Some Inconvenient Truths about Income Inequality in America

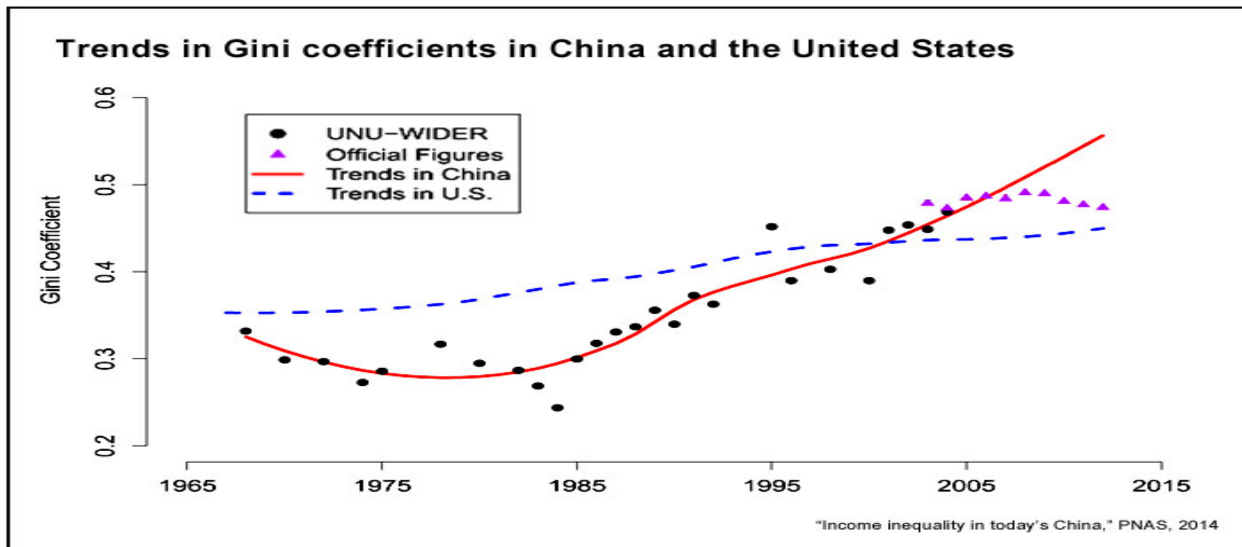
By

Stanley Jay Feldman, Ph.D.[1]

Reducing income inequality is the cornerstone of the democratic party's economic platform. According to Senator Warren rising income inequality occurs because the system is "rigged" in favor of the rich. Democratic politicians have beat the rising income inequality drum to death and as a result its existence has become an accepted fact. But like most facts of this sort, it needs to be explored to determine whether the income inequality outcry not only has a basis, but the policy proposals that emanate from this concern have been shown to achieve their stated objectives. For starters Senator Warren has proposed a 70% marginal tax rate and an annual 2% tax on wealth in excess of $50 million. Her basic thrust is that the tax revenue raised will then be used to fund government programs designed to create a more level playing field. We all can agree that a society that does not allow for equal opportunity and thereby gives rise to a bifurcated society based on income as a result is not in the best interest of our nation. But the fact that income inequality exists, and even if it is increasing, does not mean that opportunity to succeed has been limited or that barriers have been created to prevent all citizens regardless of race and gender from improving their lives. Moreover, even if this was the case, and it is not, tax reforms like those advanced by Elizabeth Warren have not been shown to make income distribution more equitable.

First, has income inequality increased in the US? The chart below shows the trend in Gini coefficients for the US and China. The Gini coefficient measures the degree of income inequality and it is measured on a scale from zero, income equally distributed- e.g. 10% of the population captures 10% of economy-wide income- to one, all the income is in the hands of one person.

[1] Stanley Jay Feldman is Chairman, Axiom Valuation Solutions, A Global Financial Service Company specializing in the valuation and financing of private firms.

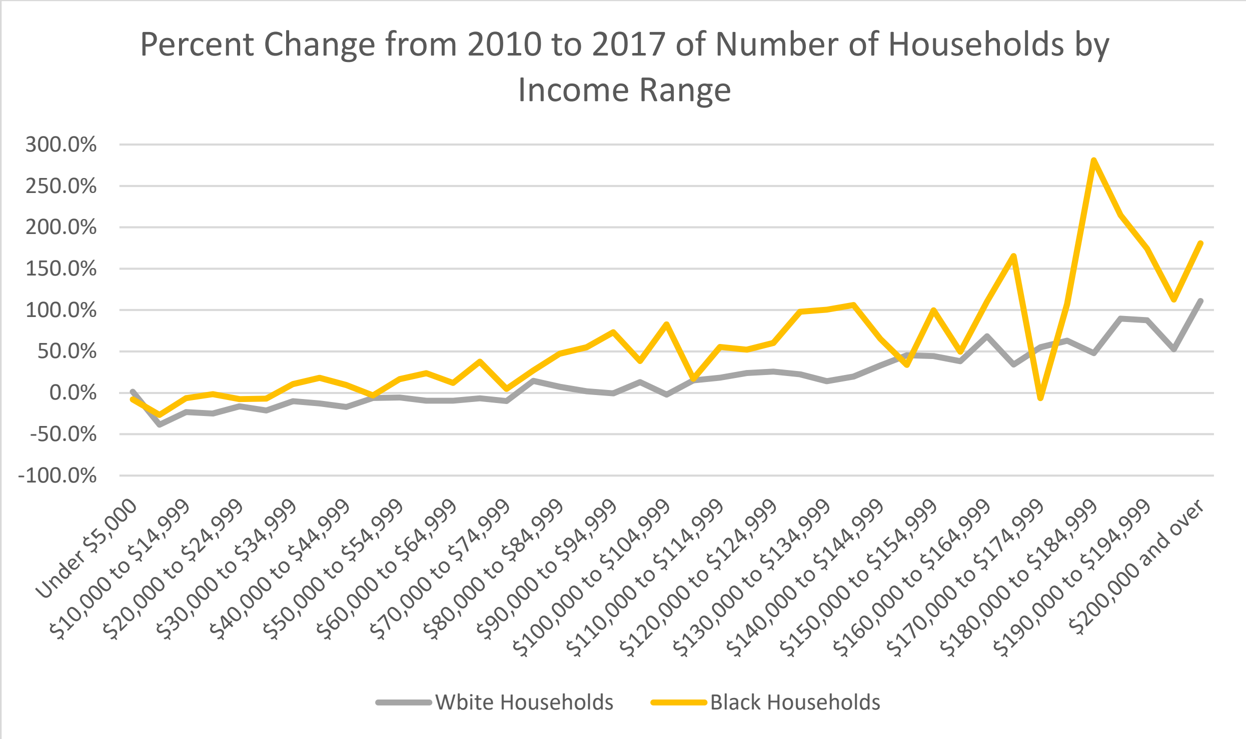


As the chart indicates, US income inequality has gradually increased between 1965 and 2014, the last year for which comparison data is available, with almost no increase in the period after the 2008 financial crisis. By comparison China, a state-run society, has exhibited a rapid increase in income inequality and its 2014 Gini coefficient is now about 25% higher than that of the US indicating that its income distribution is far more unequal than that of the US. There are two takeaways. First, the data does not support the contention that income inequality has rapidly increased in the US. The annual rate of increase in US income inequality is about .5%. Over the same period, income inequality in China has increased by roughly 1.0% per year on average. The second takeaway is that income inequality is not unique to a capitalist market driven system. Income inequality emerges and grows rapidly in any economic system that is going through rapid changes in economic growth with China being the prime example. The difference between China and the US is that in China the state decides who the winners and losers are, while in the US this has predominately, but not exclusively, been determined by the private sector.

The real issue in the US is not whether income is distributed unequally but rather what the equality of opportunity happens to be. More specifically, are previous beneficiaries of opportunity in a position to prevent others from improving their standard of living? Put differently, is the economic system so inequitable that the less well-off have no real opportunity to improve their standard of living? The stability of the US Gini coefficients indicate that this is likely not the case. But aside from statistics there is other evidence that the system works; although admittedly imperfectly.

Some have argued that income inequality results from racism. The inconvenient truth is that this is not likely to be the case, notwithstanding the fact that evidence of racism and its pernicious consequences is very evident in the real world and it is a real barrier to achievement. The chart below, based on data from the US Population Survey, measures the growth in the number of black and white households by income range in 2010 and 2017.

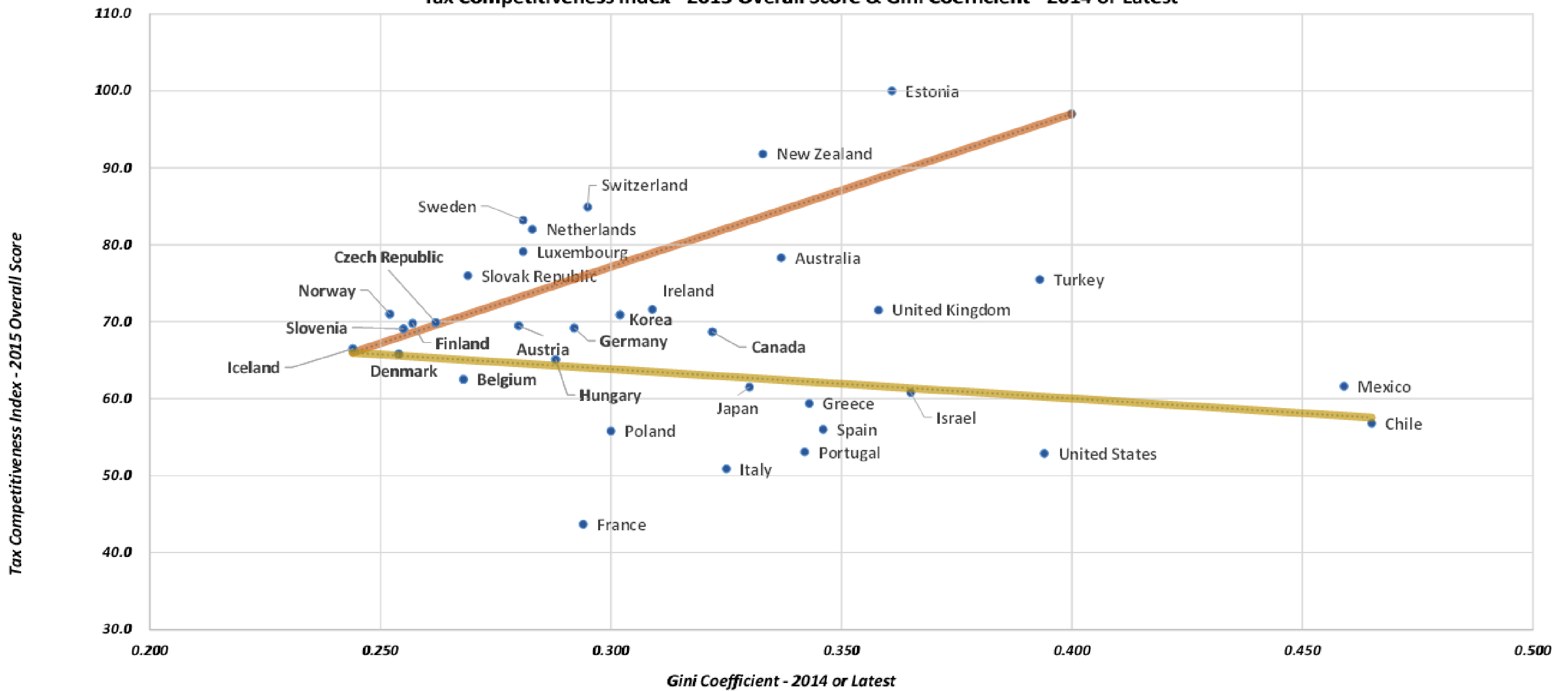
[1] Stanley Jay Feldman is Chairman, Axiom Valuation Solutions, A Global Financial Service Company specializing in the valuation and financing of private firms.



The data show that black household growth exceeds white household growth over just about all income ranges, and the growth is far greater the higher the income range. There were 199,000 black households that reported total income in excess of $200,000 in 2010. In 2017 the number increased to 560,000. or a percent change of 180%. For the same time period, the percentage change for white households with income excess of $200,000 was 111%. If racism is a central determinant of income inequality or even a critical marginal one, we would not expect to see such a large increase in the number of rich black households over a seven-year period. I am not suggesting that African Americans do not face enormous challenges relative to their white counterparts. Nor am I suggesting that one cannot collect data that makes this case. What I am suggesting is that income inequality does not emerge predominately from racism; its existence is far more complex and it results from rapid changes in technology that shape global production and distribution on the one hand, and the inability of the skill sets of the US labor force to adjust quickly enough to new demands placed on it.

All this said, progressives have consistently pressed for a more progressive tax system to reduce income inequality. However, there is almost no direct evidence that nations that have progressive tax systems also have a more equitable distribution of income. The chart below is a scatter plot between OECD member Gini coefficients and a tax competitiveness index constructed by the Tax Foundation.

[1] Stanley Jay Feldman is Chairman, Axiom Valuation Solutions, A Global Financial Service Company specializing in the valuation and financing of private firms.



Note:

** The northeast trend line is based on the following country data: Estonia, New Zealand, Switzerland, Sweden, Netherlands, Luxembourg, Australia, Slovak Republic, Ireland, Norway, Korea, Czech Republic, Finland, Austria, Germany, Slovenia, Canada, Iceland, Denmark, Hungary, and Belgium.*

The southeast trend line is based on the following country data: Turkey, United Kingdom, Norway, Korea, Czech Republic, Finland, Austria, Germany, Slovenia, Canada, Iceland, Denmark, Hungary, Belgium, Mexico, Japan, Israel, Greece, Chile, Spain, Poland, Portugal, United States, Italy, and France.

[1] Stanley Jay Feldman is Chairman, Axiom Valuation Solutions, A Global Financial Service Company specializing in the valuation and financing of private firms.

The tax competitiveness index measures the degree to which a tax regime promotes tax competitiveness through low tax burdens on business investment and a well-structured tax system. Tax regimes that have low marginal tax rates and are not overly complicated fare well on the tax competitiveness index. If the political narrative is correct, nations with the most competitive tax regimes should be associated with higher Gini coefficient values. The above chart shows this is not the case. Rather, there are two very different relationships as indicated by the trend lines. Trend line A is consistent with the political narrative- nations that have tax systems that favor capital-high tax competitiveness index value- are more likely to have greater income inequality than nations that do not. Trend line B shows the reverse relationship. These two trend lines taken together, however, indicate that the relationship between a nation's tax competitiveness and the degree of income inequality is ambiguous at best. So, therefore it does not necessarily follow that public policies that burden business investment through raising tax rates that predominantly reduce the return to capital will necessarily result in a more equitable distribution of income. If a nation initially raises taxes on corporate profits and redistributes this income to less affluent individuals for example, it is axiomatic that income inequality improves. But this is only true in the short-term. In the longer-term these policies are likely to reinforce the forces that are currently shaping the global marketplace by forcing business leaders to move centers of excellence to those parts of the world that reward risk taking and/or forcing business to go underground to escape a burdensome overreach of government.

Modest increases in income inequality are not happening because of some unfair advantage a segment of the population has. It is occurring globally for three reasons- global availability of technology, open global markets accompanied by a worldwide reduction in tariffs, Trump tariffs notwithstanding, and the free flow of financial capital seeking the highest rates of return. These factors taken together have allowed firms to substitute capital for labor across several domestic industries including manufacturing, finance and accounting, banking and retail sectors. This dynamic is most noticeable in basic manufacturing where the substitution of capital for labor has resulted in manufacturing share of total employment to decline to below 10% currently from 25% in 1960 while the share of output represented by manufacturing has remained relatively unchanged. US firms have also moved production outside the US where technology can be combined with lower wage skilled labor to produce quality products at a much lower cost than in the US even when transportation costs are considered. Technology has worked to commoditize various economic activities across a broad spectrum of industries and while this process results in lower prices for consumers, it places a great deal of downward pressure on wages of those working in affected industries. Alternatively, the demand for qualified labor in fast growing sectors like technology has expanded rapidly as has compensation. And yes, these forces necessarily mean that some segments of our population do better relative to other segments. But these outcomes reflect cyclical adjustments to economic forces. The slow increase in income inequality means that Americans are adjusting over the longer run, which is the critical factor.

In summary, income inequality has increased only marginally and attempts to reduce income inequality through more progressive tax regimes have not been shown to be an effective policy. While Americans have adjusted to global economic forces that work against a more equitable distribution of income, it is also true that human adjustment costs associated with job churn driven by a rapidly changing global competitive landscape are enormous. Public policy should be directed to accepting the churn and creating an environment that allows labor to identify new employment opportunities quickly, credits to firms that

[1] Stanley Jay Feldman is Chairman, Axiom Valuation Solutions, A Global Financial Service Company specializing in the valuation and financing of private firms.

offer retraining programs, and a far better alignment between basic education- the 3 Rs plus tech- and the skills needed to adjust to new job requirements. Protection from global competition only creates more income inequality not less. Public policy should focus on creating an environment for labor that removes the costs of skill-based renewal and far less on redistributing income honestly earned.

[1] Stanley Jay Feldman is Chairman, Axiom Valuation Solutions, A Global Financial Service Company specializing in the valuation and financing of private firms.