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TESTIMONY OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, BEFORE THE WAYS AND MEANS COMMITTEE

Thank you for the invitation to testify about widening income inequality in the United States, including the impact of recent developments in financial markets and the economy. As former Federal Reserve chairman Alan Greenspan has said, "this is not the type of thing which a democratic society — a capitalist democratic society — can really accept without addressing," and I commend the committee for holding this hearing.

My testimony falls into three parts.

- The first is an overview of the data on household income and its distribution, where I will discuss recent developments in the context of longer-term historical trends.
- The second is a discussion of the role of public policy in influencing the distribution of income. That discussion largely focuses on government tax and transfer policies — that is, on how government policies affect the distribution of after-tax income. But policy also can have some influence on the distribution of pre-tax income determined by market forces, through such things as trade policy, education policy, and labor-market policy.
- The third is a discussion of the implications for public policy generally and some specific policy recommendations for addressing the problem of widening income inequality.

Recent Developments and Longer-Term Trends in Income Inequality

I would like to start by placing the issue of income inequality into the context of recent economic developments and to review some of the salient data on longer-term trends in inequality.

In recent years, income inequality in the United States rose to historically high levels. This was not because the economy was in a recession — the latest available data on inequality do not reflect the current economic slump. And it was not a new development. Inequality has been increasing for more than 30 years.

There was, however, something different about the increase in inequality from 2001 until last year that I want to comment on before discussing very recent developments and then examining the longer-run trends. Usually, concerns about inequality move to the back burner, at least in the public discourse, during economic expansions when most people see their standard of living rise and feel good about their economic prospects. That happened, for example, during the second half of the long economic expansion of the 1990s. But those good feelings were noticeably absent in recent years, even though economic statisticians would characterize the economy's performance from the end of 2001 through most of last year as a business-cycle recovery and expansion following the 2001 recession.

The disconnect in recent years between how the overall economy was doing statistically and how most people living in that economy were doing was puzzling to some pundits and some elected officials and their advisors. But it really was not that complicated. First, the post-2001 period was the weakest of all economic expansions since World War II by almost every economic measure. Second, to an unprecedented degree, the gains from economic growth after 2001 accrued to a narrow slice of the population at the top of the income distribution.

When I said the recovery was weak by *almost* every measure, I was alluding to the fact that there was one important exception — corporate profits. While aggregate wages and salaries grew *less than half* as fast after 2001 as they did in the average postwar economic expansion, corporate profits grew almost 30 percent faster. Both employment growth and wage and salary growth were weaker in the most recent expansion than in any prior expansion since the end of World War II; growth in corporate profits was stronger than the average of all post World War II expansions.

What were the consequences for income inequality of that weak and unbalanced economic recovery? First, in 2006 the share of pre-tax income flowing to the top 1 percent of households reached its highest level since 1928. Second, the gap between the after-tax income of people at the top of the income distribution and the after-tax income of people in the middle or at the bottom continued to widen. It should not be surprising that people were pessimistic about their economic prospects even before the stunning economic and financial developments of the past few months. It was not just in their heads.

Now, of course, every new economic indicator points to a deteriorating economy. That by itself should increase inequality. A weak economy has a disproportionate impact on people who struggle against economic hardship even in a better economy, on low- and moderate-income households that don't have a savings cushion to absorb unexpected expenses or losses of income, and on people who lose their jobs and face longer spells of unemployment than they would in a stronger economy.

At the same time, however, the direct financial fallout from recent events is likely to have its most significant impact on income at the very top of the income scale. This is what happened in the dot-com collapse when, for a few years, income at the top of the distribution fell sharply. That was just a speed bump, however, and incomes at the top more than made up the lost ground from 2004 to 2006.

Thus it would not be surprising to see at least a temporary decline in the concentration of income at the very top of the distribution over the next year or so, particularly considering the sharp declines in the stock market. What happens after that will depend on how the economy and financial markets perform, and also on economic policy and what kind of institutions and social norms regarding inequality emerge from the current crisis.

Let me turn now to a discussion of the data on income inequality and what they show about longer-term trends. There are two primary sources of annual data on household income and its distribution. The first is Census Bureau data on poverty and income based on the Current Population Survey, and the second is income tax data from the IRS. Neither alone can give a complete picture of trends in income inequality. The tax data provide good coverage of people who pay income taxes, including people with very high incomes, but they omit people with low incomes who are not required to file an income tax return. The Census data have good coverage of that low-income population but for various reasons do not have good coverage of people with very high incomes.

To bridge the gap, the Congressional Budget Office has developed a method for combining the two data sources that provides the most complete picture available of the distribution of before- and after-tax income. Although the Census data are available in one form or another back to the end of World War II and IRS data are available in one form or another back to the beginning of the income tax in 1913, CBO's comprehensive data series goes back only to 1979, and the most recent published CBO estimate is for 2005. We do have a much longer consistent series on concentration at the very top of the income scale derived from IRS data thanks to the efforts of economists Thomas Piketty and Emanuel Saez. The Piketty-Saez data series covers the years from 1913 through 2006.

What do these data tell us about long-term trends in inequality? First, the CBO data in Figure 1, which shows the percentage increase in after-tax income at different points on the income scale since 1979, portray a widening gap between income at the top and income in the middle and at the bottom, with the largest income gains accruing at the very top. As Table 1 shows, after adjusting for inflation, income in the bottom fifth of the population was only 6 percent — or $900 — higher in 2005 than it was twenty-six years earlier in 1979, and income in the middle fifth of the population was 21 percent — or $8,700 — higher. In contrast, income in the top fifth of the distribution rose 80 percent — or $76,500 per household — from 1979 to 2005, and income in the top 1 percent more than tripled, rising 228 percent — or $745,100 per household.

TABLE 1: **Change in After-Tax Income, 1976-2005, by Income Group**

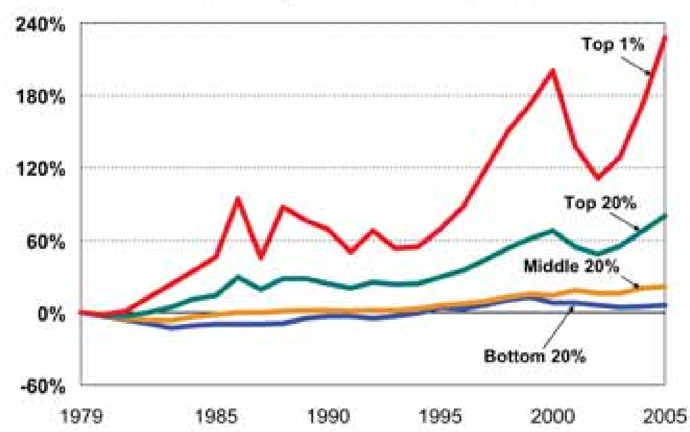
	Bottom 20 %	**Second 20 %**	**Middle 20 %**	**Fourth 20 %**	**Top 20 %**		**Top 1 %**
Increase in 2005 dollars	$900	$4,600	$8,700	$16,000	$76,500		$745,100
Percentage increase	6.3%	15.8%	21.0%	29.5%	79.9%		228.3%

While these CBO data show a strong upward trend in inequality over the past 25 years, it would be a mistake to think that rising inequality and increasing concentration of income at the very top of the income scale have been an inevitable feature of the American economy. As Figure 2 shows, the pattern of growth in household income over the past three decades is distinctly different from the pattern over the first three decades after the end of World War II. The data here are for pre-tax income, but the story for after-tax income (if it were available for this whole period) would likely not be noticeably different for the reasons discussed later in my testimony.

FIGURE 1

Highest Income Households Have Seen Far Greater Income Growth Than Others

Percent Change in After-Tax Income Since 1979



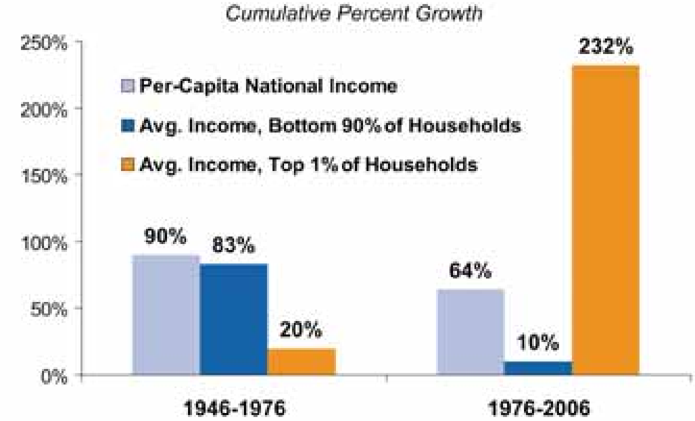
Source: CBPP calculations based on CBO data

From 1946 to 1976, the increase in the average income of the bottom 90 percent of households closely matched the growth of per capita national income, while income at the very top grew more slowly. In other words, the gap between the average income of the very richest households and that of the bottom 90 percent of households narrowed over this period. Over the next three decades, in contrast, growth in the average income of the bottom 90 percent of households fell far short of growth in per-capita national income, while growth in the average income of the top 1 percent of households soared. If we had a figure like Figure 1 for this longer period, we would see the incomes of the top, middle, and bottom fifths trending upward together at roughly the same rate from 1946 to sometime in the 1970s, followed by a sharp divergence in the years since 1976 like that depicted in Figure 1.

FIGURE 2

Uneven Distribution of Gains Since Late 1970s Different From Earlier Era, When Growth Was Widely Shared

Cumulative Percent Growth

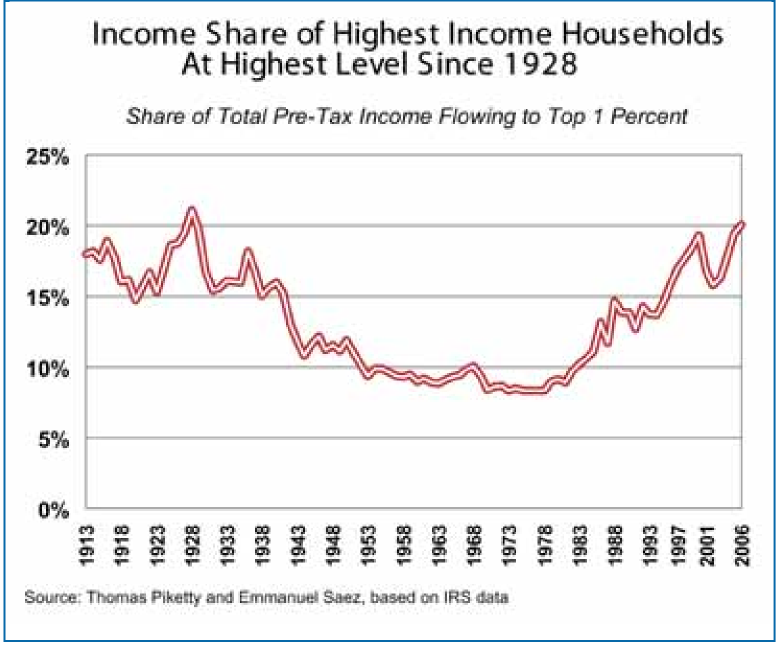


Source: CBPP calculations based on data from economists Thomas Piketty and Emmanuel Saez, the Bureau of Economic Analysis and Census. Adjusted for inflation using CPI-RS.

Figure 3, which is based on the Piketty-Saez data, provides an even longer-term perspective on trends in the concentration of income at the very top. These data show that the relatively slow growth in income at the very top from 1946 to 1976 was part of a longer term trend beginning after 1928. The share of total pre-tax income in the nation that goes to the top 1 percent of households fell from 1928 to the 1970s, but as we have seen, since then the share of income going to the top 1 percent of households has soared. Although the upward surge was interrupted by a major speed bump in 2001 as a result of the dot.com collapse, by 2006 the share of income going to the top 1 percent was at its highest level since 1928.

These data also show that the trend toward greater inequality is once again rising sharply. From 2005 to 2006, the average before-tax income of the top 1 percent of households increased by almost $60,000 (or 5.8 percent), after adjusting for inflation, while the average income of the bottom 90 percent of households rose by less than $450 (or 1.4 percent). (Note: this bottom-90 percent figure is somewhat misleading because it is heavily influenced by the larger gains received by those in the upper ranges of this group. The typical, or median, gain for the bottom 90 percent was smaller than the average gain.)

FIGURE 3



As I mentioned earlier, we are likely to see another dip due to recent financial market events. But the real question going forward is whether that will be just another pause in the rise toward greater concentration of income or whether it is possible to return to a period more like the first three decades after the end of World War II when there was both strong economic growth and broadly shared prosperity.

How Do Government Policies Affect Inequality?

TABLE 2: **Pre-Tax and After-Tax Income Shares and Effective Tax Rates by Income Group, 2001 and 2005**

	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 2 %		Top 1%
2001							
Share of pre-tax income	4.3%	9.2%	14.2%	20.8%	52.3%		14.7%
Share of after-tax income	5.1%	10.3%	15.2%	21.5%	48.8%		12.6%
Effective tax rate	5.1%	11.5%	15.3%	18.9%	26.7%		32.8%
2005							
Share of pre-tax income	4.0%	8.5%	13.3%	19.8%	55.1%		18.1%
Share of after-tax income	4.8%	9.6%	14.4%	20.6%	51.6%		15.6%
Effective Tax Rate	4.3%	9.9%	14.2%	17.4%	25.5%		31.2%
Percent change in income, 2001-2005							
Pre-Tax income	-3.0%	-1.6%	1.4%	2.4%	14.8%		34.8%
After-Tax income	-1.9%	0.3%	2.7%	4.1%	16.6%		38.0%

Government policies affect the distribution of income most directly through taxes and benefit programs, and federal taxes are, on balance, progressive. As a result, there is modestly less inequality in the after-tax distribution of income than in the before-tax distribution. But while this difference is real, it should not be exaggerated. Furthermore, the large tax cuts enacted in 2001 and 2003 favored higher income groups that were already benefiting from disproportionate gains in pre-tax income. As a result, federal taxes, while still progressive, are less progressive today than they were before the 2001-2003 tax cuts.

The progressive structure of federal taxes, as well as its erosion in recent years, is illustrated by the CBO data in Table 2. In 2005, households in the bottom fifth of the income scale paid an average of 4.3 percent of their income in federal taxes, those in the middle paid 14.2 percent, those in the top fifth paid 25.5 percent, and those in the top 1 percent paid 31.2 percent. The bottom fifth of households received 4.0 percent of before-tax income and 4.8 percent of after-tax income. For the middle fifth, those percentages were 13.3 percent of before-tax income and 14.4 percent of after-tax income. The top fifth of households, in contrast, received a larger share of before-tax income (55.1 percent) than of after-tax income (51.6 percent) as did the top 1 percent (18.1 percent of pre-tax income compared with 15.6 percent of after-tax income). Nevertheless, both before-tax and after-tax income distributions reveal a high degree of inequality. Moreover, the shares of after-tax income going to the top 20 percent and to the top 1 percent in 2005 — like their shares of before-tax income — are the highest on record in the CBO data, which go back to 1979.

I have already mentioned how high-income households benefited disproportionately from the economic growth that occurred after 2001. They also benefited disproportionately from the 2001-2003 tax cuts. As shown in the bottom section of Table 2, the before-tax income of the top fifth of households rose by 14.8 percent from 2001 to 2005. And because their effective tax rate (the percentage of income that they pay in federal taxes) fell to its lowest level on record in the CBO data, their after-tax income grew by an even greater proportion — 16.6 percent. For the top 1 percent of households, pre-tax income rose 34.8 percent from 2001 to 2005, and after-tax income rose by 38 percent. In contrast, low-income households experienced income *declines* over this period, and gains in the middle 60 percent of households were quite modest.

We hear from some quarters the argument that the tax system has become more progressive — and that this is proven by the fact that the affluent are now paying a higher share of total income tax revenues. This argument does not withstand scrutiny. A progressive tax cut, like a progressive tax system, is one that reduces inequality. The 2001-2003 tax cuts have done the opposite. When fully in effect, those tax cuts will boost after-tax income by more than 7 percent among households with incomes of more than $1 million, but just 2 percent among middle-income families, according to Urban Institute-Brookings Institution Tax Policy Center. That is an average tax cut of $158,000 in 2010 for households with incomes of over $1 million, but just $810 for middle-income families. Tax analysts know that effective tax rates and shares of after-tax income, *not* the share of taxes paid, are the proper indicators of progressivity.

The CBO data are clear about effective tax rates at the top: they are *lower* than they have been since at least 1979. These data show that the tax system has become less progressive. The share of taxes paid by high-income households has been going up, but this is because these are the households that have gotten most of the increase in before-tax income. Their income gains have been so large that they are paying more in taxes even though they have gotten substantial tax cuts and the percentage of their income that they pay in taxes has gone down. Between 2000 and 2005, the average income tax burden of the top fifth of the population fell by an amount equal to 4.8 percent of their income; in contrast, the middle and lowest fifths of the population saw their average income tax burdens reduced by amounts equal to less than 2 percent of their incomes.

So far I mainly have been documenting trends in inequality. But what has caused those trends? Princeton economist Alan Blinder expresses the view of many economists that market forces not government policies are primarily to blame:

> Let me be clear: The main culprit has not been the government but the marketplace. While there are a number of competing theoretical explanations, the fact is that, starting sometime in the late 1970s, the market turned ferociously against the less skilled and the less well educated.

Blinder criticizes government for not doing more to use the tax-and-transfer system and other policies to cushion the blow, and he condemns policies of enacting tax cuts for the wealthy while either permitting or causing large holes to emerge in the social safety net. These policies he labels "piling on," which in football would draw a penalty for unnecessary roughness. But just as football is a rough game to begin with, so too has been the labor market faced by workers without strong skills and sufficient education and training.

I will not endeavor here to disentangle the complex economic arguments about how much of the market's turning against the less-skilled and less-well-educated is due to international trade versus technological change or other factors, such as the weakening of the labor unions. I think the state of our knowledge is that there is a constellation of factors, and no single-bullet theory is sufficient. Instead I would just like to make a couple of observations.

First, to state the obvious, if the market has turned fiercely against those with lower skills and less education and training, smart policies to close the skill gap should pay off over the longer term both in boosting productivity growth and in causing the benefits of that growth to be somewhat more widely shared.

Second, an interesting but underdeveloped strand of the economics literature has begun to focus on the role that changing institutions have played in producing greater inequality. In particular, I would note the work of MIT professors Frank Levy and Peter Temin. They argue that the quite different experiences with inequality I have described between the first three decades after the end of World War II and the most recent three decades were shaped by quite different sets of economic institutions. Levy and Temin argue that the early postwar years were dominated by unions, a negotiating framework that heavily influenced wage-setting, progressive taxes, and a high minimum wage. They describe this set of institutions as "parts of a general government effort to broadly distribute the gains from growth." They argue that the economic forces of technology and trade that most economists look to in explaining trends in earnings inequality "have been amplified by the collapse of the institutions of the post-war years." If they are correct, both government intervention and changes in the norms of private sector behavior will be necessary to avoid the widening gaps in income that seem to be a feature of market-determined incomes in today's global economy.

I don't think we should interpret the Levy-Temin analysis as an argument for trying to recreate the precise institutions that prevailed in the early postwar period. It is probably not even possible, given the structural changes in the economy that have taken place. But the Levy-Temin analysis is an argument for remembering the importance of institutions and social norms in determining how market forces play out and the ability of laws and the visions that policymakers express to shape those institutions and social norms. Reducing barriers to labor organizing, preserving the real value of the minimum wage, and the other workforce security concerns of this committee would surely be a part of the kinds of institutions and social norms that would contribute to an economy with less glaring and sharply widening inequality.

Before moving to a discussion of the implications of trends in inequality for policy, I would like to note that I have been discussing trends in income inequality. As these data show, there is a great deal of inequality in the distribution of income in the United States. But that inequality pales in comparison to the inequality in the distribution of wealth. Our main source of data about wealth inequality comes from the Federal Reserve's Survey of Consumer Finances. Those data show that roughly a third of household wealth is held by the top 1 percent of households, another third is held by the next affluent 9 percent, and the remaining third of wealth is held by the remaining 90 percent of households. As extreme as the income inequality shown in Table 2 is, inequality in the distribution of wealth is considerably greater.

Implications for Policy

The United States faces a number of tough challenges ahead. The new ones caused by the current financial crisis are front and center right now, but the others have not gone away, including an unsustainable long-term deficit, the need for health care reform, fundamental tax reform, and the need to address climate change. The problem of widening income inequality is exceedingly unlikely to go away on its own. But how we address these other critical challenges also will have important implications for whether policymakers make inequality worse or better through their policy actions. In this section of the testimony, I will discuss some broad policy implications and offer some specific recommendations.

Addressing our long-term budget imbalance is important to achieving strong sustainable growth over the long term. But the distributional implications are vastly different if we address the challenge by slashing promised benefits in programs like Social Security, Medicare, and Medicaid to preserve the tax cuts we have enacted and add new regressive tax cuts on top, or if we instead pursue a more balanced approach that puts everything on the table. Similar distributional differences attach to alternative ways of approaching health care reform and fundamental tax reform.

Climate change legislation poses a similar challenge. Reducing greenhouse gas emissions, through either a cap-and-trade system or a carbon tax, works by raising the price of energy and energy-related products. Because low- and moderate-income households spend a disproportionate amount of their income on these products, they will experience the largest relative hits to their purchasing power from such legislation.

At the same time, however, either a cap-and-trade system in which most of the emissions allowances are auctioned off or a carbon tax has the potential to raise substantial revenues. If a portion of those revenues are used for well-designed climate rebates to offset the impacts of higher energy prices on low- and moderate-income households, we can achieve the benefits of reduced greenhouse gas emissions while protecting the purchasing power of vulnerable households and avoiding regressive effects. In contrast, if we give away a large percentage of the allowances to existing industrial emitters or we use the proceeds to cut income tax rates, we would provide tax relief benefits to high-income households that are larger than the increase in their energy costs while leaving low- and moderate-income households worse off. Inequality would effectively be widened further.

I believe that if we are to take the problem of increasing inequality seriously, we need to keep these distributional considerations in mind as we address the big challenges that lie ahead. At the same time, strong economic growth and rising productivity are a necessary condition for achieving widespread prosperity. Sound investments in education, worker training, infrastructure, and basic research are necessary to complement private investment in generating that growth and productivity.

Having a strong economy is a necessary condition for achieving widespread prosperity. But as we have seen for more than 30 years, the outcomes determined by market forces alone seem to be aggravating inequality, especially during periods when the political environment is tilted toward skepticism about or outright hostility toward policies that provide an effective safety net for those struggling to keep their heads above water and policies aimed at ensuring that the gains from economic growth are shared more equally, as they were in the 1946-1976 period.

One important place we need to start to achieve that goal is a focused effort to reduce poverty. The poverty rate rose for four straight years from 2000 to 2004, peaking at 12.7 percent in 2004. In 2007, the rate was still stubbornly high at 12.5 percent, and over 37 million people were poor (and the poverty rate is rising further now as the economy slumps and unemployment climbs). Poverty is higher in the United States than in many other developed countries, and it is costly to the economy to have so many adults with limited skills and earnings and to perpetuate that situation through the damaging effects of persistent child poverty. We can do better. An effort that deserves attention here is the Half in Ten campaign, which is calling on policymakers to adopt the goal of cutting poverty in half over the next ten years.

Let me conclude with some concrete steps to address the problem of widening inequality. I'll start with the tax code, which includes provisions worth hundreds of billions of dollars a year to encourage a wide variety of activities from saving for retirement to acquiring more education. From the standpoint of equal treatment of people with different incomes, there is a fundamental flaw in most of these incentives: they are provided in the form of deductions, exemptions, and exclusions rather than in the form of refundable tax credits. That means that the size of the tax break is higher for taxpayers in higher income brackets For many of the activities that the tax incentive is meant to promote, there is no obvious reason why lower-income taxpayers or people who do not file income taxes should get smaller incentives (or no tax incentives at all).

But it is worse that that: the central structure of these tax breaks also makes them economically inefficient. Because a large number of taxpayers will not have incomes high enough to benefit fully from current non-refundable incentives, society will get less of the activity it is trying to encourage; people with smaller income-tax liabilities will have a smaller incentive, and people with no income-tax liability will have no additional incentive to engage in the activity. Moreover, high-income taxpayers are likely to save for retirement and to invest in their children's education with or without the tax breaks; the tax breaks do not appear to have a large effect on their behavior. As a result, the current tax deduction structure used for these tax breaks is inefficient. Providing more modest tax breaks to high-income taxpayers and using the savings to provide refundable credits to lower-income taxpayers would increase the amount of desirable economic activity that the tax break is meant to encourage, at no additional cost.

In a 2006 Brookings Institution policy brief, three prominent tax policy analysts — Lily Batchelder, a professor of law and public policy at NYU, Fred Goldberg, who was IRS Commissioner and Assistant Secretary of the Treasury for Tax Policy under the first President Bush, and Peter Orszag, now the director of the Congressional Budget Office, recommended that the default for tax incentives designed to promote socially valued activities should be a refundable tax credit (i.e., a tax credit available to qualifying households even if they do not earn enough to owe income tax) rather than a deduction. The authors point out that such a credit would not only contribute to reducing inequality in after-tax income, but for the reasons discussed above, also would produce more powerful economic incentives.

If a system of refundable credits were in place, it also would have the virtue of providing a form of stabilization to the economy when the economic picture darkened, since people who lost their jobs or experienced a sharp drop in income during an economic downturn would continue to receive the full value of tax credits for which they qualified, rather than losing the value of the credits or seeing them reduced as is the case now. We could begin next year to take steps toward such a reform of the tax code by making the higher-education and savers' tax credits refundable and making improvements in the EITC. Moving to refundable tax credits for promoting socially worthwhile activities would be an important step toward enhancing progressivity in the tax code in a way that would improve economic efficiency and performance at the same time.

Other steps we could take that would contribute to reducing poverty and expanding educational opportunities include: increased investment in pre-school education and decent-quality child care for low- and moderate-income families. Such steps would both enable more low-income mothers to work (or enable those already working to work more) and increase the educational attainment and skills of the children.

In the area of health care, the lion's share of those without health insurance are low- or moderate-income. So legislation to achieve universal health insurance coverage *and* begin to put mechanisms in place to slow health care cost growth are important — both to improve the health and alleviate the squeeze on the uninsured *and* to ease the pressure on wages and salaries more broadly that rising health care costs impose.

Finally, with all signs pointing to a deteriorating economy and the possibility of a recession substantially more severe than what we have become accustomed to in the past two decades, the holes that have opened in the safety net over the past 20-30 years will become more apparent. For example, our unemployment insurance system has not kept up with changes in the labor market, and as a result many of the female, low-income, and part-time workers who now make up a significant portion of the labor force do not qualify for UI benefits when they are laid off. UI modernization legislation like that which the House has already passed is long overdue and is particularly badly needed now.

The basic cash assistance safety net for jobless families and individuals that do *not* qualify for UI benefits also is far weaker than in past recessions. Only about 40 percent of families that qualify for TANF cash assistance actually receive that aid (and the help in preparing for and finding jobs that should come with it) while in the recessions of the early 1980s and early 1990s, about 80 percent of poor families eligible for cash assistance received it. In addition, the safety net of last resort for jobless individuals without children — state general assistance programs — has essentially disappeared. As the Congress and a new administration consider measures to stimulate the economy and ameliorate the recession's most serious impacts, the needs of these individuals should be considered.

Clearly, the Committee on Ways and Means will play a central role in determining how we address a number of the challenges that lie before us. The decisions the Committee makes will play an important role in determining how policy can contribute to promoting more broadly shared prosperity than we have seen recently. At the same time, if the Levy-Temin analysis is correct and trends in income inequality reflect an interaction between underlying market forces and institutions and social norms that can either moderate or aggravate the effects of those market forces, the task will be easier if those institutions and social norms also reflect a greater commitment to promoting broadly shared prosperity.