

# **A History of Income Inequality or 5 Myths About Inequality**

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From President Obama to Paul Krugman, Thomas Piketty to Elizabeth Warren, the Left has adopted “inequality” as the cause of the day. They paint a picture of a new Gilded Age in which a hereditary American gentry becomes ever richer, while the vast majority of Americans toil away in near-Dickensian poverty. It’s a compelling political narrative, one that can be used to advance any number of policy proposals, from higher taxes to increases in the minimum wage

As Figure 1 shows, Piketty and others claim that income inequality in the United States is at an all time high and rising. Their data shows that high degrees of inequality was in fact the rule throughout much of US history, but plunged rapidly in the years following World War II. They credit this to a number of factors including the redistributionist policies of Franklin Roosevelt, high marginal tax rates on the wealthy (in particular high tax rates on capital), and the strength of the labor movement, among other things. As these pillars of the modern welfare state have eroded, they contend that inequality has risen. Today, it hovers just below its peak in 1930, (a small dip resulting from the recent recession), and is poised to rise to new heights. Piketty sees no end to this trend, ultimately “threaten[ing] our democratic institutions and values.” As Paul Krugman says, “describing our current era as a new Gilded Age or Belle Époque isn’t hyperbole; it’s the simple truth.”

## **Figure 1**

### **Income inequality in the United States, 1910-2010**

Source: Thomas Piketty, *Capital in the Twenty-First Century*, Figure I.1 Income Inequality in the United States, 1910-2010.

This analysis has led to a vigorous political debate and a variety of policy proposals, ranging from increases in the minimum wage to greater social welfare spending to higher tax rates on the wealthy. Krugman is not far off when he described Piketty’s book as “the most important economics book of the year — and maybe of the decade.” President Obama, Democrats in Congress and liberal academics have raced

to embrace Piketty's theory and to embellish upon it.

Unfortunately, however, bad facts make for bad policy. This is not just a question of bad data, although there have been numerous critiques of Piketty's methodology. Rather, it represents a fundamental misunderstanding of wealth and inequality in the United States.

Let's look at just some of the ways they get it wrong.

### **Myth # 1. Inequality has never been worse.**

Most claims that income inequality is at a record high in the United States are based on a measure of "market income," which does not take into account taxes or transfer payments (or changes in household composition). But failure to consider those factors considerably overstates effective levels of inequality.

For example, the Congressional Budget Office points out that excluding taxes and transfers, the share of national market income earned by the top one percent grew from 8.9 percent in 1979 to a peak of 18.7 percent in 2007, before falling to 14.9 percent in 2010. But simply including taxes would drop that share to 12.8 percent. Transfer payments would shrink the gap even more. After all, the federal government alone currently runs 72 means-tested transfer programs, providing either cash or in kind benefits to the poor. Moreover, using data for tax units rather than households fails to account for the ways household composition has changed and significantly underestimates the income of households near the bottom of the income distribution, making inequality seem worse than it is.

According to Gary Burtless of the Brookings Institution, fully accounting for all these factors actually shows that income inequality between the top one percent and everyone else actually *decreased* in the United States from 2000 to 2010. Another comprehensive study by Richard Burkhauser, controlling for changes in household composition and transfers (both cash and in-kind) found that there were significant gains across the income spectrum from 1979-2007, and for the period 1989-2007. However, gains at the top were smaller than gains at the bottom, meaning by this measure inequality actually decreased from 1989 to the Great Recession.

**Figure 2**  
**Change in After-tax Income by Household Position**  
**in Income Distribution, 2000-2010**

Source: Gary Burtless (2014).

Use of income data may also overstate the growth in inequality because changes in the tax code have caused more private business income inside C-corporations to letting earnings pass through to the owners' individual tax returns via partnerships, LLCs and Subchapter S corporations. From 1980 to 2007, reports the Congressional Budget Office, "the share of receipts generated by pass-through entities more than doubled over the period—from 14 percent to 38 percent." Moving capital income from one tax form to another did not mean the wealth of the top 1 percent increased, it was simply shifted around. In addition, tax changes from 1981 to 1997 to require that more capital income of high-income taxpayers be reported on individual returns, while excluding most capital income of middle-income savers and homeowners. And, finally, there were significant increases in reported capital gains among the top one percent after the capital-gains tax was reduced in 1997 and 2003.

Given these problems, a better way to measure inequality might be to look at differences in relative consumption between income groups.

A study by Kevin Hassett and Aparna Mathur of the American Enterprise Institute found that the "consumption gap across income groups has remained remarkably stable over time... if you sort households according to their pretax income, in 2010 the bottom fifth accounted for 8.7% of overall consumption, the middle fifth for 17.1%, and the top fifth for about 38.6%. Go back 10 years to 2000—before two recessions, the Bush tax cuts, and continuing expansions of globalization and computerization—and the numbers are similar. The bottom fifth accounted for 8.9% of consumption, the middle fifth for 17.3%, and the top fifth for 37.3%."

### **Figure 3**

#### **Share of Consumption Expenditure Across Income Quintiles, 2000 and 2010**

Source: Kevin Hasset and Aparna Mathur, "A New Measure of Consumption Inequality," American Enterprise Institute, June 2012.

Of course, these are all measures of income inequality. Piketty and others are more concerned about the disparity in accumulated wealth. The highest quintile, after all, may be saving their increased wealth rather than spending it. Over time, this can lead to increasing disparity. But even here, the evidence shows that wealth distribution has been relatively stable over the past several decades. According to research using the Federal Reserve's Survey of Consumer Finances, the wealthiest 1 percent of Americans held 34.4 percent of the country's wealth in 1969. By 2010, the last year for which data are available, that proportion had barely risen, to 35.4 percent.

To be sure, there is evidence that recovery from the recession has disproportionately benefited those with higher incomes.

But, it is also true that the share of income taken by the top 1 percent fell from 18.7 percent in 2007, before falling to 14.9 percent in 2010, so they were disproportionately hurt by the

recession. From the trough of the recession, the wealthy have fared better than other income quintiles, but this is largely a return to pre-recession levels rather than a particular burst of new wealth.

Such volatility reflects the greater exposure that the wealthy face to risks associated with investment income. The stock market, for example, declined sharply during the recession, as did, obviously, the value of real estate. Piketty largely dismisses such risks insisting that over time capital grows faster than the economy as a whole, his defining equation of  $r > g$ . That contention has been challenged by Tyler Cowen and others. However, regardless of whether one accepts Piketty's premise over the long-run,

**Myth # 2. The rich don't earn their money.** Much of the debate over inequality is tied together with notions of fairness.

The common image of the rich suggests that they inherited their wealth. And Piketty, in particular, worries that inheritance will lead to much more inequality in the future. But, at least currently, inheritance plays a very small role in why people are wealthy.

About 80 percent of American millionaires are the first generation of their family to attain that status. Only 19 percent receive any significant income or wealth from a trust fund or an estate, and fewer than 20 percent inherited 10 percent or more of their wealth. For the richest 1 percent of Americans, inheritance accounts for just 15 percent of their wealth. No doubt that's still a lot of money, but the plain fact is that most of the rich earn their wealth. Moreover, the role of inheritance has diminished over the last generation. A 2012 study by Chicago Booth Professor Steven Neil Kaplan and Joshua Rauh of Stanford, found that fewer of those who made it on to the Forbes 400 list in recent years grew up wealthy than in previous decades, falling from 60 percent in 1982 to just 32 percent today. Roughly 20 percent of the Forbes 400 actually grew up poor, roughly the same percentage today as it was in 1982. Nor did most individuals on the Forbes 400 list inherit the family business. Kaplan and Rauh found that 69 percent of those on the list in 2011 started their own business, compared with only 40 percent in 1982.

The wealthiest of the wealthy, those with incomes of more than \$30 million for instance, are even less likely to have started out wealthy. Only 19 percent inherited their wealth.

Wage income is responsible for a majority of net worth for wealthy Americans. Among the top 10 percent in terms of wealth, wages accounted for 55.8 percent of their net worth in 2010. This actually represented an increase from 46.2 percent in 2007; it is likely that stock-market losses during the recession increased the role of wages and lowered the contribution of capital gains. Interest and dividends even among this most affluent cohort accounted for less than 10 percent of net worth. Nearly half of high-net-worth households do not have the kind of capital investments in properties, businesses, or stocks that Piketty fears will lead to inherited fortunes and ever-increasing inequality.

Nor are the rich primarily involved in stock trading or other financial services. According to one survey of the top 1 percent of American earners, slightly less than 14 percent were involved in banking or finance. Roughly a third were entrepreneurs or managers of nonfinancial businesses. Nearly 16 percent were doctors or other medical professionals. Lawyers made up slightly more than 8 percent, and engineers, scientists and computer professionals another 6.6 percent. Sports and entertainment figures composed almost 2 percent. The ultra-wealthy are somewhat more likely to be involved in finance, but not much more. Roughly 22 percent of those earning more than \$30 million are involved in “finance, banking, and investments.”

In reality, the rich get rich because they work for it. And they work hard. For example, research by professors Mark Aguiar and Erik Hurst found that the working time for upper-income professionals has increased since 1965, while working time for low-skill, low-income workers has decreased. Similarly, according to a study by the economists Peter Kuhn and Fernando Lozano, the number of men in the bottom fifth of the income ladder who work more than 49 hours per week has dropped by almost 40 percent since 1980. But among the top fifth of earners, work weeks in excess of 49 hours have increased by almost 80 percent. Dalton Conley, chairman of NYU’s sociology department, concludes that “higher-income folks work more hours than lower-wage earners do.”

Research by Nobel Prize-winning psychologist Daniel Kahneman showed that those earning more than \$100,000 per year spent on average less than 20 percent of their time on leisure activities, compared with more than a third of their time for people who earned less than \$20,000 per year. Kahneman concluded that “being wealthy is often a powerful predictor that people spend less time doing pleasurable things and more time doing compulsory things.”

**Myth # 3. The rich stay rich; the poor stay poor.** Certainly some families stay wealthy for generation after generation. Yet it is also true that wealth often dissipates across generations; research shows that the wealth accumulated by some intrepid entrepreneur or businessman rarely survives long. In many cases, as much as 70 percent has evaporated by the end of the second generation and as much as 90 percent by the end of the third.

Even over the shorter term, the composition of the top 1 percent often changes dramatically. If history is any guide, roughly 56 percent of those in the top income quintile can expect to drop out of it within 20 years. Of course, they may retain accumulated wealth, but even by this measure shifts can occur rapidly. Indeed, just as rises in capital markets can make some people rich, declines can wipe out their wealth just as quickly. It is notable that of those on the first edition of the Forbes 400 in 1982, only 35 remain on the list today. Some dropped about because they died, of course. But most simply did not see their wealth grow sufficiently to maintain their place. And, this would not have required

major gains. For instance, Lawrence Summers estimates that even a 4 percent return on their wealth would have kept them on the list. That they were unable to meet even this modest goal suggests that the rich are not continuing to increase their wealth at rates well above the rate of economic growth as claimed by Piketty.

The heirs of great fortunes have done especially poorly. For example, we might think of the DuPonts or Rockefellers as personifying multigenerational wealth, but none of the 16 DuPont heirs are currently on the Fortune 400 list. Nor are any heirs to the Hearst fortune. The Mellons are out too, as are the Dursts and the Searles. Only one Rockefeller is still on the list, 99 year old David Rockefeller, Sr.

At the same time, it remains possible for the poor to become rich, or, if not rich, at least not poor. Studies show that roughly half of those who begin in the bottom quintile move up to a higher quintile within ten years. And their children can expect to rise even further. Almost one out of every five children born to parents in the bottom income quintile will reach one of the top two quintiles in adulthood.

**Myth # 4. Greater inequality means greater poverty.** Although it is a virtual matter of faith on the Left that the poor are poor because the rich are rich, there is little correlation between poverty rates and inequality. Poverty rates have sometimes risen during periods of relatively stable levels of inequality and declined during times of rising inequality. The idea that gains by one person necessarily mean losses by another reflects a zero-sum view of the economy that is simply untethered to history or economics. The economy is not fixed in size, with the only question being one of distribution. Rather, the entire pie can grow, with more resources available to all.

Comparing the GINI coefficient, the official poverty measure and the Meyer-Sullivan Supplemental Poverty Measure (which accounts for taxes and transfers) illustrates that there is no clear relationship between them. As you can see, the GINI coefficient has increased over time, while the OPM has fluctuated mostly in the 13-15 percent range and the Meyer-Sullivan SPM has decreased markedly since 1975. Again the mid 90s are an interesting period, because the inequality was markedly higher than previously, but both the SPM and OPM saw significant decreases.

#### Figure 4

#### Gini Coefficient vs. Poverty Rates, 1967-2011

Sources: Census Bureau; Meyer and Sullivan (2012).

Even if one accepts the contention that inequality has been rising in recent years, it is undeniable that the sort of deep poverty that existed during periods of lesser inequality has been largely eliminated. Take hunger, for example. In the 1960s, as much as a fifth of the U.S. population and more than a third of poor people had diets that did not meet the Recommended Dietary

Allowance (RDA) for key nutrients. Conditions in 266 U.S. counties were so bad that they were officially designated as “hunger areas.” Today, malnutrition has been significantly reduced. According to the Department of Agriculture, just 5.6 percent of U.S. households had “very low food security” in 2013, a category roughly comparable to the 1960s measurements. Even among people below the poverty level, only 18.5 percent report very low food security.

Housing provides another example. As recently as 1975, more than 2.8 million renter households (roughly 11 percent of renter households and 4 percent of all households) lived in what was considered “severely inadequate” housing, defined as “units with physical defects or faulty plumbing, electricity, or heating.” Today, that number is down to roughly 1.2 million renter households (1 percent of all households). In 1970, fully 17.5 percent of households did not have fully functioning plumbing; today, just 2 percent do not.

And if you look at material goods, the case is even starker. In the 1960s, for instance, nearly a third of poor households had no telephone. Today, not only are telephones nearly universal, but roughly half of poor households own a computer. More than 98 percent have a television, and two-thirds have two or more TVs. In 1970, less than half of poor people had a car; today, two-thirds do. Clearly, the material circumstances of poor families have improved significantly despite any possible increase in inequality.

There are relatively few studies looking into the relationship between inequality and poverty, perhaps because the sheer number of variables makes comparisons difficult. But what research there is generally finds that poverty cannot be tied to inequality.

For instance, a 2013 paper by Dierdre Bloome of Harvard finds “little evidence of a relationship between individuals’ economic mobility and the income inequality they experienced when growing up... over a twenty year period in which income inequality rose continuously, the intergenerational income elasticity showed no consistent trend.”

A study by Scott Winship and Donald Schneider finds that the correlation between ‘core’ or ‘across-the-middle’ inequality (gap between 25<sup>th</sup> and 75<sup>th</sup> percentiles) and relative mobility is low, at 0.25. He finds a 50 percent increase in the gap between the 25<sup>th</sup> and 75<sup>th</sup> percentiles of parent income predicts a 3.7 percentile-increase in the gap of average adult income between the richest and poorest child.

## **Figure 5**

### **“Across-the-Middle” Inequality vs. Relative Mobility**

#### **Across U.S. Commuting Zones**

There is no correlation between income share of the top one percent and absolute mobility. In fact, a 20 percentage point increase in the top one percent's share of income actually suggests a 0.5 percentile decline in the gap in average adult income between the richest and poorest children, although this is influenced by outliers such as Jackson Hole. Disregarding these statistical outlier Community Zones, there is no correlation either way. Similarly, the Chetty paper referenced above concluded that there is little or no correlation between mobility and extreme inequality – as measured by the top 1 percent of income.

Interestingly, while all of these studies focus on the last half century, a period when taxes and transfers resulted in widespread redistribution, it is worth noting that even during the so-called “Gilded Age,” when American inequality at was even greater than today, there was significant growth in both wages and employment for workers. For instance, looking at the Report on Manufacturing Industries in the United States from the 1890 Census, we can see aggregate data for manufacturing, and the number of firms, total employment, capital and total wages increased significantly, as the following table shows.

**Table 1**  
**Growth in the Gilded Age, 1880 to 1890**

	<b>1880</b>	<b>1890</b>	<b>Increase</b>
<b>Number of Establishments Reporting</b>	253,852	355,415	40%
<b>Number of Employees</b>	2,732,595	4,712,622	134%
<b>Capital</b>	2,790,372,606	6,525,156,486	72%
<b>Total Wages</b>	947,953,795	2,283,216,529	141%
<b>Value of Products</b>	5,369,579,191	9,372,437,283	75%
<b>Average Wage per Worker</b>	346.91	484.49	40%

Source: United States Census Bureau, “Census of Population and Housing,” Volume 6: Report on Manufacturing Industries in the United States, Table 2: Comparative Summary, By Specified Industries: 1880 and 1890.

We should also note that the international experience parallels the US. Using World Bank data, we can see that there are multiple countries where this has been the case recently. For example, China had a GINI index of 32.43 in 1990 and it rose to 42.06 in 2009 (meaning China became much more unequal). At the same time, the proportion of the population living below \$1.25 a day (purchasing power parity), the measure usually used for international poverty lines, this fell from 60.18 percent in 1990 to only 11.8 percent in 2009.

Moreover, this entire line of discussion ignores the degree to which poverty is attributable to the choices and actions of the poor themselves. High-school dropouts are roughly three and a half times as likely to end up in poverty as those who complete at least a high-school education, while few college graduates are poor for any extended period of time. Children



growing up in single-parent families are almost five times as likely to be poor as children growing up in married-couple families. Less than 3 percent of full-time workers live in poverty.

**Myth # 5. We Can Punish the Rich without Hurting the Poor.**

Even if one accepts the premise that inequality is increasing, the more interesting question from a policy perspective is what we can – or should -- do about it.

Proposals in this regard generally attack the problem from one of two perspectives. Either there are attempts to reduce inequality by raising the bottom up, or by bringing the top down. Both are problematic.

Traditional attempts to raise incomes at the bottom through redistribution have had some successes, as discussed above, but may have reached the point of diminishing returns. Combined federal and state spending on anti-poverty programs currently tops \$981 billion annually. Since the War on Poverty began, in 1965, we have spent more than \$20 trillion on anti-poverty programs. Using the Meyer-Sullivan alternative poverty rate measures (which accounts for non-cash benefits) shows that the majority of improvements in the poverty rate occurred prior to 1972. Less than a third of the improvement has taken place in the last four decades, despite massive increases in expenditures during that time.

**Figure 6**

**Meyer-Sullivan Poverty Rate vs. Combined Welfare Spending**

Sources: Bruce Meyer and James Sullivan, “Winning the War: Poverty from the Great Society to the Great Recession,” *Brookings Papers on Economic Activity*, Fall 2012; Michael Tanner, “The American Welfare State: How We Spend Nearly \$1 Trillion a Year Fighting Poverty—and Fail,” Cato Institute, *Policy Analysis* no. 694, April 11, 2012.

That may be the primary reason why many of those concerned about inequality have focused instead on measures to reduce wealth at the top. Piketty, for example, argues for a globally imposed wealth tax and a U.S. income tax rate of 80 percent on incomes over \$500,000 per year. Piketty acknowledges “would not bring the government much in the way of revenue,” but that it would “distribute the fruits of growth more widely while imposing reasonable limits on economically useless (or even harmful behavior.”

But the ultimate losers are likely to be the poor. Piketty’s plan might indeed lead to a society that was more equal, but it would also likely be a society that where everyone is far poorer.

Economic growth, after all, depends on people who are ambitious, skilled risk-takers. We need people to be ever striving for more. That means that they must be rewarded for their efforts, their skills, their ambitions, and their risks. Such rewards inevitably lead to greater inequality. But as Nobel Prize-winning economist Gary Becker pointed out, “[i]t would be hard to motivate the vast

majority of individuals to exert much effort, including creative effort, if everyone had the same earnings, status, prestige, and other types of rewards.” The Tax Foundation, for example, looked at Piketty’s proposal and found that:

- If ordinary income were taxed at the top rates of 80 and 55 percent, GDP would decrease by 3.5 percent, wages would drop 1.6 percent, capital stock would be 7.4 percent less, and there would be 2.1 million fewer jobs, after the economy adjusts to the changes.
- If capital gains and dividends were taxed at the new tax rates GDP would plunge 18.1 percent (a loss of \$3 trillion dollars annually in terms of today’s GDP), the capital stock would be 42.3 percent smaller than otherwise, wages would be 14.6 percent lower, 4.9 million jobs would be lost, and despite the higher tax rates, government revenue would actually fall.
- The after-tax incomes of the poor and middle class would drop about 3 percent if the higher rates do not apply to capital gains and dividends and about 17 percent if they do.

To be sure, since the 1970s, the relationship between economic growth and poverty reduction has been uneven at best. But we are unlikely to see significant reductions in poverty without strong economic growth. Punishing the segment of society that most contributes to such growth, therefore seems a poor policy for serious poverty reduction.

### **Conclusion**

There is good reason for this country to have a debate over issues such as how best to reduce poverty and increase middle-class incomes. In particular, we need to do more in this country to reduce poverty.

But, it is important to note that poverty and inequality are not the same thing. Indeed, if we were to double everyone’s income tomorrow, we would do much to reduce poverty, but the gap between rich and poor would still grow larger. Would this be a bad thing?

There is little demonstrable relationship between inequality and poverty. And measures designed to bring about greater equality are likely to leave the poor as well as the rich worse off.

Too much of the debate over inequality has been driven by emotion or misinformation. Heading down that road will almost inevitably leave us all poorer.