## Chapter 3: Addressing Inequality in the Context of Mobility

- In Chapter 3 of the *Report*, the Obama Administration conflates reductions in income inequality with equal opportunity to succeed, begging the question as to whether its use as a sole measure of a policy's success is correct at all.
- The *Report's* approach to the subject of income inequality excludes alternate measures of it and, critically, the subject of economic mobility, which limits the discussion of how to improve economic well-being.
- While the Federal Government has an important role in assisting individuals and families in need, real long-term progress must start with strategies that foster individual empowerment and attainment of self-sufficiency.

### Mobility Matters More

The *Report* reminds us that President Obama named inequality as the "defining challenge of our time."[i] However, it conflates reductions in income inequality with ensuring "that all Americans have the opportunity to succeed."[ii] By arguing this throughout the chapter, the Obama Administration revealed a belief that it's possible to essentially compress the top and bottom of the income distribution without considering incentives and risk-taking behaviors, stages of life and the economic mobility that attends it, geographic differences, and many other important factors that might lead naturally to income inequality. Meanwhile, the *Report* ignores the need to lift people out of long-term poverty.

*Focus on Moving Americans Out of Poverty*

An alternate approach to move people out of poverty is found in Chairman Pat Tiberi's *Investing in Opportunity Act*, which would encourage investors to help revitalize economically distressed communities that lack investment and business growth. State governors would designate these areas as "Opportunity Zones."[iii]

Another example is former Congressman—now Senator—Todd Young's *Social Impact Partnerships to Pay for Results Act,* which passed the House in the 114th Congress. The Chairman is sponsoring this measure in the 115th Congress. This legislation would request proposals from state and local governments for social impact partnerships that produce measurable social benefits, including high school graduation and employment for younger labor market entrants.

Also, Vice Chairman Mike Lee's *Welfare Reform and Upward Mobility Act* would support 1996-style modifications to Supplemental Nutrition Assistance Program (SNAP) and TANF, as well as housing programs to engage states with disadvantaged Americans and help them rejoin the workforce. Generally, states should play a much larger role in creating a smarter system. They are in a better position than the Federal Government to assess their residents' needs, and should therefore be afforded greater flexibility and responsibility in funding and administering welfare and job training programs.

Speaker Paul Ryan's "Better Way" (*Better Way*) Poverty, Opportunity, and Upward Mobility Task Force notes that the measure of success for most aid programs has customarily relied on the amount of government money spent and the number of people receiving those funds.[iv] Metrics for these programs rarely delve further to determine how long individuals are on the programs, how frequently they use the programs, or generally any other indication that individuals leaving the programs become successfully self-sufficient. The misuse of metrics is apparent in the *Report* as well. For example, though 15 percent of Americans live in poverty, as the *Report* explains,[v] the metric itself fails to include alternative forms of income and non-cash benefits that exist to alleviate poverty. To that end, Vice Chairman Mike Lee introduced *The Poverty Measurement Improvement Act* in the 114th Congress—a bill that would authorize the Census Bureau to conduct a new survey of income and Federal means-tested benefits in an effort to measure the extent and success of Federal benefits in reducing poverty and improving material well-being.

The Obama Administration's laser-like focus on income inequality begets the question as to whether its use as a sole measure of a policy's success is correct at all. As mentioned in last year's response, the 1990s was a period of high and rising income inequality, when income was increasingly concentrated within the top one percent;[vi] however, the 1990s boasted much stronger economic growth, and all incomes were rising relatively quickly across the distribution scale, albeit at different rates.[vii]

*Returning to Opportunity in Reward of Work*

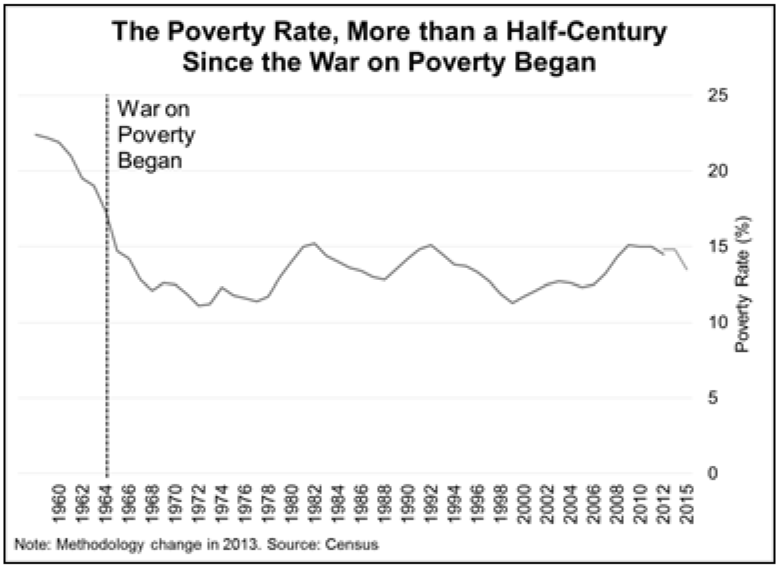
As mentioned in last year's *Response*, "it remains more important than ever to remove barriers to opportunity and continue every effort to improve economic mobility."[viii] In JEC Majority analyses, discussions of equality of opportunity for upward mobility do not focus on the "equal likelihood" that a person from the bottom quintile has equal chance to reach the top, as economists and scholars often use the term. Rather, JEC Majority analysis matches closely what Foundation for Research and Equal Opportunity scholar Scott Winship has termed "equal access" to achieve upward mobility.[ix] Last year's *Response* noted:

> *While unequal opportunities are indeed concerning and a precursor for economic immobility, they are not solely to blame for unequal outcomes. The pursuit of policies that aim for "equality of outcomes" not only fails to account for the myriad underlying reasons why one American would pursue one "outcome" over another, but it*

> *also implies that all Americans share the same "American Dream."*[x]

As noted in the JEC Majority staff analysis, "The Reward of Work, Incentives, and Upward Mobility," an unfortunate confluence of policies cumulatively chip away at work incentives, or the monetary rewards that one receives for work.[xi] Over the last half century, many programs created with the intent to improve the well-being of the most vulnerable populations often effectively hinder upward economic mobility by diminishing work incentives. These policy developments have occurred in the tax code, spending provisions, and through regulations. This combination of unintended negative policy effects cumulatively erode what University of Chicago professor of economics Casey Mulligan terms the financial "reward of work."[xii] It is important to aim for reforms that would reduce labor market distortions that have accumulated not only since the "War on Poverty," but since the most recent recession as well. As shown in Figure 3-1 below, the once-declining poverty rate has remained relatively stable since the War on Poverty began.

**Figure 3-1**




For those below the poverty threshold, a number of government policies undermine virtually any incremental work effort. This is known as the "poverty trap," the interaction between taxes and the phase-outs of social welfare benefits as income rises, imposing a high effective marginal tax on additional earnings. As noted in the JEC Majority analysis on the reward of work, "Americans struggling with economic immobility are not liabilities, but government programs often inadvertently treat them as such by making it less advantageous for people to find and keep employment."[xiii] The analysis further notes that the consequences of remaining trapped have large costs as well—the longer an individual is out of work, the greater the difficulty to obtain employment.

For those living above the poverty line, many policies effectively punish working additional hours or days, or working near certain income thresholds with steep eligibility changes, such as the ACA exchange subsidies. Discouraging additional work could prevent better opportunities to advance one's income, benefits, skills, experiences, and career—and move out of poverty, reducing income inequality. Altogether, government regulations, taxes, and spending policies can cumulatively reduce the reward of work and work opportunities, eroding many Americans' relationship with the workforce. Per the JEC Majority analysis:

> *American men in their prime working years with relatively less formal education in particular suffered the greatest declines among demographic groups. Despite the considerable downward revisions to the trajectories of the economy and labor force growth going forward, we can't be entirely certain how much demographic forces will come into play going forward. The confluence of government policies has regrettably created a path toward a vicious cycle of involuntary dependence on growing Federal spending obligations. Given this, in light of the dire fiscal circumstances the United States faces in the not-too-distant future, policymakers should turn to every structural policy reform at their disposal to unshackle the greater potential in the U.S. economy.*[xiv]

*The Importance of Two-Parent Households*

As noted in earlier research from economist Raj Chetty and his coauthors, economic mobility is higher in locations with greater concentrations of two-parent households, better elementary schools and high schools, and more civic activity and community membership.[xv] However, family structure has changed over time, and remains an important social factor in children's opportunities for upward mobility.[xvi] In fact, the Brookings Institution's Isabel Sawhill notes that gaps in family structure and parenting styles are creating "very unequal starts" for American children, affecting income inequality and potentially slowing economic mobility for those on the low end of the economic ladder.[xvii] Sawhill goes on to say that "family formation is a new fault line in the American class structure."[xviii] Though a number of factors have led to the current trends in family structures and the rise of single-parent households, marriage penalties in the tax code present a clear opportunity for Federal policy reform. Marriage penalties affect mostly two-earner couples, and furthermore, the penalties are regressive, comprising a larger share of income among the lowest income earners. Additionally, data suggest that neutral treatment of marriage in the tax code could promote marriage among low-income taxpayers.[xix]

In light of the substantial and growing evidence demonstrating the positive impact stable and healthy marriage has on children, particularly from low-income families, at a minimum it is important that public policy not discourage marriage. Yet, many public policies beyond the tax code can create a financial disincentive for low-income, single parents to marry. Research has found that the structure of Federal welfare programs includes a marriage penalty where "many low-income couples with children face substantial penalties for marrying that can amount to almost one-third of their total household income."[xx] Urban Institute fellow Eugene Steuerle noted in an earlier analysis, "In aggregate, couples today face hundreds of billions of dollars in increased taxes or reduced benefits if they marry. Cohabitating or not getting married has become the tax shelter of the poor."[xxi] This can occur on the tax side and the spending side of fiscal policy—in the former, affecting the value of and eligibility for the Earned Income Tax Credit and increased tax liability from moving from single to filing jointly, while affecting benefits received in the latter.

*Redistribution and Taxes*

The Administration boldly states that tax changes enacted since 2009 have boosted after-tax income received by the bottom 99 percent of families by more than tax changes of any previous Administration since 1960.[xxii] Figure 3-15 of the *Report* attempts to show "the change in the share of after-tax income accruing to the bottom 99 percent of families that is attributable to changes in tax policy for Presidential Administrations since 1960." However, as the *Report* points out, CEA holds the income distribution constant from a 2006 sample of taxpayers and non-filers.

While the *Report* argues that this isolates "the impact of changes in policy from other sources of variation in tax rates," it ultimately fails to show actual tax policy effects from prior Administrations and their respective populations occupying the bottom 99 percent because it is essentially holding taxpayer behavior and demography constant over time regardless of tax structure and economic environment. This is particularly egregious in the post-1986 tax reform world, in which a significant amount of pass-through business income accrues in the top 1 percent because the reform reduced the top individual rate below the top corporate rate and created additional incentives to switch from a C corporation form of organization (see Box 3-1).[xxiii]

**Box 3-1: If Taxpayers Had a Time Machine...**

Figure 3-15 of the *Report* shows essentially what would have occurred if the taxpayers and non-filers of 2006 were magically transported back in time to a period coinciding with each previous Administration, and how these 2006 filers' and non-filers' after-tax incomes would have changed in each scenario, rather than actually extrapolating the tax effects on the income shares of the bottom 99 percent of Administrations past.

Using a "fixed income distribution" for analyzing past tax policy changes ("backcasting") is misleading. It parallels an issue associated with the 2013 *Report* on Figure 3-1, which purported to show that average tax rates for the top 1 percent and top 0.1 percent in 1960 were between 40 percent and over 50 percent, compared with a 2013 average tax rate of roughly 30 percent. The apparent intention was to show how relatively low tax rates were in 2013 compared to the past. However, the figure did not actually show tax rates for taxpayers in 1960, but what rates would have been if taxpayers in 2005 were also transported back in time to 1960. The 2013 *Report* used 2005 income levels and deflated them back to 1960. However, this holds taxpayer behavior and demography constant, even though evidence shows that individuals will not earn and report as much income at marginal rates that high.[xxiv] According to JEC Majority staff calculations, using actual income reported by taxpayers in 1960, the average tax rate at the top 1 percent and top 0.1 percent in 1960 were 21 percent and 25 percent, respectively, or roughly half of what the Obama Administration was claiming in its 2013 *Report*.

As the Tax Foundation reports of their own "Taxes and Growth" model used to analyze the effects of past tax policy changes, though its equations and methodologies may be the

**Box 3-1 (Continued): If Taxpayers Had a Time Machine...**

same used for current proposals, the Tax Foundation is careful to avoid the same pitfalls that the Obama Administration has fallen prey to:

> *...we ran the model using economic and taxpayer data from the year in which each bill was enacted, to account for the different economic and demographic climates in which each tax change occurred. For instance, the economy in the 1960s had fewer pass-through businesses and more married households than today's economy.*[xxv]

It would be worthwhile to remember that policy changes do not occur in a vacuum, and isolating effects of a particular policy remains quite difficult, even with the best models at one's disposal.

The *Report* implies that reducing the income of the top 1 percent to redistribute to the bottom 99 percent was a lauded goal of the Obama Administration: "Changes in tax policy... will boost after-tax incomes in the bottom quintile by 2 percent in 2017 and reduce after-tax incomes for the top 0.1 percent by 9 percent relative to what incomes would have been under 2008 policies."[xxvi] The text suggests that the income in America is a fixed pie, from which the slices may be redistributed, but the *Report's* own argument in Chapter 5 for the pursuit of higher education to improve well-being runs counter to this representation. Investing time and money in post-secondary education enables one to rise higher in the income distribution and presumably increases the pie. Without government forcibly redistributing income from one group of Americans to another, policies that encourage and reward self-motivation and employment bring about upward mobility and rising income levels.

In last year's *Response* the JEC stated:

> *Ultimately, it is economic mobility that matters more than income inequality—the fact is that people in the lower-, middle-, and upper-income groups are always changing over time. Improving economic mobility, not income inequality, remains a challenge to the 21st-century economy. ...economic mobility in America is not laggard compared to international peers, and mobility in America has remained largely unchanged over the last 20 years.*[xxvii]

The current U.S. individual income tax system is complex and harms households and small businesses. Though the top statutory individual income tax rate is 39.6 percent, as noted in Chapters 4 and 8 of the *Response*, in combination with taxes in the ACA, the top rate paid by small businesses that file under the individual income tax is now 44.6 percent, including the surtax on investment income and additional tax penalties. This does not include state income taxes that are as high as 13.3 percent (California).[xxviii] While Americans rely on small businesses to provide a large share of new jobs, high marginal tax rates reduce resources that could be used to create jobs. Furthermore, the U.S. corporate tax rate is the highest in the developed world, making it difficult for American businesses to compete on a global scale, create American jobs, or increase worker pay.

Elsewhere in Box 3-4 of Chapter 3, the *Report* discusses alternative actions to "Make the Economy Work for All American *[sic]*" including the President's proposal to raise the minimum wage.[xxix] However, CBO previously projected that a proposed Federal minimum wage increase to $10.10 per hour could amount to an employment reduction of as many as one million workers compared to projected employment without the increase.[xxx] Yet, as mentioned in the JEC Majority analysis on the reward of work, increasing the minimum wage has another unintentional effect:

> *...as the minimum wage increases, many workers may actually prefer to work fewer hours in order to prevent the loss of Federal benefits by going over a "benefits cliff" as their incomes rise. Sometimes even a minor increase in income can be enough to make one marginal financial step forward feel like two significant and costly steps back. As an example, the Indiana Institute for Working Families points out that for a working parent in Indianapolis with a preschooler and a school-age child, simply moving from $15 per hour to $15.50 per hour would result in a benefit loss of nearly $9,000 in annual childcare subsidies.*[xxxi]

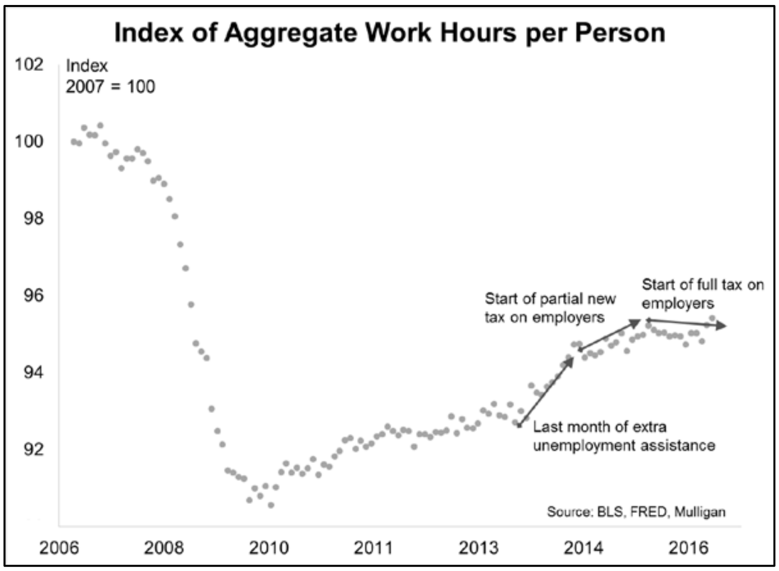
As economist Casey Mulligan testified at a JEC hearing on the employment effects of the ACA and explained in previous writing, when it comes to the sacrifice of work, many of the programs intended to help people get back on their feet have inadvertently made work more costly as Americans strive to improve the livelihoods of themselves and their families. He noted: "Another way of putting it is that taking away benefits has the same effect as a direct tax, so lower-income workers are discouraged from climbing the income ladder by working harder, logging extra hours, taking a promotion or investing in their future earnings through job training or education."[xxxii] As highlighted in the JEC analysis on reward of work, it is a mistake to assume that individuals do not consider the combined effects of taxes and benefits. Mulligan points to anecdotal evidence of potential workers estimating the change in their net benefits based on taking a job, and ultimately choosing not to work. Mulligan estimates that these effects were responsible for roughly half the drop in work hours since 2007, and possibly more.[xxxiii]

*Health Insurance Coverage and Work Incentives*

The *Report* further argues that the ACA improved families' well-being because it purportedly "increased access to care, financial security, and health."[xxxiv] The *Report* reiterates that, in addition to the expansion of Medicaid, families benefit from reduced inequality through access to coverage from the ACA on the health insurance marketplace.[xxxv] However, these claims should be considered in the larger context of the ACA's negative effects upon employment and hours worked, which could mitigate much of the purported improvements to well-being.

The ACA imposes new taxes on individual income that reduce the incentives to work, save, and invest, thereby reducing employment. Wages and self-employment income over $200,000 (single) or $250,000 (married) are now subject to an additional 0.9 percent Medicare payroll tax. Investment income, such as rent, interest, dividends, and capital gains, for this same group of earners is subject to an additional 3.8 percent tax. As of 2013, this threshold for additional taxes captures not just the top 1 percent, but a share of earners in the top quintile that are part of the bottom 99 percent as well.[xxxvi] In a 2014 study, economist Casey Mulligan estimated that in response to the law, labor markets would reduce weekly employment per person by roughly 3 percent, the equivalent 4 million full-time workers.[xxxvii] In recent data on aggregate work hours per person, Mulligan shows that work hours per person increased significantly at the end of Emergency Unemployment Assistance but then slowed significantly as the new tax on employers was partly phased in and turned slightly negative once the full tax on employers was in effect (see Figure 3-2).[xxxviii]

**Figure 3-2**




As noted in the *2016 Response*, on the employer side, compliance with the ACA means that many businesses will have fewer resources to expand and offer employment opportunities. Small- and medium-sized employers with 50 or more full-time equivalent employees are mandated to offer health insurance coverage or face a substantial tax, prorated monthly, per each full-time employee over the first 30 employees. The tax is indexed each calendar year to the growth in insurance premiums, and in 2016 the annual tax rose to $2,160 per full-time employee beyond the first 30. The employer mandate creates an incentive for employers to hire fewer full-time employees and shift some existing full-time employees to part-time employment.[xxxix]

*ARRA and Economic Growth*

The *Report* devotes the bulk of its income inequality analysis to three areas: economic growth, health insurance coverage, and the tax code. The Obama Administration argues that the policy response to the 2007-09 recession directly reduced income inequality via progressive tax and spending policies in the form of tax cuts and unemployment insurance extensions.[xl]

The Obama Administration has argued in the current and past editions of the *Report* that ARRA helped to restore economic growth and reduce earnings inequality. Yet, as mentioned in Chapter 1 of the *Response*, the pace of real GDP growth over the course of the current recovery still remains roughly half the pace of the average post-1960 recovery.[xli]

As Harvard economist Larry Summers testified in 2008 before the JEC, "a stimulus program should be timely, targeted and temporary."[xlii] In terms of timeliness, previous JEC Majority staff analysis notes that 10 percent of ARRA funds were still being spent through 2013.[xliii] ARRA temporarily expanded benefits in the SNAP;[xliv] relatedly, the number of caseloads remained elevated above 2010 levels through 2016.[xlv] ARRA's expansion of SNAP did not expire until November 2013, and the emergency extension of unemployment benefits did not expire until January 2014, nearly five years after ARRA was enacted. In some cases, such as for TANF, ARRA funding will not expire until the end of fiscal year 2018.[xlvi]

In terms of targeting the stimulus, a Mercatus Center analysis from 2011 found that roughly half of the workers hired by businesses receiving ARRA funds were hired directly from other firms instead of from the intended pool of jobless workers, revealing an important lesson on the difficulty of implementing targeted stimulus programs: "even in a weak economy, organizations hired the employed about as often as the unemployed."[xlvii] The aforementioned JEC analysis concludes that while it could be argued that some individual programs may have achieved Summers' Keynesian stimulus standards, ARRA as a whole failed to meet the standards set in place by the Obama Administration.[xlviii]

*The Obama Administration's Record on Inequality and Mobility*

While painting a picture of the disparities that exist between the lowest quintile and the top 1 percent, the Obama Administration fails to prove the problem with the disparity. It is likely that a growing number of retirees occupy the lowest income quintile, even though they may have sizable wealth in the form of cash savings and a paid-off house, for example. Many small businesses—known as passthrough businesses—occupy the top 1 percent because they pay individual income tax rates rather than corporate rates. Unlike C corporations, passthrough businesses generally are not taxed, but rather their owners are taxed as if the income was earned directly by them; the income "passes through" to the owners' tax returns.[xlix] The most common types of passthrough businesses include sole proprietorships, partnerships, limited liability companies, and S corporations. Research shows that, as of 2011, roughly two-thirds of pass-through business income accrued in the top 1 percent.[l] Furthermore, passthrough business income drove nearly half the rise in income of the top 1 percent between 1980 and 2013.[li]

Boasting of an average tax increase of more than $500,000 on those projected to have incomes of greater than $8 million in 2017, the *Report* seems to suggest that the top 1 percent and top 0.1 percent of the income distribution is solely occupied by "the most fortunate Americans"[lii] and not by businesses as well, using additional terms including "highest-income families" or "[f]amilies in the top 0.1 percent."[liii] As explained in Chapter 8, raising taxes on businesses that pay through the individual income tax system ultimately leaves these businesses with fewer resources to expand and hire more workers.

The *Report* points to the works of Chetty and his coauthors to demonstrate that the "defining challenge" does indeed extend beyond income inequality to intergenerational mobility, or how well one's progeny does compared to his or her parents, but the data highlighted in the *Report* focus on mobility for those born into the bottom income quintile to the top income quintile, which misses much of the mobility that occurs to and from the quintiles in between.

Furthermore, Chetty's work suggests that the United States sees worse mobility rates than other developed countries. In recent research, Winship noted that mobility rate comparisons between the United States and other countries are actually similar when ensuring that the mobility measures used match across countries, rather than comparing measures that appear more like apples to oranges, such as the comparison of parental family income in the United States with *paternal* earnings of other countries.[liv]

The *Report* indicates that income, wealth and consumption inequality have risen sharply over recent decades, demonstrating that change in its Table 3-1, which compares values from 1980 to the "most recent available" for each metric. The choice of 1980 (and values from 1980-82) as a basis for comparison is not good, because the economy was in recession that year for seven months. Another sharp and relatively deep recession followed from July 1981 to November 1982. The *Report* itself points out that income inequality decreases during a recession when based on more comprehensive income measures.[lv] Comparing data from a recession to that of more recent data that is close to mid-business cycle makes it more difficult to discern business cycle influences on the distribution and relationships of income, wealth, consumption and wage measurements. Investment income inequality measured in 1980 may appear narrower due to the recession and earnings inequality consequently may appear wider. Furthermore, though all three measurements are useful to determine a snapshot of economic well-being at any given point in time, omitting more detailed mobility measures excludes the dynamics that take place over time, significantly affecting policymakers' perceptions of the state of Americans' well-being over the course of their lives. As noted in last year's *Response*:

> *For wealth measurements, age is an even more important factor (in many cases, young adults have negative net worth as they pay off student loans, car payments, and mortgages, while the recently retired may have substantive wealth built over a lifetime to live off of in retirement), in addition to household formation (for example, if a married couple divorces and creates two households with lower wealth than they previously held combined, is this a policy concern when it comes to how it changes wealth inequality?), along with a number of other factors associated with the valuation of wealth as well.*[lvi]

Mobility still matters very much. Recent research reconfirms that absolute mobility rates for adults who were poor as children is still high, very likely above 90 percent, and although overall absolute mobility rates may have slowed down somewhat, most people continue to do better than their parents at the same age.[lvii]

## CONCLUSION

The most straightforward policy solutions involve putting a greater emphasis on letting people earn. Potential solutions span the breadth of tax, spending, and regulatory policies.

*Recommendations*

Specifically, the Committee Majority recommends that the new Congress and Administration:

- Remove or at least lessen the disincentives to work found in social support programs;
- Encourage or at least do not discourage two-parent households by the structure of taxes and support programs;
- Remove or at least lessen the disincentives of the tax code to work and invest; and

Stop relying on Keynesian stimulus to engender economic growth.

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[i] ERP 2017, p. 151.
[ii] ERP 2017, p. 192.
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[vi] JER 2016.
[vii] Winship, Scott, "Choosing Our Battles: Why We Should Wage a Wage on Immobility Instead of Inequality," Testimony before the Joint Economic Committee, U.S. Congress, Washington, DC, January 16, 2014. https://www.jec.senate.gov/public/_cache/files/4472dcdb-4bc9-40e0-974d-dc050719891e/testimony-winship.pdf
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[x] JER 2016, p. 7.
[xi] "The Reward of Work, Incentive, and Upward Mobility," Joint Economic Committee, December 1, 2016. http://www.jec.senate.gov/public/_cache/files/6668a0d4-cf64-4bc5-8465-1980295846af/12-1-reward-of-work.pdf
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[xiii] JEC Reward of Work.
[xiv] JEC Reward of Work.
[xv] Leonhardt, David, "In Climbing Income Ladder, Location Matters," *The New York Times*, July 22, 2013.

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