Townhall.com
WHERE YOUR OPINION COUNTS

JANUARY 12, 2012

The Income Inequality Myth

By Michael Tanner
1/12/2012

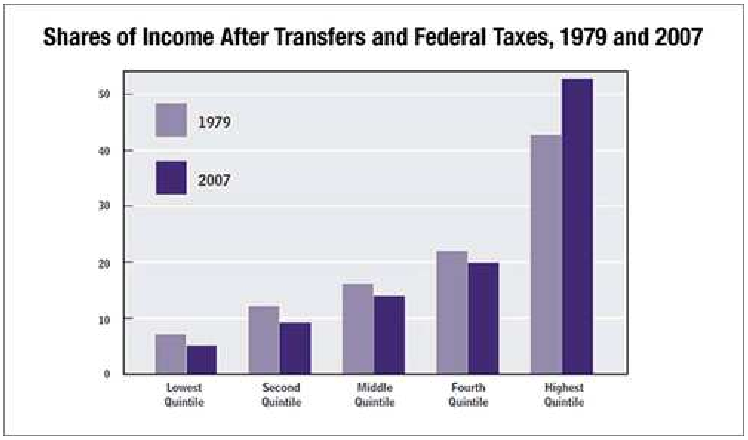
As we listen to President Obama, Occupy Wall Street, and much of the mainstream media working themselves into a lather over inequality in America, one thinks of *Harrison Bergeron*, the 1961 short story by Kurt Vonnegut that posited a society based on perfect equality, "not only equal before God and the law ... equal every which way." The government employed a "Handicapper General" to ensure that no one was smarter, more athletic, or more productive than anyone else. Beautiful people were forced to wear masks, athletic people had to carry weights, and intelligent people wore radios in their ears to interrupt their thoughts with loud noises.

Yet for all the sound and fury — and beating drums in Zuccotti Park — almost everything that people presume about inequality in America is wrong.

For example, nearly all reporting on income inequality in America has suggested that the incomes of the rich have been rising, while incomes for the rest of us have been stagnant or even declining. But that may represent a significant misreading of the data.

Most studies of inequality, including the recent widely reported study by the Congressional Budget Office, rely on IRS-reported taxable income. But, as studies by the Cato Institute's Alan Reynolds and others show, reports of skyrocketing incomes among the top 1 percent of earners may be distorted by changes in the tax code that have resulted in more wealth being reported as taxable income. These tax changes caused businesses to switch from filing under the corporate tax system to filing as individuals, and executives to switch from accepting stock options taxed as capital gains to nonqualified stock options taxed as salaries. Simultaneously, the reductions in income-tax rates in 1986 caused much previously unreported income to show up on tax returns.

At the same time, incomes among lower- and middle-income workers have been shifting from cash wages to non-cash benefits such as health insurance and pensions. These non-cash benefits frequently do not show up as taxable income even though they have value to the worker. In fact, a recent study by Mark Warshawsky of the Social Security Advisory Board suggests that nearly all of the recent increase in earnings inequality "can be explained by the rapid increase in the cost of health insurance employee benefits, and that therefore [there] has not been as significant increase, if any, in inequality of compensation."



Similarly, many studies looking at low-income Americans fail to account for non-cash social-welfare benefits such as food stamps, housing subsidies, and Medicaid. Fully accounting for all of these factors suggests that the gap between rich and poor may not be nearly as large as thought, and that inequality may not be growing at all.

Studies also show that what inequality does exist is not the result of the Bush tax cuts or a failure to spend more on social-welfare programs, but on the transformation of the American economy from a focus on manufacturing to information and technology. This change puts a greater premium on education. As a result, the incomes of high-school dropouts or those with just high-school degrees have stagnated while incomes for many college graduates and those with graduate-level educations have increased significantly. The unfortunate fact is that despite massive increases in education spending, large segments of our society remain unprepared for a 21st-century economy. That is a tragedy, but it has nothing to do with tax cuts for the rich.

In the end, however, one has to ask a more basic question. Why do we care about inequality at all?

Poverty, of course, is a bad thing. But is inequality? After all, if we doubled everyone's income tomorrow, we would eliminate an enormous amount of economic hardship. Yet, inequality would actually increase. As Margaret Thatcher said about those who obsess over inequality, "So long as the [income] gap is smaller, they would rather have the poor poorer."

In what way does someone else's success harm me? Such a viewpoint stems from the misguided notion that the economy is a pie of fixed size. If one person gets a bigger portion of the pie, others of necessity get smaller pieces, and the role of government is to divide up the slices of that pie. In reality, though, the size of the pie is infinite. But to make it grow, we need 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, "It would be hard to motivate most people if everyone had the same earnings, status, prestige, and other rewards."

Another Nobel Prize winner, F. A. Hayek, concluded, "The rapid economic advance that we have come to expect seems to be in large measure a result of this inequality and to be impossible without it. Progress at such a fast rate cannot take place on a uniform front but must take place in an echelon fashion, with some far in front of the rest."

We should all seek a prosperous, growing economy, with less poverty, and where everyone can rise as far as their talent and drive will take them. Equality? Who needs it?

This article appeared on National Review (Online) on January 10, 2012.

Michael Tanner is a senior fellow at the Cato Institute and author of Leviathan on the Right: How Big-Government Conservatism Brought Down the Republican Revolution.

Michael Tanner

Michael D. Tanner is a senior fellow at the Cato Institute, heading research into a variety of domestic policies with particular emphasis on health care reform, welfare policy, and Social Security. His most recent white paper, "Bad Medicine: A Guide to the Real Costs and Consequences of the New Health Care Law," provides a detailed examination of the Patient Protection and Affordable Care Act (Obamacare) and what it means to taxpayers, workers, physicians, and patients.