

Reducing Income Inequality

By James Sly

June 2020

Introduction

The US is currently facing an income inequality crisis that has developed over several decades. For example, the share of before tax income going to the top 1% has risen from about 10% in 1980 to over 20% today, while the wage growth for the middle 60% of the population grew almost 5 times slower than wage growth for the top 1% since 1979.(1) Over the long term, tax policy might only have a gradual impact on *before* tax income as the economy adjusts to changes in incentives, but tax policy can have an incredible impact on *after* tax incomes right away. In order to confront the problem of growing income inequality then, the US should look to tax policy for solutions. Any major reform designed to address income inequality is going to not only need significantly higher taxes on the top 1%, but also large tax breaks for the middle class funded by the tax increase on the rich.

Raising Taxes on the Top 1%

The US currently has a progressive tax system at the federal level, but it has not responded appropriately to the incredible rise in income inequality, especially since the effective tax rates on the top 1% went down as a result of the 2017 Trump tax cuts.(2) In addition, the US collects a relatively small percent of our GDP in taxes, where only Ireland, Mexico, and Chile collected less among the 34 countries in the OECD where data was projected for 2018.(3) Clearly, there is a lot more that the tax system could do to reduce income inequality, especially when compared to countries like France or Denmark that collect tax revenue 20 percentage points higher as a share of GDP.(4)

Fortunately, there are a variety of ways the US could raise taxes on the top 1%. The most obvious is to raise the top income tax rate which currently stands at 37%. Most people do not realize that the US used to have dramatically higher top tax rates in the past, where during World War II and through most the 1950s the top tax rate was above 90%. Basically, the US has been doing a grand experiment in tax policy over several decades by starting with a very high top tax rate and then decreasing it in increments over the years to see what tax rate worked best. The top tax rates over 90% during World War II were probably a bit too high, but the fastest economic growth was achieved when the top tax rate was around 70% or higher throughout the 1960s, and the top tax rate of 28% in the late 1980s was probably a bit too low.(5) The US could basically do the reverse experiment and keep raising the top tax rate over several decades to see how high it should go.

Another way to raise taxes on the top 1% is to tax capital income more heavily. Income from capital gains and dividends is currently taxed at a much lower rate than normal income, and eliminating this tax break would raise a substantial amount of money. In the late 1980s, capital gains and dividends were taxed the same as income, but the top tax rates were substantially lower then. After the top tax rate started to rise in the early 1990s then new tax rates for capital gains and dividends were created to reduce the impact on these sources of income.(6) Another way to raise taxes on the top 1% would be to raise the tax rate on corporate profits which went down substantially as a result of the 2017 Trump tax

cuts. Before the tax cut, the US had the highest corporate tax rate in the developed world at 35%, but after the tax cut this rate went down to 21%.(7) This leaves the US with a lot of room to raise corporate tax rates again, though perhaps not all the way back to their previous levels, which again would allow the US to raise substantial amounts of revenue. A some people have proposed creating a wealth tax in the US though this is not something I generally recommend. A wealth tax is difficult to administer, easy to avoid, and a similar effect can be had just by raising taxes on capital income.(8)

In general then, there are a variety of ways to raise taxes on the top 1%. Some combination of an increase in the top income tax rate, taxing capital gains and dividend income the same as normal income, and raising the tax rate on corporate profits would be advisable, and when combined together could go a long way to collecting more taxes from the top 1%. Remember though, there are two key parts to reducing income inequality, where not only do you have to raise taxes on the top 1%, you also need to cut taxes for the bottom 80% as well.

Lowering Taxes on the Bottom 80%

The best way to lower taxes for the bottom 80% of the population is to create a large refundable tax credit that phases out at higher incomes paid for by the revenue raised from the tax increases on the top 1%. In her recent presidential campaign, Senator Kamala Harris proposed a plan where each adult would get a \$3,000 refundable tax credit that phased out between \$30,000 to \$50,000 for single people and \$60,000 to \$100,000 for married couples that ultimately cost about \$300 billion a year.(9) This proposal gets the underlying structure basically right, where the tax credit is made refundable so low income people who do not pay taxes can get it, and also phases out the credit for high income people, so that the credit can be made more generous overall.

One way to improve upon this basic proposal would draw upon an idea by Senators Michael Bennet and Sherrod Brown to provide each child with a benefit as well in order to give more aid to large families.(10) Since kids are less expensive to take care of than adults, perhaps the child benefit would be set at half the amount going to adults. Another way to improve upon on Senator Harris' plan would be to raise the income limits where the credit phased out. Under her plan approximately half of all adults would get some kind of benefit from the tax credit. From a policy perspective, having a low income limit allows you to provide a larger benefit for the poor at the same price, but from a political perspective, a higher income limit is better because it wins you more votes. As a result, rather than have the benefits phase out from approximately the 30th to the 50th percentile as Senator Harris proposes, I would try and set the income limits so it phased out from the 60th to the 80th percentile.(11)

Making these changes would reduce the tax credit from a \$3,000 credit for each adult into a \$1,000 credit for each adult and \$500 for each child that phases out completely once incomes reach \$75,000 for single people and \$150,000 for married couples and would cost about \$200 billion a year rather than \$300 billion a year.(12) The question then becomes how much do you scale up this proposal. In theory, a \$200 billion dollar tax credit represents about 1% of GDP, which is substantial but not overwhelming. In practice, if you wanted to have a bigger impact on income inequality, you could pass this same tax credit multiple times building one on top of the other, so that the total tax credit grows to \$2,000, \$3,000, or even \$5,000 per person.

If you did want to dramatically scale up this tax credit for low and moderate income people, the problem then becomes how do you pay for it. It is true that Republicans pass big tax cuts for the rich

funded primarily with deficit spending, but if you want the proposal to become a permanent piece of the tax code that lasts for decade after decade, then you need to find a way to replace the lost revenue. For example, in his first term, Obama passed his tax cut targeted at middle income people, the Making Work Pay tax credit, which then morphed into a 2% cut in payroll taxes. In his second term, however, Obama felt the need to cut the deficit from the highs left over from the financial crisis, so with bipartisan support, the 2% payroll tax cut was allowed to expire.(13)

If you were stuck in the middle of an election and your opponent proposed a big deficit financed tax cut, then to offset their political advantage it might make sense to propose a large deficit financed tax cut yourself. In one of my other papers on deficits (Sly 2018), I suggest this deficit competition works as a sort of prisoners dilemma to which the best response is to play tit for tat by proposing high deficits when your opponent proposes high deficits and low deficits when your opponent proposes low deficits.(14) This realistically only works temporarily since the revenue does eventually need to be replaced after you win the election, but luckily for us, we already have a number of proposed tax increases on the top 1% that raise a lot of revenue.

Earlier, this policy memo suggested that the large refundable tax credit for low and moderate income people could be expanded in \$200 billion dollar increments. If we wanted to pay for the first \$200 billion dollar increment with tax increases on the top 1%, this could be paid for by taxing capital gains and dividend income at the same rates as for normal income (a revenue gain of about \$170 billion a year) and raise the top income tax rate up to about 40% (a revenue gain of about \$60 billion a year). If we wanted to pay for the second \$200 billion increment, this could be done by raising the corporate tax rate from 21% to 31% (a revenue gain of about \$100 billion a year) and raising the top income tax rate to 45% (a revenue gain of about \$100 billion a year). If we wanted to pay for a third \$200 billion dollar increment, we could then raise the top tax rate to 55%, and pay for a fourth \$200 billion dollar increment by raising the top income tax rate to 65%. Finally, we could pay for a fifth \$200 billion increment by increasing the top tax rate all the way up to 75%.(15)

Conclusion

This then provides us with a basic policy framework for doing our own decades long policy experiment. In the decades following World War II, we started with top tax rates that were very high and lowered them substantially over the next 40 to 50 years. Now with tax rates that are relatively low, we could experiment by raising them in increments over the next 40 to 50 years as well. At a minimum, we should do the first two policy increments, and perhaps even a third increment as well. I would suggest using the remaining policy increments as leverage to get Republican support for a Value Added Tax, so that the US would then have a whole new source of tax revenue to provide them with the needed funds for other spending proposals, as I discuss in another policy memo (Sly 2020).

Ultimately though, this is designed to be an experiment, so once we try out higher tax rates and see how it goes, then we can see if it has the economic and political impact that we want before trying another big policy increment. Because these proposals take from the top 1% and redistribute the revenue to the bottom 80%, this would likely be a very popular proposal that would help the Democrats with their own electoral fortunes and hopefully would be not be too difficult to pass into law, even with staunch Republican opposition. If the full set of policy increments were ultimately passed, this would not erase the gap in income inequality entirely, but perhaps half of the increase in the share of before tax income

going to the top 1% would be offset. Passing only a few of the increments would still have a substantial impact as well, and changing the trends to move in the opposite direction would be worth it on its own. Hopefully, this policy memo provides a starting point for future discussion about how to reduce income inequality in the United States, and eventually gets us to more desirable policy outcomes in the long run.

End Notes

#1 – Based on calculations done by Berkeley Professor Emmanuel Saez as presented by the Center on Budget and Policy Priorities (Stone et al 2020), the share of before tax income going to the top 1% rose from about 10% in 1980 to approximately 22% in 2018. Using CBO data, the Center on Budget and Policy Priorities calculates in the same report that the average after tax income for the top 1% grew by 226% compared to only 47% for the middle 60%, an amount that is approximately 4.8 times slower.

#2 – According to the CBO projections, the effective tax rate for the top 1% is going to decline by 2.9 percentage points between 2016 and 2021, largely due to the big Trump tax cut passed in December of 2017. By comparison, the bottom 80% expects to see their tax rates go down by 0.9% to 1% during that same time (CBO 2019).

#3 – The OECD estimates that the US will collect revenue worth 24.3% of GDP in 2018, down considerably from the 26.8% of GDP collected in 2017. Only Chile, Ireland, and Mexico were projected to collect less than 24.3% of GDP in 2018 (OECD 2019).

#4 – France was projected to collect revenue worth 46.1% of GDP in 2018, while Denmark was projected to collect 44.9% of GDP, which is at least 20 percentage points higher than the 24.3% of GDP that the US was projected to collect in 2018 (OECD 2019).

#5 – The top US tax rate reached 94% in 1944 and 1945, remained at 91% or 92% from 1951 to 1963, and was reduced down to 70% in 1965 and stayed at 70% with the exception of a few years until 1980. The Reagan tax cuts reduced the top tax rate down to 50% in 1982, and the 1986 tax reform lowered the rate down to 28% from 1988 to 1990 (Tax Policy Center 2020). According to data from the World Bank, US real GDP grew by an average of 4.7% from 1961 to 1969, and around 3.2% or less for all subsequent decades, meaning GDP grew the fastest when the top tax rate was at 70% or above.

#6 – After the 1986 tax reform, both capital gains and dividends were taxed at normal income. The tax rates on capital gains diverged from normal income tax rates in 1990 when the top income tax rate increased. Dividends remained taxed at normal income tax rates until 2003 when dividend tax rates went down substantially as a result of the tax cuts passed by George W. Bush.

#7 – The tax cut passed by President Trump in December of 2017 reduced the corporate tax rate from 35% to 21%. In 2017, before the tax cuts, the US had the highest corporate tax rate among all OECD countries.

#8 – In 1990, twelve countries in Europe had a wealth tax, while today only 4 European countries do (Belgium, Norway, Spain, and Switzerland), in part because it is expensive to administer, in part because rich people fled to lower taxed countries, and in part because it did not raise much revenue. If the US

imposed a 2% wealth tax when stocks grow at an average of 6% a year, then this would be similar to raising taxes on capital income by a third ($2\% / 6\%$), though a wealth tax would collect significant revenue both when stocks are going up and down, where taxes on capital income only gets collected when markets go up.

#9 – Senator Kamala Harris proposed a refundable tax credit as part of her presidential campaign that would provide a \$6,000 credit for married couples that phased out when incomes rose between \$60,000 and \$100,000. Single people would get a \$3,000 tax credit that phased out from \$30,000 to \$50,000. Single parents with children get a \$3,000 credit that phased out between \$80,000 and \$100,000. The Tax Policy Center estimates that this tax credit would cost around \$3 trillion over 10 years or about \$300 billion a year.

#10 – In 2017, Senators Michael Bennet and Sherrod Brown proposed to expand the child tax credit so that children under the age of 6 would get a fully refundable tax credit worth \$300 a month, and children between the ages of 6 and 18 would get \$250 a month. The credit would phase out over the same income range as the existing child tax credit which begins to decline when incomes for single people hit \$75,000 and married couples hit \$110,000.

#11 – The Tax Policy Center estimated that Senator Harris' tax credit would go to about half of all households, which means the tax credit likely phases out at approximately the 50th percentile. The estimate that the tax credit begins to phase out at the 30th percentile is an approximation based on the projection that the tax plan costs about \$300 billion a year, which if every adult got exactly \$3,000 with no phase out this would cover about 100 million people or about 40 percent of the 250 million adults in the US. If the 40th percentile represented the mid-point of the phase out range, then the tax credit would phase out between the 30th and 50th percentiles.

#12 – If every adult got a tax credit worth \$1,000 this would cost about \$250 billion a year since there are about 250 million people over the age of 18 in the US. If every child got a \$500 tax credit this would cost about \$40 billion a year since there are about 75 million children under the age of 18 living in the US. If the income limits reduced this to about two-thirds of the population this would reduce the total cost to around \$200 billion a year. Phasing out the credit then between the 60th percentile and the 80th percentile would put the 67th percentile right in the middle of that range. The income limits of \$75,000 for single people and \$150,000 for adults are somewhere above the range that Senator Harris proposes (which covers 50% of the population) and below the range of the income limits for the pandemic stimulus checks (which covers about 90% of the population).

#13 – The Making Work Pay tax credit was enacted into law February of 2009, and reduced taxes by \$400 for single individuals and \$800 for married couples in 2009 and 2010. The tax credit was not extended into 2011, but in December of 2010, a 2% cut in payroll taxes was enacted that lasted until the end of 2012 at which point it was allowed to expire for 2013.

#14 – My paper on deficit bias (Sly 2018) examines the problem in great detail and finds that present bias could play a role in the tendency for governments to run budget deficits, and that incorporating more assumptions from behavioral economics provides an even better model of the problem. If you assume some loss aversion, then deficits are sticky over time and eventually the problem of deficit bias fundamentally becomes a procrastination problem. In this scenario, deficits are initially created due to a

surprise economic shock, but then last a surprisingly long period of time because politicians keep delaying deficit reduction thinking, incorrectly, they will just do it in the next budget cycle.

#15 – In general, the rule of thumb for estimating the revenue gained by increasing the tax rates for the top 1% is that a 1 percentage point increase in the top marginal income tax rate raises about \$10 billion a year, that a 1 percentage point increase in the top tax rate on capital gains and dividends raises about \$10 billion a year, and that a 1 percentage point increase in the corporate tax rate raises about \$10 billion a year. The revenue gain from the top raising the top marginal income tax rate is clearly going to depend on the tax brackets, but, if need be, the tax brackets can be adjusted so that it raises about \$10 billion for each 1 percentage point increase. The top marginal rate for capital gains and dividends is currently 20% so raising that to the top normal income tax rate of 37% would increase those rates by about 17 percentage points and the Joint Committee on Taxation estimates that this would raise about \$168 billion in 2021 or about \$10 billion for each percentage point increase. Once the tax rates on normal income and capital income are unified, then raising the top tax rate by 1 percentage point would raise about \$20 billion a year, \$10 billion from the normal income and \$10 billion from capital gains and dividend income. Once combined, that means a 3 percentage point increase in the top income tax rate would raise about \$60 billion, a 5 percentage point increase in the top rate would raise about \$100 billion, and a 10 percentage point increase in the top rate would raise about \$200 billion. The Joint Committee on Taxation estimates that the decrease in the corporate tax rate by 14 percentage points from 35% to 21% would cost around \$130 billion in 2020 or about \$10 billion for each percentage point decrease. That means a 10 percentage point increase in the corporate tax rate would raise about \$100 billion in revenue.

References

Congressional Budget Office. 2019. “Projected Changes in the Distribution of Household Income, 2016 to 2021.” CBO Publication #55941. December 19th, 2020.

OECD. 2019. “Revenue Statistics 2019. Tax Revenue Trends in the OECD.” As published on OECD.org.

Sly, James. 2018. “How Present Bias and Loss Aversion Leads to Deficit Bias.” Unpublished working paper. February.

Sly, James. 2020. “New Proposals to Invest in Young Children.” Unpublished policy memo. July.

Stone, Chad, Danilo Trisi, Arloc Sherman, and Jennifer Beltran. 2020. “A Guide to Statistics on Historical Trends in Income Inequality.” Published on www.cbpp.org, and updated January 13th, 2020.

Tax Policy Center. 2020. “Historical Highest Marginal Income Tax Rates.” Posted on www.taxpolicycenter.org. February 4th, 2020.