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Income Inequality and U.S. Tax Policy

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Introduction

Many social scientists have recently commented on the high levels of income inequality in the United States. Indeed, the last time income inequality was as great as it is today was 1928, the year before the stock market crash ushered in the Great Depression. In this article, we offer a historical look at income inequality and taxation in the United States.

When the Sixteenth Amendment was ratified in 1913,[1] fortunes of men such as John D. Rockefeller and Andrew Carnegie were, for the first time, subject to direct taxation by the federal government. How has tax policy changed since then, and especially in the last several decades? What have been the implications for wealth distribution in the United States? Are there any implications for the health of this democracy of high levels of income inequality?

During the Second World War, taxes went to support the war effort and tax rates were significantly higher than they had been when the Sixteenth Amendment was passed. In the decades immediately after the end of the war, federal tax policy and the "marginal tax rate"[2] reduced the level of income inequality. Historians have characterized the 1950s and 1960s as decades in which the middle class saw real income growth:

> In the three decades following World War II (1946-1970), robust economic gains were shared widely, with the incomes of the bottom 90 percent actually increasing more rapidly, on average, than the incomes of the top 1 percent. But in the three decades since 1976, the incomes of the bottom 90 percent of households have risen only slightly, on average, while the incomes of the top 1 percent have soared.[3]

Political scientist Larry Bartels analyzes the fiscal policy choices made by politicians over the last several decades that have produced the current state of income inequality.[4] He finds that the policy choices made have increased the levels of income inequality dramatically.

In a second analysis, sociologist Douglas Massey examines the history of what he calls the "American stratification system."[5] He concludes that by the end of the twentieth century all the decline in inequality achieved earlier in the twentieth century "had been wiped out and the United States had unambiguously returned to levels of inequality not seen since the laissez-faire era of the 1920s." [6] In 1922, the top one percent of the American population held about 32 percent of the wealth, rising to 36 percent in 1929.[7] Over the next 30 years, the proportion of wealth held by the top one percent declined significantly, due to higher tax rates during World War II and the immediate post-war years.[8] As a result of these tax rates and a growing economy that expanded the middle class cohort, income inequality in the United States declined until 1967, and between 1968 and 1980 it was roughly stable, according to the U.S. Census Bureau.[9] Beginning around 1980, however, household income distribution became increasingly unequal.

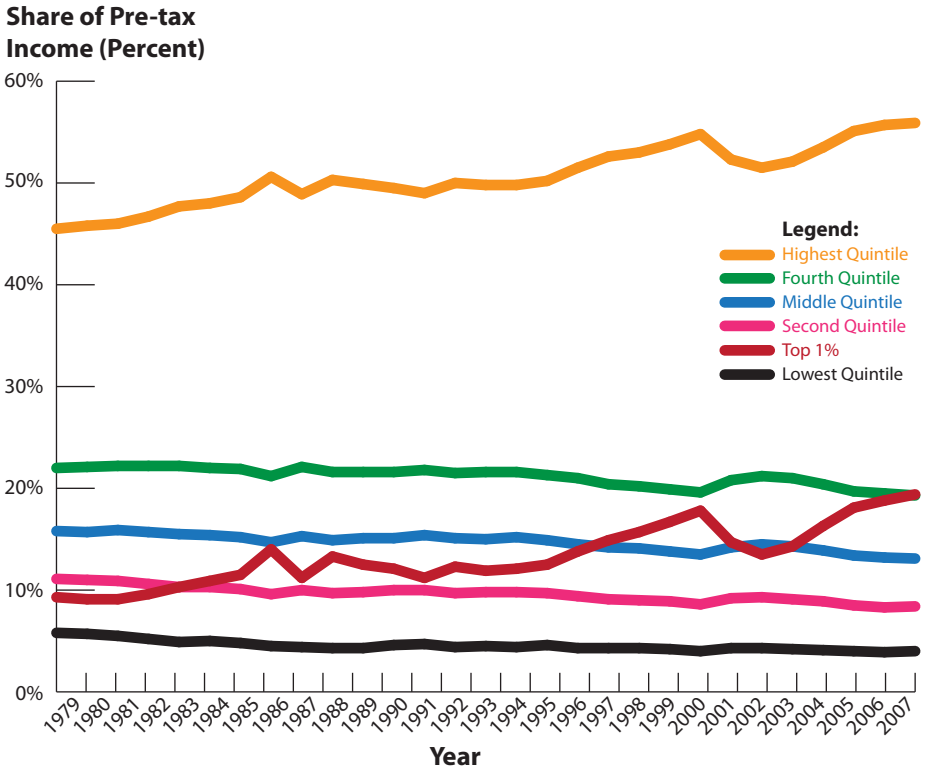
Between 1947 and 1994, the ratio of income received by the top quintile (20 percent) relative to the lowest quintile grew from about 8:1 to 11:1. By 2007, this ratio rose to 12:1.[10] Put differently, the top quintile received about half of all income; the bottom quintile received about 3.4%.[11] Economists see this as a tremendous difference, even relative to historical levels of inequality.[12]

A third analysis of recent income distribution in the U.S. of Internal Revenue Service data finds that two-thirds of the nation's total income gains from 2002 to 2007 went to the top one percent of U.S. households. The authors conclude that the top one percent of the population held a larger share of income in 2007 than at any time since 1928.[13] A summary of their data shows that:

> The incomes of the top *one-tenth of 1 percent (0.1 percent)* of U.S. households have grown more rapidly than the incomes of the top 1 percent of households as a whole, rising by 94 percent—or $3.5 million per household—since 2002. The share of the nation's income flowing to the top one-tenth of 1 percent of households increased from 7.3 percent of the total income in the nation in 2002 to 12.3 percent in 2007.[14]

Figure 1. **Inequality in the pre-tax income share of households 1979–2007**

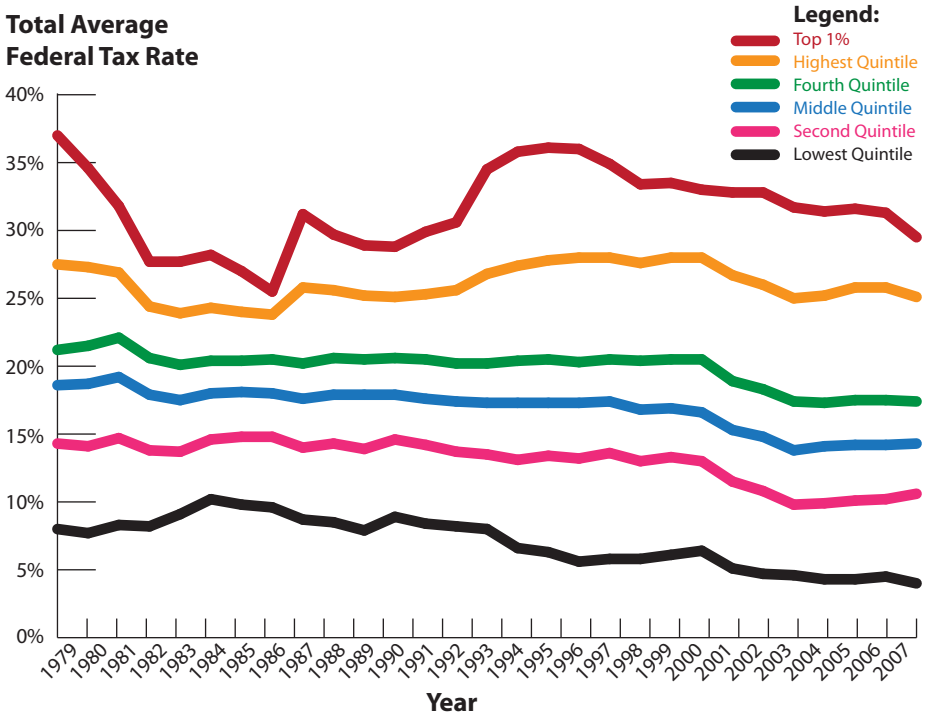
(Households are divided into quintiles, from richest to poorest)



Source: Congressional Budget Office http://www.cbo.gov/publications/collections/tax/2010/pre-tax_income_shares.pdf

Figure 2. **Changes in tax rates on the income of different households, 1979–2007**

(Rates are provided for the top 1% and in quintiles from richest to poorest)



Source: Congressional Budget Office http://www.cbo.gov/publications/collections/tax/2010/average_rates.pdf

In 2007, the richest one percent of Americans had income worth as much as the poorest 50 percent of all Americans combined.[15] The wealthiest 400 American households earned on average $345 million; they also paid an average tax rate of 16.6 percent, the lowest since the IRS began tracking such data in 1992. The *New York Times* article in which these statistics appeared noted "The top 400 [richest Americans] earned a total of $138 billion in 2007, up from $105.3 billion a year earlier."[16] At the same time, the income tax rate of the wealthiest Americans has declined steeply between 1992 and 2007.[17]

By contrast, since 2007, the real median household income of Americans has been falling. The official poverty rate in 2008 was 13.2 percent, up from 12.5 percent in 2007. More than 39 million people lived in poverty in 2008, up from 37.3 million in 2007; the number of families living in poverty went up again in 2009. Almost one child in five today lives in poverty in the United States.[18]

Is income inequality a threat to this democracy? One meta-analysis of social science research concludes that more equal societies do better on many measures of individual health, social cohesion, and social stability.[19] High levels of inequality in a nation correlate with overall lower life expectancy, higher rates of infant mortality, shorter height, poorer self-reported health, low birth-weight, higher rates of AIDS and depression.[20] As income inequalities rise, so do levels of social distrust. Inequality undermines the trust, solidarity, and mutuality on which the responsibilities of citizenship depend. Extreme inequality of income "creates a new aristocracy whose privileges perpetuate themselves over generations…and it breeds cynicism."[21]

The field of social studies has a long tradition of examining social and economic issues such as wealth and poverty.[22] Social studies teachers might be interested in an investigation of this topic, just as politicians are once again considering taxation rates in the United States.

In American history, the variations in the marginal tax rate have rested on an assumption that higher income earners ought to pay a greater percentage of their income in taxes than lower income earners.

Americans remain resolute in their faith in the opportunities provided to individuals in the United States for economic advancement, and often seem unwilling to condemn income inequality per se. However, the current "Great Recession" has sharpened many Americans' attitudes about how wealth is distributed in this country. With the prospects for the nation's recovery from the present economic turmoil raising questions in citizens' minds about America's future, the Pew Research Center found many citizens voicing concerns about income distribution:[23]

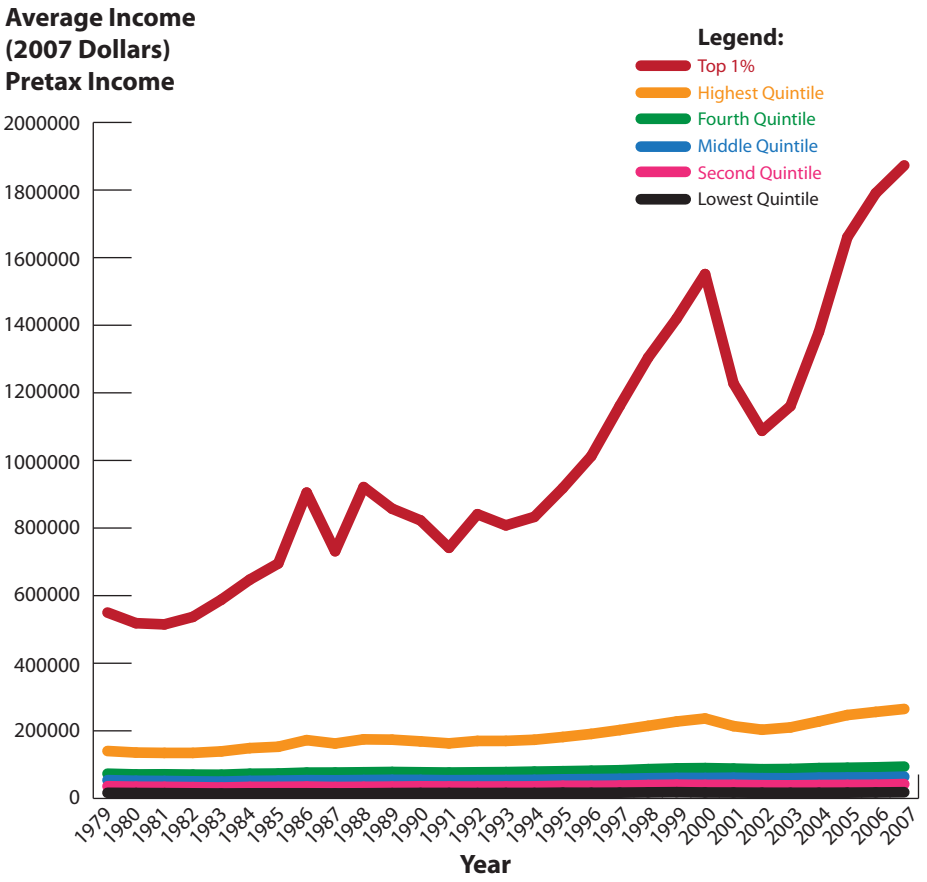
> A growing number of Americans believe that the gap between rich and poor is getting bigger, while more also say it is the government's responsibility to help the needy.[24]

Likewise, in 2008, Gallup found that 58 percent of Americans believe that money and wealth should be more evenly distributed in the country, although only 46 percent favor using heavy taxes on the wealthy to achieve that goal.[25] The Harris poll's "Alienation Index" reported in 2010 that 68% of all Americans believe the "rich are getting richer and the poor are getting poorer."[26]

The tax cuts established by the Bush Administration for the wealthiest Americans—those earning $250,000 or more—were extended at the end of 2010 by Congress in a compromise agreement on economic stimulus between Republicans who supported the cuts and Democrats who opposed them. The disagreement about these tax cuts will continue to be a political issue. A USA Today/Gallup poll conducted between August 4 and August 7, 2011 found that 66% of respondents favored increasing income tax rates for upper-income Americans to reduce the federal debt, while 33% opposed these increases. A CNN/ORC poll conducted

Figure 3. **Average pre-tax income for all households, 1979–2007**

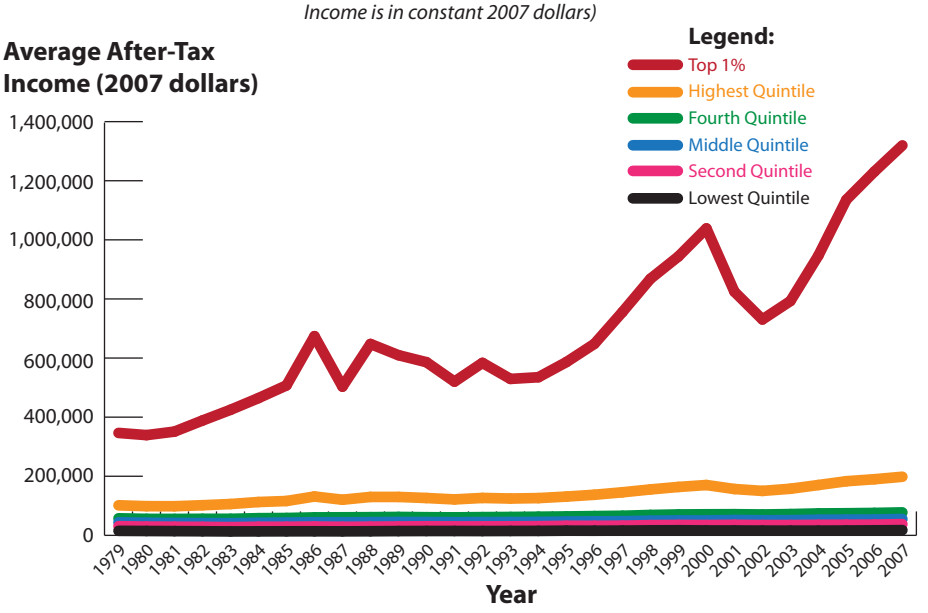
(Income levels are provided for the top 1% and in quintiles from richest to poorest. Income is in constant 2007 dollars)



Source: Congressional Budget Office http://www.cbo.gov/publications/collections/tax/2010/average_before-tax_income.pdf

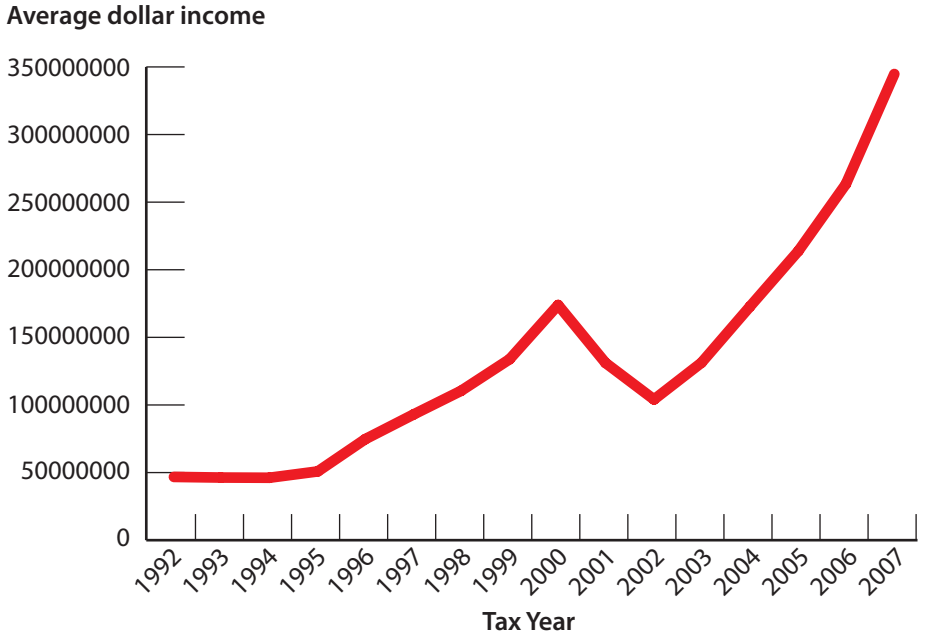
Figure 4. **Average after-tax income for all households, 1979–2007**

(Income levels are provided for the top 1% and in quintiles from richest to poorest. Income is in constant 2007 dollars)



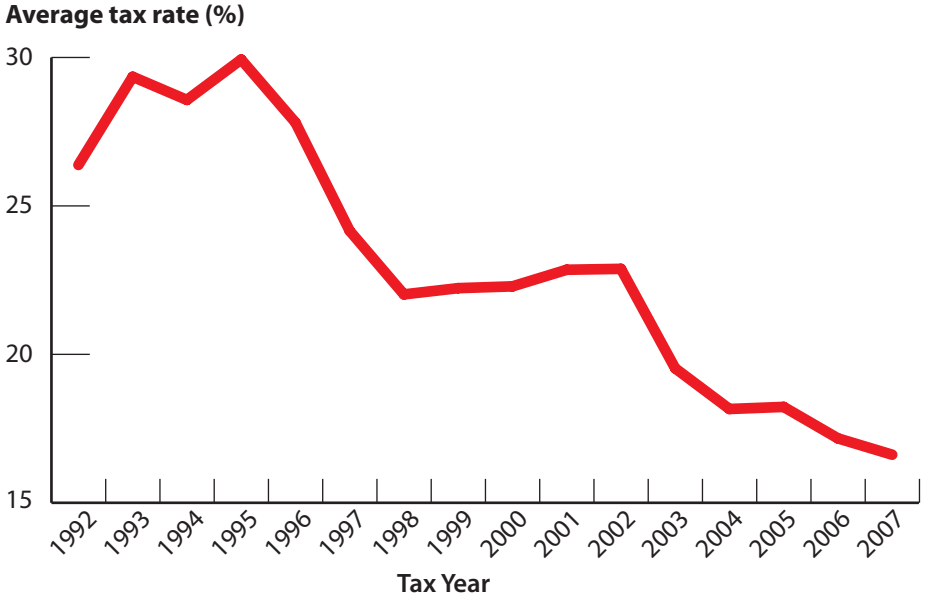
Source: Congressional Budget Office http://www.cbo.gov/publications/collections/tax/2010/average_after-tax_income.pdf

Figure 5 . **The average income of the 400 individual income tax returns reporting the highest adjusted gross incomes each year, 1992–2007**



Source: Internal Revenue Service http://www.irs.gov/pub/irs-soi/07intop400.pdf

Figure 6. **The average tax rate on the 400 individual income tax returns reporting the highest adjusted gross incomes each year, 1992–2007**



Source: Internal Revenue Service http://www.irs.gov/pub/irs-soi/07intop400.pdf

at the same time found that 62% of respondents favored increases in taxes on businesses and higher-income Americans to reduce the federal budget deficit, while 36% opposed such increases.[27]

Teaching about Income Inequality

One of the most taboo topics besides race and religion in American classrooms is social class. One approach to a discussion of social class might be through teaching about federal income tax policy. Many researchers interested in civic education call for greater discussion of social and economic issues in American schools.[28] Social studies researcher Diana Hess has also shown that discussion of controversial issues in social studies classrooms can provide a powerful and effective tool for student learning.[29]

Here we present a lesson that draws on history and current events to consider the federal income tax system. Not only do taxes have the effect of generating revenue for federal programs but they also have the effect of redistributing wealth in a society. Since the inception of the federal income tax system in 1913, its overall structure has been a "progressive" one, that is, those at the highest income levels pay a greater percentage of their income in taxes than those at lower levels. In the lesson, we pose the question: "Just how progressive should the U.S. income tax system be?" Debate over this topic may ultimately come down to differing views on the notion of fairness, which is closely connected to the larger topic of justice explored by philosophers of old. Notions of justice differ markedly among citizens, and it would surely be useful to discuss the competing perspectives on this subject that can be found among philosophers.[30] We hope teachers will find this lesson a useful entry point to debate and discussion of this timely and difficult topic in their social studies classrooms.

Notes

1. The Sixteenth Amendment reads as follows: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without

LESSON PLAN

Who Pays? Fairness, Responsibility, and the Marginal Tax Rate

Essential Question

How progressive should the United States income tax be?

Introduction

In this lesson, students participate in a structured academic controversy examining competing viewpoints concerning the marginal tax rate.* The goal is to help students understand each side's argument and ultimately reach their own conclusions about the proper tax structure for a democratic nation.

This lesson is aimed at secondary students who have been introduced to the history of the Sixteenth Amendment establishing direct taxes on U.S. citizens. It is designed for one 50-minute class period, but could easily be extended.

Key Concepts
- Marginal tax rate
- Progressive income tax structure
- Share of aggregate income

Objectives- The students will:
- Comprehend competing perspectives about the premises and effects of different federal income tax policies
- Develop an argument with fellow students representing one perspective on the debate about federal income tax policy
- Using logical reasoning and evidence, engage in a debate with students holding the opposing point of view.

Related NCSS Themes
THEME ❺ – INDIVIDUALS, GROUPS, AND INSTITUTIONS
THEME ❻ – POWER, AUTHORITY, AND GOVERNANCE
THEME ❼ – PRODUCTION, DISTRIBUTION, AND CONSUMPTION

Unfolding the Lesson

Part 1 – Developing Positions (15 minutes)
Students should be divided into groups of four students, with each group divided into two teams of two, A and B. Both teams receive background information including excerpts from the U.S. Constitution and graphs outlining tax rates, after-tax income, and share of aggregate income (Resource 1). In addition, Team A reads articles in support of a high marginal tax rate (Resource 2) and Team B reads articles in opposition to a high marginal tax rate (Resource 3). After their reading, each team collaborates to develop three or four reasons in support of their position. (Note: The teams may or may not agree with the reasons they are developing, but should strive for a thorough representation of their assigned side's viewpoint.)

Part 2 – Presenting Positions (5 minutes)
Each team should present its position in a clear and logical fashion to the other team. As one team presents, the other should listen and take notes on the arguments presented. If a student does not understand a point made by the other team, she or he may ask questions, but this is not a time for contradiction or debate.

Part 3 – Exploring Alternatives (10 minutes)
After students have finished presentations, they switch sides and read the other perspective. Team A reads articles in opposition to a high marginal tax rate (Resource 3) while Team B reads articles in favor of a high marginal tax rate (Resource 2). Both groups may continue to reference the background information (Resource 1). When the students finish reading, they collaborate with their teammates to develop the best reasons to support their side of the debate. The teacher should encourage students to focus on different reasons than those accentuated in the previous discussion.

Part 4 – Presenting Alternative Perspectives (5 minutes)
Students in each team now present their opinions to the other team. As in the last round, as one team presents, the other listens attentively and takes notes. If a student does not understand a point made by the other team, she or he may ask questions but not engage in debate.

Part 5 – Discussing Personal Perspectives (5 minutes)
Following the second presentation, the teacher will tell students that they are free to openly discuss their own opinions about the marginal tax rate. Students should be encouraged to support their opinions with information from the readings. Each student should keep notes about the areas of debate in which the group agreed and those in which it disagreed. These notes will assist students in the class discussion as well as the homework/extension activity.

Part 6 – Debriefing the Discussion (10 minutes)
The teacher leads the class in debriefing, guided by the following questions: What were the most compelling arguments for each side of the debate? Where did your group find consensus? In what areas did your group disagree? Did the concept of "fairness" arise in your discussions? If so, how was "fair" defined and what implications did that definition have on your discussion? Why is the discussion of this topic important for our nation? If you were to engage in a debate about this topic, what tactics might you use to undermine the opposing perspective? In other words, what do you think are the weakest arguments made by those supporting the opposing perspective?

Part 7 – Homework/Extension Activity
Students will write a persuasive essay answering the question: "*Should Congress continue the tax cuts for the top two percent of the income earners in the U.S.?*" In their essay, students should explain their reasoning and support their arguments using evidence from the articles read in class.

*D.W. Johnson and R.T. Johnson, "Critical Thinking through Structured Controversy," *Educational Leadership* 45, no. 8 (1988): 58-64.

Resource 1: Background Information

The Constitution and Taxes
The Constitution endowed the Congress with the power to "lay and collect taxes, duties, imposts, and excises, pay the Debts and provide for the common Defense and general Welfare of the United States" (section 8 of the Constitution). Ever on guard against the power of the central government to eclipse that of the states, the collection of the taxes was left as the responsibility of the State governments.

Source: United States Department of The Treasury
"A History of the US Tax System"
www.ustreas.gov/education/fact-sheets/taxes/ustax.shtml
Accessed on September 22, 2010

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."
Source: Sixteenth Amendment, United States Constitution

Resource 2: Arguments Supporting Marginal Tax Increases

…for much of the last decade, a very specific governing philosophy had reigned about how America should work: Cut taxes, especially for millionaires and billionaires… And for a time this idea gave us the illusion of prosperity… But while all this was happening, the broader economy was becoming weaker… Job growth between 2000 and 2008 was slower than it had been in any economic expansion since World War II—slower than it's been over the last year. The wages and incomes of middle-class families kept falling while the cost of everything from tuition to health care kept on going up.
Source: President Barack Obama, September 8, 2010
"Remarks by the President on the Economy in Parma, Ohio Cuyahoga Community College West Campus, Parma, Ohio"
www.whitehouse.gov/the-press-office/2010/09/08/remarks-president-economy-parma-ohio
Accessed on September 22, 2010

…deception and dishonesty is being deployed on behalf of tax cuts for the wealthiest Americans. So, for example, we're told that it's all about helping small business; but only a tiny fraction of small-business owners would receive any tax break at all… Or we're told that it's about helping the economy recover. But it's hard to think of a less cost-effective way to help the economy than giving money to people who already have plenty, and aren't likely to spend a windfall.
Source: Paul Krugman ,"Now That's Rich"
New York Times, August 22, 2010
www.nytimes.com/2010/08/23/opinion/23krugman.html
Accessed on September 29, 2010

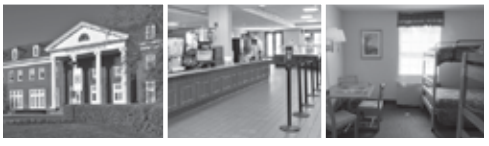
As the CBO notes, most Bush tax cut dollars go to higher-income households, and these top earners don't spend as much of their income as lower earners. In fact, of 11 potential stimulus policies the CBO recently examined, an extension of all of the Bush tax cuts ties for lowest bang for the buck… The government could more effectively stimulate the economy by letting the high-income tax cuts expire and using the money for aid to the states, extensions of unemployment insurance benefits and tax credits favoring job creation. Dollar for dollar, each of these measures would have about three times the impact on GDP as continuing the Bush tax cuts.
Source: William G. Gale
"Five myths about the Bush tax cuts"
The Washington Post, August 1, 2010
www.washingtonpost.com/wp-dyn/content/article/2010/07/30/AR2010073002671.html
Accessed on September 29, 2010

Resource 3: Arguments Against Marginal Tax Increases

Small businesses… provide 70 percent of our nation's jobs and are the heartbeat of innovation and productivity in America… Most small businesses pay taxes on income as individuals. Our budget would give these entities a tremendous boost by simplifying the tax code and lowering the highest marginal tax rate down to 25 percent… We believe that small businesses, entrepreneurs and the self-employed are the solution to our ills...
Source: Congressman Eric Cantor (R-Virginia), Republican Whip
"Don't get in way of job creation"
The Washington Times, April 8, 2009
www.washingtontimes.com/news/2009/apr/08/don39t-get-in-way-of-job-creation/
Accessed on September 22, 2010

So if anyone suggests to you that… we should raise taxes "on the rich" (or on some other politically unpopular constituency), please remind them that taxes are now right about at their historic average, that they are projected to increase both in real terms and as a share of the economy, and that as soon as next year they will again be above their historic average share. …the federal government is taking the same share of the economy as it has since the end of World War II.
Source: Keith Hennessey
"Are taxes too low?"
KeithHennesy.com, February 15, 2008
http://keithhennessey.com/2008/02/15/are-taxes-too-low/
Accessed on September 29, 2009

The latest data from the Congressional Budget Office and the Internal Revenue Service show that the lowest 40 percent of income earners… get 3.8 percent of total federal income tax revenues instead of paying any income taxes. The middle 20 percent of income earners pay 4.4 percent of federal income taxes. Thus the bottom 60 percent of income earners together, on net, pay less than 1 percent of all federal income taxes…
The data show that the top 1 percent of income earners now pay 40 percent of all federal income taxes, which is almost double their share of the national income. The top 10 percent pay 71 percent of federal income taxes, though they earn just 39 percent of the nation's pretax income.
Source: Newt Gingrich and Peter Ferrara
"Tax Cuts, Real and Imaginary: Obama's spending programs in disguise."
The Weekly Standard, September 15, 2008, Vol. 14, No. 01
www.weeklystandard.com/Content/Public/Articles/000/000/015/533kqlep.asp
Accessed on September 29, 2010



regard to any census or enumeration." Accessed on September 5, 2010, at: http://www.usconstitution.net/xconst_Am16.html

2. The "marginal tax rate" is the amount of tax placed on each additional dollar of income.
3. Chye-Ching Huang and Chad Stone, "Average Income in 2006 up $60,000 for Top 1 Percent of Households, Just $430 for Bottom 90 Percent," Center for Budget and Policy Priorities (Washington DC: October 22, 2008).
4. Larry M. Bartels, *Unequal Democracy: The Political Economy of the New Gilded Age (New York: Russell Sage Foundation, 2008), p. ix*
5. D. S. Massey, *Categorically Unequal: The American Stratification System* (New York: Russell Sage Foundation, 2007).
6. Ibid., p. 36.
7. Robert J. Lampman, *The Share of Top Wealth-Holders in National Wealth*, 1922-1956 (Princeton, NJ: Princeton University Press for the National Bureau of Economic Research, 1962), p. 25.
8. Ibid.
9. Arthur F. Jones, Jr. and Daniel H. Weinberg, *The Changing Shape of the Nation's Income Distribution: 1947–1998.* (Washington DC: US Department of Commerce, 2000). The Bureau acknowledges that "the choice of measurement method does make a difference." Use of different measurements modifies the picture of income inequality slightly for the period 1967-1980, but the overall picture since that time remains much the same—that is, one of rising inequality.
10. Alemayehu Bishaw and Jessica Semega, American Community Survey Publication on Income, Earnings, and Poverty ACS-09 (Washington, DC: US Census Bureau, 2008).
11. Ibid.
12. Personal communication from Professor Henry Levin, Teachers College, Columbia University, to authors, March 7, 2010.
13. Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States: 1913-1998," *Quarterly Journal of Economics*, 118 (1) February 2003: 1-39. The updated version of this article to 2007 is available in: A.B. Atkinson and T. Piketty, *Top Incomes: A Global Perspective* (New York: Oxford University Press, 2010) and *Top Incomes over the 20th Century* (New York: Oxford University Press, 2007). Also of interest to the general reader and available online would be Saez's chapter on US top incomes: a http://elsa.berkeley.edu/~saez/saez-UStopincomes-2007.pdf
14. Avi Feller and Chad Stone, "Top 1 Percent of Americans Reaped Two-Thirds of Income Gains in Last Economic Expansion: Income Concentration in 2007 was at Highest Level Since 1928, New Analysis Shows." Center on Budget and Policy Priorities, September 9, 2009.
15. Michael Linden, "Golden Years for the Gilded." Accessed on September 4, 2010, at: www.americanprogress.org/issues/2010/08/linden_golden_years.html
16. "Prime Number," *New York Times*, Sunday Week in Review Section, February 19, 2010.
17. Jones and Weinberg, p. 10. Researchers give many reasons for the changes in income inequality: labor market and household composition shifts, changes in labor demand; global competition and immigration, the decline of labor unions and in the real value of the minimum wage, trends in marriage and child birth, and many others.
18. U.S. Census Bureau, Income, Poverty and Health Insurance Coverage in the United States: 2008 (Washington, DC: US Department of Commerce, 2009).
19. R. Wilkinson and K. Pickett, *The Spirit Level: Why Greater Equality Makes Societies Stronger* (New York: Bloomsbury Press, 2009). See also William Bernstein, "How Big of a Deal Is Income Inequality?" *New York Times* online, August 27, 2008: Guest blog in Freakonomics section.
20. Wilkinson and Pickett, *The Spirit Level.*
21. Robert Reich, in Foreword, in Wilkinson & Pickett, p.viii.
22. See, for example, the recent history of *The New Social Studies: People, Projects, and Perspectives*, edited by Barbara Slater Stern (Charlottesville, North Carolina: Information Age Publishers, 2010).
23. Don Peck, "How a New Jobless Era Will Transform America." *The Atlantic* (March, 2010).
24. Andrew Kohut, Trends in Political Values and Core Attitudes: 1987–2007 (Philadelphia: Pew Research Center, 2007).
25. "Americans Split on Redistributing the Wealth by Taxing the Rich," Gallup Poll, October 30, 2008, Accessed on September 5, 2010, at: www.gallup.com/poll/111655/americans-split-redistributing-wealth-taxing-rich.aspx
26. Harris Interactive Alienation Poll. Accessed on September 5, 2010, at: www.harrisinteractive.com/NewsRoom/HarrisPolls/tabid/447/ctl/ReadCustom%20Default/mid/1508/ArticleId/450/Default.aspx
27. The polling results were accessed on August 31, 2011 at www.pollingreport.com/budget.htm
28. Bill Bishop, *The Big Sort* (New York: Houghton & Mifflin, 2008); Diana C. Mutz, *Hearing the Other Side: Deliberative versus Participatory Democracy* (New York: Cambridge University Press, 2006); Lawrence R. Jacobs, Fay Lomax Cook, and Michael X. Delli Carpini, *Talking Together: Public Deliberation and Political Participation in America* (Chicago: University of Chicago Press, 2009).
29. Diana Hess, *Controversy in the Classroom: The Democratic Power of Discussion* (New York: Routledge, 2009).
30. Michael J. Sandel, *Justice: What's the Right Thing to Do?* (New York: Farrar, Strauss, & Giroux, 2010).

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