[Should the Government Narrow the Income Gap (Part I)?]

10:52 am

November 28, 2011 by Dan Kedmey

In his latest [New York Times Magazine column], Adam Davidson writes, "many do want a return to the spirit of the old rules, when the government sought to make life more equal, more stable and, for some, less rewarding."

To continue the discussion, we asked two economists on different sides of the debate — [Alan Reynolds] of the Cato Institute and [Christian Weller] of the Center for American Progress — to answer the following question:

Should the government take stronger measures to close the gap between the top 1 percent of earners and everyone else?

Alan Reynold's answer is below.

In 2007, the top 1 percent received 23.5 percent of income according to economists Thomas Piketty and Emmanuel Saez, but only 17.1 percent of income according to the Congressional Budget Office. The wide gap between those two measures is because Piketty and Saez exclude taxes and $2.3 trillion of government transfer payments, while the CBO does not. You would have needed just $252,607 in disposable income to make it into the top 1 percent in 2007, once taxes and transfers are taken into account.

The wide gap between figures that include taxes and transfers and those that do not shows the government is doing a lot to redistribute income – though not necessarily to the poor. Anti-poverty programs such as Medicaid, food stamps and the earned-income tax credit, accounted for only $600 billion of the $3.6 trillion of federal spending in 2011.

The grander estimates of Piketty and Saez are frequently cited as a rationale for increased tax rates on the rich and increased transfer payments to the rich. This is an irrational rationale. Even doubling tax rates and transfer payments would have no direct effect on those estimates, because they explicitly ignore taxes and transfers.

The CBO estimates for 2007 are more relevant, but hopelessly obsolete. Newer IRS reports show, for example, that from 2007 to 2009 the number of tax returns with incomes above $1 million dropped by nearly 40 percent to 236,882. They amounted to less than two-tenths of one percent of all tax returns yet paid 20.5 percent of all income taxes in 2009 — down from 27.8 percent in 2007 — because their share of pretax income had dropped from to 9.5 percent from 16.1 percent.

University of Chicago economist Steve Kaplan updated the top 1 percent's share as Piketty and Saez define it, finding it dropped to 17.6 percent in 2009 from 23.5 percent in 2007. Adjusting for taxes and transfers, as the CBO does, cuts the top 1 percent's share to about 11.3 percent by 2009.

One of the Occupy Wall Street websites says, "We are getting nothing while the other 1 percent is getting everything. We are the 99 percent." Actually, the share of after-tax income going to the 99 percent rose dramatically to 88.7 percent in 2009 from 82.9 percent in 2007. Indeed, the top 1 percent's share always falls in recessions and rises during periods of rapid economic growth such as 1983-89 and 1997-2000. This *cyclicality* of the top 1 percent's share makes that share a preposterous definition of "inequality" because poverty rises in recessions. Are the unemployed supposed to welcome recessions and stock market crashes simply because such crises demolish top incomes from capital gains, dividends, interest, and small business?

Trying to squeeze more revenue from today's dwindling ranks of top taxpayers is likely to backfire. The individual income tax brought in 8.1 percent of GDP when the top tax rate was 28 percent (1988 to 1990), but only 7.7 percent when the top tax rate was 91 percent (1951 to 1963). Higher tax rates on capital gains in 1987-1996 discouraged investors from selling assets, and higher tax rates on dividends before 2003 discouraged investing in dividend-paying stocks rather than tax-exempt bonds. Less income reported by the top 1 percent meant less taxes paid.

The top 1 percent did not pay less income tax in 2009 than in 2007 because they stopped paying their fair share, but because their average incomes fell by at least 40 percent. The only way higher tax rates on the top 1 percent might reduce those incomes even further would be by provoking another recession.