16.10: Government Policies to Reduce Income Inequality

Learning Objectives

• Explain the arguments for and against government intervention to reduce economic inequality

HOW DO YOU MEASURE WEALTH VERSUS INCOME INEQUALITY?

Income is a flow of money received, often measured on a monthly or an annual basis; wealth is the sum of the value of all assets, including money in bank accounts, financial investments, a pension fund, and the value of a home. In calculating wealth all debts must be subtracted, such as debt owed on a home mortgage and on credit cards. A retired person, for example, may have relatively little income in a given year, other than a pension or Social Security. However, if that person has saved and invested over time, the person’s accumulated wealth can be quite substantial.

The wealth distribution is more unequal than the income distribution, because differences in income can accumulate over time to make even larger differences in wealth. However, the degree of inequality in the wealth distribution can be measured with the same tools we use to measure the inequality in the income distribution, like quintile measurements. Data on wealth are collected once every three years in the Survey of Consumer Finance.

Redistribution

Redistribution means taking income from those with higher incomes and providing income to those with lower incomes. Earlier in this module, we considered some of the key government policies that provide support for the poor: the welfare program TANF, the earned income tax credit, SNAP, and Medicaid. If a reduction in inequality is desired, these programs could receive additional funding.
progressive tax system designed in such a way that the rich pay a higher percent in income taxes than the poor. Data from household income tax returns in 2009 shows that the top 1% of households had an average income of $1,219,700 per year in pre-tax income and paid an average federal tax rate of 28.9%. The effective income tax, which is total taxes paid divided by total income (all sources of income such as wages, profits, interest, rental income, and government transfers such as veterans' benefits), was much lower. The effective tax paid by the top 1% of householders was 20.4%, while the bottom two quintiles actually paid negative effective income taxes, because of provisions like the earned income tax credit. News stories occasionally report on a high-income person who has managed to pay very little in taxes, but while such individual cases exist, according to the Congressional Budget Office, the typical pattern is that people with higher incomes pay a higher average share of their income in federal income taxes.

Ladder of Opportunity

Public policy can attempt to build a ladder of opportunities so that, even though all children will never come from identical families and attend identical schools, each child has a reasonable opportunity to attain an economic niche in society based on their interests, desires, talents, and efforts. Some of those initiatives include those shown in Table 1.

<table>
<thead>
<tr>
<th>Children</th>
<th>College Level</th>
<th>Adults</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Improved day care</td>
<td>• Widespread loans and grants for those in financial need</td>
<td>• Opportunities for retraining and acquiring new skills</td>
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<tr>
<td>• Enrichment programs for preschoolers</td>
<td>• Public support for a range of institutions from two-year community colleges to large research universities</td>
<td>• Prohibiting discrimination in job markets and housing on the basis of race, gender, age, and disability</td>
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<tr>
<td>• Improved public schools</td>
<td>–</td>
<td>–</td>
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<tr>
<td>• After school and community activities</td>
<td>–</td>
<td>–</td>
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<tr>
<td>• Internships and apprenticeships</td>
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Inheritance Taxes

estate tax—that is, a tax imposed on the value of an inheritance—which suggests a willingness to limit how much wealth can be passed on as an inheritance. However, according to the Center on Budget and Policy Priorities, in 2013 the estate tax applied only to those leaving inheritances of more than $5.25 million and thus applies to only a tiny percentage of those with high levels of wealth.
Tradeoff between Incentives and Income Equality

Figure 1. The Tradeoff between Incentives and Economic Equality. (a) Society faces a trade-off where any attempt to move toward greater equality, like moving from choice A to B, involves a reduction in economic output. (b) Situations can arise like point C, where it is possible both to increase equality and also to increase economic output, to a choice like D. It may also be possible to increase equality with little impact on economic output, like the movement from choice D to E. However, at some point, too aggressive a push for equality will tend to reduce economic output, as in the shift from E to F.

OCCUPY WALL STREET

The Occupy movement took on a life of its own over the last few months of 2011, bringing to light issues faced by many people on the lower end of the income distribution. The contents of this module indicate that there is a significant amount of income inequality in the United States. The question is: What should be done about it?

The Great Recession of 2008–2009 caused unemployment to rise and incomes to fall. Many people attribute the recession to mismanagement of the financial system by bankers and financial managers—those in the 1% of the income distribution—but those in lower quintiles bore the greater burden of the recession through unemployment. This seemed to present the picture of inequality in a different light: the group that seemed responsible for the recession was not the group that seemed to bear the burden of the decline in output. A burden shared can bring a society closer together; a burden pushed off onto others can polarize it.

On one level, the problem with trying to reduce income inequality comes down to whether you still believe in the American Dream. If you believe that one day you will have your American Dream—a large income, large house, happy family, or whatever else you would like to have in life—then you do not necessarily want to prevent anyone else from living out their dream. You certainly would not want to run the risk that someone would want to take part of your dream away from you. So there is some reluctance to engage in a redistributive policy to reduce inequality.

However, when those for whom the likelihood of living the American Dream is very small are considered, there are sound arguments in favor of trying to create greater balance. As the text indicated, a little more income equality, gained through long-term programs like increased education and job training, can increase overall economic output. Then everyone is made better off. And the 1% will not seem like such a small group any more.

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Learning Objectives

[glossary-page][glossary-term]effective income tax:[/glossary-term]
percentage of total taxes paid divided by total income

A tax imposed on the value of an inheritance

A flow of money received, often measured on a monthly or an annual basis

A tax system in which the rich pay a higher percentage of their income in taxes, rather than a higher absolute amount

Taking income from those with higher incomes and providing income to those with lower incomes

The sum of the value of all assets, including money in bank accounts, financial investments, a pension fund, and the value of a home

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