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INCOME INEQUALITY: EDUCATION, MARRIAGE AND WORK PLAY A DEFINING ROLE

Getting a college education, holding a job, and forming a family through marriage are three steps that most distinguish the highest from the lowest ends of the economic spectrum.

Income inequality in the U.S. and a number of other industrialized nations has been rising for decades. This trend leads to concern over a possible return to the "Gilded Age" with the rich living in lavish luxury while the poor subsist in poverty.

Any discussion of inequality must begin with a definition of the term and the manner in which inequality is to be measured. There can be inequality in income, wealth, consumption, opportunity, or outcomes. Even in a society where everyone has an equal opportunity to succeed, freedom of choice and individual preferences and abilities will result in unequal outcomes. Additionally, one can measure inequality based on income, earnings, wealth, or consumption. The choice of definition, along with the method of measurement, can determine the apparent "level" of inequality.

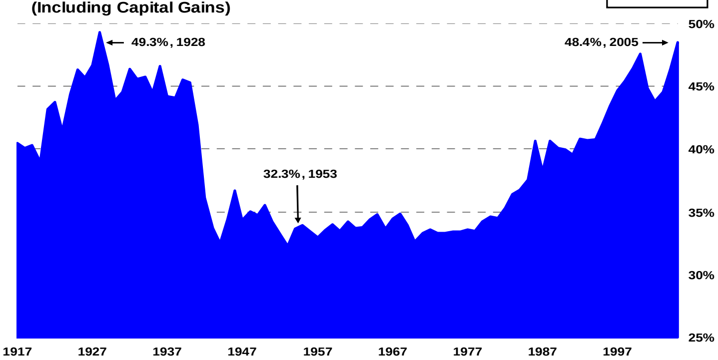
One way of looking at inequality involves the distribution of incomes across the population of households. The foremost source of data on income inequality, the Census Bureau, divides households into five income groups, each containing one fifth of all households.[1] When looking at trends in income inequality, it is instructive to understand who is in the lowest income group and who is in the highest, and how households move up and down the income groups throughout their lifetimes. This report provides some background information on income inequality, including a brief overview of who is in the lowest and in the highest of the U.S. income distribution.

Rising Income Inequality is not Unprecedented

The share of total income accruing to the highest 10% of income earners has been rising since the 1970s (see Figure 1). Similar trends of rising income inequality have also occurred in countries such as the U.K. and Canada.

Share of Total Income Accruing to the Top 10%
(Including Capital Gains)

FIG. 1



Data Source: National Bureau of Economic Research, Piketty and Saez

[1] Each "group" of the five is often referred to as an income "quintile." That is, the income distribution is often divided into five equal groups based on income levels. For example, in 2007, the first "quintile" had incomes ranging from $0 to $19,178, the second from $19,179 to $36,000, the third from $36,001 to $57,660, the fourth from $57,661 to $91,705, and the fifth quintile had incomes above $91,705.

Income Inequality is often Overstated

Data provided by the Census Bureau overstate the level of income inequality that actually exists in at least three ways:

- **Incomplete Income**: The Census Bureau's measure of income leaves out taxes paid, tax credits received (such as the EITC), and non-cash transfers received (such as Medicaid, food stamps, and subsidized housing). Most households spend a significant portion of their income on healthcare, food, and housing. Households that receive these goods and services in the form of government transfers are left with a greater portion of their income to use for other spending.

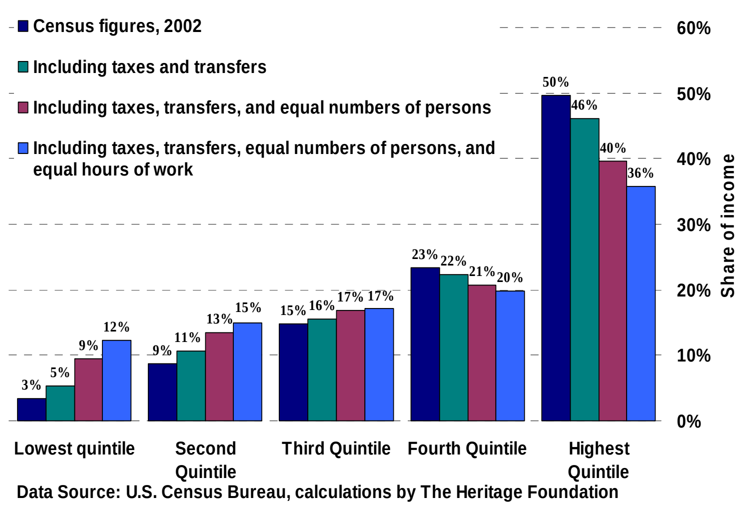
- **Different Household Sizes:** The division of groups by households results in groups of unequal sizes. In 2002, households in the lowest 20% of the income distribution had an average of only 1.8 people while households in the highest 20% had an average of 3.2 people. In 2002, the lowest group contained only 14.3% of the population while the highest contained 24.6%. With more people, households in the highest 20% of the income distribution naturally have more workers and more income potential.[2]

- **Differences in Hours Worked**: For every one hour of work performed by households in the lowest 20% of the income distribution, eight hours are performed by household in the highest 20%. This considerable difference in work activity is not incorporated into the Census Bureau's measure of inequality. A relatively high concentration of retirees in the lowest 20% explains part of the difference in hours worked, but even when limiting the comparison to only working age adults, households in the highest 20% of the income distribution perform twice as many hours of work as the lowest.

Overlooking these fundamental differences creates an incomplete and misleading picture. A more complete measure of income inequality would compare the total measure of after-tax income (including non-cash benefits) available to households of equal size and equal labor force participation hours. After accounting for taxes and transfers, household size, and hours of work, an analysis by the Heritage Foundation estimated that households in the highest 20% of the adjusted-income distribution have about $3 for every $1 in the lowest 20%, rather than the roughly $14 to $1 ratio apparent in the Census measure of income inequality (see Figure 2).

Various Measures of Income Distribution, 2002

FIG. 2



Data Source: U.S. Census Bureau, calculations by The Heritage Foundation

[2] Rector, Robert and Rea Hederman. "Two Americas: One Rich, One Poor? Understanding Income Inequality in the United States," August 24, 2004. http://www.heritage.org/Research/Taxes/bg1791.cfm

Highest vs. Lowest: What are the Differences?

Conversations about income inequality typically include comparisons between the lowest and highest income earnings groups. But what do the households in these two groups actually look like? An examination of the demographic and personal characteristics of households in the highest and lowest income groups provides a telling explanation, at least in part, of income discrepancies.

FIG. 3

Characteristic	Group Lowest	Group Middle	Group Highest
Age			
Under 35	23%	26%	15%
35 to 64	40%	57%	77%
65 and older	37%	17%	8%
Family Status			
Married	18%	51%	79%
Work			
Did not work	64%	25%	11%
Earners per Household	0.5	1.4	2.1

Source: U.S. Census Bureau, Current Population Survey, 2006 Annual Social and Economic Supplement

Age

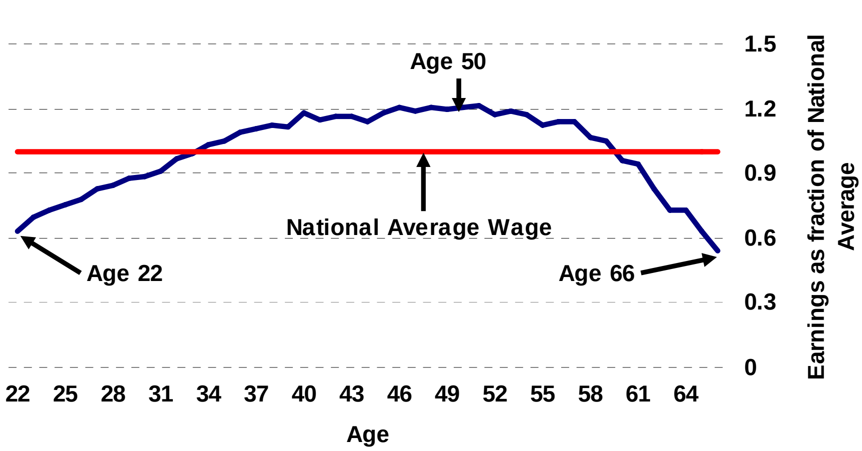
Age of the head(s) of household can help explain inequality. Consider your household income today. Now compare that to your income 10 years ago and to the income you expect to be making 10 years from now. Most likely, the numbers are very different.

Typical earners start out at a relatively low level of compensation. As they gain education, skills, and/or experience, their earnings rise, peaking around mid-age. Then, as they approach retirement, earnings begin to decline (see Figure 4).

A break-down of income groups based on age (of the head of household) shows that a majority (60%) of households in the lowest income group are either very young or elderly. Households in the highest income group, on the other hand, consist primarily (77%) of individuals in their peak earnings years. While elderly households in the lowest income group have relatively low *incomes*, many have amassed a large amount of wealth carried over from earlier in their lives when their incomes exceeded their consumption. On the other hand, young heads of household start out with relatively low incomes, but they have the potential (particularly if they go to college, get married, work, etc.) to realize significant increases in their income later on in life.

Lifetime Earnings Profile of an Average Worker

FIG. 4



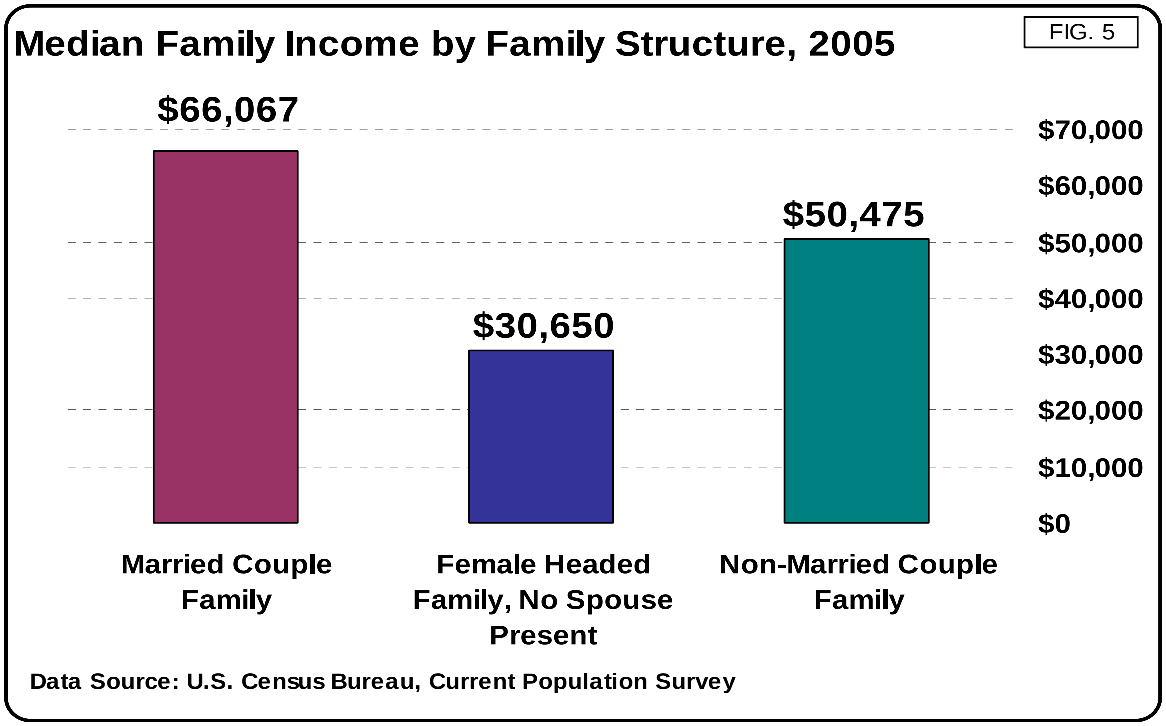
Data Source: National Average Wage Index Profiles

Differences in age account for some of the observed inequality in incomes. Other factors such as marriage, labor force participation, and education—factors over which individuals exert personal control—play a defining role in determining what end of the spectrum a household's income lies.

Marriage Matters

The difference in marriage rates between the lowest and highest income groups is astounding. While 79% of households in the highest income group consist of married couples, only 18% of households in the lowest income group are married. Research consistently reveals that married couple families are economically more secure than unmarried families.[3] In 2005, for example, married couple households had a median income of $66,067 versus only $30,650 for female headed families (see Figure 5).

FIG. 5



With median income of $50,475, unmarried couple families did better than female headed families, but were worse off than married couple families. These discrepancies in income by family structure come from two factors:

- Combined Incomes: Marriage can essentially double household income by combining two individual incomes into one household income (see statistics on number of earners in Figure 3).
- The Marriage Premium: Although selection contributes to higher incomes among married people (people who are educated, healthy, and financially stable are more likely to marry, and to marry those with similar characteristics), studies reveal that higher incomes and more stable environments within marriage lead to a marriage premium.[4] The marriage premium is primarily evident among men, for whom marriage results in

[3] Waite, Linda J. and Gallagher, Maggie. *The Case for Marriage: Why Married People Are Happier, Healthier, and Better Off Financially*. New York, New York: DoubleDay, 2000.

[4] Nock, Steven L. "Marriage as a Public Issue." *The Future of Children*, Vol. 15, No. 2, Marriage and Child Wellbeing. (Autumn, 2005), pp. 13-32. and Neumark, David and Sanders Korenman. "Does Marriage Really Make Men More Productive?" *The Journal of Human Resources*, Vol.26, No.2. (Spring, 1991), pp. 282-307.

increased health, more responsible behavior, better job prospects, and higher wages. [5] Men who divorce lose the marriage premium because, even if they retain some of the positive characteristics gained through marriage, they no longer benefit from the shared allocation of household duties that led to a marriage productivity premium.

Work is Fundamental

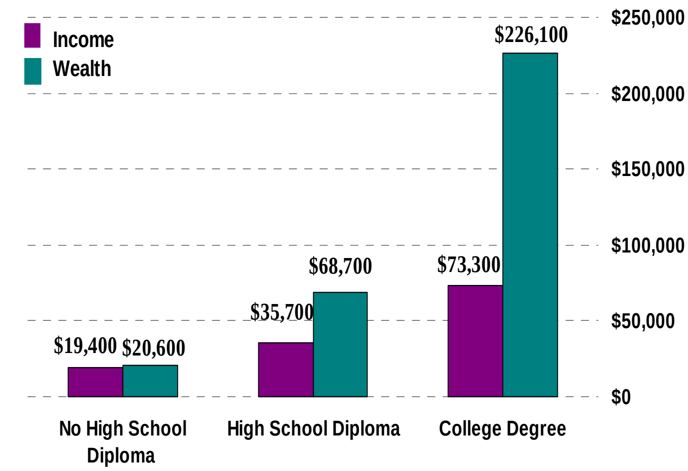
Earnings from labor income represent the primary source of income for most Americans. While 64% of household heads in the lowest income group performed no work (in the formal labor market), only 11% of heads of household in the highest income group did not work (see Figure 3). In terms of workers per household, the ratio between the highest and lowest income groups is 4 to 1. Households in the highest income group have, on average, 2.1 earners per household, while households in the lowest income group average only 0.5. The changing nature of the U.S. labor force—including earlier retirement ages, the widespread entry of women into the labor force, and the increased availability of cash and transfer payments—helps explain some of the trend of rising inequality over the past three decades.

Education is Key

Perhaps the single best explanation for why some households have more income, earnings, and wealth than others is their level of education. While the difference between households headed by persons with a high school education and those without is significant, the gap between households headed by college degree holders and those without high school diplomas is massive. Households headed by college degree holders take in 3.8 times as much income and hold 11.0 times as much wealth as those with no high school diploma (see Figure 6).

Median Income and Wealth by Education Level, 2004

FIG. 6



Data Source: Survey of Consumer Finances, 2004

Consumption Inequality is Lower and has Risen Less than Income Inequality

An often overlooked but arguably better measure of economic wellbeing than income is consumption. People care about how much they consume and not simply about income per se. Even in times with relatively low income, a household can consume more than its current income by accessing credit markets or by consuming out of previously accumulated wealth. For example, even with low incomes, many elderly people enjoy relatively high levels of consumption, facilitated by drawing down wealth they accumulated in their working years. And

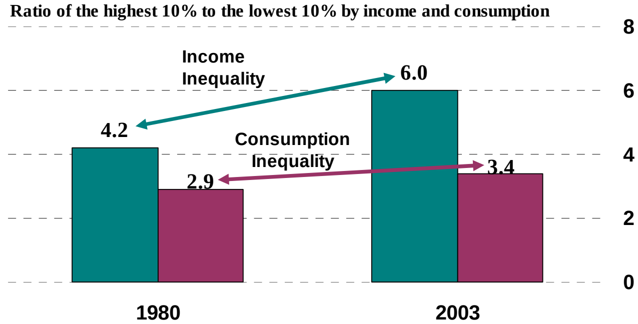
[5] Researchers attribute the larger marriage premium among men than women to the fact that unmarried men generally take greater risks and lead less healthy lifestyles than unmarried women.

a promising MBA student might easily consume more than her current low income while in school by borrowing against her expected future (higher) income.

Changes in Income and Consumption Inequality, 1980 to 2003

FIG. 7

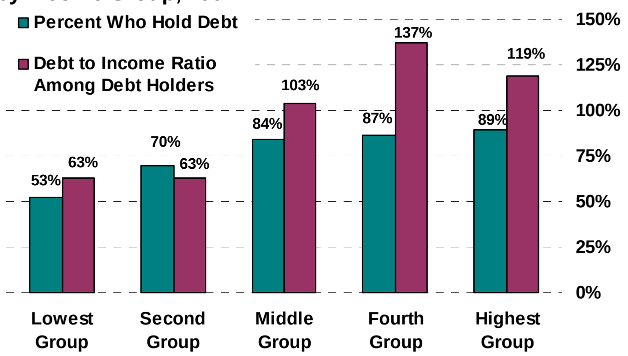
Ratio of the highest 10% to the lowest 10% by income and consumption



Data Source: Federal Reserve Bank of Minneapolis

Debt Holders and Debt: Income Ratio by Income Group, 2004

FIG. 8

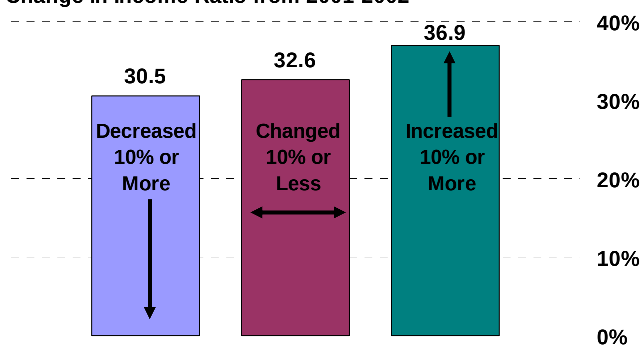


Data Source: 2004 Survey of Consumer Finances

Income Mobility

Change in Income Ratio from 2001-2002

FIG. 9



Data Source: Survey of Income and Program Participation

Between 1980 and 2003, according to researchers at the Federal Reserve, consumption inequality increased only one-fourth as much as income inequality, indicating that households at the low end of the income distribution fare much better than income inequality measures imply (see Figure 7).

The stark difference between income and consumption inequality could lead to concerns that lower income households are financing greater consumption through potentially detrimental sources, such as credit cards. However, low income households are significantly less likely to hold debt than high income household. Almost 90% of households in the highest 20% of the income distribution hold debt versus just over 50% among households in the lowest 20% (see Figure 8). Furthermore, among households holding debt, those in the lowest 20% of the income distribution hold only half as much debt as a percent of their income (63%) as households in the highest 20% (119%).

Not Always Poor, Not Always Rich: Mobility Is Significant.

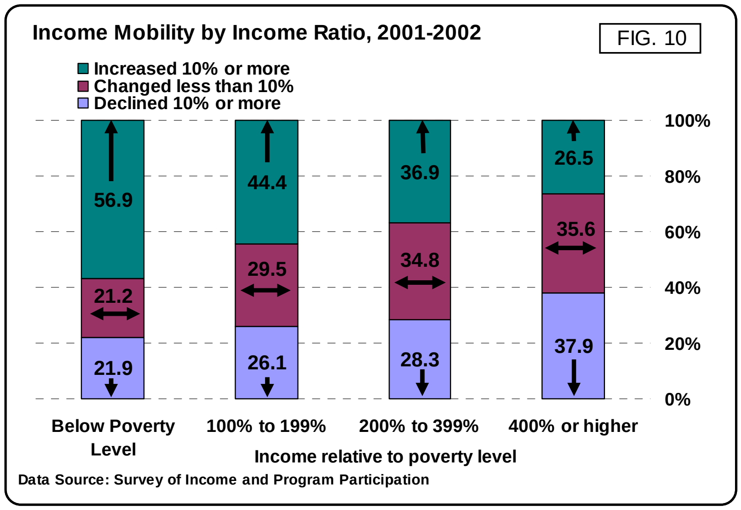
Economic mobility (movement up and down the income ladder by households) remains an important element of the thriving U.S. economy. Most evidence shows that income mobility has not changed significantly over the past few decades.

The ability of Americans to move up and down the economic ladder means that the rich do not always stay rich and the poor do not always stay poor. For example, between 2001 and 2002, 37% of people experienced a 10% or greater increase in their income ratio (defined as their income relative to the official poverty level)[6] (see Figure 9).[7]

[6] An individual's income ratio is defined as that person's total family income divided by the official poverty level for a family of that size. An income ratio below one indicates that the individual and all members in the family are living below poverty. An income ratio of 2, for example, indicates that total family income is two times the official poverty level.

[7] Khan, Beethika. "A Chance to Advance: A Look at Income Variability in the U.S." U.S. Department of Commerce, Economics and Statistics Administration. July, 2005.

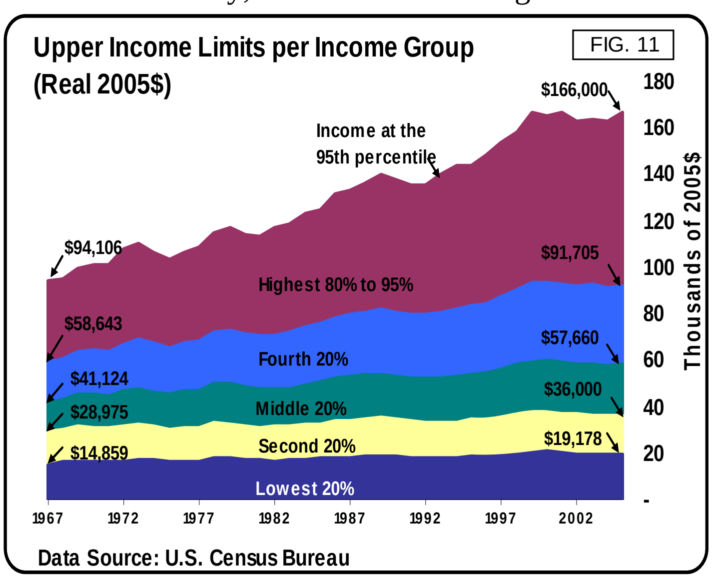
Meanwhile, 32.6% experienced a change of 10% or less while 30.5% experienced a decline of 10% or more. A breakdown of income mobility by income ratio reveals that those who start out with lower levels of income are much more likely to experience significant increases in income. Between 2001 and 2002, 56.9% of people living below the poverty level experienced a 10% or greater increase in their income ratio. Among those with incomes 4 times or greater than the poverty ratio, only 26.5% experienced 10% or greater increases in their income ratio (see Figure 10).



Today's low-income MBA student in graduate school may well be in the upper 20% of the income distribution a few years from now. And, today's high-income lottery winner may fall into a lower income group in years to come. As demonstrated by the upward ascent of Bill Gates and by the downfall of many top CEOs, households in today's lowest income group may someday be in the highest, while households in today's highest income group may someday drop down to the lowest. These notions identify the importance of keeping in mind that the Census data on the annual income distribution represent a snapshot of one period of time. The individuals that comprise the highest and lowest income groups vary greatly from one point in time to another.

When is Rising Inequality Bad?

Rising inequality can be bad for a society if it is caused by a drop in incomes at the lowest end, a decline in mobility, or if it results in negative social outcomes. Rising inequality in the U.S. is not associated with any of these outcomes. Rather, all incomes, including those in the lowest 20% of the distribution, have risen over time after adjusting for inflation. Although incomes in the highest 20% have risen more than those in the lowest, all have achieved real income gains over time (see Figure 11).

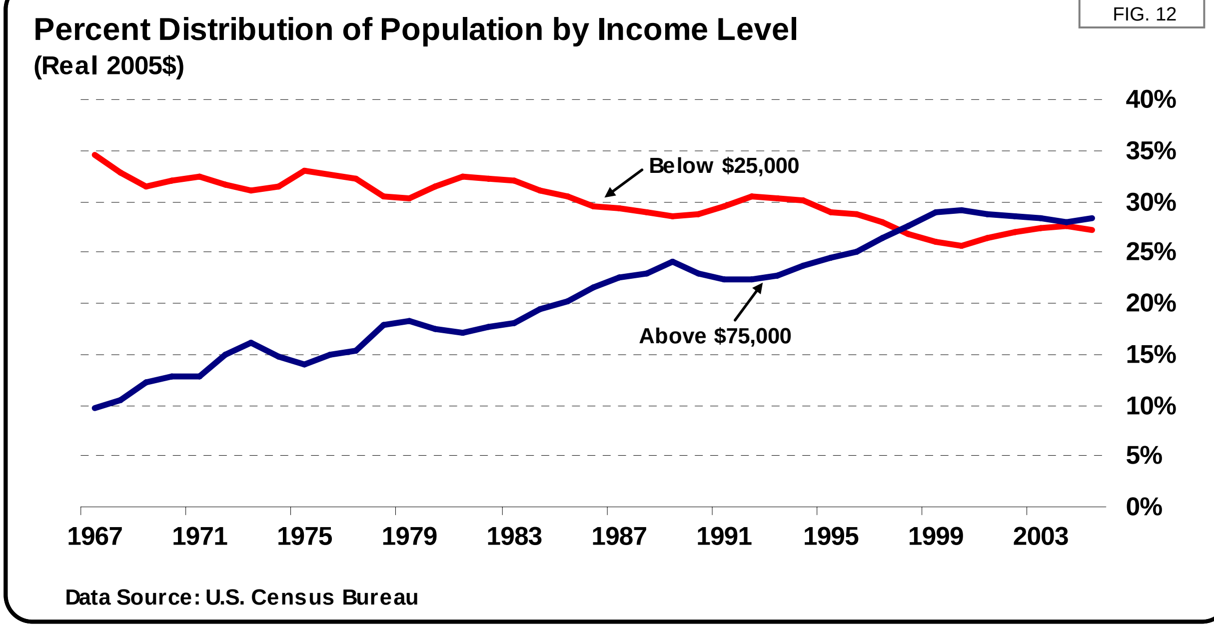


While some argue that *only* those at the very top have enjoyed real income gains, the data prove that this is simply not true. In 1967, fewer than 10% of all households made $75,000 or more (inflation adjusted, 2005 dollars).[8] By

[8] 1967 is the earliest year for which Census data were available.

2005, 28% of all households made $75,000 or more. Meanwhile, the percentage of households making $25,000 or less fell from 35% in 1967 to 27% in 2005 (see Figure 12).

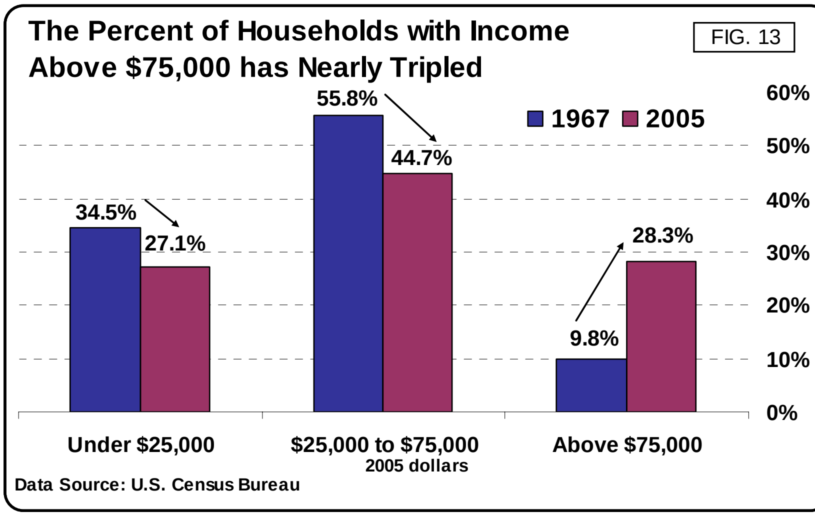
FIG. 12



There has been a great deal of emotional, politically-motivated hyperbole surrounding the "declining middle class" or an economy "leaving all but the wealthiest behind." While there has been a decline in the percentage of households earning between $25,000 and $75,000 in inflation adjusted terms, it is not because they are dropping below the $25,000 threshold. To the contrary, the percentage of those making more than $75,000 has increased, while the percentage of those earning either less than $25,000 or between $25,000 and $75,000 has declined (see Figure 13). Such movement is worthy of praise, not criticism.

A Call to Reduce Inequality

FIG. 13



Although to date, rising inequality has not apparently caused economic or social harm in the U.S., many see it as a problem that needs to be addressed. Some argue that increasing the minimum wage will help reduce income inequality. However, few heads of households are affected by the minimum wage. Increasing the minimum would likely reduce employment among the same low wage workers that an increase is intended to help. Minimum wage increases have proven less effective at reducing poverty and inequality than programs such as the Earned

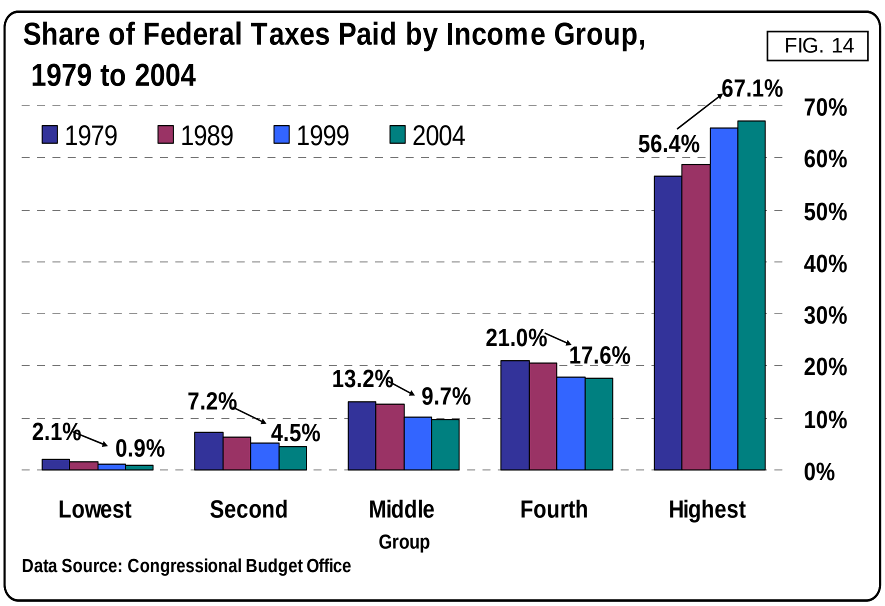
Income Tax Credit (EITC), which targets benefits to poor heads of households and provides incentives to increase, rather than decrease, employment.

Another proposal thought to reduce inequality is to raise taxes on the "rich" and redistribute to the "poor," but this would distort incentives and hinder economic growth. Higher taxes mean lower take-home pay. When the reward to work decreases, so too does the motivation to participate in the labor market. Some may reduce their hours of work while others, such as the spouses of high earners, may decide not to work at all. Many business owners and partners who currently report business income in the form of individual income (because of the tax code) might have to cut back on the money they re-invest in their businesses. Any reduction in investment would hurt job creation, innovation, productivity growth, and general economic growth. Higher taxes can also lead to reduced savings and investment among individuals with regular wage and salary income. Reduced investment will hurt all income groups by slowing productivity and economic growth.

The Highest 20% of Income Earners Pay a Disproportionate Share of Federal Taxes

Households in the highest 20% of the income distribution already pay 67.1% of all federal taxes while the lowest 20% pay only 0.9%. Limiting the comparison to income taxes (excluding excise, social insurance, and corporate income) reveals that the top 20% pay an even larger share while the lowest 20% pay a negative share — they actually pay nothing in income taxes and receive money back from the government.

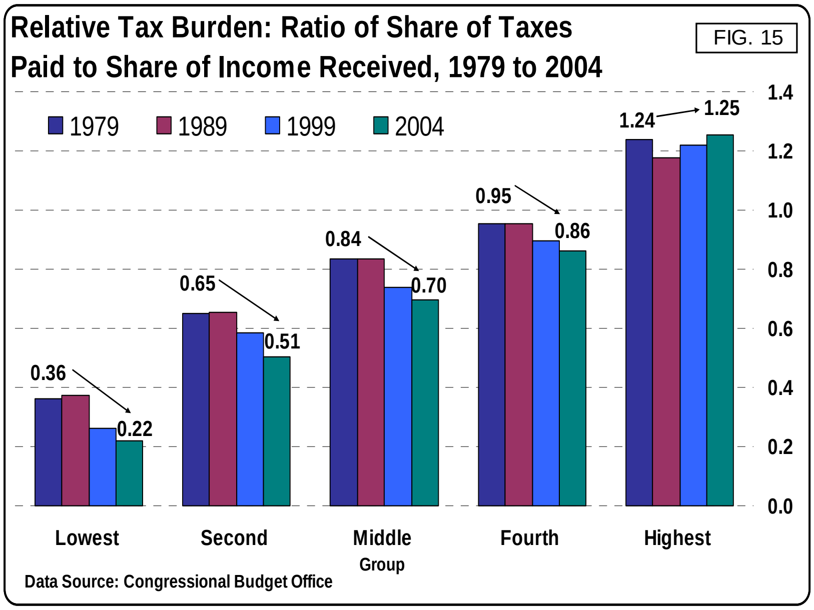
The distribution of federal taxes has not always been as progressive as it is today. The share of federal taxes paid by the highest 20% of households has been rising since the Carter Administration while the share paid by the lowest 80% of households has been falling (see Figure 14).[9] Despite claims that recent tax breaks have only benefited the "rich," the share of taxes paid by the highest 20% of households by income actually increased by 3 percent from 2001 to 2005.



Although it is natural that the highest 20% would pay a greater share of taxes (given the greater share of income they receive), an analysis by the Congressional Budget Office reveals that the *relative* tax burden of the highest 20% is more than five times as high as that of the lowest 20%. To determine each group's relative tax burden, CBO divided the share of taxes paid by the share of pre-tax income received. If

[9] 1979 was the earliest year for which CBO produced an analysis on income and tax shares.

each group paid the same share of taxes as they received in income, all relative income shares would equal one. However, in 2005, the relative tax burden for the highest 20% of the income distribution was 1.25 (67.1% taxes / 53.5% income) while the relative burden for the lowest 20% was 0.22 (0.9% taxes / 4.1% income) (see Figure 15). The relative tax burden for the highest 20% is greatest in the most recent year of data availability, 2004. On the other hand, the relative burden for the lowest 20% is lowest in 2004.



Whether this shift is attributed to the stimulating effects of the tax relief or simple economic growth (or a combination of the two), the fact remains that today, the highest 20% of income earners bear a larger share (both in absolute and relative terms) of the tax burden today than at any other time in recent history.

History Provides a Potent Lesson.

Throughout history, numerous countries and leaders have attempted to generate income equality. However, each attempt failed miserably—witness the former Soviet Union and Castro's Cuba, for example. And some argue that policies adopted in many European countries that were designed to reduce inequality have led to lower employment levels, economic growth, and standards of living than might otherwise have arisen.

The focus for the United States should be on continuing to promote policies conducive to growth, employment, and investment, which will improve the standard of living for everyone, including the least well off. Raising taxes and redistributing income and wealth from the highest to the lowest income earners may reduce inequality in the short term, but would likely come at the cost of diminished growth and a lower standard of living for all in the long run.

Getting a college education, holding a job, and forming a family through marriage are three steps that most distinguish the highest from the lowest ends of the economic spectrum. Programs that promote education, marriage, thrift, productivity, investment, and hard work—all characteristics overwhelmingly shared by those in relatively high income groups—will provide individuals the tools they need to advance up the economic ladder.