

THE PARALLEL MARCH OF THE GINIS

How does taxation relate to inequality, and what can be done about it?

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The United States currently has one of the highest levels of inequality among industrialized economies. In addition, numerous scholars have shown that social mobility in the United States is significantly lower than it was in the period between 1945 and 1970, when inequality was declining. The combination of these trends is dangerous because it risks transforming the United States into a society where small elites capture most of the gains, a pattern in which growth cannot be sustained over time. The level of inequality in the United States after taxes and transfers are taken into account is much lower, but it is still higher than in most OECD countries, and the trend is still for inequality to increase. This article explores how the U.S. tax system can be used to counter these trends and concludes that the key is not to increase taxes on the rich (although some reforms in this direction can be adopted) but instead to adequately fund and even strengthen the social safety net. The only way to do this in the medium to longer term is to adopt a broad-based federal consumption tax.

The United States currently has one of the highest levels of inequality among the members of the Organization for Economic Cooperation and Development (OECD), as measured by the Gini coefficient before taxes and transfers. The U.S. Gini coefficient before taxes is 0.53 or 53, measured on a scale in which 100 is perfect inequality (one person has all the income) and 0 is perfect equality. Figure 1 shows that the U.S. Gini is higher than that of most other OECD members, and it is also higher than that of many developing countries (e.g., China and India).

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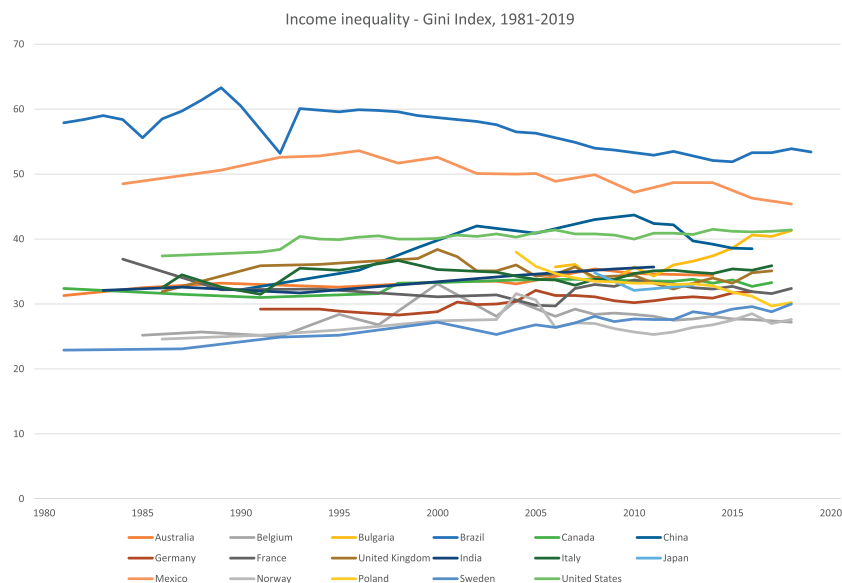


Figure 1. Gini Index by Country (World Bank)

This level of inequality would not matter if social mobility in the United States were high because in that case, every U.S. child could achieve the “American dream.” However, an OECD study pointed out that “[m]obility in earnings across pairs of fathers and sons is particularly low in France, Italy, the United Kingdom and the United States, while mobility is higher in the Nordic countries, Australia and Canada.”¹ The United States ranked third from the bottom among the twelve countries studied.² A primary reason cited was that the United States ranked first in the influence of parental background on student achievement in secondary education.³ In general, the OECD found that intergenerational social mobility tends to be lower in more unequal societies.⁴

Numerous economists have shown that social mobility in the United States is significantly lower now than it was in the period between 1945 and 1970, when inequality was declining.⁵ The combination of these trends is dangerous because it risks transforming the United States into a society where small elites capture most of the gains, a pattern in which growth cannot be sustained over time. As Daron Acemoglu and James Robinson showed,

1 ORG. FOR ECON. CO-OPERATION & DEV., ECONOMIC POLICY REFORMS: GOING FOR GROWTH 183 (2010), <https://doi.org/10.1787/growth-2010-en>.

2 *Id.* at 185 fig.5.1.

3 *Id.* at 188 fig.5.3.

4 *Id.* at 195 fig.5.10.

5 See, e.g., Robert Frank, *The Vicious Cycle of Income Inequality*, N.Y. TIMES (Jan. 11, 2014), <https://www.nytimes.com/2014/01/12/business/the-vicious-circle-of-income-inequality.html>.

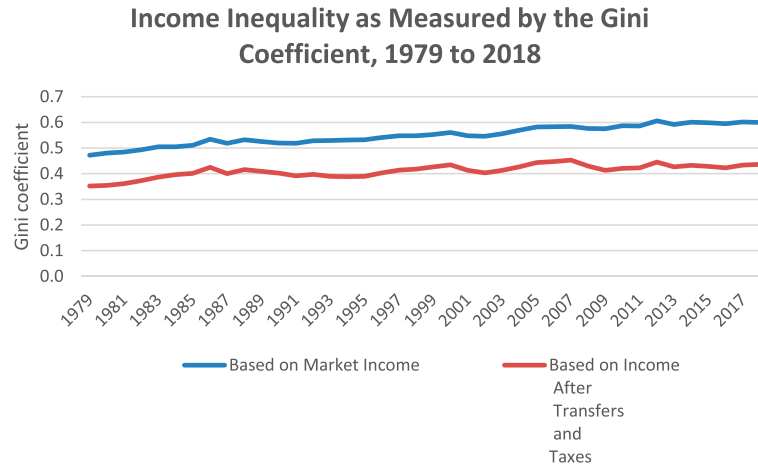


Figure 2. US Gini Before and After Taxes (CBO data)

societies with “extractive” institutions (where elites capture most resources) tend to stagnate in comparison with societies with “inclusive” institutions.⁶ Moreover, as Luigi Zingales pointed out, the United States used to be more inclusive but is now becoming more extractive as established elites use their financial resources to lobby for and capture economic rents.⁷ A classic example is the tax treatment of the labor income of hedge fund managers as capital gains taxed at half the rate.⁸

How does taxation enter into the picture? The level of inequality in the United States after taxes and transfers are taken into account is significantly lower, although it is still higher than in most OECD countries⁹ and the trend is still for inequality to increase.

The striking fact visible in the data above is that the trend line is the same from 1984 to 2019; that is, the Gini coefficient moves in parallel before taxes and transfers and after

6 DARON ACEMOGLU & JAMES A. ROBINSON, *WHY NATIONS FAIL: THE ORIGINS OF POWER, PROSPERITY, AND POVERTY* (2012).

7 LUIGI ZINGALES, *A CAPITALISM FOR THE PEOPLE: RECAPTURING THE LOST GENIUS OF AMERICAN PROSPERITY* (2012).

8 See Randall Dodd, *Tax Breaks for Billionaires: Loophole for Hedge Fund Managers Costs Billions in Tax Revenue*, ECON. POL’Y INST. (July 24, 2007), <https://www.epi.org/publication/pm120/>. Daniel Shaviro notes two more dimensions of research on inequality. The first is normative inquiry regarding why, when, how, and to what extent inequality matters, moving beyond the economic literature’s often predominant focus on declining marginal utility. The second is better connecting the analysis of purely economic inequality to that of its other dimensions, such as racial and ethnic inequality. See Daniel Shaviro, *Tax Law, Inequality, and Redistribution: Recent and Possible Future Developments*, NYU L. & ECON. RESEARCH PAPER No. 22-06 (2021), <https://ssrn.com/abstract=3962466> or <https://dx.doi.org/10.2139/ssrn.3962466>.

9 See, e.g., CONG. BUDGET OFFICE, *THE DISTRIBUTION OF HOUSEHOLD INCOME, 2016* (July 2019), <https://www.cbo.gov/system/files/2019-07/55413-CBO-distribution-of-household-income-2016.pdf> (finding that the U.S. Gini coefficient in 2016 ranged from 0.59, before accounting for any forms of taxes and transfers, to 0.42, after accounting for taxes and transfers).

taxes and transfers are taken into account. This pattern is surprising because (a) the United States relies heavily on individual income taxes, and those taxes are very progressive; and (b) the top marginal tax rate and the tax rates on capital gains and dividends changed numerous times during the relevant period. Therefore, if progressive income taxation reduces inequality, one would expect the before- and after-tax Ginis to diverge rather than march in parallel.

Compared to other countries, the United States relied heavily on individual income taxes throughout the relevant period, and, as mentioned, those taxes are quite progressive. In 2001, the top 1% of the U.S. population by adjusted gross income (AGI) paid 33.89% of federal personal income tax, and the top 5% paid 53.25% (by comparison, the bottom 50% of the AGI distribution paid less than 4% of total income taxes collected).¹⁰ This is a significant increase from 1994, when the top 1% of taxpayers paid only 28.7% of federal personal income tax. In 2004, after President Bush's tax cuts, the top 1% still paid 32.3% of federal individual income taxes, and the top 5% paid 53.7%.¹¹ In 2008, the top quintile of taxpayers paid 94.6% of federal individual income taxes, the highest percentage since 1979.¹² The same pattern persisted even after the Tax Cuts and Jobs Act of 2017,¹³ which disproportionately benefited the rich.¹⁴

Given this level of progressivity, it is striking that the U.S. Gini after taxes increased steadily during the entire period from 1983 to 2019, in parallel to the before-tax Gini. Moreover, if one examines the movements of the top individual tax rate in that period, one can see quite dramatic fluctuations. The top rate went from 50% in 1983 down to 28% in 1986, then gradually up to 39.6% in 1993, then down to 35% in 2001, then back to 39.6% in 2012, then down to 37% in 2017.¹⁵ The capital gains rate went up from 20% in 1983 to 28% in 1986, then down to 20% in 1997, then down again to 15% in 2003, and up to 23.8% in 2012.¹⁶ None of these changes seem to have made an impact on the after-tax Gini.

10 S. REP. NO. 108-206, at 54 (2003), https://www.jec.senate.gov/public/_cache/files/a643e271-e9c6-42fa-b22d-96b897abdcc8/the-2003-joint-economic-report-1762-.pdf.

11 CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES UNDER CURRENT LAW, 2001 TO 2014, at 11 (Aug. 2004), <https://www.cbo.gov/sites/default/files/108th-congress-2003-2004/reports/08-13-effectivefedtaxrates.pdf>.

12 IRS, STATISTICS OF INCOME (2013).

13 See Erica York, *Summary of the Latest Federal Income Tax Data, 2021 Update*, TAX FOUND. (Feb. 3, 2021), <https://files.taxfoundation.org/20210202124940/Summary-of-the-Latest-Federal-Income-Tax-Data-2021-Update.pdf>.

14 See, e.g., *TCJA by the Numbers*, INST. ON TAXATION AND ECON. POL'Y (Aug. 28, 2019), <https://itep.org/tcja-2020/>.

15 See *Historical U.S. Federal Individual Income Tax Rates & Brackets, 1862–2021*, TAX FOUND. (Aug. 24, 2021), <https://taxfoundation.org/federal-capital-gains-tax-collections-historical-data/>.

16 See *Federal Capital Gains Tax Collections, Historical Data (1954–2018)*, TAX FOUND. (Apr. 26, 2021), <https://taxfoundation.org/federal-capital-gains-tax-collections-historical-data/>.

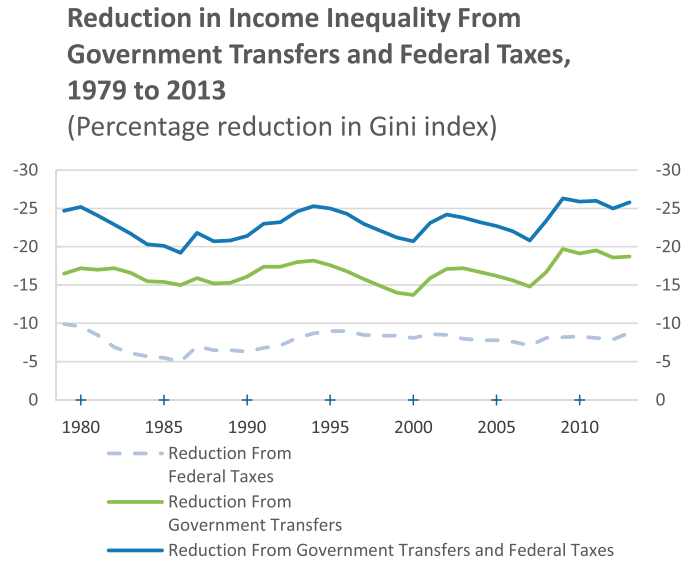


Figure 3. Reduction in Income Inequality (CBO data)

A more detailed examination of the data, however, suggests the answer to this puzzle. Figure 3 shows the Congressional Budget Office estimate of the contribution of taxes and transfers to the reduction in the Gini coefficient.¹⁷

The figure indicates that (a) there was some decline in the degree to which taxes and transfers reduced the Gini from 1979 to 2007, but the system as a whole was still quite progressive, reducing the Gini by about 17%; (b) both taxes and transfers contribute to the reduction, but transfers contribute more than taxes; and (c) after 1986, despite numerous changes in the tax rates, the contribution of taxes to decreasing inequality was essentially flat, with all the fluctuation due to changes in transfers (since the overall line tracks the transfers line).

These data suggest that the answer to increasing inequality is not more-progressive income taxation. High rates of income taxation raise familiar problems, such as increased tax avoidance, leisure being chosen over labor, and potential emigration to low-tax jurisdictions.¹⁸ While the U.S. top individual tax rate is lower than that in some OECD countries, those countries typically have lower rates on capital income, which is highly concentrated at the top of the income distribution. This comparison suggests that in a globalized world, the United States does not have a lot of capacity to raise the tax rate

17 CONG. BUDGET OFFICE, TRENDS IN THE DISTRIBUTION OF HOUSEHOLD INCOME BETWEEN 1979 AND 2007 20 (Oct. 2011), <https://www.cbo.gov/sites/default/files/cbofiles/attachments/10-25-HouseholdIncome.pdf>.

18 Reuven S. Avi-Yonah, *And Yet It Moves: Taxation and Labor Mobility in the 21st Century*, U. MICH. LAW & ECON. RESEARCH PAPER NO. 12-008 (2012), <https://dx.doi.org/10.2139/ssrn.2055160>.

on the rich further; certainly the 70% top marginal rate of 1980 or the 94% tax rate of the 1950s appear unlikely to return when the rich can easily move to other countries, give up their U.S. citizenship, and enjoy much lower rates.

Overall, the U.S. tax and transfer system has a very significant impact on inequality: as Figure 2 indicates, it reduces the U.S. Gini by over ten points, which is more than the difference between the pre-tax Gini of the United States and Sweden. So if it is not the progressive tax system that does the work, what does? The answer must be the much-maligned “entitlements”: Social Security, Medicare, and Medicaid. These programs are very progressive in that while only Medicaid is means-tested, their benefits are more important to the poor, while the funding comes from progressive taxation of labor income (although in the case of Social Security the funding could be made more progressive by eliminating the income cap).

Thus, one key to reducing inequality in the United States is to bolster the social safety net. We should at least maintain current benefits and possibly increase them. In particular, Social Security should be strengthened, since most baby boomers do not have nearly enough saved for retirement (and many have seen their savings decimated by the Great Recession).¹⁹ The Affordable Care Act has strengthened health care, but it will probably require more funding to support insurance for persons with preexisting conditions and the poor if not enough young, healthy people sign up for the exchanges.²⁰

Moreover, strengthening the social safety net is important to sustaining growth. Open economies tend to have stronger safety nets because the gains from having an open economy tend to impose risk on the people who lose from globalization, so a strong safety net is, in a democracy, a precondition to obtaining widespread political support for openness, which in turn produces growth.²¹ Thus, if we want to avoid the pattern that led to the end of the first era of globalization a hundred years ago, we need to maintain a strong safety net lest the U.S. public vote for protectionism, decreased immigration, and less tolerance for the “creative destruction” of technologically inspired growth. Fundamentally, there is an inherent tension between democracy, globalization, and tax competition: if the voters desire a robust safety net, they may vote for limits on globalization, which leads to tax competition and the need to cut tax rates, which in turn negatively impacts the social safety net. The only solution is to limit tax competition by increased cooperation, which

19 See, e.g., William Englund, *Millions of Baby Boomers Are Getting Caught in the Country’s Broken Retirement System*, WASH. POST (May 4, 2020), <https://www.washingtonpost.com/business/2020/05/04/baby-boomers-retirement/>.

20 See, e.g., Uwe Reinhardt, *Why Are Private Health Insurers Losing Money on Obamacare?*, JAMA F. (Aug. 25, 2016), <https://jamanetwork.com/channels/health-forum/fullarticle/2760061>.

21 See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).

underlies the current OECD effort to establish minimum corporate taxes and combat individual tax evasion.²²

How can the U.S. safety net be financially sustained in the long run? The answer cannot be more deficit financing, for two reasons. First, this just means passing the buck to our children, which seems both unfair and risky. As the population ages, the proportion of working-age adults to seniors (the dependency ratio) will decline in the United States, as it already did elsewhere,²³ unless we are willing to accept much more immigration, which carries its own risks.²⁴ Second, much of the U.S. Treasury debt is held by China, and that is exactly how the U.K. lost its position as a great power after World War II: too much of its debt was held by the United States, which was able to dictate terms.²⁵

Nor is the answer raising the income tax. There are not enough rich people to support the safety net, and, as stated above, the rich can adjust to a higher rate by avoiding taxes, working less, or moving. Nor would it be wise to increase the income tax on corporations (they can move even more easily than the rich) or on the middle class, since they already carry heavy burdens and cannot afford to bear the entire load.²⁶

Some economists have recently argued for a return to the marginal tax rates of the 1950s and 1960s, pointing out that those rates coincided with much lower inequality.²⁷ But this is a spurious correlation; as Figure 4 shows, the effective tax rate paid by the top 1% was always much lower than the top marginal rate,²⁸ and the reason for greater equality in the 1950s and 1960s had more to do with trends in education (the GI Bill), labor (widespread unionization), and the closed U.S. economy before globalization than with the top marginal tax rates.²⁹

22 See Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State: A Twentieth Anniversary Retrospective*, in THINKER, TEACHER, TRAVELER: REIMAGINING INTERNATIONAL TAX, ESSAYS IN HONOR OF H. DAVID ROSENBLUM 39 (Georg Kofler & Ruth Mason Alexander Rust eds., 2021).

23 See, e.g., Luke Rogers & Kristie Wilder, *Shift in Working-Age Population Relative to Older and Younger Americans*, CENSUS BUREAU (June 25, 2020), <https://www.census.gov/library/stories/2020/06/working-age-population-not-keeping-pace-with-growth-in-older-americans.html>.

24 See, e.g., PAUL COLLIER, *EXODUS: HOW MIGRATION IS CHANGING THE WORLD* (2013). The main issues are pressure on wages and resistance to rapidly changing demographics.

25 CHARLES WILLIAMS, HAROLD MACMILLAN 259–61 (2009) (discussing Eisenhower threat to sell U.K. bonds, leading to U.K. withdrawal from Egypt).

26 See, e.g., ELIZABETH WARREN & AMELIA TYAGI, *THE TWO-INCOME TRAP: WHY MIDDLE-CLASS PARENTS ARE GOING BROKE* (2007).

27 See, e.g., Emmanuel Saez, *Income Inequality: Evidence and Policy Implications*, Stanford University Arrow Lecture 18 (Jan. 2013), https://eml.berkeley.edu/~saez/lecture_saez_arrow.pdf.

28 W. Elliot Brownlee, *Historical Perspectives on U.S. Tax Policy Toward the Rich*, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 61 tbl.2.6 (Joel B. Slemrod ed., 2000).

29 CONG. BUDGET OFF., *supra* note 17.

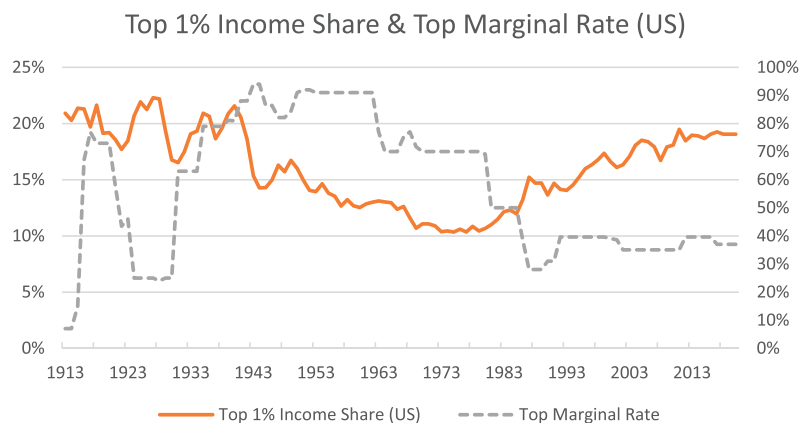


Figure 4. WID_Data_12042022-191740

Another reason the social safety net cannot be financed by increased taxes on labor (either income or payroll taxes) is intergenerational equity. The benefits of Social Security and Medicare flow to the old, while income and payroll taxes are borne by the young. In addition to the dependency ratio concerns raised above, it seems unfair (and will certainly appear so to many young voters) to transfer so much from the old to the young.

The solution is to enact a broad federal consumption tax—that is, a value-added tax (VAT). This proposal has been developed in detail elsewhere.³⁰ For present purposes, a VAT has an important advantage: unlike income and payroll taxes, consumption taxes do not discourage work, and because the old as well as the young consume, they are borne in significant part by the principal beneficiaries of the social safety net. In addition, VATs are used in over 150 countries and have a demonstrated capacity to raise revenues even with tax administrations far weaker than the IRS.

The VAT is regressive, and while there are ways to mitigate regressivity within the VAT, such as exempting basic living necessities, such exemptions subsidize well-off consumers and make the tax needlessly complicated. If VAT revenues are segregated and used to fund Social Security, Medicare, and Medicaid, the inherent progressivity of those programs mitigates the regressivity of the underlying tax.

Moreover, in addition to bolstering the safety net, a VAT can be used to fund opportunity programs for the next generation, such as universal pre-K, which will contribute directly to improving social mobility. The biggest obstacle to enhancing social mobility in the United States is that by the time children start formal schooling, many of them lag so far behind their peers that even good public schools cannot enable them to get

30 Reuven S. Avi-Yonah, *Designing a Federal VAT: Summary and Recommendations*, 63 TAX L. REV. 285 (2010).

to college, which is the essential gateway to the middle class in a technology-dominated economy.

Ultimately, the challenge in enacting a VAT is political. Rep. Ullman, who was Chair of Ways and Means in the 1970s, supposedly was defeated after proposing one. But that story is a myth, and good politicians, such as John Howard of Australia, have managed to build a broad legislative coalition to enact a VAT—even after promising not to do so—and to win reelection decisively.³¹ A VAT serves the right’s need for fiscal balance and the left’s need to expand social outlays, so it represents the ultimate “grand bargain” in American politics. It is a fair and sensible way to address the inequality that threatens our future.

31 See Shane Wright, *‘It Was Heated’: Cabinet Papers Show John Howard’s Government Grappled with How to Introduce the GST*, SYDNEY MORNING HERALD (Jan. 1, 2021), <https://www.smh.com.au/politics/federal/it-was-heated-cabinet-papers-show-john-howard-s-government-grappled-with-how-to-introduce-the-gst-20201223-p56pv8.html>.