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RESEARCH SUMMARY

POLICIES TO ADDRESS INCOME INEQUALITY AND INCREASE ECONOMIC OPPORTUNITIES FOR LOW-INCOME FAMILIES

Inequality has become a central economic and political issue in the wake of America's modest and uneven rebound from the Great Recession. An oft-discussed proposal during the 2016 election was to increase taxes on the highest earners as a means of minimizing economic disparity. A range of academic research cautions, however, that such a use of the tax code is unlikely to be effective in addressing inequality and may be self-defeating.

In "Policies to Address Income Inequality and Increase Economic Opportunities for Low-Income Families," University of Maryland economics professor Phillip Swagel and PhD candidate Cynthia Boruchowicz assess proposed policies designed to address inequality, focusing particularly on policies intended to improve incomes for those at the bottom of the income distribution. They find that tax policies oriented toward redistribution are likely to hamper growth and limit society's ability to address the underlying challenges of inequality. Instead, policymakers should focus on strategies that improve work incentives as a means of raising incomes for lower-income individuals.

BACKGROUND

The United States has long been the land of opportunity, but it has also been a land of persistent income inequality. The gap between people with incomes in the top 20 percent and everyone else has widened over the past four decades.

- From 1979 to 2013, incomes after taxes and transfers rose by a total of 46 percent for households in the lowest quintile, by 41 percent for the middle three quintiles, and by 70 percent for the highest quintile (excluding the top 1 percent).
- Income inequality persists despite a highly progressive US tax code, with an average rate (in 2013) of 34 percent for the top 1 percent, 13.8 percent for the middle three quintiles, and 3.3 percent for the bottom quintile.

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- A divergence of skills is an important part of this growing inequality. The gap in labor market outcomes between those with a college degree and those without accounts for a greater share of inequality than the growth of income among the top 1 percent.

TAXING THE RICH

Tax increases meant to redistribute the income of high earners may appear an easy cure for inequality, but the scope of the increases required could significantly affect economic growth.

- Income taxes have long been seen as a vehicle for reducing inequality. However, even significant increases in the top rate would produce only modest declines in inequality. Truly reversing inequality would require nearly tripling the tax burden of the top 1 percent, a policy that could have a substantial negative impact on economic growth.

- Capital taxes are also seen as a vehicle for redistributive policies, despite the high likelihood that taxes on saving and investment would have an especially negative impact on wage growth. A better policy for improving wages would instead focus on increasing productivity through lower capital taxes and improving individuals' skills and readiness to take advantage of the increased capital.

- Financial transaction taxes appear highly progressive, as they target owners of assets that are traded. However, such taxes affect all trading and would therefore reduce the efficiency of financial markets and negatively affect families and businesses looking to borrow money.

Taxes should be set at a level that funds the government with the least cost to economic activity. The tax code should be appropriately simple for households and businesses and should satisfy societal preferences for fairness.

HELPING THE POOR

A better solution than increasing tax rates for the rich is focusing policy on the bottom of the income distribution. Goals should be getting more people into the workforce, increasing before-tax earnings, and improving incomes with the least possible distortion to overall growth. Widely discussed possibilities include the following:

- The Earned Income Tax Credit (EITC) has been tremendously successful at improving the income, well-being, and incentives to work for low-income workers. The EITC can be extended by educational efforts that could increase participation, such as increasing the amount, phase-out period, and rate of the credit itself, and reducing current penalties for secondary earners in a household.

- Minimum wage increases are popular in the political discussion, but they feature the significant downsides of missed job opportunities for less-skilled workers, including those seeking to enter the labor market. Such policies are also poorly targeted; those at the bottom of the income distribution bear a large proportion of the unemployment effects, but only 19 percent of the wage gains accrue to families in poverty.

- Childcare subsidies and paid parental leave might increase labor force participation and thus increase pretax earnings among low-income workers, as well as improving intergenerational opportunity as children's outcomes improve. These policies might also have a positive effect on future human capital accumulation.