

October 2015

Can taxing the rich reduce inequality? You bet it can!

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Executive summary

Two recently posted papers by Brookings colleagues purport to show that “even a large increase in the top marginal rate would barely reduce inequality.”¹ This conclusion, based on one commonly used measure of inequality, is an incomplete and misleading answer to the question posed: would a stand-alone increase in the top income tax bracket materially reduce inequality? More importantly, it is the wrong question to pose, as a stand-alone increase in the top bracket rate would be bad tax policy that would exacerbate tax avoidance incentives. Sensible tax policy would package that change with at least one other tax modification, and such a package would have an even more striking effect on income inequality. In brief:

- A *stand-alone* increase in the top tax bracket would be bad tax policy, but it would meaningfully increase the degree to which the tax system reduces economic inequality. It would have this effect even though it would fall on just ½ of 1 percent of all taxpayers and barely half of their income.
- Tax policy significantly reduces inequality. But transfer payments and other spending reduce it far more. In combination, taxes and public spending materially offset the inequality generated by market income.
- The revenue from a well-crafted increase in taxes on upper-income Americans, dedicated to a prudent expansion of public spending, would go far to counter the powerful forces that have made income inequality more extreme in the United States than in any other major developed economy.

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The claim

My colleagues reported that an increase in the top-bracket tax rate from 39.6 percent to 50 percent would lower one measure of inequality, the Gini coefficient,² by a seemingly negligible amount—from 0.5595 to 0.5558. While that shift looks small—it is just 0.7 percent of the original value—it increases by 10 percent the income equalizing effect of the current tax system. And, if one counts the impact on inequality of distributing the revenue, \$95 billion in the first year and \$1.3 trillion over a decade³ to people in the bottom fifth of the income distribution, this policy would lower inequality as measured by the Gini coefficient by 20 percent of the reduction produced by the current tax system.

Even using the measure that my colleagues employ, the reduction in inequality is not negligible. But the Gini coefficient, although the most commonly used measure of *overall* inequality, is poorly suited to measure the impact of a tax increase on the very rich. Specifically, ‘the Gini’ is relatively insensitive to income changes at both the top and the bottom of the income distribution. My colleagues acknowledge this point, writing “We acknowledge that the Gini coefficient is more sensitive to changes in the middle of the income distribution than in the tails of that distribution.” It would have been helpful, therefore, to have used another indicator of income inequality that does not share this shortcoming.

As it happens, my colleagues presented data on one such measure, the 99/10 ratio. It shows the ratio of incomes of taxpayers at the 99th percentile to those at the 10th percentile of the income distribution. That measure shows that raising the top personal income tax rate when coupled with transfer of the revenue to the lowest-income fifth of taxpayers has a large effect on inequality. That combination lowers the 99/10 ratio by nearly as much as does the current tax system.

No single measure of income inequality is superior to all others for all purposes. Some show greater sensitivity to changes in income at the top, some to changes in incomes at the bottom, and some to changes in between. For example, almost none of the *tax* effects of an increase in the top-bracket tax rate show up in the 99/10 ratio for the simple reason that the top bracket applies only to the top ½ of 1 percent of all filers.

When different measures give different results, the sensible course is to take a step back, and use one’s judgment as to decide which is most informative. In this case, using a measure that focuses on income changes

at the top and bottom of the income distribution demonstrates that an increase in the top bracket rate combined with distribution to people at the bottom has a major effect on measured inequality.

Sensible tax policy

It is important to use judgment not only in selecting a measure of inequality, but also in choosing what tax policy to evaluate. Simply raising the top tax bracket would aggravate a well-recognized problem with the current tax system. For that reason, an increase in the top-bracket rate should, and almost certainly would, be combined with other measures. Here is why.

Raising the tax on ordinary income but not that on gains and dividends would exacerbate tax avoidance. The 39.6-percent top tax rate on ordinary income, such as wages and salaries, is much higher than the 20-percent top rate on capital gains and dividends.⁴ Currently, the highest income 1 percent of all filers derive slightly more income from capital gains and dividends than they do from wages and salaries.⁵

The gap between tax rates on various forms of income encourages people to go to considerable effort and expense to convert more-highly-taxed wages and salaries into capital gains or dividends. Although such conversions are often costly, they are worth it, provided one has enough income to shelter. A multi-billion dollar tax planning industry thrives on fees wealthy filers willingly pay for help to do just that. Tax avoidance is quite legal, but if one is interested in boosting taxes on the rich, one would be ill advised to encourage them to shelter more of it.

An increase in the top rate on ordinary income should be linked to an increase in the rate on capital gains and dividends to avoid making a bad problem worse. Exactly how much the rate on capital gains and dividends would have to go up to achieve that result is hard to pin down. For illustration, however, I assume that if the top rate on ordinary income were increased to 50 percent, the tax rate applied to capital gains and dividends would go up by the same amount, from 20 percent to 30.4 percent.⁶ These two changes would boost revenue by \$144 billion a year or \$2.0 trillion over ten years. If that revenue were distributed to the bottom 20 percent of the income distribution, the rate increases combined with the transfers would lower the 99/10 income ratio by 110 percent as much as it is by the entire current tax system.

As noted, the 99/10 ratio misses nearly all of the tax effects of raising the top bracket. If the top bracket rate

of 50 percent is extended to the highest-income 1 percent of tax filers, the impacts on inequality are increased. Over the ten-year budget window, applying the 50 percent rate to the top 1 percent of all filers and boosting the rate on capital gains and dividends from 20 to 30.4 percent would raise \$2.3 trillion. If this revenue were distributed to the bottom 20 percent of the income distribution, the gap between the incomes of people at the 99th and 10th percentile would be cut by almost half from its pre-tax level.

Sensible budget policy

Taxes are collected for one of two reasons: to balance current spending; or, when deficits are problematic, to avoid undesired spending cuts that would otherwise be necessary. Thus, to gauge the full impact on inequality of changes in tax policy one should pair them with the spending they pay for. Using the Gini coefficient, the Congressional Budget Office reports that government transfers in cash and in kind reduce inequality of market incomes more than twice as much as do taxes of all kinds. Transfers account for nearly 40 percent of the income of people in the bottom income quintile (and even more of those at the 10th income percentile). This fact underscores two key points.

- Because taxes pay for public spending, one cannot understand the impact of tax changes on income inequality without considering the activities that they pay for.
- Public expenditures are a much more powerful instrument than is the tax system for equalizing the distribution of income.

The conclusion that boosting the top bracket can powerfully affect inequality holds even if the revenue is

not directly allocated to lower-income households. Projected budget deficits are fueling calls for massive cutbacks in public spending. The Congressional budget resolution passed this year calls for spending cuts of \$4.9 trillion over ten years. Of that total, \$3.1 trillion would fall on people with low or modest incomes.⁷ The tax changes shown in lines 3, 4, and 5, of the table below would yield, cumulatively over ten years, respectively, \$1.3 trillion, \$2.0 trillion, and \$2.3 trillion.

Even if one accepts the view that currently projected deficits justify such spending cuts (which I do not), the added revenue from tax increases falling exclusively on the highest-income Americans would undercut the argument that such spending cuts are necessary to prevent an increase in the ratio of debt to GDP. The benefits of avoiding such cuts would accrue to people of modest means who benefit from the programs on which spending would be slashed. These benefits should be counted along with the direct revenue effects in measuring the impact on inequality of tax increases.

That income inequality has increased massively in the past four decades is beyond serious dispute. Most income gains have accrued to those at the very top of the income distribution. Large proportional gains have accrued to the top 10 percent, larger proportional increases to the top 1 percent, and truly massive increases to the top 0.1 percent of income recipients. My colleagues and I agree that inequality has increased so much and for so many reasons that no single policy can fully offset their effects. That conclusion certainly holds for so narrowly focused a policy as one that increases just the top tax rate on ordinary income from 39.6 percent to 50 percent, a measure that affects only about half of the income of ½ percent of tax payers. But the question remains: can such a policy make a significant dent in inequality? The answer is a clear: Yes.

Table 1.

Tax regime	Gini Coefficient		99/10 Income ratio		Added revenue per year, relative to current law (billions)
	No redistrib.	Redistribution	No redistrib.	Redistribution	
Pre tax	0.5965		50.3		
Current law	0.5595		39.3		
Raise top rate from 39.6 percent to 50 percent	0.5558	0.5447	39.2	30.8	+\$95.5
Raise top rate from 39.6 percent to 50 percent and rate on capital gains and dividends from 20 percent to 30.4 percent	0.554	0.537	39.2	30.8	+\$144.3
Raise top rate from 39.6 to 50 percent on the top 1 percent of all filers and rate on capital gains and dividends from 20 to 30.4 percent	0.55	0.53	38.7	27.9	+\$162.9

Note: These values for the Gini coefficient are somewhat smaller than those shown in the papers cited in note 1. Those estimates treated as separate household dependents who are required by tax law to file separately. These filers, on the average, have low incomes and therefore make inequality seem more extreme than it would be if they were not treated as separate households. Ideally, the income of these filers should be merged with the incomes of the other filers with whom they live. But data do not permit this linkage. Accordingly, these dependent filers are dropped in computing the Ginis shown in the text. Excluding dependent returns has no impact on the relative changes in inequality using either the Gini coefficient or the 99/10 ratio.

Notes

1. The quotation is from Peter R. Orszag, “Education and Taxes Can’t Reduce Inequality,” Bloomberg View, September 28, 2015 (at <http://www.bloombergview.com/articles/2015-09-28/raising-taxes-on-the-rich-can-t-fix-inequality>). The two papers are William G. Gale, Melissa S. Kearney, and Peter R. Orszag, “Would a significant increase in the top income tax rate substantially alter income inequality?” September 28, 2015 (at <http://www.brookings.edu/research/papers/2015/09/28-increase-in-top-income-tax-rate-not-substantially-alter-income-inequality-gale-earney-orszag>) and “Raising the top tax rate would not do much to reduce overall income inequality—additional observations,” October 12, 2015 (at <http://www.brookings.edu/blogs/upfront/posts/2015/10/12-increase-top-marginal-tax-rate-will-not-reduce-income-inequality-gale-kearney-orszag>).
2. “The Gini” is a measure of inequality that ranges from zero, if income is equally distributed, to 1, if a single person receives all income and everyone else receives none. These values for the Gini coefficient are somewhat smaller than those shown in the papers cited in note 1. Those estimates treated as separate household dependents who are required by tax law to file separately. These filers, on the average, have low incomes and therefore make inequality seem more extreme than it would be if they were not treated as separate households. Ideally, the income of these filers should be merged with the incomes of the other filers with whom they live. But data do not permit this linkage. Accordingly, these dependent filers are dropped in computing the Ginis shown in the text.
3. This 10-year estimate, as well as those presented later, are computed on the assumption that income tax revenues grow at the same rate as GDP. Overall income tax rates grow a bit faster than GDP does because of ‘bracket creep,’ the movement of people into higher marginal tax brackets as real incomes grow.
4. The effective rate on capital gains is even lower than the maximum statutory rate of 20 percent, as taxes are not imposed on capital gains accrue but are delayed until capital gains are realized, often years or even decades later. Delay of taxes is equivalent to an interest-free loan from the government to the taxpayer for as long as the tax is not collected. In addition, a sizeable fraction of capital gains are never taxed. The gain on appreciated assets donated to charity are not taxed, although the donor gets to deduct the full value of the asset. And gains on assets held until the owner dies are never taxed at all.
5. The concentration of capital gains and dividends among those with highest incomes is partly tautological—people who just happen to have large capital gain and dividend income will normally have high incomes. But tax planning also contributes to the disproportion of income from these sources among top-bracket filers
6. An increase in the tax rate on capital gains raises difficult and complex issues of its own. In particular, raising the tax rate on realized gains would suppress realizations and would yield much less revenue than indicated here. To maintain revenues, it would be necessary to couple an increase in the tax rate on realizations with other reforms that promote realizations. The most obvious candidates are to tax some or all of unrealized capital gains on assets donated to charity or to end or limit the ‘step up of basis’ of capital gains transferred at death. Revenue from this additional measure is not included in the text estimates.
7. Joel Friedman, Richard Kogan, and Isaac Shapiro, “The Congressional 2016 Budget Plan: An Alarming Vision,” Center on Budget and Policy Priorities, June 8, 2015 at <http://www.cbpp.org/research/federal-budget/the-congressional-2016-budget-plan-an-alarming-vision>.