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6 Myths About Income Inequality in America

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Rhetoric about income inequality fueled recent protests across the globe and political debates in Washington, D.C. Income inequality is the difference between the shares of aggregate income among households, but the gap between the top and bottom 20% of household incomes generally makes the headlines. However, there are many myths regarding income inequality in America, and I discuss the six primary myths.

In 2010, the U.S. Census Bureau reported that the share of income for the top 20% was 50.2% and only 3.3% for the bottom quintile. Some consider this widening spread between the "rich" and the "poor" to be the primary problem for our economic woes. One argument is that the rising share of income in the hands of those at the top of the income ladder has slowed economic growth, primarily from their preference to save. Proposals to solve this problem recently included a surtax on millionaires and other measures to redistribute income from those who save to those who consume.

During the 2008 presidential campaign, then Senator Barack Obama discussed his views on income inequality with "Joe the Plumber" by stating, "I think when you spread the wealth around, it's good for everybody." Not only are these types of policy choices unlikely to reduce the gap between upper and lower income households, but the last forty years of economic data reveal that the presumed negative effects from income inequality are based on the following 6 myths.

1) Standards of living for households in the lowest quintile have not increased:

Since 1970, incomes between households in the top and bottom quintiles appear to be different in nominal and real terms, in which real income is the amount of goods and services each dollar of income can purchase in 2010 dollars (Figure 1). The argument that the lowest quintile is worse off than in the past is a myth; this group's average real income rose by 10.5% over this period. Moreover, higher incomes not only increased consumption, but the quality of these purchases improved substantially over the last forty years. Therefore, standards of living have increased for households in the lowest quintile.

2) Tax reforms did not change the incentives to report income:

The demonized top 20% of income earners had an average income of $169,633 in 2010, which was up 56% in real terms since 1970. There were many reasons for this substantial increase, but at the top of the list was income tax reform. Specifically, the top income tax rate of 71% in 1970 decreased incentives for top income earners to report their income to the government, which sent a false signal of less income inequality than actually existed.

After the Reagan Administration lowered tax rates in the 1980s and the Bush Administration lowered them again in the 2000s, the incentives for the top quintile of income earners to report their income increased; therefore, the government income data more accurately reflected true incomes compared with earlier periods. Lower tax rates also allow top income earners to keep more of their income and make choices that are productive instead of giving it to the government. Although income inequality may look worse because of tax reform, reforming our tax system should continue to be at the forefront of political debates despite the myths about income inequality.

3) Real income growth did not occur for all households:

Economist Joseph Stiglitz recently wrote, "All the growth in recent decades—and more—has gone to those at the top." Examining income growth rates since the 1970s indicates that this is another myth of income inequality. While many blast the top 20% for their income growth, growth rates for nominal and real incomes of all other quintiles have increased as well (Figure 2).

The top income group has seen their incomes rise faster than others over most decades in the sample, but this has not come at the expense of falling income growth rates for other groups. Many upper income earners tend to be involved in labor markets that demand higher pay, this side of the economy allows the creation of more jobs and higher wages for all Americans. Thus, policies based on the myth of income inequality create an economic environment unkind to upper income earners then everyone will be worse off from fewer incentives for this group to innovate, invest, and provide economic growth.

4) Investment income and the size of each group bias the shares of aggregate income:

Many blame the multitude of problems in our nation on income inequality. Although there are certainly differences in shares of income between groups, these shares have not changed much over the last 40 years (Figure 3).

The average share over the whole period for the bottom 20% was 3.8% and 47% for the top 20%. This 43.2% difference between the two groups may be a straw man for what is causing our nation's ills, but the gap overlooks other evidence that indicates otherwise.

The fact that top income earners tend to gain more of their income from capital investments compared with the bottom 20%, who tend to get theirs from labor hours, provides evidence of the fallacy of income inequality. The Congressional Budget Office noted that capital income can be very volatile, but it has been rising rather dramatically relative to labor income. Since this increases the income for those in the top 20% at a higher rate than those with lower incomes, it is likely there would be an increase in income inequality between the two groups.

Additionally, the Census data distorts the share of each income quintile because of the unequal number of individuals in each group. The top quintile has an over-represented amount of 24.3% and the lowest has 14.8%. Thus, these quintiles are not representative of the groups in the population that they are supposed to reflect, which misrepresents income shares and biases the gap.

5) The economy continued to expand despite income inequality:

President Kennedy's quote that "a rising tide raises all boats" accurately describes how economic growth increases incomes for all households. Collectively, rising incomes for those at the top of the income ladder by more than those at the bottom leads to a rising income gap, but this has not reduced growth in the economy.

From 1970 to 2010, income inequality rose between the top and bottom quintiles from 39% to 47%, but real gross domestic product expanded briskly from $4.3 trillion to $13 trillion (Figure 4). In other words, the size of the pie kept growing, which allowed everyone to share the wealth created. Once the distribution of the pie becomes a concern, then policymakers may enact policies that will stifle economic growth and reduce the size of the pie, reducing everyone's income. Thus, growing the size of our economy should be the emphasis of government policies, not the distribution of income.

6) Income mobility distorts the static analysis of income inequality:

Possibly the most important factor that explains the myth of income inequality is income mobility, which is the ability for individuals to move across income quintiles. Although some arguments may accurately reflect income inequality, their points overlook the fact that these are different individuals in each share of aggregate income over time.

Additionally, demographics affect the income gap because there are more high-income earners nationwide from the rapid growth in life expectancy. Although people see their incomes increase from rising productivity over their lifetime, more people are entering the bottom quintile. Many of these lower income earners are those who just entered the labor force, immigrants, and those without a high school education, which is highly correlated with lower income.

As workers increase their education, training, and productivity, they tend to move into higher income groups. Since 1970, around 50% of those in the bottom quintile moved into a higher income group and income mobility accelerated from 1999-2007 to 60%. Conversely, those in the top 20% may have their capital income fall from a drop in the stock market, reductions in their productivity, or a combination of the two, contributing to a 40% decline to lower income group from those in the top income quintile over the last forty years.

Incomes for those at the top of the income spectrum have also become more volatile and sensitive to fluctuations in aggregate income. Income data indicate that the top 400 earners in America were highly volatile, which only 1% of this group stayed there for fourteen or more years, 12% for two years, and 73% for one year. Thus, arguments about income inequality typically only tell part of the story because they do not include the volatility of incomes across quintiles.

Although some argue that other factors, such as globalization, increase income inequality, these reasons are not legitimate if they do not include issues related to an individual's productivity, education, and similar explanations.

As with any public policy, we should weigh all of the marginal costs and benefits before we make broad arguments for or against policies. The myth of income inequality is clear from the facts above, which contradict the claims made by those adamant about the problems income inequality supposedly creates.

A quote by Will Wilkinson, from the Cato Institute, summed up this concern quite succinctly: "Income inequality is a dangerous distraction from the real problems: poverty, lack of economic opportunity, and systematic injustice." Moving forward we must keep the myth of income inequality in mind and deter our attention away from class warfare and towards areas that will benefit everyone.

The great economist Milton Friedman once said, "A society that puts equality before freedom will get neither. A society that puts freedom before equality will get a high degree of both." These are wise words for moving forward in America.