways and Means, pp. 1465, 1488-89 (Comm. Print 1993).

<sup>17</sup> Daniel Weinberg, A Brief Look at Postwar U.S. Income Inequality, in U.S. Census Bureau, Current Population Reports: Household Economic Studies (June 1996), <http://www.census.gov/prod/1/pop/p60-191.pdf> .

The Census Bureau calculates poverty thresholds by using the Economy Food Plan published by the Department of Agriculture. Since a Department of Agriculture survey indicated that families spent about one-third of their income on food, the thresholds were set at three times the cost of the Economy Food Plan.

<sup>18</sup> U.S. Census Bureau, Historical Income Tables, Table F-21: Average Income-to-Poverty Ratios for Families, by Income, Quintile, Race, and Hispanic Origin of Householder: 1967 to 2009, <http://www.census.gov/hhes/www/income/data/historical/families/index.html>.

<u>PERCENTILE</u>	<u>1980 RATIO</u>	<u>2001 RATIO</u>	<u>CHANGE</u>
1 <sup>st</sup> -20 <sup>th</sup>	1.03	1.06	+3%
21 <sup>st</sup> -40 <sup>th</sup>	2.17	2.39	+10%
41 <sup>st</sup> -60 <sup>th</sup>	3.11	3.64	+17%
61 <sup>st</sup> -80 <sup>th</sup>	4.20	5.23	+25%
81 <sup>st</sup> -100 <sup>th</sup>	6.82	10.78	+58%

According to these figures, the ratio of income to the poverty threshold was higher for all five groups in 2001 than in 1980. However, the ratio increased more for families higher up the income scale. The increase in the ratio for the richest 20% of families was nearly twenty times the increase for the poorest 20%. The changes in income to poverty threshold ratios demonstrate that, when variations in family size are taken into account, economic inequality has increased even more over the period.<sup>19</sup>

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<sup>19</sup> Increases in average income-to-poverty ratios imply that average incomes have risen over this period, and other data appears to support this implication. Despite increasing income inequality, the average after-tax household income appears to have risen for all quintiles. Calculations based on CBO data, for example, indicate increases in real incomes between 1979 and 2006, in ascending order from the lowest to the highest quintiles of 11%, 18%, 21%, 32%, and 55%. Jacob S. Hacker and Paul Pierson, Winner-Take-All Politics: How Washington Made the Rich Richer and Turned Its Back on the Middle Class, p. 23 (2010). While the top quintiles have had the largest increases, the average income had increased even for the lowest quintile. However, these increases (except for the top quintile) may be more apparent than real for at least two reasons.

First, families are working more hours per week than before. For example, for the period from 1979 to 2002, married couples with children increased their working hours on average by an estimated 16% or almost 500 hours per year. Jared Bernstein and Karen Kornbluh, Running Faster to Stay in Place: The Growth of Family Work Hours and Incomes, p. 1 (2005), [http://www.newamerica.net/publications/policy/running\\_faster\\_to\\_stay\\_in\\_place](http://www.newamerica.net/publications/policy/running_faster_to_stay_in_place).

The increase in hours working outside the home means that there is less time for housekeeping, childcare, and other household work, all of which generate imputed income from services. This loss of imputed income from services due to increased hours working outside the home is not reflected in data on changes in real incomes over time.

## VI. CONCENTRATION AT THE VERY HIGH END

The Census Bureau does not provide information about income shares at the very high end, which might be defined as the top 1%, that is, or those whose income place them above the 99<sup>th</sup> percentile.<sup>20</sup> However, the Congressional Budget Office (CBO), a nonpartisan research office of the U.S. Congress, does provide such estimates by supplementing the Census Bureau data with Internal Revenue Service statistics on incomes reported on federal tax returns.<sup>21</sup> CBO's definition of income (unlike that of the Census Bureau) includes both realized capital gains and income in kind. In addition, the CBO adjusts its estimates to reflect household size, and the estimates themselves cover a different (although overlapping) period from 1979 to 2007 (the last year for which figures are now available).<sup>22</sup>

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Second, inflation adjustments that make the data from different years comparable do not seem to reflect adequately increases in the cost of housing, which is the largest single expenditure for most households. According to a study by Prof. Robert H. Frank, the median earner, who had to work 41.5 hours monthly to pay for a home in 1970, had to work 67.5 hours monthly to pay for an equivalent home in the year 2000. Robert H. Frank, *Supplementing Per-Capita GDP as Measure of Well-Being*, pp. 8-9 (2011), <http://www.scribd.com/doc/46504495/Supplementing-Per-Capita-GDP-as-Measure-of-Well-Being>.

<sup>20</sup> This information is not available because the Census Bureau records income amounts only up to fixed limits. Income above the limit is recorded simply as being above that amount. For example in 1966, the Census Bureau recorded incomes above \$1 million as being \$1 million or more. Frank Levy, *The New Dollars and Dreams*, p. 205 (1998).

<sup>21</sup> Congressional Budget Office, *After-Tax Income Shares for All Households, by Household Income Category, 1979-2006*, [http://www.cbo.gov/publications/collections/tax/2009/after-tax\\_income\\_shares.pdf](http://www.cbo.gov/publications/collections/tax/2009/after-tax_income_shares.pdf).

<sup>22</sup> CBO explains:

The Bureau of the Census and the Congressional Budget Office (CBO) both produce statistics on the distribution of income. The

The CBO has calculated that shares of after-tax income received by households in each of the five quintiles category decreased or increased as follows:

<u>PERCENTILE</u>	<u>1979 Share</u>	<u>2007 Share</u>	<u>Change</u>
1 <sup>st</sup> -20 <sup>th</sup>	6.8%	4.9%	-28%
21 <sup>st</sup> -40 <sup>th</sup>	12.3%	9.4%	-24%
41 <sup>st</sup> -60 <sup>th</sup>	16.5%	14.1%	-15%
61 <sup>st</sup> -80 <sup>th</sup>	22.3%	20.0%	-10%
81 <sup>st</sup> -100 <sup>th</sup>	42.4%	52.5%	+24%

CBO then breaks down the top quintile to calculate income shares held by the top 10%, 5%, and 1% of families as follows:

<u>PERCENTILE</u>	<u>1979 Share</u>	<u>2007 Share</u>	<u>Change</u>
TOP 10%	27.5%	38.7%	+41%
TOP 5%	18.1%	29.3%	+62%
TOP 1%	7.5%	17.1%	+128%

The top quintile is the only group whose income share increased during the period. In addition, these data indicate that increases in income shares were especially concentrated in the very richest families at the very high end. From 1979 to 2007, the after-tax income share of the richest 1% of families went up by a striking 128%, while the share of all families in the 96th to 100th percentiles

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Census Bureau's statistics are a product of its annual March Current Population Survey (CPS); CBO's are a by-product of its analyses of the distribution of tax liabilities. Although both offices base their distributional studies on the CPS, they differ in the sources of income they consider, how they adjust data on incomes for underreporting and concerns about confidentiality, and the measure of income they use to rank households. The alternative methodologies result in different estimates of the distribution of income among quintiles (fifths of the distribution), but the trends in the distribution over time are similar under both approaches.

Congressional Budget Office, Historical Effective Tax Rates, 1979-1997, Appendix F, Comparing Income Statistics from CBO and the Bureau of the Census (2001).

rose by 62%, and the share of all families in the 91st to 100th percentiles by 41%. Families below the 80th percentile experienced decreases in their shares.

Work by Professors Thomas Piketty and Emmanuel Saez illustrates even more dramatically the extreme concentration of gains at the very top of the income scale between 1968 and 2008. Using data provided by U.S. tax authorities, they calculated before-tax income shares for families in the top 10%, the top 5%, the top 1%, the top .5%, the top .1% and the top .01%.<sup>23</sup>

<u>PERCENTILE</u>	<u>1968 Share</u>	<u>2008 Share</u>	<u>Change</u>
TOP 10%	31.98%	45.60%	43%
TOP 5%	20.98%	33.36%	59%
TOP 1%	8.35%	17.67%	112%
TOP .5%	5.58%	13.75%	146%
TOP .1%	2.15%	7.77%	261%
TOP .01%	0.58%	3.34%	476%

While all top percentiles have experienced substantial gains in their shares of before-tax income since 1968, the percentage gain increased steadily with income. Those at the very top of the income distribution have done especially well. In particular, among the top 10%, the richer the household or filing unit, the greater the increase in income share. The richest 1/100<sup>th</sup> of one percent of families experienced an astonishing increase of nearly 500% in their share of total before-tax income during the period from 1968 to 2008.

## VII. HISTORICAL TRENDS: 1947-2009

To place rising income inequality since 1980 in a broader historical context, it is necessary to rely on data for family income before taxes, which the Census Bureau has provided beginning with the year 1947.<sup>24</sup> The Census

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<sup>23</sup> Thomas Piketty and Emmanuel Saez, Income and Wage Inequality in the United States, 1913-2002, in A.B. Atkinson and T. Piketty, eds., Top Incomes over the 20<sup>th</sup> Century (2007). The data in this study is supplemented for the years 2003-2009 by The Top Incomes Database, <http://g-mond.parisschoolofeconomics.eu/topincomes/>.

Bureau began compiling data for before-tax *household* income beginning only with 1967<sup>25</sup> and for *after-tax* household income beginning only with 1980.<sup>26</sup>

As noted above, since 1980, changes in before-tax family income inequality have closely resembled changes in household income inequality measured by a wide variety of before-tax and after-tax definitions. Therefore, it is plausible to rely on before-tax family income data as a reasonable indicator of historical trends in income inequality.

The before-tax family income data divide into two distinct periods: 1947-1968 and 1968-2009 (with 2009 being the most recent year for which the data is available). From 1947 to 1968, there was a steady decrease in income inequality, as shares of before-tax family income changed as follows:

<u>PERCENTILE</u>	<u>1947 SHARE</u>	<u>1968 SHARE</u>	<u>CHANGE</u>
1 <sup>st</sup> -20 <sup>th</sup>	5.0%	5.6%	+12%
21 <sup>st</sup> -40 <sup>th</sup>	11.9%	12.4%	+4%
41 <sup>st</sup> -60 <sup>th</sup>	17.0%	17.7%	+4%
61 <sup>st</sup> -80 <sup>th</sup>	23.1%	23.7%	+3%
81 <sup>st</sup> -100 <sup>th</sup>	43.0%	40.5%	-6%

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<sup>24</sup> U.S. Census Bureau, Table F-2, Share of Aggregate Income Received by Each Fifth and Top 5 Percent of Families: 1947 to 2009, <http://www.census.gov/hhes/www/income/data/historical/families/index.html>. Starting with 1947, questions were asked about two categories of money income: employment income and income from all other sources. The number of questions has now expanded to cover “more than 50 different sources of income, including noncash income sources such as food stamps, school lunch program, employer-provided group health insurance plan, employer-provided pension plan, personal health insurance, Medicaid, Medicare,” and other forms of government aid.

<sup>25</sup> U.S. Census Bureau, Historical Income Tables, Table H-2: Share of Aggregate Income Received by Each Fifth and Top 5 Percent of Households (All Races): 1967 to 2009, <http://www.census.gov/hhes/www/income/data/historical/inequality/index.html>.

<sup>26</sup> U.S. Census Bureau, *supra* note 2.

96<sup>th</sup>-100<sup>th</sup>      17.5%      15.6%      -11%

The shares of before-tax income received by all categories of families below the 80th percentile increased during this 1947-1968 period, with the share received by the poorest 20% increasing the most. The share received by the top 20% of families decreased, with the share received by the richest 5% decreasing even more.

Since 1968, the trend has reversed, with income inequality increasing rather than decreasing. The increase in income inequality since 1980, discussed above, is part of this larger trend. From 1968 to 2009, shares of before-tax family income changed as follows:

<u>PERCENTILE</u>	<u>1968 SHARE</u>	<u>2009 SHARE</u>	<u>CHANGE</u>
1 <sup>st</sup> -20 <sup>th</sup>	5.6%	3.9%	-30%
21 <sup>st</sup> -40 <sup>th</sup>	12.4%	9.4%	-24%
41 <sup>st</sup> -60 <sup>th</sup>	17.7%	15.3%	-14%
61 <sup>st</sup> -80 <sup>th</sup>	23.7%	23.2%	-2%
81 <sup>st</sup> -100 <sup>th</sup>	40.5%	48.2%	+19%
96 <sup>th</sup> -100 <sup>th</sup>	15.6%	20.7%	+33%

The shares of income received by all categories of families below the 80th percentile decreased during the 1968-1997 period, with the share of the poorest 20% decreasing the most. The share of income received by the top 20% of families increased by nearly 20%, with the share received by the richest 5% increasing even more, by one-third.

The numbers for the Gini Coefficient for before-tax family income indicate the same historical trends of decreasing income inequality from 1947 to 1968, followed by increasing inequality from 1968 to 2000. From 1947, when the Census Bureau first began collecting data, until 1968, the Gini Coefficient for before-tax family income declined more or less steadily from .376 to .348. Since 1968, however, the Gini Coefficient for this category has risen from .348 to .433 in 2009.<sup>27</sup>

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<sup>27</sup> See U.S. Census Bureau, *supra* note 14.

A Census Bureau report has described these changes in Gini Coefficients:

[T]he Gini index...indicated a *decline* in family income *inequality* of 7.4 percent from 1947 to 1968. Since 1968, there has been an *increase* in income inequality, reaching its 1947 level in 1982 and increasing further since then.<sup>28</sup>

#### VIII. Estimates of Wealth Inequality

Prof. Edward N. Wolff has estimated changes in wealth inequality between 1983 and 2007, relying principally on data collected by the U.S. Federal Reserve Board's triennial Survey of Consumer Finances, supplemented by Internal Revenue Service statistics.<sup>29</sup> According to Prof. Wolff:

Most studies have looked at the distribution of well-being or its change over time in terms of income. However, family wealth is also an indicator of well-being, independent of the direct financial income it provides. There are six reasons. First, owner-occupied housing provides services directly to their owner. Second, wealth is a source of consumption, independent of the direct money income it provides, because assets can be converted directly into cash and thus provide for immediate consumption needs. Third, the availability of financial assets can provide liquidity to a family in times of economic stress, such as those occasioned by unemployment, sickness, or family break-up. Fourth, . . . wealth is found to affect household behavior over and above income. Fifth, . . . wealth-generated income does not require the same trade-offs with leisure as earned income. Sixth, in a representative democracy, the distribution of power is often related to the distribution of wealth.<sup>30</sup>

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<sup>28</sup> Weinberg, *supra* note 17. See also Jack McNeil, Changes in Median Household Income: 1969 to 1996 (1998), <http://www.census.gov/prod/3/98pubs/p23-196.pdf>. McNeil's study presents data showing mean income increasing more rapidly than median income, which provides another indicator of increasing economic inequality. If mean income rises more than the median income, as it has, then more of the benefits of the rising mean accrue to upper income groups above the median.

<sup>29</sup> Edward N. Wolff, Recent Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze—an Update to 2007, Levy Economics Institute of Bard College (2010).

<sup>30</sup> *Id.*, p. 4.



In Prof. Wolff's study, wealth is defined as net worth in nonhuman capital<sup>31</sup> and is measured on a *household* basis. Changes in the shares of net worth held by different ranges of households during this period are listed below.

<u>PERCENTILE</u>	<u>1983 SHARE</u>	<u>2007 SHARE</u>	<u>CHANGE</u>
1 <sup>st</sup> -40 <sup>th</sup>	0.9%	0.2%	-78%
41 <sup>st</sup> -60 <sup>th</sup>	5.2%	4.0%	-23%
61 <sup>st</sup> -80 <sup>th</sup>	12.6%	10.9%	-14%
81 <sup>st</sup> -90 <sup>th</sup>	13.1%	12.0%	-8%
91 <sup>st</sup> -95 <sup>th</sup>	12.1%	11.2%	-7%
96 <sup>th</sup> -99 <sup>th</sup>	22.3%	27.3%	+22%
99 <sup>th</sup> -100 <sup>th</sup>	33.8%	34.6%	+2%

For the 1983-2007 period, shares of total net worth decreased for 95% of all households. Only the top 5% of households, above the 95th percentile, saw their share of net worth increase. Using this data, Wolff also found that the Gini Coefficient for net worth rose during this period from .799 to .834.

In addition, Prof. Wolff estimated the changes in the *dollar amount* of average (that is, mean) net worth holdings for various groups between 1983 and 2007. (The amounts shown are in constant 2007 dollars.)

<u>PERCENTILE</u>	<u>1983</u>	<u>2007</u>	<u>CHANGE</u>
1 <sup>st</sup> -40 <sup>th</sup>	5,900	2,200	-63%
41 <sup>st</sup> -60 <sup>th</sup>	70,600	106,000	+50%

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<sup>31</sup> Prof. Wolff defines net worth to include the following assets (minus liabilities):

- Owner-occupied housing
- Other real estate
- Savings deposits
- Bonds
- Cash surrender value of life insurance
- Cash surrender value of pension plans
- Corporate stock and mutual funds
- Equity in unincorporated businesses
- Equity in trust funds

61 <sup>st</sup> -80 <sup>th</sup>	170,000	291,000	+71%
81 <sup>st</sup> -90 <sup>th</sup>	354,500	641,900	+81%
91 <sup>st</sup> -95 <sup>th</sup>	656,600	1,201,300	+83%
96 <sup>th</sup> -99 <sup>th</sup>	1,510,000	3,656,000	+142%
99 <sup>th</sup> -100 <sup>th</sup>	9,127,000	18,529,000	+103%

The dollar amount of average wealth decreased for households in the bottom 40 percent. Average wealth increased for households in the third quintile, from the 41<sup>st</sup> to the 60<sup>th</sup> percentile by 50% and then by even larger percentages moving up the wealth scale. Prof. Wolff explained that increasing wealth inequality represented a reversal of earlier historical trends and that before 1970 wealth inequality, like income inequality, had been steadily declining.<sup>32</sup>

#### IX. TOP INCOME SHARES IN INDUSTRIALIZED COUNTRIES

As noted above, there have been two distinct trends in the distribution of income in the U.S. over the past sixty plus years. From 1947 to 1968, the U.S. experienced increasing equality in the distribution of incomes. Since 1968, however, inequality has steadily and inexorably grown. How do these trends compare with developments in other industrialized countries?

Prof. Wolff believes that increasing wealth inequality has reversed the relative position of the U.S. vis-à-vis other industrialized nations:

[T]he evidence seems to suggest that in the early part of the twentieth century..., wealth inequality was much lower in the United States than in the United Kingdom, with U.S. figures more comparable to Sweden. America appeared to be the land of opportunity, whereas Europe was a place where an entrenched upper class controlled the bulk of wealth. By the early 1990s, the situation appeared to have completely reversed, with a much higher concentration of wealth in the United States than in Europe.<sup>33</sup>

The U.S. Central Intelligence Agency (CIA) has published data for the Gini Coefficients of before-tax income distribution for different countries that appears

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<sup>32</sup> Edward N. Wolff, Top Heavy: The Increasing Inequality of Wealth in America and What Can Be Done About It, pp. 2, 8-9 (2002).

<sup>33</sup> *Id.*, p. 31.

to support Wolff's comparison.<sup>34</sup> According to the CIA, the Gini Coefficient for the US is higher—thus evidencing more income inequality—than for any other industrialized country. Of course, such comparisons can be misleading, if the procedures for collecting and analyzing the data vary from country to country, as is almost certainly the case. Moreover, the CIA does not disclose the methodology it uses, except to indicate that the data presented is for different years. Nevertheless, the contrast between the U.S. and other industrialized countries is significant. The CIA's Gini figure for the U.S. is .450 (2007), compared for example to .270 for Germany (2006), .327 for France (2008), .247 for Hungary (2009), .320 for Italy (2006), .376 for Japan (2008), and .340 for the United Kingdom (2005).

The most comprehensive comparisons of before-tax income shares of top income groups, covering 23 different countries, are collected in two volumes edited by Anthony B. Atkinson and Thomas Piketty, Top Incomes over the Twentieth Century: A Contrast between Continental European and English-Speaking Countries (2007), and Top Incomes over the Twentieth Century: A Global Perspective (2010). The data in these studies is updated periodically on a related website, The Top income Database.<sup>35</sup>

In only one other industrialized country, the United Kingdom, do top income shares appear to have increased as dramatically as the United States. The Top Income Database includes the study by Professors Piketty and Saez, discussed above, which finds that the share of before-tax incomes received by the top 10% of U.S. families grew from 31.98% in 1968 to 45.60% in 2008, an increase of 43%. In the United Kingdom, the share rose by slightly more, from 28.55% in 1968 to 41.62% in 2005, a 46% increase, although overall inequality as measured by the Gini Coefficient was less.

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<sup>34</sup> Central Intelligence Agency, *Distribution of family income - Gini index*, The World Factbook, [tps://www.cia.gov/library/publications/the-world-factbook/fields/2172.html](https://www.cia.gov/library/publications/the-world-factbook/fields/2172.html).

<sup>35</sup> <http://g-mond.parisschoolofeconomics.eu/topincomes/>.

In France, however, the share of before-tax incomes received by the top 10% of families actually fell from 34.80% in 1968 to 32.81%, in 2006, a decrease of 6%. In Germany, the share rose from 30.30% in 1968 to 35.40% in 1998 (the last year for which data is presented), a 17% increase. In Italy, the share rose from 30.50% in 1974 (the first year for which data is presented) to 32.64% in 2004, a 7% increase.

## X. CAUSES

The dramatic increase in U.S. economic inequality over the past four decades is probably due to multiple causes. These causes include changes in U.S. tax law, the disappearance of constraints on executive compensation and the decline of labor unions.

The marginal income tax rates for high-income taxpayers have fallen more or less steadily since 1968, from a maximum of 70% to 35% today. Moreover, dividends and capital gains, which bulk large for such taxpayers, are now subject to a special top rate of 15%. In addition, under debatable interpretations of the tax law, most of the compensation of hedge fund managers is taxed at this special 15% rate.

Corporate income taxes have also plummeted for two distinct reasons. Until 1986, the flat tax rate applied to most corporate income had hovered around 50%. Since 1986, it has fallen to 35%. In addition, corporate tax shelters have proliferated, reducing substantially the amount of reported corporate income subject to the 35% rate.<sup>36</sup> Moreover, the ownership of corporate stock in the U.S. is heavily concentrated in top income groups. To the extent that the corporate tax is borne by the owners of capital (rather than shifted to consumers, workers, or suppliers), the burden on capital has lessened.

Estate and gift taxes, imposed on intergenerational transfers within the wealthiest families, have dropped considerably. Before 2002, a married couple

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<sup>36</sup> See, e.g., David Kocieniewski, G.E.'s Strategies Let It Avoid Taxes Altogether, *New York Times*, March 25, 2011.

could transfer up to \$1.375 million during their lifetimes to their children (or others) tax-free. Excess amounts were subject to tax at increasing marginal rates of up to 55%. Beginning in 2001, the annual exemption began to rise and the top marginal tax rate began to fall. Currently, a married couple can transfer \$10 million to their children (or others) tax-free and the top marginal tax rate is 35%.

While the progressivity of both the income tax and estate and gift taxes has declined, payroll taxes—which tax labor income at regressive rates—have become even more regressive and thus a more important factor in the total tax burden of low-income and middle-income taxpayers. In 1968, the payroll tax rate was only 8.8%. This rate has since increased to 15.3%.<sup>37</sup>

Moreover, labor income above a ceiling amount (currently \$106,800 and adjusted annually for inflation) is subject to payroll taxes at a rate of only 2.2%, and capital income is entirely exempt from payroll taxes. In addition, the payroll tax, unlike the income tax, does not exempt subsistence level wages from taxation. The very first dollar of labor income earned in any year bears the full brunt of the 15.3% payroll tax. As a consequence of these payroll tax rate increases, the payroll tax burden is actually higher than the income tax burden for two-thirds or more of U.S. taxpayers.<sup>38</sup>

Although taxes rates on top incomes have fallen, the relative before-tax incomes paid to top corporate executives have skyrocketed. In 1968, the average chief executive in the United States earned 29 times the pay of the average worker. By 2005, the average chief executive in the United States earned 262 times the pay of the average worker, an increase in the ratio of chief

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<sup>37</sup> Social Security Administration, Social Security and Medicare Tax Rates, <http://www.ssa.gov/oact/progdata/taxRates.html>.

<sup>38</sup> In 2006, the burden of payroll taxes was higher for two-thirds of U.S. taxpayers. Len Burman and Greg Leiserson, Two-Thirds of Tax Units Pay More Payroll Tax Than Income Tax, *Tax Notes*, April 9, 2007, p. 173. If anything, the ratio has probably increased since 2006.

executive pay to worker pay of over 900%.<sup>39</sup> Moreover, while the ratio of chief executive pay to average worker pay has increased, the ratio of chief executive pay to the pay of other top executive of a given company has remained constant. Thus, large increases in the relative pay of chief executives reflect a general increase in the relative pay of other top executives of U.S. companies.

Piketty and Saez observe:

[T]he increase in top income shares in the last three decades [since about 1968] is the direct consequence of the surge in top wages. As a result, the composition of income in the top income groups has shifted dramatically over the century: the working rich have now replaced the coupon-clipping rentiers.<sup>40</sup>

At the same time, the power of labor unions has declined precipitously. In 1968, 27.9% of working Americans were union members.<sup>41</sup> Forty-two years later, in 2010, the figure was 11.9%.<sup>42</sup> The loss of labor union members and labor union power presumably means that ordinary workers are unable to bargain as effectively for higher wages. Compounding the inability of workers to bargain effectively through unions has been a decline in real terms in the value of the minimum wage. Although the minimum wage amount has increased in nominal dollars, the real value has declined by nearly 30% during the period from

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<sup>39</sup> The data is from a study of Lawrence Mishel of the Economic Policy Institute, [http://www.epi.org/economic\\_snapshots/entry/webfeatures\\_snapshots\\_20060621/](http://www.epi.org/economic_snapshots/entry/webfeatures_snapshots_20060621/).

<sup>40</sup> T. Piketty and E. Saez, *supra* note 19, p. 142.

<sup>41</sup> Gerald Mayer, Appendix A, Union Membership Trends in the United States, Congressional Research Service, Appendix A, August 31, 2004.

<sup>42</sup> U.S. Department of Labor, Bureau of Labor Statistics, Union Members Summary, January 21, 2011, <http://www.bls.gov/news.release/union2.nr0.htm>.

1968 to 2007.<sup>43</sup> In addition, the proportion of jobs covered by minimum wage requirements has fallen.<sup>44</sup>

According to Professors Jacob S. Hacker and Paul Pierson, the decline of labor union power has broader consequences far beyond wage levels:

[O]rganized labor's role is not limited to union participation in the determination of wages. Much more fundamental is the potential for unions to offer an organizational counterweight of the power of those at the top. Indeed, while there are many 'progressive' groups in the American universe of organized interests, labor is the only major one focused on the broad economic concerns of those with modest incomes. In the United States, and elsewhere, unions are the main political players pushing leaders to address middle-class economic concerns and resisting policy changes that promote inequality. Unions also have the resources and incentives to check corporate practices, such as bloated executive pay packages. . . . It is surely no coincidence that nearly all the advanced democracies that have seen little or no shift toward the top 1 percent have much stronger unions than does the United States.<sup>45</sup>

## XI. A CONCLUDING OBSERVATION

President Obama should explain the enormous increase in income inequality since 1968 and the relevance of increased inequality to allocating the pain of deficit reduction. His model could be President Franklin D. Roosevelt.

On March 12, 1933, a few days after taking office, Roosevelt made a speech that helped alleviate the nation's banking crisis. He explained in detail the functioning of banks, the causes of the crisis, and the steps taken by government to restore a sound financial system. He avoided platitudes and generalities. He did not patronize. Roosevelt treated his fellow Americans as intelligent listeners who could comprehend a complex economic problem if

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<sup>43</sup> In constant 2009 dollars, the minimum wage was \$10 in 1968 but only \$7.25 in 2009. In addition, for much of this period, the minimum wage was below the \$7.25 level.  
<http://oregonstate.edu/instruct/anth484/minwage.html>

<sup>44</sup> *Id.*

<sup>45</sup> Jacob S. Hacker and Paul Pierson, *supra* note 24, p. 57.

explained in clear, plain language. Obama should do likewise.