

# Income inequality: How to fix it

By [Geoff Colvin](#), senior editor at large April 7, 2011: 5:39 AM ET

FORTUNE -- The hot topic of income equality gets especially emotional now, at tax time, and will get even more so this year, with the latest IRS data showing what happened in the recession.

A close look at the new data from the past few years -- and from the past few decades -- illuminates some of the real reasons inequality is a problem, plus the reality of how -- and how not -- to fix it. Key points:

Yet they grew more equal in the recession. The long-term trend is indisputable: High-income Americans have been receiving a growing share of total income for the past 30 to 40 years. The latest IRS data show that in 2008, the top 1% of taxpayers accounted for 20% of total pretax income; in 1986, by contrast, they accounted for only 11%. Over that same period, the share of income going to the bottom 50% of taxpayers fell from about 17% to 13%. You can poke holes in the statistics, as the Cato Institute's Alan Reynolds has done, but there's no mistaking the big picture of growing income inequality.

Yet during the recession, the trend reversed. The bottom half's share of total income actually increased slightly, while the top half's share declined. The people whose income shares shrank most dramatically were the top 10%, top 5%, and top 1%. The rich got poorer, and the middle class got relatively richer. The same thing happened in the recessions of 1990-91 and 2001 and in the Great Depression. So here's one proven way to achieve greater equality: Make the country poorer. No one wants to do that, of course. A popular alternative is to extract more in taxes from the highest earners. Candidate Obama pledged repeatedly to do that, a campaign promise that he prudently broke when he signed the bill [extending the Bush tax cuts](#). It's just as well, because when it comes to income inequality ...

## Soaking the rich won't fix it.

Another eye-opener from the latest IRS data is that in the recession the top 5% and top 1% of earners actually paid tax at a higher effective rate than they did in the boom year of 2007, while everyone else paid at a lower rate. That is, the tax system did what it's supposed to do in tough times, taking from the rich and giving to the rest even more than it normally does. The larger point is that redistributing wealth through the tax code can be taken only so much further. Consider: In 2008 the top 0.1% of earners paid more total income tax than the bottom 75% did. The most surprising fact in the latest IRS data is that in 2008 the proportion of total income tax paid by the bottom half of earners sank to its lowest in decades: 2.7%. [If we raise taxes on the rich](#) so that we can cut taxes on the rest -- thus making incomes

relatively more equal -- we'll create an even larger class of Americans with little or no stake in financing the government. It's a recipe for social and political instability or even chaos.

**Worker education is the key.**

It will make them more productive -- and richer. Harvard economists Claudia Goldin and Lawrence Katz have shown persuasively that the largest factor in inequality's rise is the slowing pace of educational attainment since the early 1970s. Workers' skills aren't keeping up with the advance of technology, so the **shrinking proportion of workers with the needed skills** command a larger share of the pie. Get high school and college graduation rates rising again, and the economic forces reverse, spreading the benefits of economic growth more evenly.

There's no clearly ideal level of income inequality, but it is a problem, and your Form 1040 symbolizes one of the most serious reasons why: Too few people now pay most of the country's bills. It could also symbolize the solution. The best news for the bottom half of earners will be when they're making a larger share of the nation's total income -- and paying more taxes.

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