

## Taxes and Income Inequality

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Income inequality has increased sharply over the past 35 years. What role has the federal tax system played in creating—or reducing—inequality?

### INCREASING INCOME INEQUALITY

A simple way to measure inequality is by looking at the share of income received by the highest-income people. Using a broad measure that includes labor, business, and capital income; government cash payments (such as Social Security); and the value of in-kind benefits from government programs (such as Medicare and Medicaid), the Congressional Budget Office finds that the income share of the top fifth of the population rose from 43 to 53 percent between 1979 and 2013 (figure 1). This increase in income inequality came about despite the growth in Social Security, Medicare, and Medicaid, which provide the greatest boost in before-tax income to low- and middle-income households.

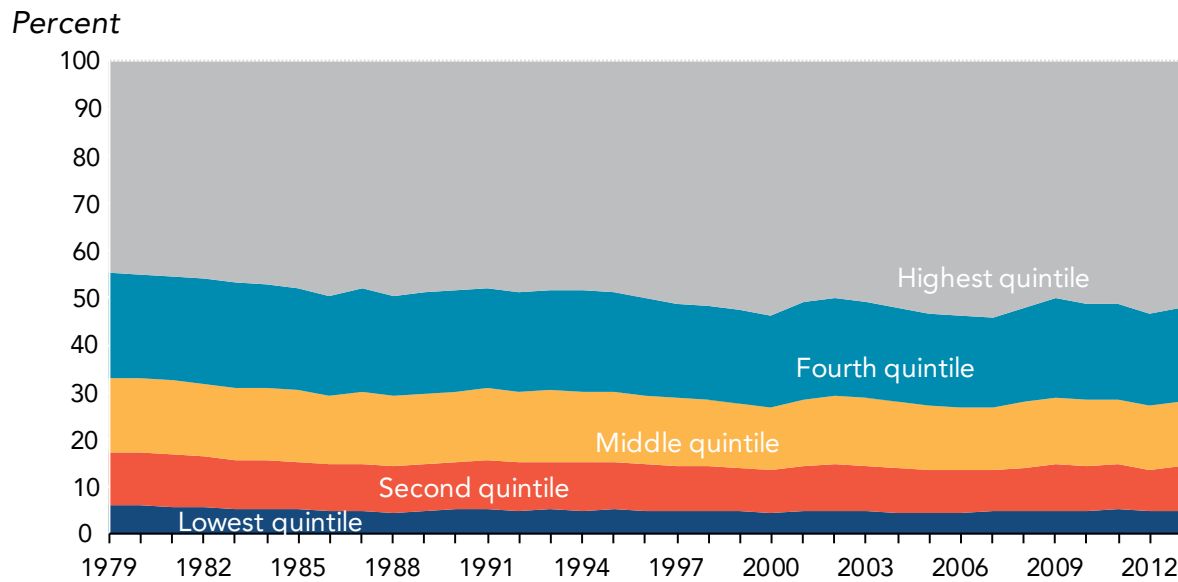
This year, Congress will consider what may be the biggest tax bill in decades. This is one of a series of briefs the Tax Policy Center has prepared to help people follow the debate. Each focuses on a key tax policy issue that Congress and the Trump administration may address.

Much of the gain in the top income share went to the top 1 percent of the population. In 1979, they received 9 percent of all income. By 2013, their share grew to 15 percent, more than all the income received by the bottom 40 percent (figure 2). The income measure used in figures 1 and 2 includes realized capital gains, which are sensitive to business cycle fluctuations and to changes in tax rates. Because realized capital gains are a significant income component for the top 1 percent, their income share is more volatile than income shares of other groups.

FIGURE 1

## Share of Before-Tax Income by Quintile

1979–2013

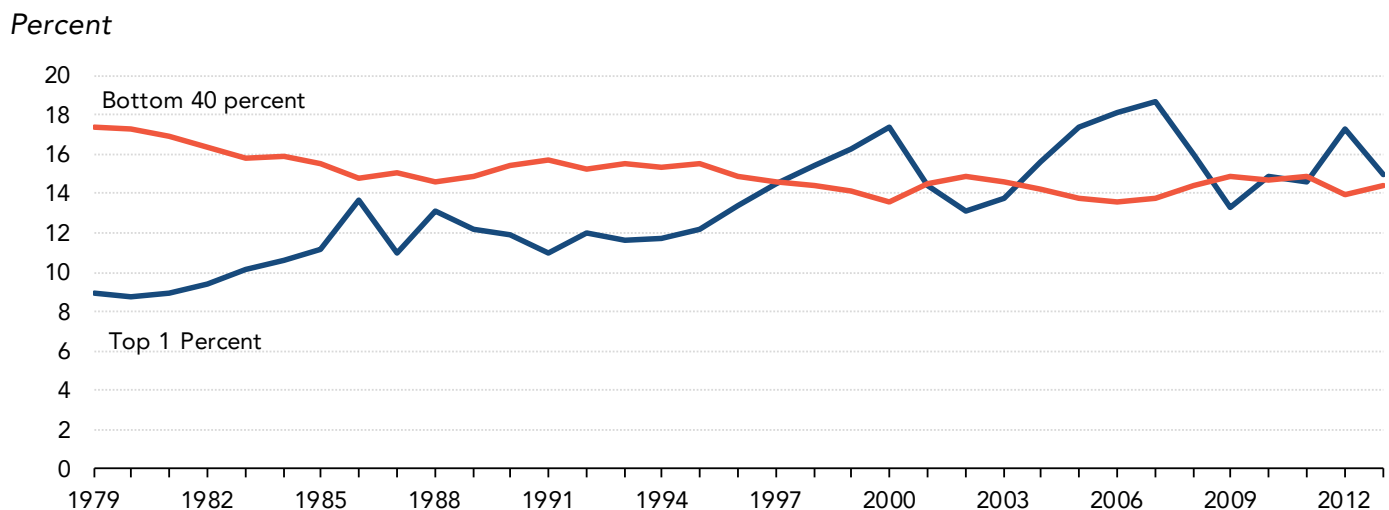


Source: Congressional Budget Office (CBO), *The Distribution of Household Income and Federal Taxes, 2013* (Washington, DC: CBO, 2016), supplemental data.

FIGURE 2

## Share of Before-Tax Income for the Top 1 and Bottom 40

1979–2013



Source: Congressional Budget Office (CBO), *The Distribution of Household Income and Federal Taxes, 2013* (Washington, DC: CBO, 2016), supplemental data.

Top income shares have not reached these levels since the 1920s (figure 3). After falling precipitously during the Great Depression and World War II, the income share of the top 1 percent leveled off during the next three decades. It began climbing again in the 1980s, interrupted only by the 2001 and 2008–09 recessions. Since the stock market rebound, income shares of the top 1 percent have increased again.

## A WORLDWIDE PHENOMENON

The United States is not the only country with increasing income inequality. Most member countries of the [Organisation for Economic Co-operation and Development](#) have experienced the same phenomenon, though to a lesser degree than the United States (figure 4).

## THE ROLE OF TAXES

The figures so far only consider income before taxes. What happens after we account for taxes?

The US federal tax system is progressive. High-income households pay a larger share of their income in total federal taxes than low-income households (figure 5). State and local taxes, which are not included in this analysis, are much less progressive, and some, such as sales taxes, are regressive (low-income households pay a higher share of their income in sales taxes than high-income households).

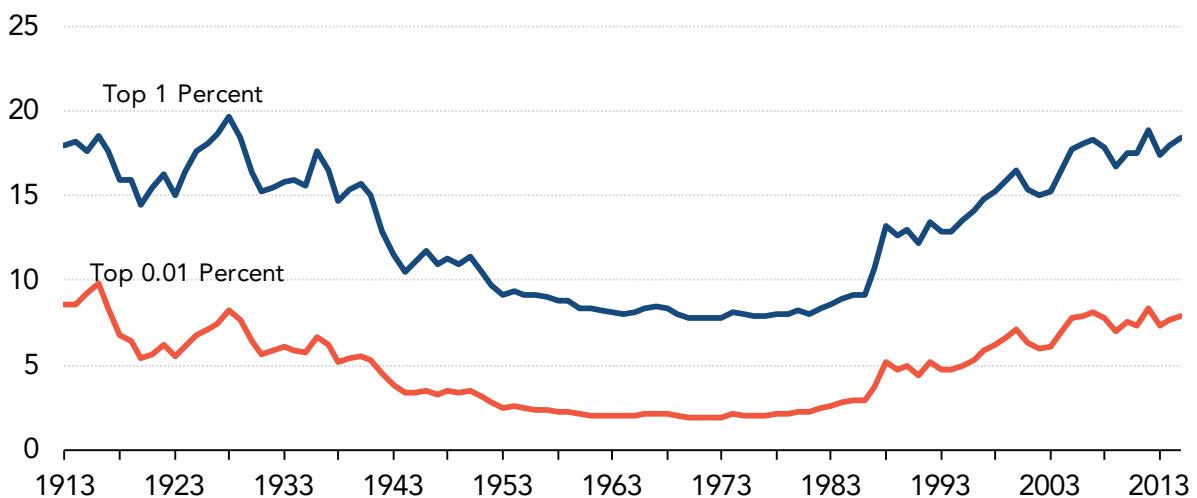
Because federal taxes are progressive, the distribution of after-tax income is more equal than income before taxes. High-income households have a slightly smaller share of total income after taxes than their share of income before

FIGURE 3

## Top Income Shares in the United States

1913–2015

Percent



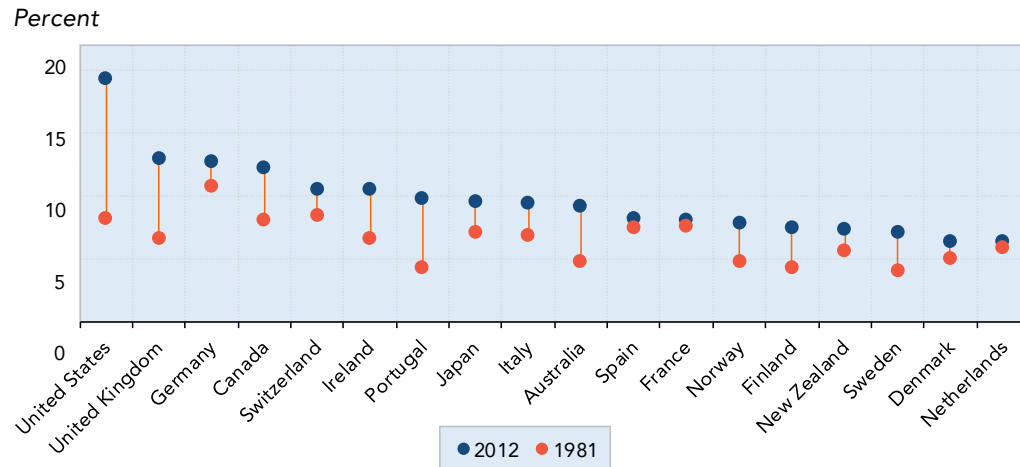
**Source:** Emmanuel Saez, "Striking It Richer: The Evolution of Top Incomes in the United States (Updated with 2015 preliminary estimates)" (Berkeley: University of California, Berkeley, 2016).

**Note:** Income is annual gross income reported on individual tax returns, excluding capital gains and government transfers (such as Social Security, unemployment benefits, and welfare payments) and before individual income taxes and employees' payroll taxes.



FIGURE 4

## Shares of Top 1 Percent Incomes in Total Pretax Income 1981–2012 (or closest)

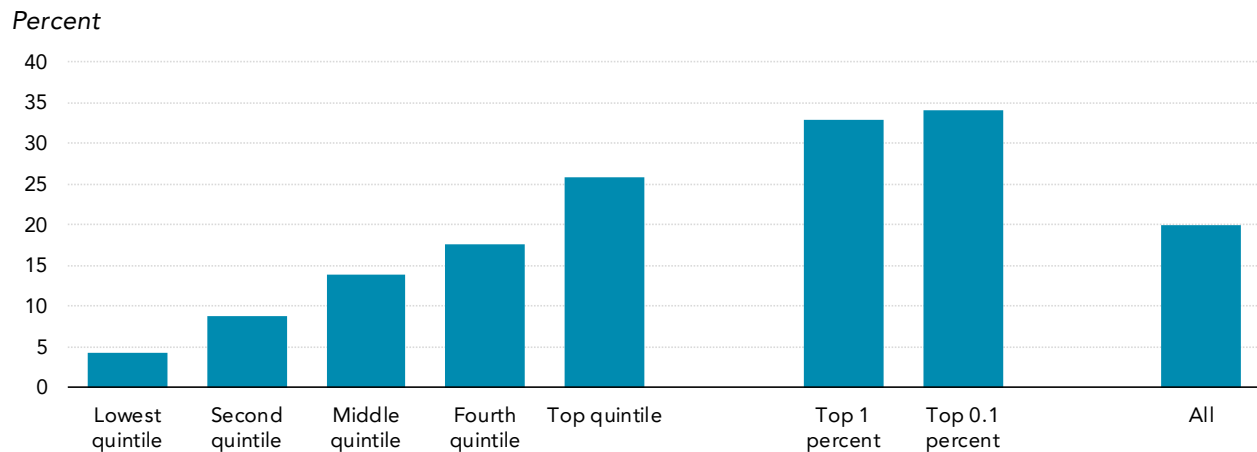


**Source:** Organisation for Economic Co-operation and Development (OECD), "FOCUS on Top Income and Taxation in OECD Countries: Was the crisis a game changer? (Paris: OECD, 2014), figure 1.

**Note:** Incomes refer to pretax incomes, excluding capital gains, except in Germany (which includes capital gains). Latest year refers to 2012 for the Netherlands, Sweden, and the United States; 2011 for Norway and the United Kingdom; 2009 for Finland, France, Italy, and Switzerland; 2007 for Germany; 2005 for Portugal; and 2010 for Australia, Canada, Ireland, Japan, New Zealand, and Spain.

FIGURE 5

## Average Effective Federal Tax Rate by Income Percentiles 2017



**Source:** "T17-0042—Average Effective Federal Tax Rates—All Tax Units, by Expanded Cash Income Percentile, 2017," Urban-Brookings Tax Policy Center, last updated March 17, 2017.

**Note:** The average effective federal tax rate is the sum of individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes as a percentage of expanded cash income. For a description of expanded cash income, see "Income Measure Used in Distributional Analyses by the Tax Policy Center," Urban-Brookings Tax Policy Center, accessed June 8, 2017.

taxes, while the reverse is true for other income groups (figure 6).

Federal taxes are more progressive than they were 35 years ago. Although the average tax rate for high-income households has varied a lot, the average tax rate for these households was nearly the same in recent years as at its peaks in 1977 and 1995. Meanwhile, the average tax rate for middle- and low-income groups dropped incrementally from the early 1980s through 2007 and then fell dramatically from 2007 through 2009 because of [temporary tax cuts](#) enacted in response to the Great Recession. Average rates rebounded as those tax cuts expired, but by 2013, remained well below their 1979 values for those groups (figure 7).

## EFFECT OF TAXES ON INCOME INEQUALITY

A more progressive tax system would reduce income inequality if nothing else changes. But while federal taxes became more progressive, they also were shrinking relative to before-tax income starting in 2001, thanks to tax cuts during the administrations of George W. Bush and Barack Obama. A lower average tax rate offset the equalizing effect of increased tax progressivity, leaving the effect of federal taxes on income inequality little changed.

A widely used measure of income inequality is the Gini index. The index has a value of zero when income is distributed equally across all income groups and a value

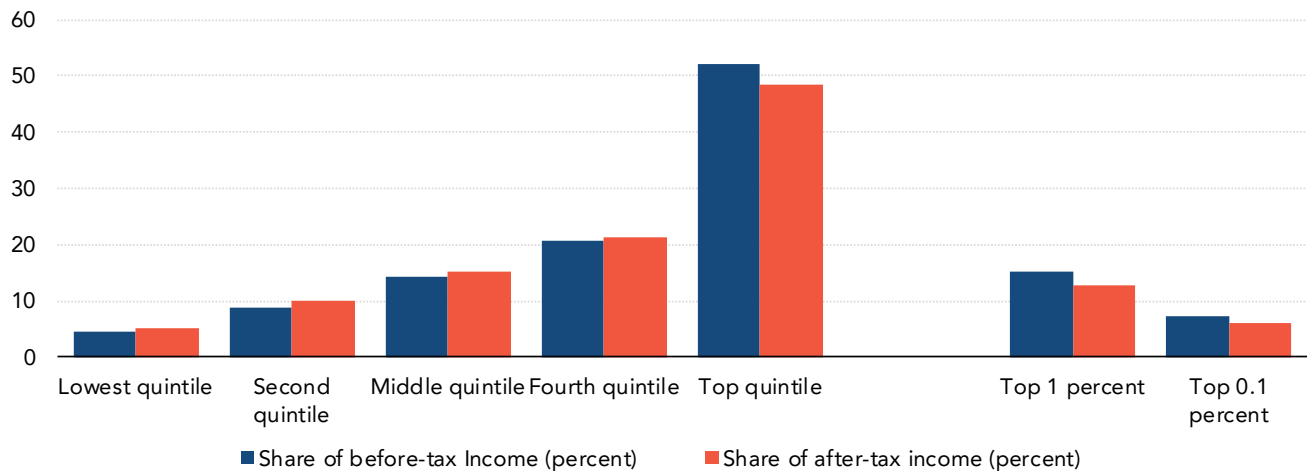
FIGURE 6

### Shares of Before- and After-Tax Income by Quintile



2017

Percent



**Source:** "T17-0007—Baseline Distribution of Income and Federal Taxes, All Tax Units, by Expanded Cash Income Percentile, 2017," Urban-Brookings Tax Policy Center, March 10, 2017.

**Note:** Before-tax income is measured as expanded cash income. For a description of expanded cash income, see "Income Measure Used in Distributional Analyses by the Tax Policy Center," Urban-Brookings Tax Policy Center, accessed June 8, 2017. After-tax income is expanded cash income less individual income tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), the estate tax, and excise taxes.

of one when the highest income group receives all the income. By this measure, inequality has been consistently lower for after-tax income than for before-tax income (figure 8).

The gap between the index for before-tax and after-tax incomes measures how much taxes reduce inequality. The bigger the difference, the more taxes equalize income. The gap closed during the 1980s as taxes relative to income fell more for high-income households than for low-income groups. But as federal taxes became more progressive starting in the 1980s, the gap between before-tax and after-tax income inequality widened. It remains at roughly the pre-1980 level.

The bottom line is that before-tax income inequality has risen since the 1970s, despite an increase in government transfer payments. Because high-income people pay higher average tax rates than others, federal taxes reduce inequality. But the mitigating effect of taxes is about the same today as before 1980. Thus, after-tax income inequality has increased about as much as before-tax inequality. Taxes have not exacerbated increasing income inequality, but have not done much to offset it.

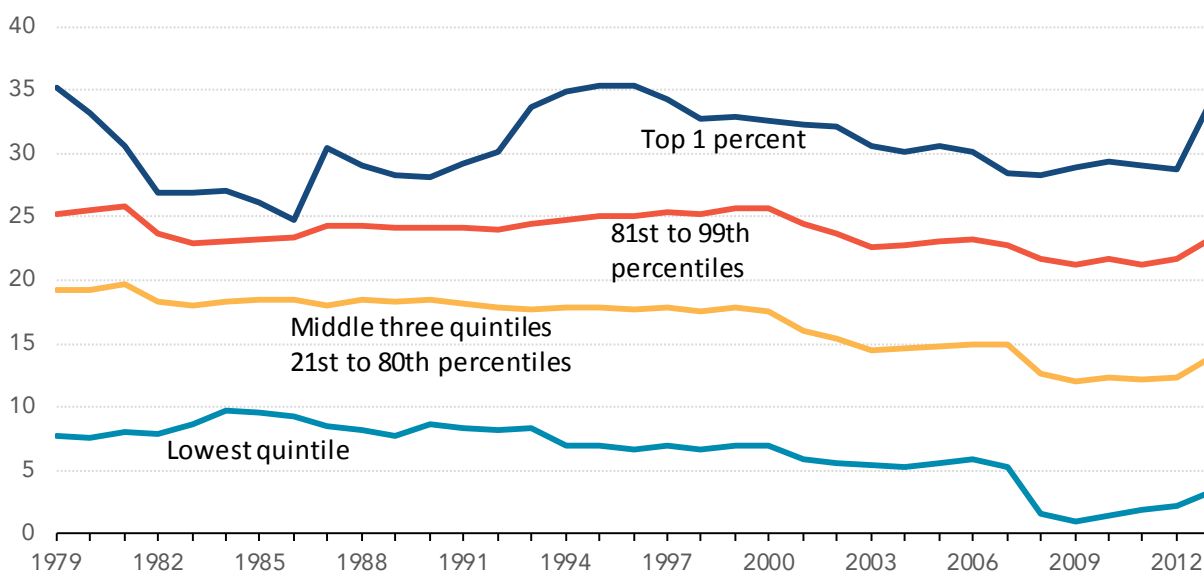
**FIGURE 7**



## Average Federal Tax Rates for All Households by Before-Tax Income Group

1979–2013

Percent



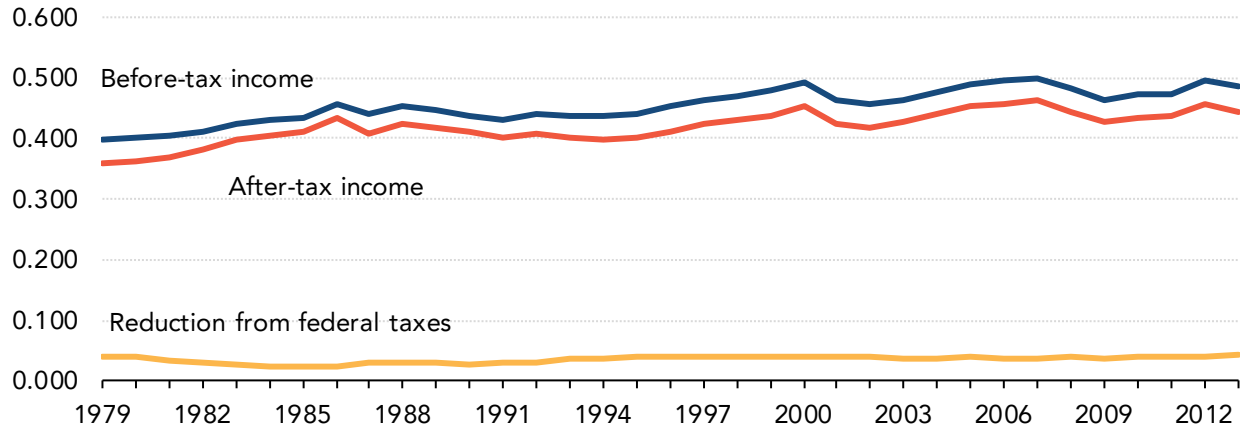
**Source:** Congressional Budget Office (CBO), *The Distribution of Household Income and Federal Taxes, 2013* (Washington, DC: CBO, 2016), figure 2.

FIGURE 8

# Inequality Index for Before- and After-Tax Income 1979–2013



Gini coefficient



Source: Congressional Budget Office (CBO), *The Distribution of Household Income and Federal Taxes, 2013* (Washington, DC: CBO, 2016), supplemental data.