

Testimony Submitted
To
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Committee on Appropriations
Subcommittee on Labor, Health and Human Services, and Education

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Alan D. Viard is a Resident Scholar at the American Enterprise Institute. The views expressed in this testimony are solely his own and do not reflect the views of the American Enterprise Institute or any other institution.

Chairman Obey, Ranking Member Walsh, Members of the Subcommittee; it is an honor to appear before you today to discuss, “Implications of Economic Trends for Workers, Families, and the Nation.”

I would like to make three major points:

- Despite the rise in inequality during the last few decades, real incomes have risen significantly in the middle of the income distribution. Real incomes have also risen at the bottom of the income distribution, although at a very slow pace.
- The existing federal tax system is highly progressive, with a small group of high-income taxpayers bearing a large portion of the federal tax burden.
- Due to economic mobility, annual income can be a misleading measure of wellbeing. A significant portion of households with low incomes in any given year experience large income gains in later years.

Real Incomes Have Risen in the Middle of the Income Distribution

Some observers have claimed that the middle class has experienced falling living standards in recent decades, as their incomes have failed to keep up with inflation. The best evidence demonstrates, however, that real incomes have risen significantly in the middle of the distribution, although not as rapidly as at the top of the distribution. Real incomes have also risen in the bottom of the distribution, although those gains have been extremely small.

To assess this issue correctly, it is necessary to use a measure of the overall economic status of middle-income Americans. Incomplete measures can yield misleading results.

For example, the Bureau of Labor Statistics’ measure of average hourly earnings of production and non-supervisory workers has often failed to keep pace with inflation. At best, however, that measure reflects households’ before-tax cash wage income, which is only part of the picture. To obtain a comprehensive measure of the economic resources available to households, it is necessary to include their other sources of income – fringe benefits, property income, and government benefits – and to subtract their tax payments. Even the Census Bureau’s measure of household money income is incomplete, because it omits fringe benefits, in-kind government benefits, and capital gains and does not subtract tax payments.

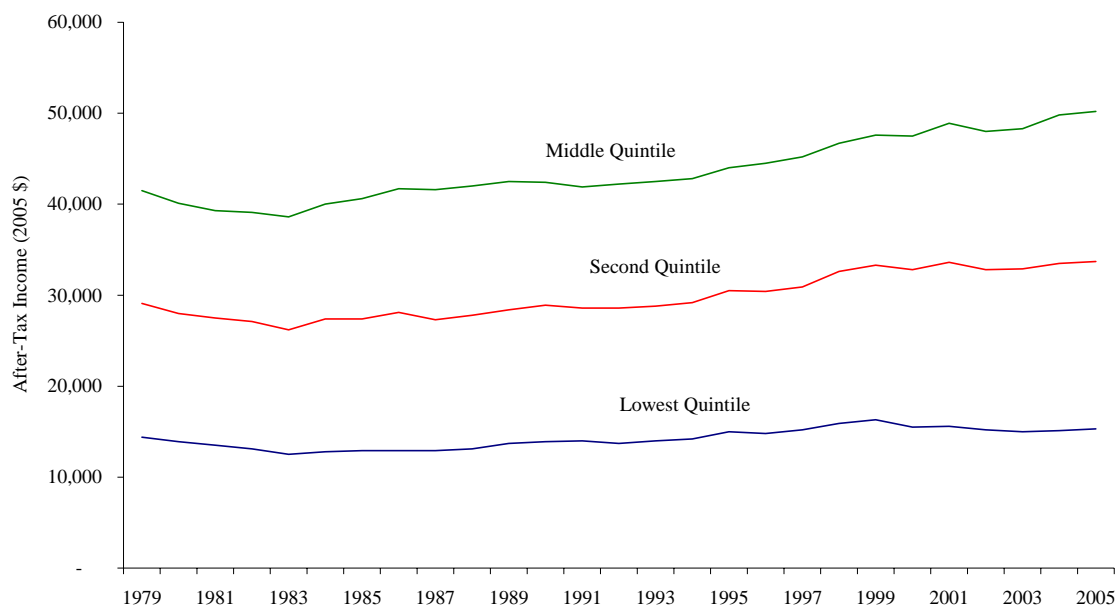
The Congressional Budget Office (CBO) has constructed a more comprehensive measure of income. CBO uses tax return data to obtain a broad measure of wages and property income, including realized capital gains and retirement benefits, and then draws on other data sources to include additional forms of income, such as employer-provided health insurance, government cash benefits, and some in-kind government benefits.

CBO classifies households into different income groups based on their before-tax income, divided by the square root of household size. For each income group, CBO reports average before-tax and after-tax incomes. To compare incomes across different

years, CBO reports real (inflation-adjusted) incomes, computed using the Consumer Price Index Research Series.

Figure 1 presents average real after-tax incomes for the bottom three quintiles of the income distribution for 1979 through 2005. Each quintile is 20 percent of the population. I will first focus on the middle quintile. (In 2005, a four-person household was classified in this quintile if its before-tax income was between \$61,000 and \$90,400; a one-person household was so classified if its before-tax income was between \$30,500 and \$45,200.) This quintile is in the middle of the income distribution; 40 percent of the population has higher income and 40 percent has lower income.

Figure 1: Real After-Tax Incomes Have Risen for Middle Quintile



Source: Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2005*, December 2007. Income groups are classified by comprehensive before-tax household income divided by square root of household size. For each quintile, the chart shows after-tax comprehensive income, not weighted by household size, deflated by the Consumer Price Index Research Series.

From 1979 to 2005, the average real after-tax income of the middle quintile, as shown by the top line in Figure 1, rose 21 percent. This finding decisively refutes the claim that middle-income households have not kept up with inflation. The 2005 value of real after-tax income was the highest value in the 26-year period, 6 percent higher than in 2000 and 14 percent higher than in 1995.

It is true, of course, that incomes have not risen as rapidly for the middle quintile as for those further up in the income distribution. From 1979 to 2005, average real after-tax income rose 29 percent for the fourth quintile and 80 percent for the top quintile. The disparity in growth rates confirms the rise in inequality during this period. Nevertheless, the tide of economic growth still lifted the middle-income boat.

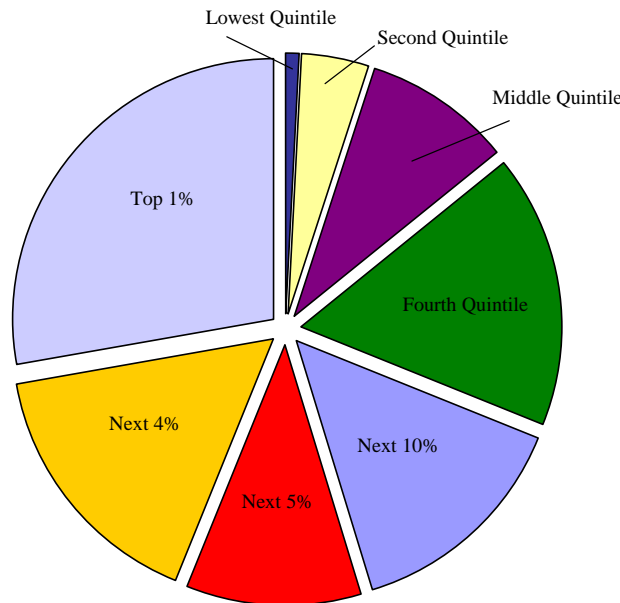
The CBO data show that real after-tax incomes also rose for the bottom two quintiles, although by smaller amounts. For 1979 to 2005, the second quintile's real after-tax income grew by 16 percent, not quite as fast the middle quintile's income gain. The lowest quintile registered a meager 6 percent gain. (In 2005, the lowest quintile included four-person households with before-tax income less than \$35,800 and one-person households with before-tax income below \$17,900). The slow income growth at the bottom is clearly a source of concern.

The Federal Tax System Is Highly Progressive

In the face of rising inequality, some have complained that the federal tax system is too generous towards those with high incomes. Of course, the appropriate division of the tax burden between different income groups requires difficult value judgments. In making these judgments, however, it is important to recognize that the federal tax system is already highly progressive, placing much of the federal tax burden on a small group of high-income taxpayers.

Figure 2 depicts the allocation of the federal tax burden across income groups in 2005, as computed by CBO. The income classification is the same as that described above. The data include nearly all federal taxes; individual income taxes, corporate income taxes (which are assumed to be borne by households with capital income), social insurance taxes such as the Social Security-Medicare payroll tax (which is assumed to be borne by workers), and excise taxes.

Figure 2: High-Income Groups Bear Most of Federal Tax Burden
(Shares of Federal Tax Liabilities, 2005)



Source: Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2005*, December 2007. Data include federal individual and corporate income taxes, social insurance taxes, and excise taxes. Corporate income taxes are assumed to be borne by households with capital income and social insurance taxes are assumed to be borne by workers.

The data reveal a striking degree of progressivity. The lowest quintile bears about 1 percent of the federal tax burden and the second quintile bears 4 percent. The burden is higher for the next income groups, as the middle quintile bears 9 percent of the burden and the fourth quintile bears 17 percent.

That leaves the top quintile paying 69 percent of the cost of government; one fifth of the population pays more than two-thirds of the cost. The breakdown within that quintile is even more striking. Most notably, the top 1 percent of the population bears a staggering 28 percent of the tax burden. In other words, a mere 1 percent of the population shoulders more than one-quarter of the costs of the various services that the federal government provides – Social Security, Medicare, national defense, the FBI, and so on.

Furthermore, the shares of the tax burden borne by high-income groups exceed their shares of national income. In other words, these groups pay bigger portions of their incomes to the government than other Americans. For example, the top 1 percent has 18 percent of the country's before-tax income, but pays 28 percent of the taxes.

Individual income taxes alone are even more progressive; the top 1 percent pays 39 percent of those taxes in 2005 while the bottom 40 percent pays *negative* 4 percent of those taxes. Of course, the progressivity of individual income taxes is partly offset by the regressivity of social insurance taxes. As Figure 2 shows, however, the overall federal tax system remains highly progressive, even when the regressive social insurance taxes are included.

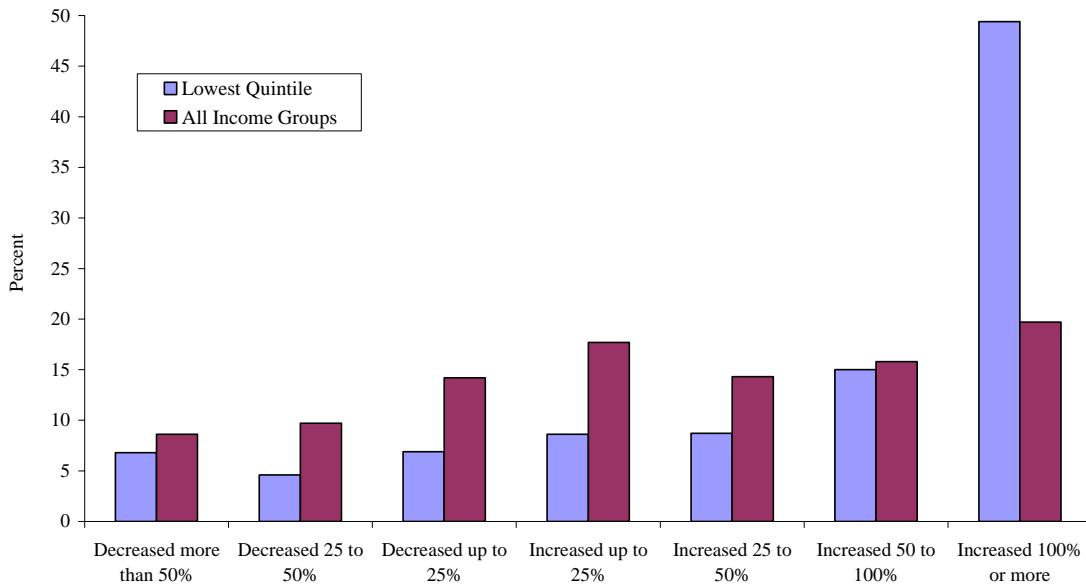
Economic Mobility Can Make Annual Income a Misleading Measure of Wellbeing

All of the above discussion relies on annual income measures. These measures can be misleading because household incomes can change over time. In particular, some of the households who are in the bottom of the income distribution in a particular year are likely to be there due to temporary factors and may experience higher incomes in later years. As a result, their living standards and economic wellbeing may not be as unfavorable as their current income would suggest.

A recent Treasury Department study documents economic mobility between 1996 and 2005. The study examined a large sample of taxpayers 25 years and older in 1996 who filed tax returns in both 1996 and 2005. Each taxpayer's income was measured as adjusted gross income plus tax-exempt interest and the non-taxable portion of Social Security benefits minus alimony paid by the taxpayer. As in the CBO study mentioned above, the Consumer Price Index Research Series was used to measure real (inflation-adjusted) incomes.

Figure 3 shows the distribution of real income changes from 1996 to 2005 for those taxpayers who were in the bottom quintile of the income distribution in 1996. For comparison, the figure also shows the corresponding distribution of real income changes for taxpayers in all income groups.

Figure 3: Large Gains for Many Taxpayers with Low 1996 Incomes
 (Distribution of Percentage Changes in Real Income, 1996 to 2005)



Source: Department of the Treasury, *Income Mobility in the U.S. from 1996 to 2005*, November 13, 2007, Table 3. Income is adjusted gross income plus tax-exempt interest and non-taxable portion of Social Security benefits minus alimony payments. Results are for taxpayers 25 and older in 1996 who filed tax returns in both 1996 and 2005.

Most strikingly, the figure shows that 49 percent of the low-income taxpayers in 1996 had an income gain of 100 percent or more from 1996 to 2005. In other words, almost half of this group saw their real incomes double or better over a nine-year period. In contrast, only 20 percent of taxpayers in all income groups saw income gains of that magnitude.

More generally, 82 percent of the low-income group (compared to 67 percent of taxpayers in all income groups) experienced real income gains from 1996 to 2005. Also, the mean income for the low-income group more than tripled from 1996 to 2005. Due to their income gains, 45 percent of those in the bottom 1996 quintile moved out of the bottom quintile of the sample in 2005.

Conversely, taxpayers with high incomes in a given year do not always maintain their incomes. The Treasury study found that, among the top 1 percent in 1996, 65 percent experienced losses in real income over the next nine years, with 60 percent moving out of the top 1 percent of the sample and 13 percent moving out of the entire top quintile.

These data make clear that some taxpayers with low income in a given year will move to higher incomes in later years while some with high income in a given year will move to lower incomes. For those taxpayers, annual income may be a misleading measure of their economic wellbeing. As a result, inequality in economic wellbeing may be smaller than inequality in annual income.

Of course, some low-income taxpayers suffer from longer-term problems. The Treasury data show that 18 percent of the taxpayers in the bottom quintile in 1996 experienced a loss in real income over the next nine years. Indeed, 7 percent of the bottom quintile lost half or more of their initial meager income. Also, the Treasury study did not include households that do not file tax returns, some of whom may face long-term economic difficulties. The plight of households with long-term low incomes is clearly a source of concern.

Summary

Despite the rise in economic inequality over the last few decades, real income growth has continued at the middle of the income distribution. Real incomes have also risen at the bottom of the income distribution, though very slowly. Also, the current federal tax system is highly progressive, with a small group of high-income households paying a large share of the federal tax burden. Furthermore, economic mobility allows some households with initially low incomes to move to higher income levels, casting doubt on the accuracy of inequality measures based on annual income.