



**Testimony on the Growing Income
Gap in the American Middle Class**

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**Testimony before the Subcommittee on Workforce Protections
of the House Committee on Education and Labor**

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The Income Gap in the American Middle Class

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Mr. Chairman, members of the Committee, I am honored to testify before your Committee today on the subject of the income gap in the American middle class.

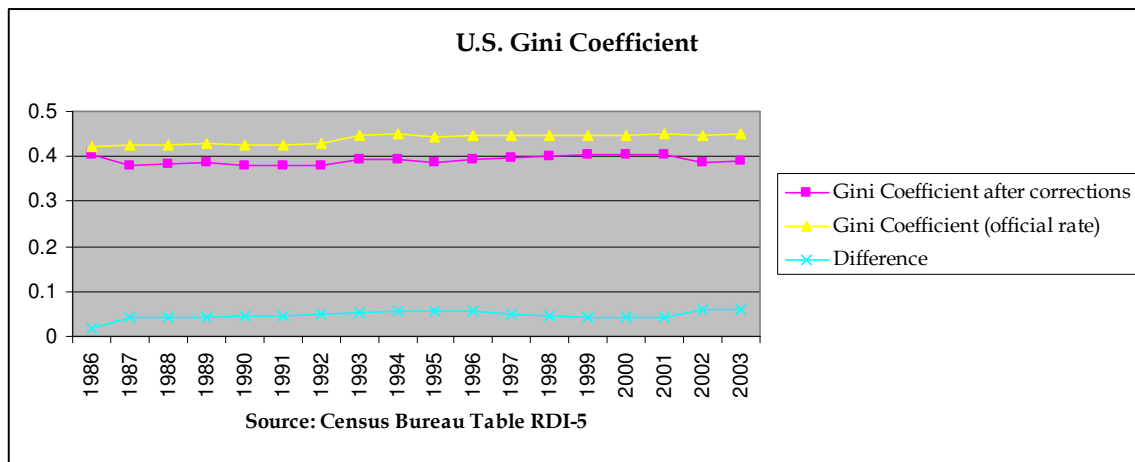
American workers are earning more today than they were a year ago. Real disposable personal income has increased steadily since 1996. Between January 1996 and May 2008, real disposable personal income increased 54.5 percent. Over past year, from May 2007 to May 2008, real disposable income increased by 7.3 percent. In addition, the Census Bureau reported 0.7 percent increase in median household income from 2005 to 2006 (the 2007 numbers will come out next month).

With increases in income, what has happened to inequality? The popular perception of income inequality is dire. A quick search through the popular press will yield dozens of articles and speeches decrying the increasing excesses of the super-rich while the poor grow ever poorer. Robert Frank's best-selling book, *Richistan*, portrays the "new rich" who have multiple mansions and staffs of household helpers. David Shipler's *The Working Poor: Invisible in America* describes those in low-wage jobs, struggling to get by. Yet rather than relying on

anecdotes, we should base our views of inequality on a firm understanding of the data.

Economists use a variety of measures to determine how equally the income “pie” is divided. These measures include inequality indices and earning shares.

Common to all these measures, however, are certain challenges. All measures need a definition of income, and defining income is not as straightforward as it seems. Some researchers will use pre-tax income, while others will look post-tax income before transfer payments such as food stamps, Medicare, or Social Security. Others use post-tax, post-transfer income. What measure is used makes a significant difference.

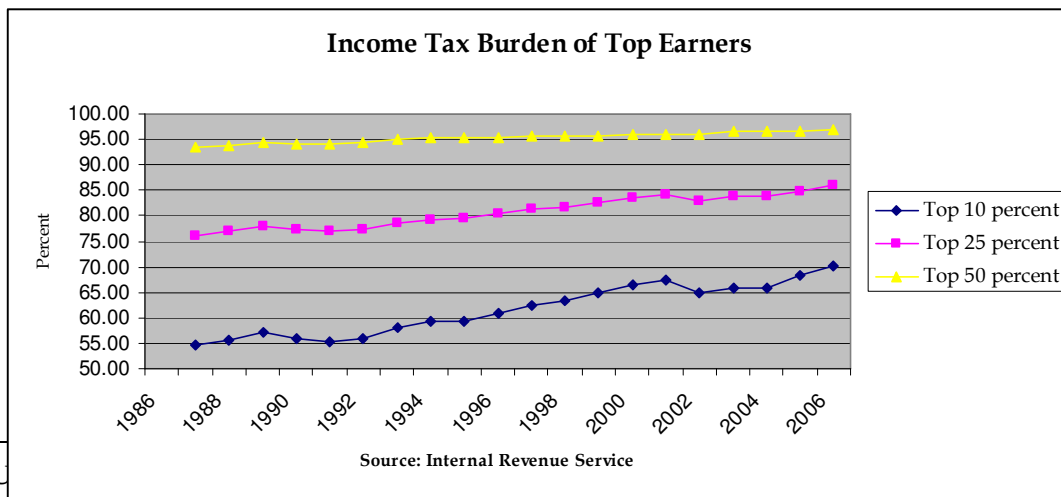


For example, consider the Gini coefficient, as calculated by the Census Bureau.

The Gini coefficient is a statistical index inequality ranging from zero to one, calculated from the distribution of income throughout the population. Low

values represent low levels of inequality, while values near one mean that income is concentrated among a few individuals. As can be seen from a Census Bureau table using alternate measures of income, the official Gini coefficient is consistently overestimated by about 5 percentage points¹, after taxes and transfers are accounted for (see figure above).

A report from the Census Bureau concludes that “there have not been any statistically significant annual changes in the Gini index over the last 10 years.”² A Congressional Budget Office report found that, between 1991 and 2005, the quintile of households with children with the lowest earnings experienced the second greatest percentage increase in income, after the top quintile. The lowest quintile experienced the largest percentage growth in earnings³.

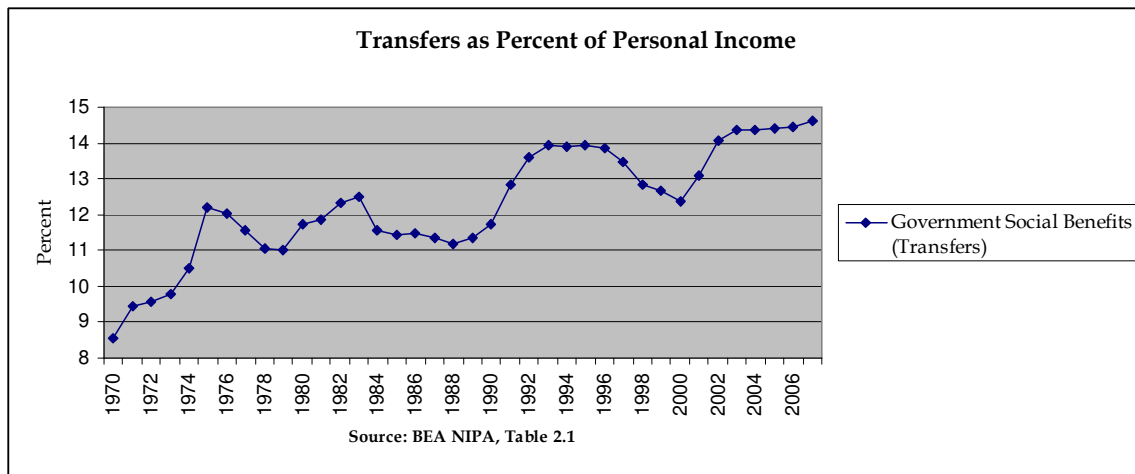


¹ U.S. Census Bureau, “Table KDI-5, Index of Income Concentration (Gini Index), by Definition of Income: 1979 to 2003.” Available at <http://www.census.gov/hhes/www/income/histinc/rdi5.html>

² Ibid.

³ Dahl, Molly, Congressional Budget Office, “Changes in the Economic Resources of Low-Income Households with Children” May 2007. Available at <http://www.cbo.gov/ftpdocs/81xx/doc8113/05-16-Low-Income.pdf>

The Internal Revenue Service reports that the top 50 percent of earners paid 97 percent of income taxes in 2006, a percentage which increased in almost every year since 1992⁴ (see figure above). Meanwhile, personal current transfer receipts, as reported by the Bureau of Economic Analysis, have been steadily increasing (see figure below). These transfer payments go disproportionately to lower-income individuals. The net effect of taxes and transfer programs is to bring greater equality to the purchasing power of individuals.



Additionally, we need to consider the spending power of American dollars.

Low-income households spend a greater portion of their income on goods that have become cheaper with international trade, such as food. High-income households, on the other hand, spend for “high-end services like private secondary schools, college tuition, high-end spas, message therapists, landscape

⁴ Internal Revenue Service, SOI Tax Stats – Individual Income Tax Rates and Tax Shares, Table 1 “Number of Shares, Shares of AGI and Total Income Tax, AGI Floor on Percentiles in Current and Constant Dollars, and Average Tax Rates.” Available at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=129270,00.html>

gardeners, and other service providers whose relative prices rise steadily relative to the overall consumer price level.”⁵ Jerry Hausman and Ephraim Leibtag found in 2004 that a Wal-Mart in a new market decreases food prices by 15 to 25 percent.⁶

Demographic changes can create potentially spurious increases in income inequality. Most inequality measures are calculated from household or family income. So the increasing tendency of high-income men to marry high-income women will boost the inequality among household incomes without changing inequality among individual earners.

Furthermore, not all households are the same size, and household size has diminished over time due to later marriages, fewer children, and divorce. There are 1.7 people in the average household in the lowest fifth of households, and this number rises steadily to 3.1 persons in the top fifth of households.

Differences in household income, then, are larger than differences in income per person. Similarly, there are differences in the number of earners per household, with the top fifth averaging 2.1 earners compared to the bottom fifth’s half an

⁵ Gordon, Robert and Ian Dew-Becker. “Controversies about the Rise of American Inequality: A Survey.” NBER Working Paper No 13982 (May 2008), pg 33.

⁶ Hausman, Jerry and Ephraim Leibtag. “CPI Bias From Supercenters: Does the BLS Know that Wal-Mart Exists?” NBER Working Paper No 10712 (August 2004).

earner per household⁷. Since more people are working in the higher income households, it is hardly surprising that the household as a whole is earning more.

Besides the questions of determining the “true” Gini coefficient highlighted above, there are concerns when using the Gini coefficient for comparison. It is important to realize that the Gini coefficient represents a snap-shot of inequality. As the working force population changes its average characteristics, the Gini coefficient likewise changes.

Consider an economy where workers have the same earnings experience over their lives. Younger workers earn less than older workers, and earnings rise throughout workers’ careers. A snap-shot of this economy will show income inequality between workers even though lifetime income is more equal. In this case, the Gini coefficient indicates less an egregious lack of income equality than a need for good credit markets.

But even more than properly understanding the nuances of the numbers used to track income inequality, we need to understand the data that are used to generate them. A study by Thomas Piketty and Emmanuel Saez is the basis,

⁷ U.S. Department of Labor, Consumer Expenditure Survey, Table 55. Available at <ftp://ftp.bls.gov/pub/special.requests/ce/aggregate/2006/quintile.txt>

directly or indirectly, for many of the commentators warning of rising income inequality. This study uses individual income tax returns from 1913 to 1998 (updated to 2001) to chart changes in the top earners' income shares over the past century.

To calculate these shares, Piketty and Saez aggregate the reported income of the top percentage groups of interest (specifically, the top 1 percent) and divide this number by the total personal income reported in the National Income and Product Accounts by the Bureau of Economic Analysis.⁸

Unfortunately, this simple measure is wholly dependent on the consistency of the underlying data. Individual income tax returns provide complicated data to work with, especially over time, because income tax returns provide data on tax units, not individuals. A married couple filing together represent one tax unit, as does their teenage son whose earned \$3,350 at his part-time and summer jobs⁹. These three represent one household, but two tax units: one relatively rich, the other relatively poor.

With the entry of greater numbers of women into the workforce over the past 25 years, the growing tendency towards dual income couples polarizes the income

⁸ Piketty, Thomas and Emmanuel Saez. "Income Inequality in the United States, 1913-1998." *Quarterly Journal of Economics*, Vol 118, Is 1 (Feb 2003) pp 1-39.

⁹ Internal Revenue Service, "2007 Inst 1040 Instructions for Form 1040 and Schedules A, B, C, D, E, F, J, and SE." Chart B, pg 7, for dependent children who are not blind or over 65 years of age.

distribution without any change in individual income inequality. Two earners marrying, whether they be attorneys or automotive mechanics, results in an immediate change in the income distribution. A police officer married to a nurse, each at the top of their profession, can earn almost \$200,00. If more teenagers take after-school jobs, the number of low-income tax “households” balloons and income inequality appears to rise.

The Tax Reform Act of 1986 lowered the top income rate from 50 percent to 28 percent, and raised the capital gains tax to equal the ordinary income rate¹⁰.

Prior to the passage of the Tax Reform Act, it was advantageous for many small-business owners to file under the comparatively lower corporate tax rate. After the Act, the individual tax rate was more favorable than the corporate rate, so small businesses switched to filing individual tax returns. This explains that large jump in the inequality series of Piketty and Saez between 1986 and 1988. A mass switch from corporate to individual filings by small-business owners fits this pattern perfectly¹¹. After correcting for this change and the effect of transfer payments, Cato Institute economist Alan Reynolds finds that “the *apparent*

¹⁰ Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, as reported by Stacey Kean and David Brumbaugh, Congressional Research Service, CRS Report for Congress No. 87-231E, “Tax Reform Act of 1986 (P.L. 99-514): Comparison of New with Prior Tax Law.”.

¹¹ Reynolds, Alan. “Has U.S. Income Inequality *Really* Increased?” Policy Analysis no 586, Jan 8, 2007.

increase of 1.7 percentage points in the top 1 percent's share from 1988 to 2003 in the unadjusted Piketty-Saez estimates becomes no increase."¹²

As well as analyzing income inequality directly, we can consider consumption inequality. This provides a better view of how much citizens actually spend, and therefore how well Americans live. Consumption spending generally has fewer fluctuations than income, so consumption data will be influenced less by transitory shocks. Data from the Consumer Expenditure Survey of the Bureau of Labor Statistics adjusted for the number of people per household gives us insight into spending equality among Americans.¹³

In 2006, the last year for which data are available, Americans in the lowest quintile of pre-tax income spent \$12,006 per person, compared to \$16,572 per person in the middle fifth household, and \$30,371 per person in the top quintile. On a per person basis, the top quintile spends only 2.5 times what the bottom quintile does, and 1.8 times what the middle fifth does.

When spending is broken down into categories, results are similar. The bottom quintile spends \$874 per person for health costs, about 1.5 times as much as the top quintile's \$1318 per person. For food, the bottom fifth paid \$1,878 while the

¹² Ibid., at 11.

¹³ All calculations on per-person spending are performed using U.S. Department of Labor's Consumer Expenditure Survey, table 1, available at <http://www.bls.gov/cex/home.htm>.

top fifth paid \$3,304. The top 20 percent spend only 1.8 times as much. In housing, the lowest quintile spent \$4,781 to the top's \$9,700 – about two times as much. In all these categories, the middle quintiles are roughly in between.

The areas where the high-income quintile outspends the low-income quintile are personal insurance and pension, entertainment, and transportation. The top 20 percent spend 14.6 times more on personal insurance than the lowest fifth, but only three times more than the middle fifth. In both entertainment and transportation, the top quintile expends about three times as much as the bottom quintile. The top quintile outspends the middle quintile in entertainment and transportation by 2.2 times and 1.7 times, respectively. The pattern that emerges is not one of extreme inequality. The top income earners do not outspend the lowest earners by extreme amounts.

The demographic characteristics of the bottom fifth of households shed light on consumption patterns. The bottom income quintile has the highest average age, 52, while the top quintile has the second youngest age at 47 (the second-highest quintile has an average age of 46). Only 17 percent of the top twenty percent own homes mortgage-free, with 75 percent still paying off their mortgage; 30

percent of the bottom fifth own homes free of any mortgage, and only 13 percent have to spend for mortgages.¹⁴

These data support the conclusion that some households in the bottom income quintile are not truly poor. Instead, they are older citizens living off accumulated savings. Some of those in the top quintile are at the peak of their earning careers, and are saving up for their future.

Another important difference between income quintiles is in education. The percentage of reference people in each household with a college education rises to 83 percent in the top quintile, starting at 40 percent for the lowest 20 percent of households¹⁵.

Studies consistently find high returns to education. A study by economists Louis Jacobson, Robert LaLonde, and Daniel Sullivan on displaced workers in Washington State found that workers increased their incomes by 7 to 10 percent per year of community college, the same as students entering directly from high school¹⁶. Another study by economists Thomas Kane and Cecilia Rouse found that these returns, about a 5 to 10 percent improvement in earnings per year of

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ Jacobson, Louis, Robert J LaLonde and Daniel Sullivan. "The Impact of Community College Retraining on Older Displaced Workers: Should We Teach Old Dogs New Tricks?" *Industrial and Labor Relations Review*, Vol 58, No 3 (April 2005) pp 398 - 415.

education, are remarkably similar across community colleges and four-year colleges¹⁷.

Perhaps more importantly, the subjects studied make a difference. A related study by Jacobson, LaLonde, and Sullivan find higher returns, 14 percent income improvement per year of education for men and 29 percent for women, when more technical or quantitative subjects are taken¹⁸.

Education gives Americans the skills they need to succeed in today's dynamic business world. Improvements to the education system focused on providing quality education in key areas will increase the human capital of America's citizens and help workers attain their potential in the workplace.

America's workforce is not in the midst of a surge of inequality as popularly portrayed. We should be wary of conclusions reached from dubious data, and keep in mind other ways of determining inequality, such as through consumption expenditures. To the extent that there is inequality in incomes, differences in education are an important factor. A better education system gives everyone a fairer shot in the workplace.

¹⁷ Kane, Thomas J. and Cecilia Elena Rouse. "The Community College: Educating Students at the Margin Between College and Work," *Journal of Economic Perspectives*, 13, no. 1 (Winter 1999): 63-84.

¹⁸ Jacobson, Louis, Robert J LaLonde and Daniel Sullivan. "Is Retraining Displaced Workers a Good Investment?" FRB of Chicago Economic Perspectives, Vol 29, Iss 2 (2nd Quarter 2005) pp 47-66.

Putting in place more mandated employer-provided benefits to combat alleged problems of inequality would hurt those Americans that members of Congress are seeking to help. Many of the protections are aimed at women. Examples of such protections include paid maternity leave, government-provided child care, and “paycheck fairness” – mandating that women be paid the same as men not for equal work, as is the case now, but for jobs of equal worth.

Yet women in the United States have enjoyed a low unemployment rate, one comparable to men’s, because low taxes and lack of employer mandates encourage women to work outside the home and be hired. This has remained true over the past year, as the economy has slowed. According to BLS data, the 2007 unemployment rate for American women was 4.5 percent and the rate for men was 4.7 percent. In June, 2008, the adult female unemployment rate in the United States was 4.7 percent, compared to the male rate of 5.1 percent. Of particular note is that the unemployment rate for American women moves closely to the rate for men.

In other countries, unemployment rates for women are higher than in the United States. In 2007, compared to the rate for American women of 4.5 percent, the rate for women in Canada was 4.8 percent; Australia, at 4.8 percent; France, at 9.1 percent; Italy, at 7.9 percent; Sweden, at 6.4 percent; and the UK, at 5 percent. In

Italy, France, the Netherlands, and Sweden, women have a significantly higher unemployment rate than men.¹⁹

Not only do women in the United States have a lower unemployment rate, they also find jobs more quickly. According to the latest release from the OECD, only 9.2 percent of unemployed women in the United States had been unemployed for a year or more. This compares favorably to Australia, where 15.2 percent of unemployed women were unemployed for a year or more; France, where it was 43.3 percent; Germany, where it was 56.5 percent; Italy, where it was 54.8 percent; Japan, where it was 20.8 percent; the Netherlands, where it was 43.6 percent; Spain, where it was 32.2 percent; Sweden, where it was 12.2 percent; and the UK, where in 2006 14.9 percent of unemployed women had been unemployed for a year or more.²⁰

The labor force participation rate for American women is also high. From 1980 to 1990, the participation rate rose 6 percentage points to 57.5 percent as large numbers of women entered the workforce. The rate peaked in 1999 at 60 percent, and in 2007 was only seven tenths of a percentage point lower, at 59.3 percent. In April 2008, 59.6 percent of women were in the labor market. The 2007 labor force participation rate for women was higher than in Australia at 59 percent; Japan, at

¹⁹ Bureau of Labor Statistics, "Comparative Civilian Labor Force Statistics, 10 Countries, 1960-2007," Washington, DC: Department of Labor, Updated April 18, 2008.

²⁰ OECD Employment Outlook 2007, Statistical Annex Table G, p 267.

47.9 percent; France, at 51.3 percent; Italy, at 37.9 percent; the Netherlands, at 59 percent; and the UK, at 56.5 percent.

The way to reduce economic inequality is to provide more education and job opportunities for those in lower income groups. To that end, we need to focus not only on education, but also on how to spur economic growth and keep prices low. Members could consider keeping taxes low, making use of America's oil and gas reserves through oil drilling and exploration so that we have a reliable source of energy, and removal of the ethanol mandates that are driving up our food prices.

Thank you for giving me the opportunity to testify today. I would be glad to answer any questions.