

# Income Inequality Briefing

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**Harvard Model  
Congress Asia**

## INCOME INEQUALITY

Across the world, most people agree that freedom and equality are good things. All of the most important modern political movements have expressed support for both. The American Declaration of Independence affirmed that “all men are created equal,” endowed with an unalienable right to liberty. The first article of the Declaration of the Rights of Man, which set forth the goals of the French Revolution, declared that “Men are born and remain free and equal in rights.” The Declaration of the Rights of the People of Russia, proclaimed during the 1917 Communist Revolution, set forth the “equality and sovereignty of the peoples of Russia.” The Preamble to the United Nations Charter, signed in 1945, reaffirmed “the equal rights of men and women” while promising to promote “larger freedom.”

Despite these lofty aims, it has been much more difficult to promote freedom and equality in practice. One continuing problem is that freedom and equality are often conflicting values. In many situations, one person’s freedom might compromise another’s equality. This is not simply a debate for philosophers: the conflict between freedom and equality underlies many of the most wrenching political debates of our times. Americans during the 1960s debated whether Southerners’ freedom to choose who to hire at their businesses should take precedent over African-Americans’ right to participate equally in society. The Great Leap Forward in the People’s Republic of China sacrificed citizens’ freedom to own land in an attempt to guarantee social equality.

So which is more important, liberty or equality? The question figures very prominently in debates over the distribution of wealth. Some societies choose to preference individuals’ freedom to hold property and benefit from their employment, even if they have very high salaries and great wealth. Others instead focus on ensuring basic equality among citizens, even if that means seizing the property of others and restricting how they can do business. The basic question that this committee will address is this: should we consider American income inequality a problem, and if so, what should be done?

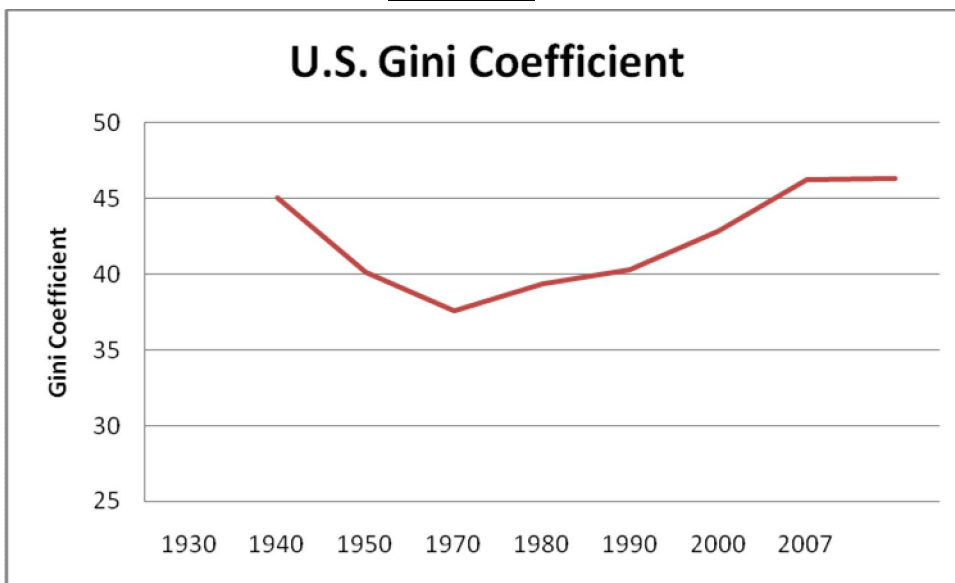


## EXPLANATION OF THE ISSUE

Income inequality refers simply to the fact that in every society, some people have more money than others. Income inequality can come from a variety of ways. Some jobs pay more than others; some people work harder and longer than their co-workers; and some inherit money from their parents. The effects of income inequality are significant: in nearly every society, wealthier people tend to have longer and healthier lives; be better educated; be more involved in politics; and have higher social status. Societies with high levels of income inequality tend to have significant disparities in health and education between their wealthier and poorer citizens; countries with less inequality have more equal health outcomes and education levels/

Economists measure income inequality by using the Gini Coefficient, which assesses the average income disparity in a country on a scale between zero and one. If everyone in a society had exactly equal salaries, the Gini coefficient would be zero; if one person in a society held all of the wealth, it would be 1. As a result, countries with high levels of inequality score closer to 1 on the Gini scale, while countries with less inequality score closer to zero. Chart A, below, shows trends in American income inequality over the past eight decades. As the chart shows, income inequality in the US declined significantly during the 1930s and 1940s, but increased during the 1970s and 1980s

**CHART A**



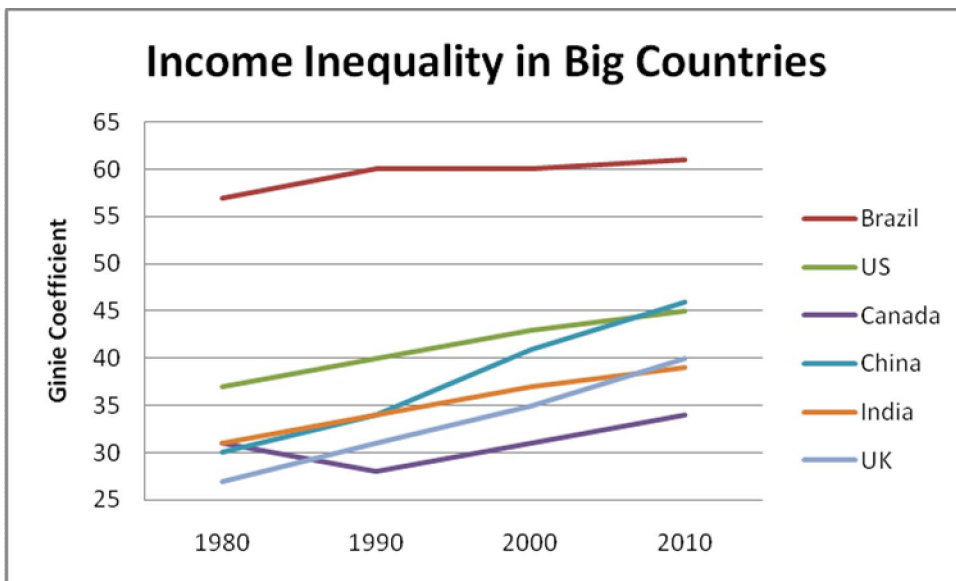
Levels of income inequality vary drastically throughout the world. There are many reasons for this difference. In some countries, for example, only a portion of the population has the opportunity to get edu-



cated, leading to a massive gap between skills, and thus between the wages of educated and non-educated workers. Other countries work to counteract this by enacting government policies to redistribute wealth, taking some from rich citizens and giving it to poorer ones. There is no obvious relation between a country's wealth and its level of equality: some wealthy countries are very equal, like Denmark (Gini of 24.7); others, like the Chile are rather unequal (Gini of 54.9). At the same time, impoverished Ethiopia is quite equal (Gini of 30), while Sierra Leone has a Gini of 62.9.

There are some significant regional differences in Gini Coefficients worldwide: Latin American countries tend to have less equal incomes, while European countries, which tend to aggressively redistribute wealth, have lower Gini levels. Chart B, below, showcases income inequality in several world countries. A general global trend of increase is notable over the past three decades. The UK and China have the largest increases, both having experienced rapid economic growth during the period.

**CHART B**

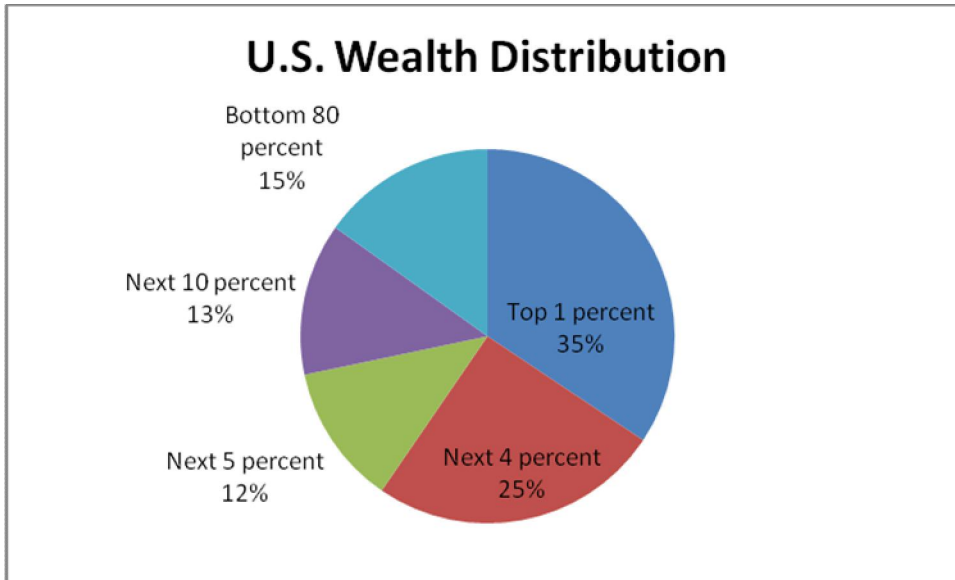


***Concentration of Wealth***

It is certainly true that the wealthiest in the US have the largest portion of income. Recent statistics from 2004 show that the wealthiest 1% of Americans have 34% of total wealth. By contrast, the bottom 80% only have 15% of wealth. In a perfectly equal society, 1% of Americans would have exactly 1% of wealth. Chart C, below, shows this divide more clearly.



**CHART C**



### ***Social Mobility***

In addition to overall inequality, many people also focus on income mobility, which refers to whether income levels are determined or strongly affected by the wealth of one's parents. In societies with high levels of income mobility, children of poor families regularly attain wealth, and children of wealthy families often find themselves less relatively well off than their parents.

To measure social mobility, statisticians divide society into five quintiles based on income. The wealthiest 20% are considered the first quintile, the next 20% is in the second quintile, and so on, so that the poorest 20% are in the fifth quintile. Statisticians then measure how many people stay in the quintile in which their parents lived.

Studies suggest that income mobility for American men has stayed roughly the same over the past three generations, though it has increased markedly for American women. (Insert chart here? [http://www.economicmobility.org/assets/pdfs/EMP\\_Trends\\_F2.pdf](http://www.economicmobility.org/assets/pdfs/EMP_Trends_F2.pdf)) However, international studies also show that income mobility is much lower in the US than in some European countries, notably in Scandinavia. Statisticians estimate that in the US, on average, half of a person's income is determined by their parents' income, while the other half is determined by their skills, education, luck, and hard work. By contrast, in countries



such as Finland, Norway, and Canada, only 20% of a person's income is determined by their parents' income. (Insert chart here? [http://www.economicmobility.org/assets/pdfs/EMP\\_Trends\\_F2.pdf](http://www.economicmobility.org/assets/pdfs/EMP_Trends_F2.pdf))

However, surveys show that Americans remain very pleased with the level of social mobility in their country. Sixty percent agree that “people get rewarded for their effort,” compared with an average of 37% across the developed world. Only 20% believe that “coming from a wealthy family is essential to getting ahead.” And only 33% think that “it is the responsibility of government to reduce the differences in income”—compared with over 70% in other rich countries.

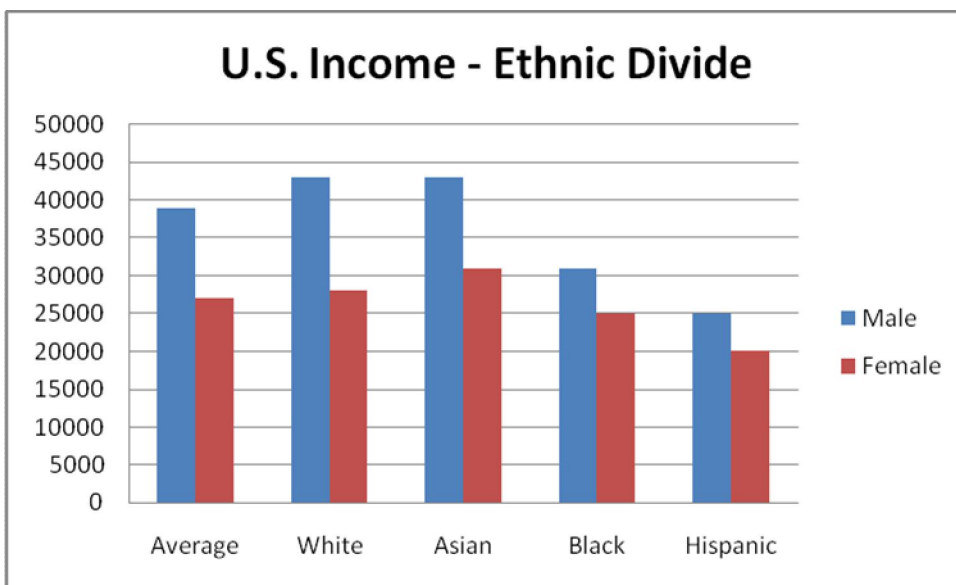
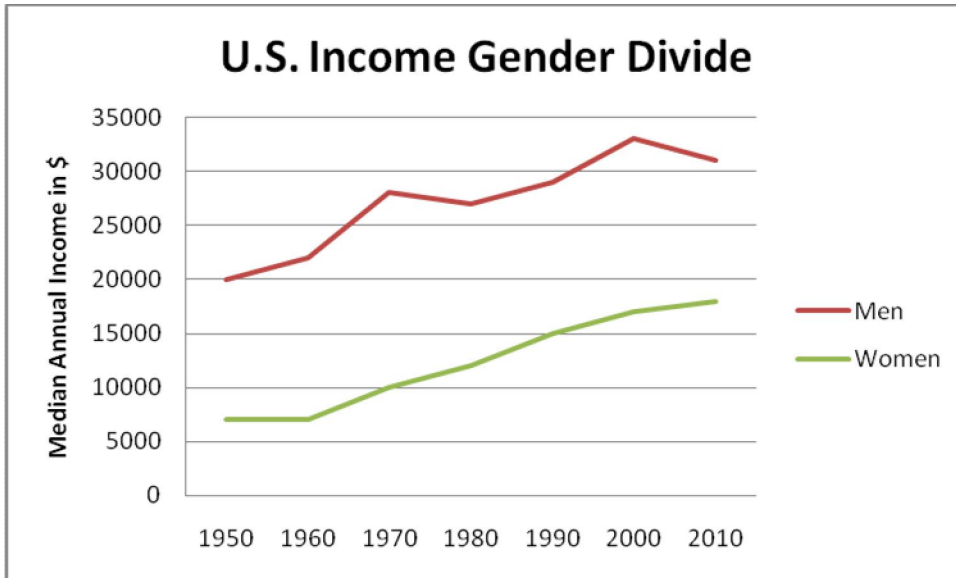
### ***Ethnic and Gender Divides***

In the United States, and in many countries, income inequality is not shared equally among different social groups. For example, women, blacks, and Hispanics tend to have lower than average incomes in the US. As a result, questions of income inequality must consider not only the fact that inequality exists, but that it may also exacerbate existing social divides.

Ethnic disparities in income have several potential causes. For one, black and Hispanic people tend to come from less affluent families and receive less education, leading to a skills gap between them and the American average. Additionally, some argue that racism – for example, an unwillingness to hire a black worker because of the belief that blacks are less capable – remains a significant cause of income inequality in the US today. One recent study created job applications that were exactly equal except for the applicants' name. Applications with a name that is commonly associated with African Americans were significantly less likely to get called in for an interview than were applications with other names. This shows that racial divides remain a significant issue in causing income inequality.

Similarly, American women continue to take home lower salaries than men, despite that they are equally well educated. The gender gap has closed somewhat since the 1950s, but it still remains large. Part of this is because women tend to choose to work less overall; work in sectors of the economy with lower salaries; and are less likely to assume management positions (though whether by choice or because of ingrained discrimination is debated). In addition, while collected and analyzing this data is complex, some evidence suggests that women tend to make less than men even when they are working at equivalent jobs. At the very least, any proposal regarding income inequality must take its ethnic and gender divides into consideration.





### ***Education and Income Inequality***

A large portion of income differences in the US can be explained by education. Simply put, better educated people are significantly more likely to have high salaries than their worse-educated peers. For example, 42% of Americans without a high school education are in the lowest income quintile, while only 5% are in the top fifth. By contrast, 54% of Americans with a graduate degree are in the top fifth, while only 5% are in the bottom fifth. Clearly education matters.



On the one hand, this gives credibility to the view that America is a mobile society. In this perspective, if an individual gets a good education, he or she is likely to succeed. However, it is important to note that parental income is correlated with a good education. Primary and secondary schools tend to be best in wealthier neighborhoods, meaning that people with wealthier parents get better schooling and are more likely to get into college. In addition, wealthier parents are more likely to be able to pay for better colleges. As a result, there is a significant correlation between education and parental income.

### ***Health Care and Income Inequality***

Over the past generation, Americans have spent increasing percentages of their income on health care. Americans get health insurance through a variety of means: through their employer, through government programs, or by purchasing it themselves. Employer-provided programs are among the most generous, covering most health care costs and requiring fewer payments. Government provided plans are less generous, requiring individuals to help pay for more of the costs. As a result those without employer-provided plans tend to have to spend more on health costs, reducing their extra income.

However, it should also be pointed out that people with employer-provided plans tend to have higher incomes. Thus the generosity of employer-provided plans tends to heighten income inequality in a way that doesn't immediately show up in most data. At the same time, those without employer-provided health care, who already tend to have lower salaries, have to pay more for their health care, which further reduces their income.

### ***Perspectives on Income Inequality***

Incomes are clearly unequal. But is that a problem? Opponents of inequality say it is. They point out that despite America's massive wealth, many still lack complete health care and good schools. Inequality also fuels social divisions, and is correlated with higher levels of crime and racism.

Yet others say that the current distribution of income in the U.S. is both just and effective. It is just, they say, because it compensates workers based on the amount that they produce, and it is effective because it encourages people to produce a lot. In fact, some argue that income inequality is conducive to economic growth. This might be true for two reasons. First, economies with lots of inequality tend to concentrate money in the hands a very few people, who have more money than they can reasonably spend. As a result, they invest their money in new businesses or in stocks or bonds, allowing other firms



to expand. If that same money was spread out equally throughout society, it would be more likely to be spent, because the poorer members of society are more likely to have needs and wants to spend it on. But while consumption does not fuel economic growth over the long term, investment does – so putting money in the hands of likely investors may be a positive strategy over the long run.

Additionally, the types of government policies that have the effect of redistributing income – which make the income distribution more equal – tend to remove incentives to work and make money. Most commonly, governments use taxes to take from the rich and give to the poor. Yet economists agree that, in general, higher taxes encourage people to work less, make less money, and contribute less to economic growth. The reason is simple: people work to make money, but if the government reduces their salary through taxes, they have less of an incentive to work. Thus some people argue that the best way of dealing with income inequality is to leave it alone. If it is left alone, they say, the economy will grow over all, lifting everyone's income. By contrast, policies of redistributing income do not contribute at all to increasing overall wealth, and may actually reduce the total amount of wealth in a society.

### ***Equal Outcome vs. Equal Opportunity***

Others focus on the distinction between 'equal outcome' and 'equal opportunity'. Equal outcome refers to a policy of ensuring that everyone in a society has a roughly equal position, and advocates redistributionary programs to ensure equality. By contrast, equal opportunity refers to a policy of ensuring that everyone has the same opportunity to succeed – most importantly, the same educational options – but then accepts the results of whatever happens after that. If two people go to the same school, and face the same constraints, but one makes \$50,000 per year, while the other makes half that, proponents of equal opportunity would not support redistribution.

## **POTENTIAL SOLUTIONS**

**Do nothing.** Some argue that our economy is more or less in a position of equal opportunity today, and any attempts to make it more so will lead to higher taxes and thus painful cutbacks on our economic growth. Instead of meddling, the government should encourage low-tax policies that will fuel growth and lead to growing incomes for everyone. What matters is not the relationship between two peoples' incomes, but that both continue to grow.



**Progressive Taxation.** Today, many governments have forms of taxation that are called ‘progressive’, meaning that they tax the rich more than the poor. The easiest way of creating a progressive tax is to tax income at a certain percent. Under a 20% income tax system, for example, someone making \$50,000 per year pays \$10,000 in taxes, where as someone making less, like \$10,000 per year, pays only \$2,000 in tax.

The opposite is **regressive taxation**, in which the poor pay a higher portion of their income in tax. Taxes on goods tend to be regressive. Consider a tax on food. In developed countries, most people eat fairly similar amounts of food, regardless of whether they are poor or rich. Some people eat more expensive food than others, but there isn’t that much variation. Assume that this food tax cost \$2000 per year. This would be very significant to someone who made only \$10,000 per year – it would be a fifth of their total income. But it would be much less important to someone who made \$50,000 per year, as it would be only one-twenty fifth of their income. As a result regressive taxes are much more burdensome on the poor. Cutting regressive income taxes or increasing progressive taxes could have the effect of reducing inequality.

**Focus on Education.** As education is one of the major determinants of future income in the united states, policies to ensure a good education to all, regardless of their parents’ income, would likely increase income mobility, though it may have a limited effect on income inequality. Focusing on education is likely to appeal to proponents of equal opportunity, though it may be less important to proponents of equal outcome.

**Focus on Healthcare.** As one of the major determinants of income inequality, a policy to bring about more government funding of health care might also serve to significantly reduce income inequality.

**Affirmative Action to Overcome Ethnic and Gender Divides.** In the case of deeply rooted discrimination, which may be an important cause of income inequality, some governments have created programs to encourage businesses to hire racial minorities and women. In the United States, this has mostly taken place at universities, most of which give some preference to minorities. In other coun-



tries, like South Africa and Malaysia, governments have mandated that certain portions of businesses be set aside for poorer ethnic groups, and placed other economic restrictions on businesses with the goal of redistributing income to them.

Recently, however, affirmative action has become less popular. In Malaysia, the government recently repealed several sections of what was called the “New Economic Policy,” allowing (generally wealthier) ethnic Chinese and Indians to participate on equal terms. In South Africa, the affirmative action program known as “Black Economic Empowerment” has come under criticism for supporting corruption rather than actually spreading wealth.

**Handouts and Welfare.** Many governments seek to fight inequality by directly handing out money to lower-income citizens. The U.S. does this in many ways: through payments to the unemployed; through food programs; through the “Earned Income Tax Credit,” which funnels extra money to low-income workers. This is a direct means of decreasing inequality, by taking from the rich (through taxes) and giving to the poor.

## FOCUS OF DEBATE

### *Republican View*

Republicans tend not to be very concerned about income inequality. They argue that America is already a society of equal opportunity, and that most variations in income result from skill and hard work rather than from inheritance. Republicans are wary of progressive taxation, because it takes money away from the rich, who are likely to invest it in economically productive activities. They are unlikely to want to put additional federal funding in place for health care and education, as they will argue that these are areas that already benefit from much federal funding. Republicans also oppose affirmative action, on the grounds that it promotes unqualified individuals and heightens racial tensions. On top of that, all of the potential solutions to income inequality would distort economic incentives and might lead to lower levels of economic growth. Rather than cutting up the economic pie in a different way, republicans would prefer to expand its size, so that the income of everyone in society continues to grow.



## ***Democratic View***

By contrast, Democrats remain very interested in reducing income inequality. Moderate democrats focus on creating a society with equal opportunity, while more liberal democrats say that the goal should be equal outcomes. As a result, Democrats differ on which means should be most actively used: proponents of equal opportunity focus on education and health care; while proponents of equal outcome look toward more progressive taxation, affirmative action programs, and income transfers to guarantee a more equal society.

## ***Interest Group Perspectives***

### *NAACP*

The National Association for the Advancement of Colored People, one of America's oldest and most influential associations for black political advancement, has long been concerned about inequality in America. In particular, the NAACP points out that racial disparities remain a major cause of overall inequality in America.

The NAACP explains this through two ways. First, they argue that racial discrimination remains a significant feature in American society. Thus they promote improved protections against racial discrimination, as well as affirmative action programs that work to promote racial equality. The NAACP remains very supportive of affirmative action programs overall.

Additionally, the NAACP is concerned that the poor state of education for many black students leaves them behind in the working world. Because many black parents are poor, their children attend underperforming schools, and thus have worse opportunity in the working world. As a result income disparities are passed between generation, and there is reduced income mobility for black Americans.

### *American Chamber of Commerce*

The American Chamber of Commerce is America's most important business lobby. The Chamber supports low taxes and low levels of government intervention in the economy. Though the Chamber does not deny that income inequality is an issue, it worries that any attempts to deal with the issue through higher taxes or more regulation will cause more problems than they will solve. Higher taxes will reduce business' ability to invest, while more regulations about providing health coverage or hiring minorities and women will burden them



with extra costs. As a result, the Chamber advocates policies that do not raise taxes, decrease investment, and lower overall economic growth.

### *CATO Institute*

The CATO Institute does not believe income inequality is a problem in America because current incomes are directly related to an individual's productivity. Workers who produce a lot (which benefits everyone) get paid a lot; workers who produce less get paid less. In the view of the CATO institute, this is simply just.

CATO ascribes differences in productivity primarily to skill and hard work. Because education is publically funded in the United States, all people have the opportunity to go to school and gain skills. CATO opposes redistributionary programs, because it believes that the government should not take one person's lawfully obtained property and give it to another person who did not earn it. CATO also opposes affirmative action programs, because they prohibit companies' ability to hire the best workers. In CATO's view income inequality isn't a problem. Instead, it is important for economic growth, as no one would have an incentive to work hard and be successful unless there was a significant payoff. Higher taxes, by reducing the payoff, make it less likely that Americans will be willing to continue working hard, reducing economic growth in the future.

## **QUESTIONS A BILL SHOULD ADDRESS**

No bill can answer every question relating to income inequality. But a good bill (or series of bills) should address a number of critical questions. First, is income inequality a problem? If so, it should be remedied. If not, Congress may want to repeal current programs to reduce inequality.

Second, if income inequality is a problem, should we focus on guaranteeing equal opportunity or equal outcome? If the former is the goal, education may be the solution. If the later, policy might focus instead on income transfers. Finally, policy makers should consider how to blunt the potentially negative effects of higher taxes and increased regulation on economic growth, which remains a priority for most legislators.



## CONCLUSION

Income inequality remains a divisive issue in America. Some believe that the richest country in the world has an obligation to provide a good life for all its citizens. Others argue that it has become the richest country in the world by rewarding merit; any attempt to change that system and violate individuals' right to hold property – their income – would infringe upon a basic American liberty. As a result, the debate between freedom to hold property and the possibility of equality continues. Its resolution is up for you to decide.

## FUTURE RESOURCES

The Economic Mobility Project

[www.EconomicMobility.org](http://www.EconomicMobility.org)

“How Health Care Costs Contribute to Income Disparity in the United States,” A report by the McKinsey Global Institute. Online at

[http://www.mckinseyquarterly.com/Economic\\_Studies/](http://www.mckinseyquarterly.com/Economic_Studies/)

[Country\\_Reports/](http://www.mckinseyquarterly.com/Economic_Studies/Country_Reports/)

[How\\_health\\_care\\_costs\\_contribute\\_to\\_income\\_disparity\\_in\\_the\\_United\\_States\\_2328?gp=1](http://www.mckinseyquarterly.com/Economic_Studies/Country_Reports/How_health_care_costs_contribute_to_income_disparity_in_the_United_States_2328?gp=1)

“Class Matters,” A New York Times Special Report. Online at [http://](http://www.nytimes.com/pages/national/class/)

[www.nytimes.com/pages/national/class/](http://www.nytimes.com/pages/national/class/)

The Center for American Progress, a liberal think-tank, has articles and policy ideas.

<http://www.americanprogress.org/issues/domestic>

The American Enterprise Institute, a conservative think-tank, also has articles and policy ideas.

<http://www.aei.org/ra#3>

