# Strengthening Economic Foundations & Growing the Middle Class

## Senate Committee on Finance

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Senator Wyden, Senator Hatch, Members of the Committee. It is an honor to be here today to discuss the challenge our country faces in growing its middle class. America has always been a middle-class nation – one in which most people are neither a part of a permanent "over class" of the type which governs many nations politically and economically nor part of an "under class" that is dependent upon the charity of others or of the government. The key attribute of the middle class is self-reliance; something that is part of our national identity from our beginnings as a country, and something that in my judgment public policy should encourage, not inhibit.

I'd like to begin by laying out some facts that are not part of the conventional wisdom regarding income in America and the state of the middle class. The first observation is that neither political party has been particularly effective at fostering policies that make American income distribution more equal. Chart 1 shows the change in two measures of income inequality used by the Department of Commerce to give a summary statistic of the state of income inequality in America. In both cases the higher the number the more unequal the income distribution. Note that income inequality has risen under every President for half a century. It rose fastest under President Clinton. During those eight years it increased more than under the eight years of President Reagan and the eight years of President Bush combined. Rising income inequality was not the intent of any of these Presidents; it just has not been something that has proven very tractable to public policy.

That apparent intractability is not for want of trying. For example, Chart 2 shows how much more progressive income taxation has become since 1980. The first column shows the share of income received by the top 5 percent of the income distribution according to the Department of Commerce. The second column shows the share of income taxes that they pay. Note that both columns have been moving up. The share of income received by the top 5 percent has risen a little over 5 percentage points in the last 30 years. The share of income taxes paid by the top 5 percent has risen a bit more than 20 percentage points over the same time. The third and fourth columns compare the taxes paid and income received by the top 5 percent and by the other 95 percent of households. In 1980, for example, the share of taxes paid by the top 5 percent of the income distribution was roughly 2 1/4 times their share of the income they received. For the remaining 95 percent, the share of taxes they paid was about ¾ their share of income. Thus, by comparing these ratios we get a sense of how much the average taxes paid by the top 5 percent compares with the share of taxes paid by everyone else. In 1980 the top 5 percent paid about three times what everyone else paid in terms of their share of income. By 2010, the share of taxes relative to the share of income for the top 5 percent had risen to about 2 ¾ while the same ratio for everyone else had fallen to about ½. This means that by 2010 the relative tax burdens had risen from 3 times to 5 ¼ times.

The chart is illustrative for two reasons. First, the top marginal tax rate generally declined during that period. It was 70 percent in 1980 and fell to just over 35 percent by 2010. Despite this, the share of taxes paid by the top 5 percent rose consistently, and it also rose consistently faster than their share of income. Second, despite an ever increasing share of income taxes being paid by the top 5 percent, income inequality continued to rise. In other words, higher taxes are simply not an effective means of levelling out the income distribution. None of these points are what one would consider conventional wisdom.

The other important indicator about the inability of government policy to affect income distribution is that income inequality has risen despite a massive increase in the share of income that government redistributes. Consider the third chart in this presentation. It shows the shares of personal income that come from government transfer payments to individuals and the share of income coming from what the national income accounts call property income – interest and dividends. Despite the indications of rising income inequality over the last half century or so, the share of personal income coming from transfer payments has roughly tripled, from six cents on the dollar to eighteen cents on the dollar. It is almost incomprehensible that one can move a full twelve percent of income around in an effective matter and not make income distribution more equal if that is the intent. Of course, the answer is that our massive panoply of income distribution programs are not effectively designed, a point I will return to.

The other line on the chart shows the share of income that is property income. That shows a more complicated pattern, rising until 1980 and then falling after 1990. Today transfer payments are a more important source of personal income than are interest and dividends, an enormous change. If we think about the issue of class, and Mr. Chairman, you have called this hearing to think about what is happening to the middle class, one need only look at these lines to understand the middle class issue. As I said at the beginning of my testimony, the key sociological fact of being in the middle class is self-reliance. Middle class individuals are not dependent on government for their livelihood, nor are they coupon clippers, dependent on income from capital to live on. They live on wages they earn in the market place.

What is fascinating is that income inequality has increased and many believe the middle class has shrunk DESPITE more income redistribution and DESPITE having the share of income coming from "coupon clipping" dropping. The only explanation for this must be that something is happening to the third main source of income and the main source of middle class income, which is wages. The data on this are clear – fewer people are working. With fewer people working, wages are a less important source of income and with fewer people working there are by definition fewer people who are going to be able to be self-reliant.

There is no greater challenge to the growth of the middle class and promoting income inequality in America, and might I add to the pace of economic growth, than the rate of labor force participation. This rate has collapsed in the last five years. More than half of the explanation for the drop in the unemployment rate since the recession began has not been due to job creation – but people dropping out of the labor force. Consider the magnitude of this. Figure 4 shows what has happened to middle aged labor force participation between 2007 and the end of 2013. If we had the same fraction of middle aged people participating in the labor force as we had in 2007 there would be 2 million middle aged males and a million middle aged females active in the economy than we actually had . Note, these people aren't saying they can't find a job, they are saying they don't want a job.

This drop in labor force participation has corresponded to a large increase in the scope of government transfers and the increase in the effective disincentive to return to work. I would urge you to examine a paper on the subject developed by the Urban Institute and published in the National Tax Journal. It found out that the effective marginal tax rate faced by a single mom with two kids was between 50 and 80 percent. I append two charts from that paper. Is it any wonder that middle aged people who lose their jobs and get trapped in our entitlement system choose to leave the labor force rather than return to work?

So, Mr. Chairman, you asked for a creative thought on how to prevent the bar-bell like developments in the income distribution. I have one suggestion: Keep It Simple. The expansion of complex government solutions has not worked well. An ever more complicated income tax system, despite placing an ever increasing share of the tax burden on the top 5 percent of taxpayers has not made income more equally distributed. Redistributing 18 percent of personal income has not either. And from the "Benefits Mountain" chart from the Urban Institute, one can understand why.  These programs are not well co-ordinated.  They are layered one on top of the other.  And as such they are neither well thought out from the government side.  As a result, they create a complex problem for the intended beneficiary and a disincentive for them to participate in the labor market.  In terms of tax reform, with apologies for some immodesty, I commend a recommendation I made in my recent book The Growth Experiment Revisited.  Tax Simplification –an outright abolition of the personal, corporate and social security tax – and a replacement with a single cash flow tax is the goal.

Thank you and I would be happy to answer any questions.

# Chart 1

## Neither Party Has Reduced Income Inequality

| Presidency | | Change in GINI Coefficient | Change in Mean-Log Coefficient |
|---|---|---|---|
| Nixon/Ford - | 8 years | + 0.012 | + 0.005 |
| Carter | 4 years | + 0.005 | + 0.014 |
| Reagan | 8 years | + 0.023 | + 0.026 |
| Bush - 41 | 4 years | + 0.007 | + 0.015 |
| Clinton | 8 years | + 0.029 | + 0.074 |
| Bush - 43 | 4 years | + 0.004 | + 0.051 |
| Obama (first 2 years) | | + 0.003 | + 0.031 |

Source: US Dept. of Commerce, The Lindsey Group, See Also Lindsey *The Growth Experiment Revisited* (2013) p. 208

## Chart 2

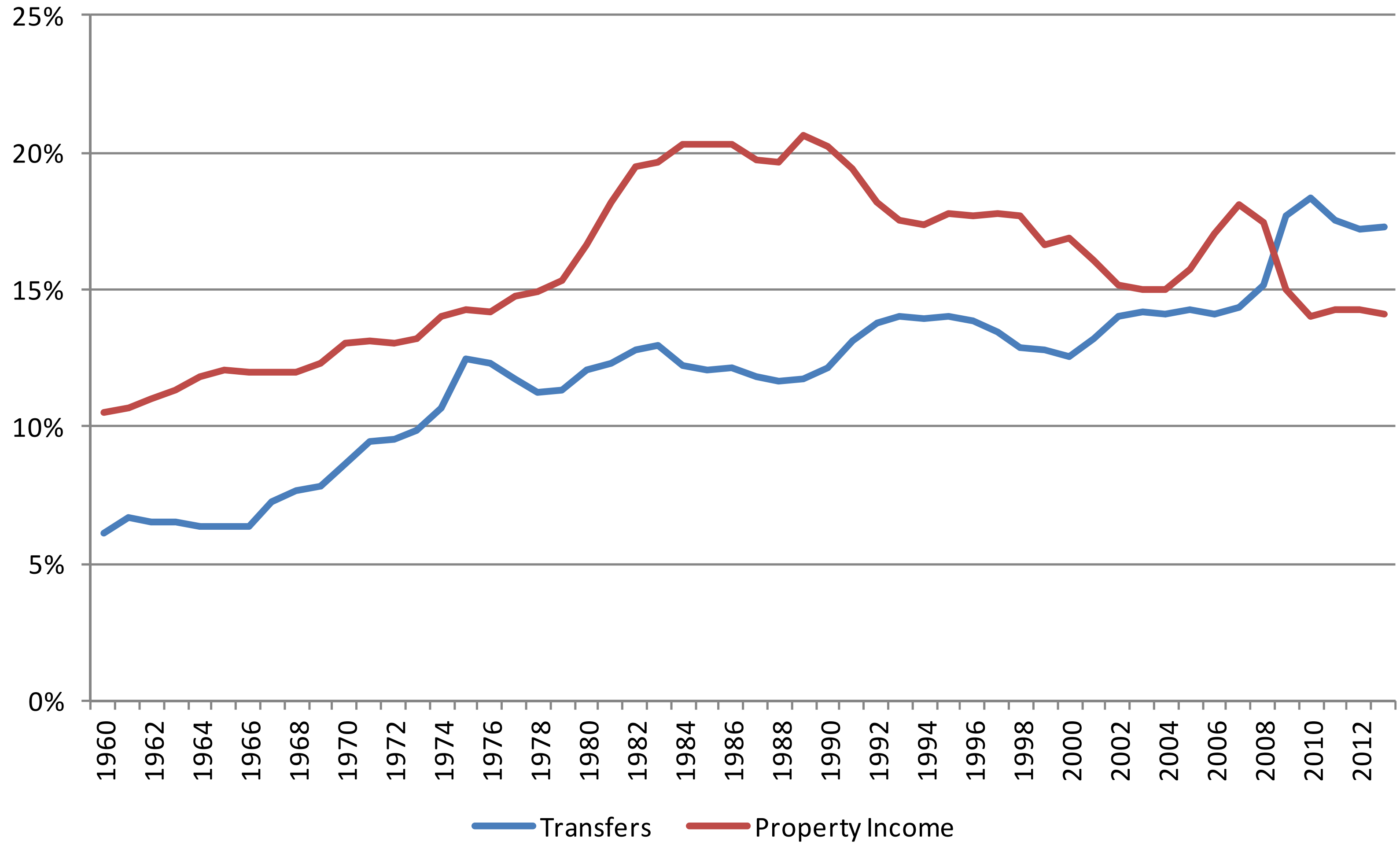
## Share of Taxes Paid by Rich Rose Faster Than Their Share of Income

| | Top Five Percent | | Tax Share / Income Share | | Ratio of Tax/Income |
|---|---|---|---|---|---|
| | Share of Income | Share of Income Tax | Top 5% | Everyone Else | Shares Top/Bottom |
| 1980 | 16.5 | 36.9 | 2.24 | 0.76 | 2.95 |
| 1990 | 18.5 | 43.6 | 2.36 | 0.69 | 3.42 |
| 1995 | 21.0 | 48.9 | 2.33 | 0.65 | 3.58 |
| 2000 | 22.1 | 56.4 | 2.55 | 0.56 | 4.55 |
| 2005 | 22.2 | 58.9 | 2.65 | 0.53 | 5.00 |
| 2010 | 21.7 | 59.1 | 2.72 | 0.52 | 5.23 |

Source: Bureau of Census, Internal Revenue Service

# Chart 3

## Transfer Payments Now Bigger Than Capital Income




Source: Bureau of Economic Analysis

# Chart 4

## Decline in Middle Aged Labor Force Participation

| **Men** | 2007* Participation | Dec-13 Participation | Lost Workers |
|---|---|---|---|
| *25 - 34* | 91.4% | 87.9% | 734 |
| *35 - 44* | 91.1% | 89.4% | 335 |
| *45 - 54* | 88.3% | 84.3% | 850 |
| Total *('000s)* | | | 1,918 |

| **Women** | 2007* Participation | Dec-13 Participation | Lost Workers |
|---|---|---|---|
| *25 - 34* | 75.4% | 74.2% | 241 |
| *35 - 44* | 74.7% | 73.8% | 188 |
| *45 - 54* | 76.2% | 73.0% | 725 |
| Total *('000s)* | | | 1,154 |

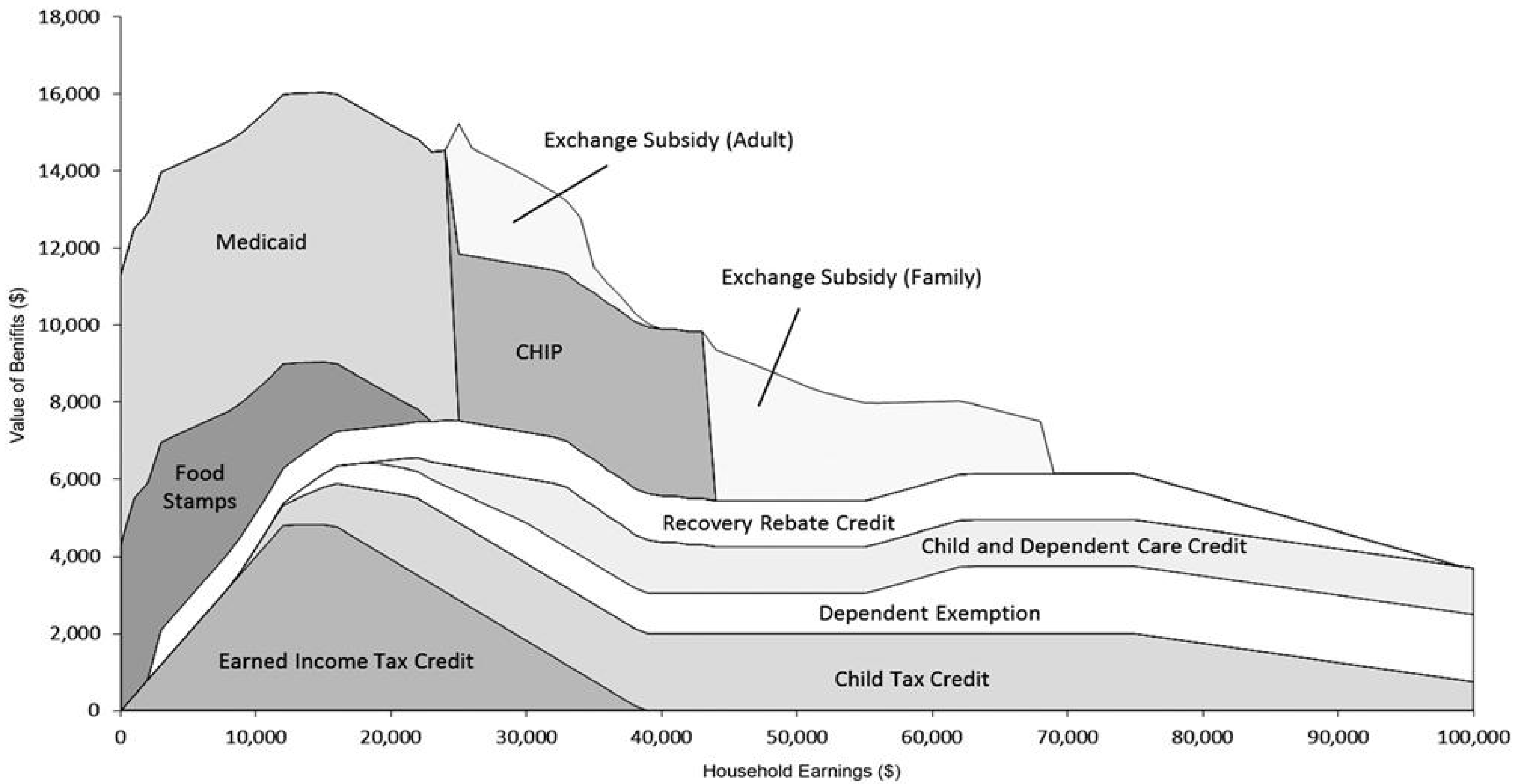
Total Both Genders: 3,073

* Avg. monthly participation

Source: Bureau of Labor Statistics, Current Population Survey, TLG

# Chart 5

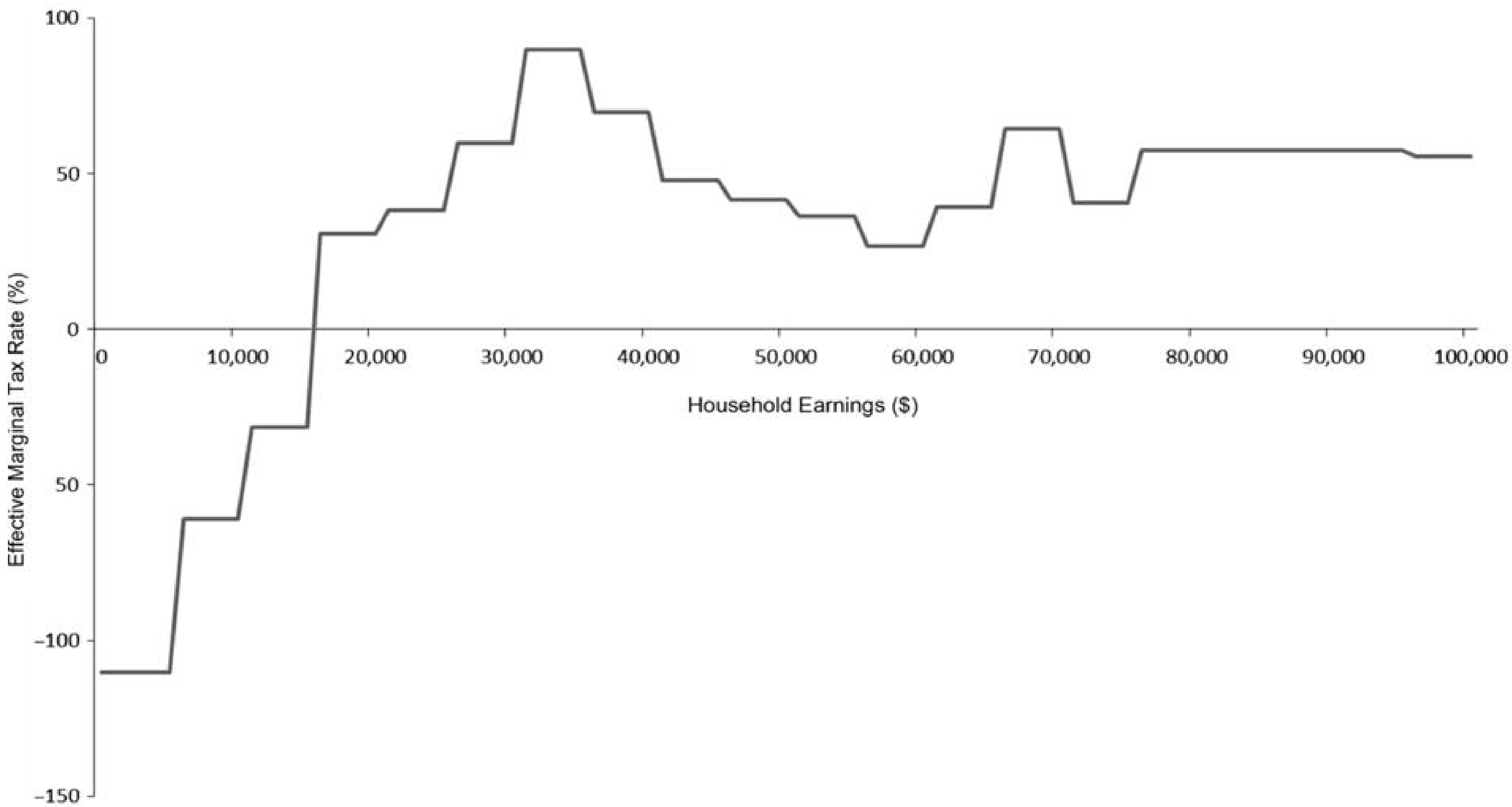
# Benefits for Single Parent With Two Children




Source: The Urban Institute

# Chart 6

## Marginal Tax Rate for Single Parent With Two Children




Source: The Urban Institute