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Reducing Poverty, Not Inequality: What Changes in the Tax System Can Achieve

DAVID KAMIN¹

I. INTRODUCTION

It is the 100th anniversary of the federal income tax, and it is not surprising at all that, to mark the occasion, this conference has organized a panel on inequality and the Code. The federal tax system, and the income tax in particular, are often held out as a key—and perhaps *the* key—tool for combatting income inequality.² Especially given the rapid rise in inequality seen over the last thirty years,³ it is natural to look to the Code and ask what can or should be done in response.

The tax system's effect on overall inequality—by this I mean the shares of income earned by the various income classes—however, has, and is likely to continue to be, decidedly limited. As someone con-

¹ Assistant Professor of Law, New York University School of Law. I am indebted to the insightful commentary of participants in the NYU-UCLA Tax Policy Symposium, the Loyola Law School Tax Policy Colloquium, and the Columbia Law School Tax Policy Workshop. Also, I am deeply grateful to Deborah Schenk and the editors of the Tax Law Review for their time and editing prowess.

² In fact, at the founding of the income tax a century ago, the Democratic Party offered a denunciation of the extensive tariff system in place at the time based on that system's effect on inequality. Democratic Party Platform of 1912, The American Presidency Project, June 25, 1912, <http://www.presidency.ucsb.edu/ws/index.php?pid=29590> (“The high Republican tariff is the principal cause of the unequal distribution of wealth; it is a system of taxation which makes the rich richer and the poor poorer.”). Some forty years later, in their classic article parsing the arguments for progressive taxation, Walter Blum and Harry Kalven conclude by saying that the most powerful case for a progressive tax system rests on the system's central role in addressing inequality. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. Chi. L. Rev. 417, 520 (1952) (“The case [for progressive taxation] has stronger appeal when progressive taxation is viewed as a means of reducing economic inequalities. . . . Ultimately a serious interest in progression stems from the fact that a progressive tax is perhaps the cardinal instance of the democratic community struggling with its hardest problem [of economic inequality].”). The idea that the federal tax system plays an important role in addressing inequality continues in modern scholarship and analysis. The White House recently highlighted this. White House, Nat'l. Econ. Council, *The Buffett Rule: A Basic Principle of Tax Fairness* 4 (2012), www.whitehouse.gov/sites/default/files/Bufferet_Rule_Report_Final.pdf (justifying a new minimum tax on high-income Americans by citing an array of statistics that suggests growing income inequality). For a discussion of some of the academic literature in this vein, see notes 110-121 and accompanying text.

³ See notes 52-60 and accompanying text.

cerned with the distribution of resources in this country, I find this to be a depressing prospect. For all the talk about distributional tables and the grand debate that just ended about the top tax rate and the Bush tax cuts, there simply is not much “there, there.” Irrespective of how these tax debates are resolved, income inequality would change little, especially in comparison to overall economic trends, if the tax system remains within the politically plausible parameters.

However, we should not pack up the distributional tables or this conference session. Even as the Code may not have much effect on overall inequality, our choices—again, within politically plausible parameters—*do* have large effects on other important distributional metrics. In this Article, I focus on one, and that is poverty. I focus on poverty in large part because many, of different ideological stripes, agree that poverty matters and should be reduced.⁴ Or, at the least (and putting this in welfarist terms, which so often dominate the tax academic literature), they agree that welfare matters, and that poverty is bad for welfare.

This Article’s tasks are twofold. The first is descriptive—to explore the limits of the tax system when it comes to inequality and poverty through a series of thought experiments and a review of recent history. The takeaway from this is that, within politically plausible parameters, the tax system seems to have little effect on overall inequality but much larger effects on poverty. The second task is normative and more tentative and that is to assess what this description has to tell us about the course of policy. Here, I conclude that we should be concerned with the distribution of tax policies but not so much because of the effect on overall income inequality but instead because of the effect on measures of welfare, like poverty. Furthermore, to the extent one cares about income inequality (as I do), one should look to policy tools beyond the tax system, because changes in the tax system are unlikely to have major effects.

The concept of poverty is of course related to that of income inequality, but they are not the same concerns. Economic inequality is focused on the differences between classes and shares of total income, while poverty, at least as employed in this Article, is gauging the absolute material well-being of those toward the bottom of the income

⁴ Unlike with reducing inequality, conservatives often embrace the idea of enacting policies to reduce poverty. For an argument in this vein (and a title very similar to the one of this Article), see Martin Feldstein, *Reducing Poverty, Not Inequality*, *Pub. Int.*, Fall 1999, at 33, 34-36 (describing how Pareto improvements could increase inequality whereas that is not the case with poverty). Of course, there are also many liberal arguments for reducing poverty. The point is that this tends to be a goal embraced by people of different ideological stripes.

spectrum.⁵ To say this somewhat differently, the concept of inequality looks to the shares of income earned by different income classes and the extent to which those shares earned by the higher income classes are disproportionate, while the concept of poverty looks to the extent to which people experience “economic deprivation.”⁶

Data from the Congressional Budget Office (CBO) suggest exactly how limited the effects of the tax system are on overall income inequality. According to CBO, which publishes among the most comprehensive data on income and tax burdens, the federal tax system reduced overall income inequality (as measured by what is known as the Gini coefficient⁷) by about 8.5% as of 2009.⁸ The CBO data begin in 1979 and the tax system had roughly the same effect in 1979 as it does today, reducing inequality by just under 10% (and with the effect being larger back then in percentage terms because inequality was smaller).⁹ Moreover, the effect on inequality has been relatively stable, especially over the last two decades, and despite a number of significant changes in the tax law over that period. Finally, if the 2013 tax deal is any evidence, plausible changes in the Code are unlikely to change this pattern significantly.¹⁰

To give a sense for relative magnitudes, it is worth gauging these changes in comparison to the increase in inequality seen over the last thirty years. Compared to some thirty years ago, after-tax inequality was 19% higher in 2009 (the latest year of CBO data available when most of the numbers for this article were finalized).¹¹ This probably understates the long-term shift in inequality because 2009 was the bot-

⁵ See, e.g., Martin Ravallion, *The Debate on Globalization, Poverty, and Inequality: Why Measurement Matters*, 79 *Int'l Aff.* 739, 740 (2003) (“Most observers have a reasonably clear idea about the difference between ‘poverty’ and ‘inequality.’ As these terms are normally defined, poverty is about *absolute levels of living*—how many people cannot attain certain predetermined consumption needs. Inequality is about the *disparities in levels of living*—for example, how much more is held by rich people than poor people.”).

⁶ See, e.g., Nat'l Acad. Sci., *Measuring Poverty: A New Approach* 21 (Constance F. Citro & Robert T. Michael eds., 1995) (“Poverty is a circumstance, defined by a set of specific conditions that are considered to reflect economic deprivation.”).

⁷ For a description of the Gini coefficient, see notes 22-29 and accompanying text.

⁸ See Cong. Budget Office, *The Distribution of Household Income and Federal Taxes: 2008 and 2009, Supplemental Data Spreadsheet tbl.9* (2012), www.cbo.gov/publication/43373 (last visited Aug. 27, 2013). After most of the numbers in this article were finalized but before it went to print, CBO released an updated version of its analysis, extending its figures by one year through 2010. As compared to 2009, most of the figures in 2010 were little changed and do not significantly affect any of the conclusions in this article. See generally Cong. Budget Office, *Pub. 4613, The Distribution of Household Income and Federal Taxes: 2010* (2013), available at <http://www.cbo.gov/sites/default/files/cbofiles/attachments/44604-AverageTaxRates.pdf>.

⁹ *Id.*

¹⁰ See Section II.D.

¹¹ CBO, note 8, *Supplemental Data Spreadsheet tbl.9*.

tom of the economic cycle (and the stock market)—which most dramatically affects capital gains receipts for those at the top. As of 2007, inequality was 30% higher than as of thirty years ago.¹² The point of these statistics is to show that the effects of changes in the tax system on inequality are not just small relative to the level of inequality; they are also small relative to the changes in inequality being driven by broader economic trends.

This is in sharp contrast to the tax system's effect on poverty. Over the last thirty years, the federal tax system has gone from significantly adding to poverty to no longer doing so. As of the mid-1980's, the federal income and payroll tax systems—which account for most federal revenues¹³—were increasing the number of those in poverty in this country by roughly 13%.¹⁴ As of 2011, these same systems were reducing the number in poverty by around 6%—or a roughly 20% swing from the effect as of less than three decades before.¹⁵ Notably, taking the federal tax system into account also substantially changes the apparent historical trend of poverty rates in the United States. Putting to the side the tax system, poverty now looks like it is at a relative high point, as Americans suffer the after-effects of the Great Recession; with the tax system accounted for, poverty is, in fact, below the average of the last thirty years, which is rather remarkable given current economic conditions.¹⁶ Similarly, the 2013 tax deal—the various outcomes of which would have barely budged overall inequality—will have a substantially larger effect on poverty.¹⁷

To boil down the historical finding: Policy choices over the last thirty years have had a relatively small effect on overall inequality but a much larger effect on poverty. How could this be? In part, the answer is captured by a simple illustration: Say we shift \$10 billion (or any other such number) from the top of the income spectrum toward the bottom (or vice versa). That looks very small relative to the whole size of the economy and would barely shift income shares; however, the effect on the welfare of those at the bottom could be much more significant—\$10 billion is real money to them.

What effect should this have on policymaking? Here, my conclusions are more tentative. This suggests that we spend too much time and energy, both in academic and political circles, studying and debating the tax system's impact on the overall income distribution in this country. Rather, to a much greater degree, the focus should be turned

¹² *Id.*

¹³ See note 138 and accompanying text.

¹⁴ See notes 137-42 and accompanying text.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ See notes 150-52.

to how the tax system affects measures of welfare—like poverty. In these terms, the effects of plausible changes in the system are likely to be much more profound. Further, this indicates that we should be looking beyond the tax system when addressing economic inequality. Changing tax policies is unlikely to prove a fruitful way to address the broader trends toward greater inequality.

This Article proceeds as follows: Part II lays out what I describe as a “bare bones” normative framework. This framework helps motivate the Article’s analysis. Part III then details the tax system’s effect on inequality. This starts with a more theoretical exploration of the possible effects holding the size of the system constant and using extreme systems to illustrate the (relatively narrow) range of outcomes. This Part then moves on to the actual effects in recent years, including the 2013 tax deal, where there are an even narrower range of outcomes. Part IV repeats much of the same analysis in terms of the effect of different tax regimes but using poverty rather than overall income inequality. Finally, Part V concludes with some tentative thoughts about where analysts and policymakers should focus their efforts in light of the practical limitations on the tax system.

II. A “BARE BONES” NORMATIVE FRAMEWORK: POVERTY V. INEQUALITY

A. *Why a Normative Framework and Why Bare Bones?*

This Article does not commit to a single, fully articulated theory of fairness. Instead, it lays out a “bare bones” framework—what is something close to the minimum necessary to motivate this analysis. By keeping it “bare bones,” the purpose is, in part, to maximize “buy in” to this Article. Many (though certainly not all) will find their theories of tax fairness to be consistent in some way with the basic tenets set out here. If so, then the empirical observations of this Article—and the tentative conclusions about what the tax system can practically accomplish when it comes to distribution of resources—should be meaningful.

Even if the framework may be bare bones, a framework is needed still. While the crux of this Article focuses on practical limits of the tax system, the argument is motivated by underlying theories of fairness. In particular, I ask how we should approach distributional questions in the tax system in light of both what we consider to be fair and what the tax system can actually do within the bounds of likely policy constraints. Most of the Article is focused on this second point, but it is only given meaning by the first point.

To put this differently, a discussion of inequality or poverty is practically meaningless unless these concepts, in themselves, are actually meaningful. So, I start by laying out two basic principles of fairness: that inequality is undesirable and that poverty is too. The Article then goes on to describe how, between these two principles, tax policy in practice has far greater leverage over the latter than the former—which has implications for where policymakers and analysts should focus their attentions.

B. The Framework: Inequality and Poverty Are Undesirable

The title of this Section may seem like a truism to some. To the extent it does, then the “bare bones” normative foundation of the Article is largely laid, and its observations should hold at least some relevance. Still, even for those who immediately embrace the concepts, it is worth better defining how I employ them here.

1. Inequality

The first basic tenet underlying the Article is that inequality in itself is undesirable. This view is widely, though certainly not universally, held. For some, it may be a question of basic fairness—inequality often being a product of “brute luck,” as Ronald Dworkin once termed it.¹⁸ Others argue that inequality is undesirable by connecting it to other negative attributes (from their point of view). This includes inequality undermining democracy by concentrating economic and, thus, political power in the hands of only a few; inequality slowing economic growth by reducing the buying power of the middle class; and inequality cutting economic mobility.¹⁹ To be clear, I do not mean this to suggest that accepting this tenet means reducing inequality is all that matters; most would agree that other factors, such as autonomy and efficiency, should be given real weight and would limit the degree to which reducing inequality is desirable. Rather, this is

¹⁸ Ronald Dworkin, *What Is Equality? Part 2: Equality of Resources*, 10 *Phil. & Pub. Aff.* 283, 293 (1981) (describing the apparent unfairness of “brute luck”—luck that is not a function of one’s “deliberate gambles” but is instead imposed on the individual).

¹⁹ For example, Joseph Stiglitz details all three of these possible negative consequences of inequality—as well as other detriments—in a new book on the subject. Joseph E. Stiglitz, *The Price of Inequality* 83-106 (2012). This joins a number of other recent works on the topic describing the consequences of growing inequality. See, e.g., Larry M. Bartels, *Unequal Democracy: The Political Economy of the New Gilded Age* 1-23 (2010) (describing the consequences for democracy of growing inequality and associating that growing inequality with policies pursued by policymakers); Timothy Noah, *The Great Divergence: America’s Growing Inequality Crisis and What We Can Do About It* (2012) (addressing broadly the consequences of inequality).

simply to say that inequality's undesirability is one important factor—among others—to be taken into account in policymaking.

In the face of the rapid rise in inequality over the last thirty years and recent economic turmoil, discussions of inequality have reached a high pitch. President Obama and his economic advisers have given speeches decrying the rise in inequality.²⁰ Meanwhile, the “Occupy” movement has taken to the streets to attack growing inequality here in the United States and other advanced countries, with a focus on the gap between the top 1% and everyone else.²¹

For purposes of this Article, it is not necessary to decide why this inequality is undesirable. The Article simply proceeds under the assumption that it is, and that, for one reason or another, analysts and policymakers should be seeking ways to address it. Taking this as the starting point, I then ask what the tax system, as a practical matter, can do to address inequality.

Before proceeding, though, it is necessary to define what I mean by inequality—and how I measure it. There are any number of ways to gauge inequality.²² In this Article, I use the Gini coefficient, which is the dominant measure of inequality used throughout the academic literature. The Gini coefficient has received considerable attention, and this is not the place to explore it in detail and its alternatives. Nevertheless, given that I rely on it heavily in the next Section, it deserves some explication here, and the requisite drawing of the Lorenz curve.²³

Using a Lorenz curve, Figure 1 illustrates the distribution of after-tax-and-transfer income in the United States based on data from

²⁰ President Barack Obama, Remarks by the President on the Economy in Osawatomie, Kansas (Dec. 6, 2011), <http://www.whitehouse.gov/the-press-office/2011/12/06/remarks-president-economy-osawatomie-kansas> (describing how “inequality—a level that we haven’t seen since the Great Depression—hurts us all” and going on to argue that inequality undermines democracy, slows growth, and reduces mobility); Alan B. Krueger, Chairman, Council of Econ. Advisers, *The Rise and Consequences of Inequality in the United States: Address at the Center for American Progress* (Jan. 12, 2012), http://www.whitehouse.gov/sites/default/files/krueger_cap_speech_final_remarks.pdf (focusing on how widening inequality may reduce mobility and weaken economic growth).

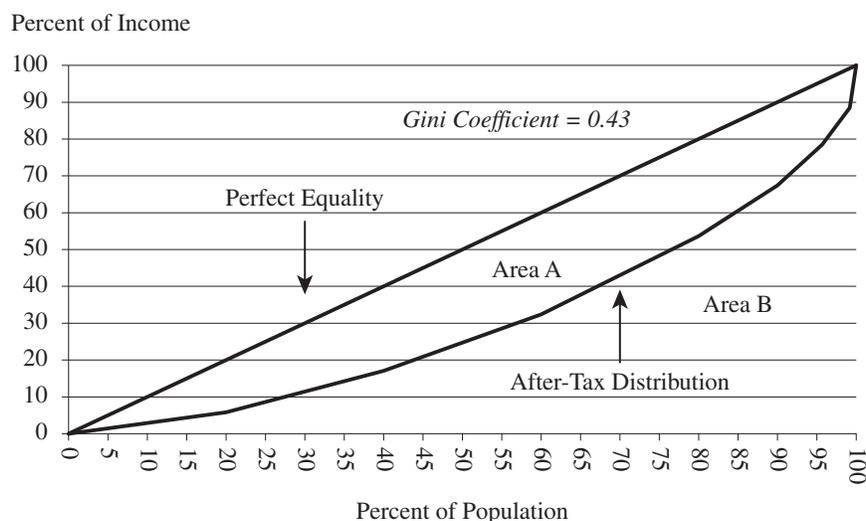
²¹ See, e.g., Erik Eckholm, *Occupy Movement Regroups, Preparing for Its Next Phase*, N.Y. Times, Feb. 11, 2012, at A18.

²² For brief overviews of different methods for measuring inequality, see, e.g., Debraj Ray, *Development Economics* 169-93 (1998); *Measuring Inequality, Poverty Reduction & Equity*, World Bank, <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPA/0,,contentMDK:20238991~menuPK:492138~pagePK:148956~piPK:216618~theSitePK:430367,00.html> (last visited Aug. 27, 2013). For a more detailed comparison of the various metrics of inequality and how these metrics relate to normative theories of inequality, see Amartya Sen & James Foster, *On Economic Inequality* 24-46 (1973).

²³ See M.O. Lorenz, *Methods of Measuring the Concentration of Wealth*, 9 *Am. Stat. Ass'n* 209 (1905) (introducing the Lorenz curve as a measure of inequality).

CBO.²⁴ The line shows the cumulative income earned up to a given percentile of income earners. For example, it shows that the bottom quintile earns a total of 6% of U.S. income; the bottom two quintiles earn 17% of U.S. income; and so on.²⁵ The curve is compared to the line of “perfect equality” (labeled as such in Figure 1).²⁶ If there were perfect equality (so that the “bottom” quintile earned exactly 20% of income, the bottom two quintiles earned 40% of income, and so on), the Lorenz curve would exactly follow that line.

FIGURE 1
AFTER-TAX AND TRANSFER INCOME DISTRIBUTION IN THE
UNITED STATES, 2009



This brings me to the Gini coefficient. Repeating the oft-used definition: The Gini coefficient is an attempt to summarize the disparity of an income distribution in a single index. It is equal to the ratio of: (1) the area between the line of perfect equality and the Lorenz curve; and (2) the total area under the line of perfect equality. In Figure 1, this is area *A* divided by the sum of areas *A* and *B*. A completely equal society would feature a Gini coefficient of zero (since the Lorenz curve would exactly follow the line of equality). And, a completely unequal society (where the highest income person earned all income) would feature a Gini coefficient equal to one.²⁷ According to

²⁴ CBO, note 8, Supplemental Data Spreadsheet tbl.3.

²⁵ See *id.*

²⁶ See Sen & Foster, note 22, at 24-46.

²⁷ See, e.g., Ray, note 22, at 189-90; Sen & Foster, note 22, at 30.

CBO, the U.S. after-tax and after-transfer Gini coefficient is 0.43 as of 2009.²⁸

To be clear, the Gini coefficient is simply a statistical measure. It is a number that lacks any meaning unless it aligns with a normative theory of equality, and there are reasons to question whether it does.²⁹ Specific theories of equality may weigh changes in the income distribution differently than implied by the Gini coefficient—for example, those most concerned with the effects of inequality on democracy and undue concentrations of political power may give special weight to the concentration at the very top of the income distribution. Others may be concerned with the inequality of something other than income—such as opportunity—but for which income provides a proxy. Or, some may give particular weight to the well-being of those at the bottom of the income distribution, in which case the concern with inequality may more approach the concern with poverty.

This Article is not meant to litigate the issue of exactly why inequality matters—and how that should best be captured. I adopt the Gini coefficient as a rough-and-ready (and widely used) measure of inequality. So, the results of this Article are, to some degree, bounded by the metric of inequality that it adopts. With that said, it is a widely used measure, and I believe that the point the Article makes will relate to many people’s concepts of inequality even if not everyone’s.

2. *Poverty*

The second tenet underlying the Article is that it is undesirable for people to be in poverty. Despite this idea being a point of agreement across many ideological lines, the very concept of poverty can engender difficult definitional questions. For purposes of this Article (and to borrow a definition offered by the National Academy of Sciences), in referring to poverty, I mean a state of “economic deprivation” such that it is not possible to maintain a “minimally adequate standard of living.”³⁰

There are probably few who would dispute this tenet on its face—that having people in or near a state of economic deprivation is unde-

²⁸ CBO, note 8, Supplemental Data Spreadsheet tbl.9.

²⁹ See Sen & Foster, note 22, at 32 (describing how the Gini coefficient implies “a welfare function which is just a weighted sum of different people’s income levels with the weights being determined by the rank-order position of the person in the ranking by income level”); see also Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 *Colum. L. Rev.* 609, 623 (1995) (“[T]he ethical and normative force of the Gini coefficient has been questioned. . . . Nevertheless, economic treatments of income distribution issues continue to accord Gini a prominent place.” Graetz then goes on to use the Gini coefficient in his own analysis.).

³⁰ *Nat’l Acad. Sci.*, note 6, at 65.

sirable. The undesirability of poverty is a point of broad agreement among diverse normative theories.³¹ As with inequality, some may see poverty as a violation of fundamental fairness. President Franklin Roosevelt famously described one of the four fundamental freedoms being “freedom from want.”³² John Rawls went even further, arguing that the welfare of society should be largely (though not necessarily entirely) defined by the well-being of the worst-off in society.³³ And, for others, poverty may be seen as undesirable because of what it may produce—among other effects being higher crime³⁴ and children in poverty today who, as a result, are more likely to grow up to be low-educated, poor adults.³⁵

Inequality and poverty are distinct, but related, concepts. A concern with inequality is fundamentally focused on the differences between classes and shares of total income, while poverty (at least as defined here) is focused most on the absolute material well-being of those toward the bottom of the income spectrum.³⁶

As with inequality, it is not necessary to define exactly why poverty is undesirable. It is simply from this starting point that the Article then asks what the tax system can practically accomplish, and the answer is that the effects on poverty can be substantial—and in contrast to the relatively limited effects on overall inequality.

³¹ See note 4 and accompanying text.

³² President Franklin D. Roosevelt, Annual Message to Congress, The Four Freedoms (Jan. 6, 1941), <http://docs.fdrlibrary.marist.edu/pdfs/fftext.pdf> (“The third is freedom from want—which, translated into world terms, means economic understandings which will secure to every nation a healthy peacetime life for its inhabitants—everywhere in the world.”).

³³ Rawls is widely associated with the “maximin” criterion, which defines social welfare in terms of the well-being of the worst-off individual. John Rawls, *A Theory of Justice* 133 (rev. ed. 1999) (“The maximin rule tells us to rank alternatives by their worst possible outcomes: we are to adopt the alternative the worst outcome of which is superior to the worst outcome of the others.”). Note that, while Rawls gave priority to the welfare of the worst-off individual, he also valued reducing inequality more broadly. See, e.g., John Rawls, *Some Reasons for the Maximin Criterion*, 64 *Am. Econ. Rev. (Papers & Proc.)* 141, 145 (1974) (articulating the difference principle according to which social institutions should be arranged so that “inequalities are no greater than necessary to produce corresponding advantages for the less fortunate.”).

³⁴ See, e.g., Sarah B. Heller, Brian A. Jacob & Jens Ludwig, *Family Income, Neighborhood Poverty, and Crime*, in *Controlling Crime: Strategies and Tradeoffs* 419, 420 (Philip J. Cook, Jens Ludwig & Justin McCrary eds., 2011) (describing a longstanding debate on the relationship between crime and poverty and concluding that “[t]he best available empirical evidence suggests that government efforts to increase the incomes of poor families, or to help them move out of the highest-poverty urban areas, can reduce criminal involvement”).

³⁵ See Caroline Ratcliffe & Signe-Mary McKernan, *Urban Inst., Childhood Poverty Persistence: Facts and Consequences* 6-9 (2010) (quantifying how “[i]n general, the longer a child is poor, the worse his or her adult outcomes”).

³⁶ See note 5.

Of course, saying that poverty is defined as a “state of economic deprivation” is not sufficient for empirical work. Economic deprivation must be quantified. In doing so, I use the Census Bureau’s official poverty thresholds.³⁷ These official poverty thresholds have been (rightly) subject to considerable criticism over the years. Among other things, the critiques focus on how the threshold is defined (without reference to housing or medical costs, for instance) and what is included in income (not taking into account taxes or important federal benefits, like food stamps).³⁸ My analysis corrects the measure in one important way—taking into account changes in federal taxes. It does not in other ways, however, in large part because of data limitations in some of the historical poverty data. With that said, the basic result—that the tax system has had a large and changing effect on poverty—appears to hold whether using the official measure of poverty or supplemental ones developed to correct deficiencies in the official approach.³⁹

However poverty is measured, it can be criticized as giving too much weight to arbitrary lines in the sand. A critic can ask: Why should a dollar that lifts someone from poverty be given great weight, while the measures give no weight to any improvement in income for those above the threshold? There is of course something to the criticism. Many (including myself) can agree, however, that there is something specifically unfair or of concern about people living in or near economic destitution. And, yes, defining where “economic destitution” begins and ends involves somewhat arbitrary judgments, and perhaps the idea could be better captured by a more gradual weighting of incomes towards the bottom of the income spectrum. Nonetheless, the arbitrariness involved does not deny the poverty concept any meaning. I think many can agree that, despite the judgment calls, there is something important to the idea of how many are in poverty.

³⁷ U.S. Census Bureau, Poverty Thresholds for 2012 by Size of Family and Number of Related Children Under 18 Years, <https://www.census.gov/hhes/www/poverty/data/threshld/thresh12.xls> (last visited Aug. 27, 2013). For a broad discussion of the official poverty figures, see generally Carmen DeNavas-Walt, Bernadette D. Proctor & Jessica C. Smith, U.S. Census Bureau, Income, Poverty, and Health Insurance Coverage in the United States: 2011 (2012), www.census.gov/prod/2012pubs/p60-243.pdf (last visited Aug. 27, 2013).

³⁸ For a discussion of the limitations of the official poverty measure, see generally Nat’l Acad. Sci., note 6.

³⁹ See note 141.

*C. If You Disagree with This Framework,
Should You Stop Reading?*

While I believe that many should find this bare bones framework to be attractive, certainly some will not agree with its two basic tenets: that inequality and poverty are undesirable. To the extent one believes that neither inequality nor poverty are undesirable, then this Article probably has little to recommend it. The same is true for those (almost certainly very few) that find inequality unattractive, but do not have any independent objection to poverty. Finally, for those who see poverty as undesirable but do not believe inequality to be undesirable (and this is a more widely held belief), then this Article is unnecessary. It reaches tentative conclusions based on practicality that they have already reached based on principle. For these readers, however, the Article might provide one more arrow in the quiver in debating tax policy; when others want to discuss the tax system's effect on inequality, this lends them a new response—focusing on this may not just be silly from the perspective of principle (in their view) but also from the perspective of practicality, since the changes will not make much difference.

There may be others who do not know whether to agree or disagree with this framework—and, instead, simply have their brows knitted in puzzlement. Perhaps there are many readers like these (though I hope not), but here I am specifically referring to the welfarists.⁴⁰ In tax policy circles and especially among public finance economists, welfarism is a widely employed normative framework; there has been many a paper evaluating tax policy from the perspective of maximizing total social welfare—which is the welfarist's *sine qua non*.⁴¹

For many welfarists, this framework may seem confused because, in their eyes, the two tenets I put in tension with each other are not so easily distinguished. Many welfarists do believe in redistribution.⁴² They do so, however, not because either inequality or poverty is in itself undesirable or unfair, but rather because maximizing total social welfare would tend to involve reducing both. This result is driven by the assumption that the marginal utility of income falls as income rises, and, as a result (and assuming no other changes), total welfare

⁴⁰ See, e.g., Louis Kaplow & Steven Shavell, *Fairness Versus Welfare* 15-16 (2006) (describing how the essence of welfare economics is, first, assessing the effects of policies on the well-being of individuals and then aggregating the information about individuals' well-being into "an overall social judgment").

⁴¹ Welfarism is the basis for the considerable economic literature on optimal tax analysis—a field with its modern foundation in the work of James Mirrlees, that has since been expanded on by an array of economists. See generally J.A. Mirrlees, *An Exploration in the Theory of Optimal Income Taxation*, 38 *Rev. Econ. Stud.* 175 (1971).

⁴² See, e.g., Kaplow & Shavell, note 40, at 30-35.

can be increased by redistributing income from those at the top toward those at the bottom.⁴³ Most welfarist models then weigh this against the economic distortions generated by redistributive policies.⁴⁴ In other words, welfarists may be confused by this framework because neither inequality nor poverty are independent, motivating concerns for the welfarist—rather the only motivating concern is total social welfare.

Still, this Article should have some relevance for the welfarist. In particular, from a welfarist's perspective, it can be seen as describing the practical limits of the tax system in increasing total social welfare. The system can have very significant effects on the welfare of those toward the bottom or middle of the income distribution—and increase (or decrease) social welfare in that way. However, the system seems unlikely to undertake major redistributions of income, where large shares of concentrated income at the top are passed down to those toward the middle and bottom. If that is a goal, other policy tools must be employed. Practically speaking, the tax system can matter in increasing total social welfare through redistribution, but this is within limits.

D. Taxes Versus Spending

This Article focuses almost exclusively on the effect of the federal tax system on inequality and poverty.⁴⁵ Some may complain that this ignores the “spending” side of the budget, which, of course, can (and does) have significant effects on the distribution of income. Furthermore, this complaint is given even greater force by the fact that the distinctions between “spending” and “taxes” are formalisms.⁴⁶ Transfers can be delivered through either the spending or tax system, with the same or very similar substantive effect. (And, there is of course a highly developed literature exploring what it means to have “tax expenditures” in the Code.) Essentially, what is considered to be “tax” and “spending” is a function of placement in the law books rather than anything else. In short, this Article can be accused of telling only a very partial story—and not the story of the *overall* tax and transfer system.

⁴³ Id.

⁴⁴ See e.g., id.

⁴⁵ By the tax system, I mean provisions generally operating through the Code—and grouped by analysts, such as CBO, as “taxes.” This includes refundable income tax credits.

⁴⁶ See Daniel N. Shaviro, Rethinking Tax Expenditures and Fiscal Language, 57 *Tax L. Rev.* 187, 191 (2003) (“The distinction between taxes and spending thus depends on pure form. For example, ‘spending increases’ can be converted into ‘tax cuts’ if they are netted against tax payments before being made in a manner that looks sufficiently as if the tax system is the responsible agent.”).

I am guilty as charged. Not surprisingly, however, I believe that the analysis here still carries significance. As a first defense, I offer precedence. The distribution of the tax system has frequently been discussed separately from that of the overall transfer system. There is a long and storied literature quantifying and debating the distributional effects of the tax system—a literature to which this Article contributes.⁴⁷ This Symposium itself is yet another entry; it discusses the 100-year anniversary of the federal income tax. Perhaps this set of Articles alternatively could have been titled “the effects of all government transfers on inequality,” but, like many discussions before this, it is meant to focus on one part of that system—the federal tax system (and perhaps even more narrowly the income tax system).

However, precedence alone is unsatisfying. As a second defense, I offer practicality. For better or worse, tax and spending policies tend to be debated and analyzed separately from one another. Distributional tables are most often produced looking at only the distributional effects of tax policies.⁴⁸ And, whereas such tables are often employed in tax debates, they are far less frequently used when it comes to spending policy.⁴⁹ In the coming years, it is possible that policymakers will be engaged in the process of trying to reform the tax system, and, in that process, the question will be asked—“what matters for distributional purposes”? In other words, policymakers and analysts will be staring at distributional analysis of various tax reforms—separate and apart from “spending” policies—and asking what really matters.

⁴⁷ For an early and influential article analyzing the progressivity of the federal income tax system and its effect on inequality (ignoring the transfer system), see generally R.A. Musgrave & Tun Thin, *Income Tax Progression, 1929-48*, 56 *J. Pol. Econ.* 498 (1948). This tradition has continued as distributional analysis developed over time. See, e.g., Joseph A. Pechman, *Federal Tax Policy* 370 tbl.D-4 (5th ed., 1987) (showing progression of effective tax rates under the federal income tax); Daniel B. Suits, *Measurement of Tax Progressivity*, 67 *Am. Econ. Rev.* 747, 747-52 (1977) (proposing a new approach for measuring the progressivity of the tax system).

⁴⁸ For instance, the Urban-Brookings Tax Policy Center (TPC) has taken a particularly prominent role in tax debates in Washington. See, e.g., Annie Lowrey, *Tax Policy Center in Spotlight for Its Romney Study*, *N.Y. Times*, Oct. 24, 2012, at A4. Whenever there is a significant tax change proposed, TPC produces distributional numbers for that tax change. See Urban-Brookings Tax Pol’y Ctr., *The Numbers*, <http://www.taxpolicycenter.org/numbers/index.cfm> (last visited Aug. 29, 2013). Notably, it does this for tax changes only, not those on the spending side.

⁴⁹ There is quite simply no TPC-equivalent when it comes to spending programs, producing readily available and understandable distributional estimates for changes in spending programs.

III. INEQUALITY: TAX SYSTEM'S LIMITED EFFECT

A. “*The Great Divergence*”

The last thirty years have been characterized by a remarkable (and much remarked upon) increase in economic inequality in the United States. Paul Krugman has famously labeled the trend as “the great divergence.”⁵⁰ In broad strokes, the United States saw a significant reduction in income inequality—and, specifically, the share of income flowing to the very top of the income distribution—in the midst of World War II. That drop in inequality was maintained through the late 1970’s.⁵¹ Income inequality then began widening in the decades that followed, until reaching levels only last seen in the 1920’s and 1930’s.⁵² Some economists have recently challenged this economic narrative using alternative measures of income that do not show a large increase in inequality,⁵³ but, so far, the dominant view remains that the country has seen a substantial increase in inequality in recent decades.

To give a sense of the magnitude of the increase in inequality over the last thirty years, I use data from CBO, which supplies one of the most comprehensive views of income and inequality in the United

⁵⁰ Paul Krugman, *Introducing This Blog, Conscience of a Liberal* (Sept. 18, 2007, 11:45 PM), <http://krugman.blogs.nytimes.com/2007/09/18/introducing-this-blog/> (“The great divergence: Since the late 1970s the America I knew has unraveled. We’re no longer a middle-class society, in which the benefits of economic growth are widely shared: between 1979 and 2005 the real income of the median household rose only 13 percent, but the income of the richest 0.1% of Americans rose 296 percent.”).

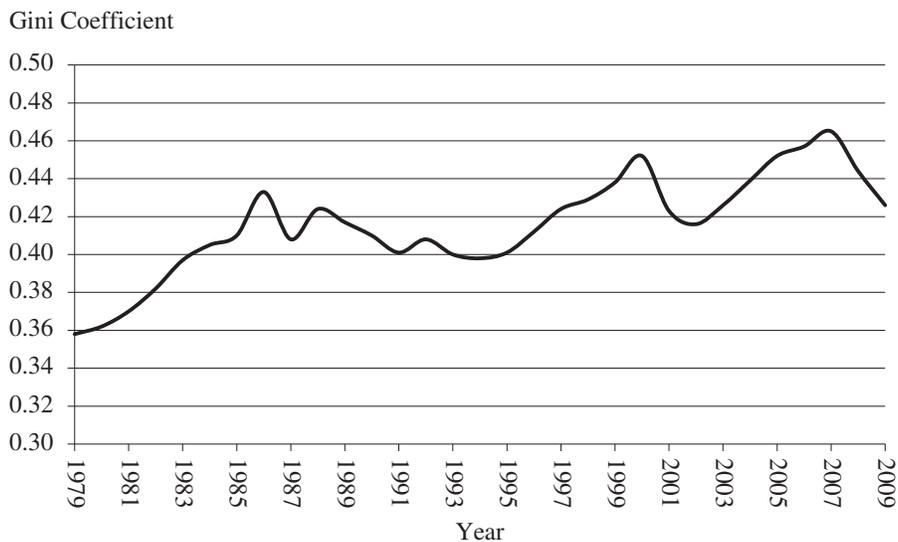
⁵¹ Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, 118 Q.J. Econ. 1, 11 fig.I (2003) (showing the top decile’s share of income over time).

⁵² Id; see also Thomas Piketty & Emmanuel Saez, *Updated Data tbl.1* (Jan. 2013), <http://elsa.berkeley.edu/~saez/TabFig2011prel.xls> (updating data on inequality through 2011).

⁵³ In particular, a new paper suggests that the increase in inequality is far smaller if capital income is measured in terms of accrued gains (the new paper’s preferred method) rather than realized gains (the method used in most of the literature so far). See generally Philip Armour, Richard V. Burkhauser & Jeff Larrimore, *Levels and Trends in United States Income and Its Distribution: A Crosswalk from Market Income Towards a Comprehensive Haig-Simons Approach* (Nat’l Bureau of Econ. Research, Working Paper No. 19110, 2013), available at www.nber.org/papers/w19110. The paper was recently released, and so the academic discussion of it is at an early stage. Thomas Edsall of the New York Times asked some of the leading academic authorities for their early reaction and summarized this and his own view in a blog post. See generally Thomas B. Edsall, *What If We’re Looking at Inequality the Wrong Way?*, N.Y. Times Opinionator (June 26, 2013, 11:13 PM), <http://opinionator.blogs.nytimes.com/2013/06/26/what-if-were-looking-at-inequality-the-wrong-way/>. While praised in some quarters, a number of academics criticize the new study for relying, to a significant degree, on a dataset that does not do a good job of capturing income trends at the very top of the income distribution and, perhaps more seriously, assuming that the entire population has essentially the same rate of return on capital in calculating accrued gains—rather than reflecting the reality that some do much better than others. Id.

States over the last thirty years.⁵⁴ Whereas in 1979 (near the low point for inequality in the United States and also the start of the availability of income data from the CBO), the top quintile earned 42% of national income on an after-tax and transfer basis, that had increased to 47% by 2009.⁵⁵ For the top 1%, the share increased from just over 7% to over 11%.⁵⁶ Or, to put this in terms of the Gini coefficient, the Gini increased from 0.36 to 0.43⁵⁷—an increase of about one-fifth over thirty years. This trend in the Gini coefficient is shown in Figure 2.

FIGURE 2
INCOME INEQUALITY AFTER TAXES AND TRANSFERS



To be clear, and as also shown in Figure 2, this is a drop in inequality relative to the peak in 2007, prior to the start of the Great Recession. The Great Recession especially affected the capital gains receipts of those toward the top of the income spectrum. From 2007 to 2009, the after-tax Gini coefficient fell from 0.47 to 0.43 (as incomes of the top 1% fell by 37% in a period of just two years).⁵⁸ It seems likely that inequality has increased once more as the economy rose

⁵⁴ CBO, note 8, Supplemental Data Spreadsheet.

⁵⁵ Id., Supplemental Data Spreadsheet tbl.3.

⁵⁶ Id.

⁵⁷ Id., Supplemental Data Spreadsheet tbl.9

⁵⁸ Id., Supplemental Data Spreadsheet tbl.3.

out of the doldrums and the stock market has recovered and, in fact, some data suggest that this is the case.⁵⁹

This is not the place to delve into the details of these trends nor the possible causes of them. That has been covered in great detail in other sources.⁶⁰ Instead, this is meant to set out the basic context for the current debate over inequality, and why it has generated such considerable attention in recent years—namely, a significant trend (interrupted only by the effects of recessions) toward greater income inequality in the United States.

B. Limit on Effect of the Tax System: Size of the System

In the face of this trend toward greater inequality and with many believing that income inequality is undesirable, there has been a high-profile debate in the United States as to how to address it. As noted, the tax system frequently comes up as a key, if not *the* key, tool.⁶¹

In practical terms, however, the effects of the system are limited. I explore the practical limits through a number of different lenses, including the experience of the last thirty years and the recent tax deal that Republicans and Democrats struck to continue most—but not all—of the 2001 and 2003 tax cuts. Before arriving at those two perspectives, I begin with one limit on the effect of the tax system on overall economic income inequality—namely, the size of the tax system.

This is a simple point, but one that is under-appreciated and with important practical consequences. To start off with an extreme example—say that the tax system raised \$1 of revenue. That system could be entirely concentrated on the highest income household or the lowest income household, but it would have very little effect on overall inequality in the United States.

Of course, the federal tax system raises more than \$1. As of fiscal year 2013, the federal tax system raised revenue equal to about 17%

⁵⁹ Piketty & Saez, note 51, at tbl.A2 (showing that, while the share of income including capital gains earned by the top fractiles fell from 2007 to 2009, that had largely returned to its pre-recession level by 2011). After most of the numbers for this article were finalized, CBO released an updated version of its analysis extending the figures through 2010. From 2009 to 2010, CBO found that there was a slight increase in inequality as measured by the Gini coefficient. The after-tax and after-transfer Gini coefficient rose by 0.008 but still remained significantly below its prerecession peak. Cong. Budget Office, *The Distribution of Household Income and Federal Taxes: 2010*, Supplemental Data Spreadsheet tbl.9 (2013), <http://www.cbo.gov/publication/44604> (last visited Dec. 31, 2013).

⁶⁰ See generally Noah, note 19, at 1-163 (analyzing the trends in and sources of equality); Stiglitz, note 19, at 9-17, 57, 67, 70, chs. 1-3 (also exploring these themes).

⁶¹ See note 2.

of GDP.⁶² With the economy recovering and temporary tax breaks expiring (including certain high-income 2001 and 2003 tax cuts), that amount is expected to rise to a number just above 18% of GDP for much of this decade.⁶³ Looking back historically, revenues in the United States have never been higher than just under 20% of GDP (the peak as of 2000).⁶⁴

This symposium is specifically focused on the income tax and its 100-year anniversary. The individual income tax raises considerably less than the tax system as a whole. In 2013, the income tax raised about 8% of GDP (or just under half of total revenues)⁶⁵—with that projected to increase up to between 9% and 10% of GDP as the decade progresses.⁶⁶ And, historically, the income tax has never raised more than just over 10% of GDP.⁶⁷

Assuming the federal tax system stays somewhere close to these historical bounds in terms of size, this represents a practical limit on the system's effect on overall inequality in the country. To put this in context, the entire amount raised by the federal tax system—roughly 20% of total income—is equivalent to less than half of the income earned by the top quintile.⁶⁸ The income tax is equivalent to only about one-fifth.⁶⁹ There is only so much that the decision about how to distribute a tax system of this size will do to either increase or decrease income inequality.

To clarify the degree to which the size of the tax system represents a limit on its effect on overall inequality, I take two extreme examples—one of a poll tax and one of a system in which those at the top of the income spectrum pay the entire tax. Both of these examples assume a tax system that is roughly the same size as we will have in the United States over the coming decade—with the total tax system equal to about one-fifth of income and the income tax equal to about half that.

⁶² Joint Statement of Secretary Lew and OMB Director Burwell on Budget Results for Fiscal Year 2013 tbl.1, <http://www.treasury.gov/press-center/press-releases/Pages/jl2197.aspx> (last visited Dec. 31, 2013) [hereinafter Joint Statement].

⁶³ Cong. Budget Office, CBO's Baseline Budget Projections, as of May 2013, With Percentages of GDP Updated to Reflect Recent Revisions by the Bureau of Economic Analysis, <http://www.cbo.gov/publication/44574> (last visited Dec. 31, 2013).

⁶⁴ See Cong. Budget Office, Historical Budget Data—August 2013, <http://www.cbo.gov/publication/44507> (last visited Dec. 31, 2013).

⁶⁵ Joint Statement, note 62, at tbl.2.

⁶⁶ See CBO, note 63.

⁶⁷ See CBO, note 64, at tbl.2.

⁶⁸ CBO, note 8, Supplemental Data Spreadsheet tbl.3 (showing that the top quintile makes about 50% of pretax income).

⁶⁹ See *id.*

1. *Poll Tax*

A poll tax (alternatively called a head tax) is one in which each person contributes the same amount to finance the tax system. It is the textbook example of a tax system that would produce no economic distortions, even if it would generate significant economic inequity.⁷⁰ That is because no one could change their behavior in such a way as to reduce their tax liability—each person would owe the same amount irrespective of their decisions. In sum, this is an extreme system in which concerns about distribution are entirely put to the side and the tax system is designed to optimize “economic efficiency” in this very limited sense.

Not surprisingly, a poll tax like this would significantly increase income inequality. The before-tax (after-transfer) income distribution has a Gini coefficient of 0.47 as of 2009, according to CBO.⁷¹ A poll tax would raise this Gini coefficient to about 0.57—or nearly one-quarter higher than before the imposition of a poll tax.⁷² Or, to put this in other terms, the top quintile would go from earning about 51% of pre-tax income⁷³ to about 59% of after-tax income.⁷⁴ This is of similar magnitude to the size of the shift in inequality between 1979

⁷⁰ See, e.g., Michael J. Graetz & Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 34 (7th ed. 2013) (“Perhaps the most economically efficient tax would be a so-called head tax.”).

⁷¹ See CBO, note 8, Supplemental Data Spreadsheet tbl.9.

⁷² This is a rough estimate and is the author’s calculation using two sources: (1) The Congressional Budget Office for data on income and taxes. See CBO, note 8. (2) A World Bank program (named “POVCAL”) to calculate the Gini coefficient. For a description of the World Bank program, see: <http://iresearch.worldbank.org/PovcalNet/index.htm?0,5>.

Specifically, I start with the CBO after-transfer income distribution, which they supply based on quintiles for the bottom 80% of the income distribution and with greater detail for the top quintile (81st to 90th percentile, 91st to 95th percentile, 96th to 99th percentile, and top 1%). Note that households are ranked adjusting for household size.

I then assume imposition of a head tax that generates tax liabilities equal to 20% of post-transfer income. Note that, according to CBO’s figures, federal taxes over the last thirty years have averaged just a bit over 20% of post-transfer income (as measured by CBO). In applying the head tax, I simply divide the tax equally across the various percentiles—so the bottom 20% of the population pays 20% of the tax and so on.

I then calculate the change in the Gini coefficient with a head tax imposed. I do so based on the grouped data (grouped by the percentiles described above). Based on grouped data, though, it is not possible to exactly estimate the Gini coefficient, since that would require access to the underlying individual-level data. As a best guess at the change in the Gini coefficient, I use the POVCAL computer program from the World Bank, which employs a parametric equation to estimate the Lorenz curve and Gini coefficient based on grouped data.

⁷³ See CBO, note 8, Supplemental Data Spreadsheet tbl.3.

⁷⁴ Author’s calculations.

and 2007 (and somewhat larger than that through 2009, after the start of the Great Recession).⁷⁵

The smaller the tax system, the smaller is this effect. If the income tax alone were imposed as a poll tax, the Gini coefficient would rise from 0.47 to about 0.51 as a result of this tax, with the top quintile going from earning 51% of total income to earning 54% of total income.

As an extreme example of a regressive tax system (a system that I think almost all would agree is far from fair), the effect of the poll tax on inequality seems somewhat underwhelming. With that said, a poll tax *would* have a major effect on welfare, especially for those at the bottom of the income distribution. Income for the bottom quintile would be nearly entirely eliminated (of course, it seems likely that means many would refuse to pay the tax at all, but I put that to the side). The bottom quintile would go from earning 5% of pre-tax income to roughly 1%—a move from destitution to utter destitution. The size of this effect is explored in greater detail in Part III, with the point being that a poll tax would have a very large effect on poverty but a significantly smaller one on overall income shares.

Note that these estimates of the poll tax—and all other calculations in this Article on the effects of tax changes—do not take into account the behavioral effects from imposition of taxes. These are “static estimates,” as they are often called. This is a significant simplifying assumption, but a defensible one. In fact, dynamic estimates—that account for the expected change in behavior—do not necessarily produce more accurate figures for purposes of distributional analysis.

The poll tax illustrates how static results, in some cases, can better capture distributional changes than dynamic estimates. In the face of a poll tax, it is very possible that some—especially those with lower incomes—would work more to help pay the tax and purchase necessities. (In economics parlance, this would be an income effect—with these people consuming less leisure and working more as a result of a reduction in resources.) It is not clear, however, that one would want to count this additional monetary income among those at the bottom as decreasing income inequality—for even as they increase their monetary incomes, they are decreasing the amount of leisure they consume. In other words, while pretax monetary income might go up as a result of the tax, total pretax income—including the consumption value of leisure—might not rise at all. In this case, the *static* estimate

⁷⁵ From 1979 to 2007, the share of income earned by the top quintile went up by about 10 percentage points, see CBO, note 8, Supplemental Data Spreadsheet tbl.3, and the Gini coefficient rose by about 30%, *id.*, Supplemental Data Spreadsheet tbl.9.

is the more accurate measure in terms of the tax's effect on relative incomes (including the value of leisure).

Static estimates will not always be better than dynamic ones. Whether to use static or dynamic estimates for purposes of distributional analysis has long been a point of contention among tax experts.⁷⁶ The point is that the simpler approach adopted by this Article—of using static estimates—is a reasonable one and one used by others in doing distributional analysis.⁷⁷

2. *Highest Income Americans Pay Everything*

The poll tax can be contrasted with another extreme—that of the highest income Americans paying all federal taxes. This hypothetical assumes that the top 20% pays this entire burden and with the effective tax rate phasing up from about 20% for the 81st to 90th percentiles of income to a high of 65% for the top 1%.⁷⁸ It is, of course,

⁷⁶ For a description of this debate, see Graetz, note 29, 624-34. When tax changes involve not just income effects but also substitution effects, the story becomes more complicated than described in my example of the poll tax—and a static estimate is not necessarily superior. For instance, take a tax on labor income. That, too, would tend to have an income effect—causing people to work more because of the reduction in resources, and the analysis above would apply (the static approach should produce the better distributional estimate). But, it would also produce a substitution effect. In particular, this would make leisure less expensive relative to working (and the goods consumed from labor income) and so lead people to work less for that reason. A dynamic analysis would take the reduction in monetary income from the substitution effect into account in distributional analysis, while a static analysis would not. Neither is entirely right though. The dynamic analysis overstates the tax burden because even as monetary income falls, the amount of leisure enjoyed increases—which has a real value. However, static analysis understates the burden because, while leisure has value, it has less value to the individuals than the goods they are giving up by substituting leisure for labor in the face of taxes. This is a deadweight loss—and the static analysis does not properly account for this. The bottom line is that dynamic analysis is not clearly superior to static analysis in distributional analysis—and, in some cases (the poll tax and other “lump sum” taxes that produce only income effects), the opposite is true.

⁷⁷ For instance, the TPC uses static estimates when it comes to its distributional estimates, but semi-dynamic estimates (taking into account behavioral changes except those affecting larger macroeconomic variables) when it comes to revenue estimates. See, e.g., Robertson Williams, Eric Toder, Donald Marron & Hang Nguyen, Urban-Brookings Tax Policy Center, *Toppling Off the Fiscal Cliff: Whose Taxes Rise and How Much?* 7 n.9 (2012), <http://www.taxpolicycenter.org/UploadedPDF/412666-toppling-off-the-fiscal-cliff.pdf> (noting that the distributional estimates are static and that the revenue estimates take into account short-run behavioral changes).

⁷⁸ Like with the poll tax example, the numbers in this hypothetical are the author's calculations using CBO data on the income distribution and the World Bank's POVCAL program to calculate the Gini coefficient. See note 72. This assumes federal taxes equal to 20% of total income and then generates this through a tax imposed solely on the top quintile. Based on the income breaks provided by CBO for the top quintile (81st to 90th percentile, 91st to 95th percentile, 96th to 99th percentile, and top 1%), I assume a progressive structure at the top—an effective tax rate of approximately 20% for the 81st to 90th percentile; approximately 30% for the 91st to 95th percentile; approximately 45% for the 96th

possible that the system could be made even more progressive—with the top 10% or less paying the entire tax burden (and effectively wiping out their incomes). This hypothetical, however, certainly represents a highly progressive tax system.

This hypothetical tax system—equal to about 20% of total income and in which the highest income Americans paid everything—would reduce the Gini coefficient from the pretax level of about 0.47 to about 0.35 on an after-tax basis, or a reduction of about one-quarter. The top quintile would go from earning 51% of pretax income to 39% of after-tax income. (And, like the poll tax, the effect would be about half that if focused on the income tax alone since the income tax represents just about half of total U.S. taxes. In that case, the Gini coefficient falls from over 0.47 to about 0.41).⁷⁹

No doubt—this represents a significant move in inequality and income shares. To put this in context, however, entirely concentrating the full tax system's burdens on the top 20% would roughly offset the increase in income inequality experienced over the last thirty years—producing an after-tax Gini coefficient about equal to that in 1979. (The share of income earned by the top quintile would be somewhat lower than in 1979—although that too would be about the same if we returned to the inequality levels seen last in 2007.)

Note that this hypothetical constrains the progressivity of the tax system as a whole in an important way. It sets the lowest possible tax rate as zero. That is, it has the highest-income taxpayers pay the entire tax burden to finance an as-yet unidentified set of services and transfers provided by the federal government on the spending side of the budget. A more progressive tax system could have a negative tax rate (such as a demogrant) for those toward the bottom of the income distribution. As a practical matter, the federal tax system so far tends not to deliver net benefits to people—consistent with the assumption in this hypothetical. For the average low-income family, the federal tax rate was close to zero in recent years, and that was a record low within the last thirty years.⁸⁰ Some people within that quintile cer-

to 99th percentile; and approximately 65% for the top 1%. For additional description of the methodology, see *id.*

⁷⁹ Author's calculations.

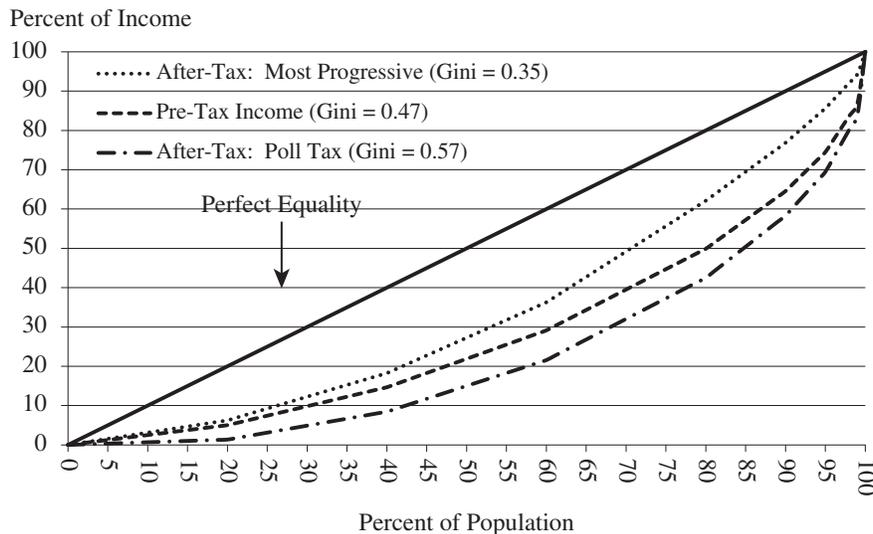
⁸⁰ CBO reports that, as of 2009, the bottom quintile paid an average federal tax rate of 1%, the lowest rate in thirty years. CBO, note 8, Supplemental Data Spreadsheet tbl.1. TPC finds the average tax rate for the lowest quintile in 2009 to be -1.6%, although this does not take into account federal excise taxes (like the gas tax). Urban-Brookings Tax Pol'y Ctr., Table T13-0035, Baseline Distribution of Cash Income and Federal Taxes Under Current Law by Cash Income Percentile (2013), <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3792>. TPC finds that, from that low, the average tax rate for the bottom quintile rose to 0.9% by 2012 (with the expiration of Making Work Pay benefits)—and is expected to rise still further to 1.8% in 2013 (with the expiration of the payroll tax

tainly had negative average tax rates, but the point is that is the exception rather than the rule—even the lowest income Americans tend not to get back a lot from the federal government *on net* through the tax system and taking into account all federal taxes.

3. *The Range of Outcomes for the Tax System*

The two examples essentially define the range of possible outcomes when it comes to the tax system's effect on inequality—and assuming we have a tax system that generates revenue equal to about 20% of GDP (and does not provide much in the way of funds back to individuals). The decision as to how to distribute that tax burden could shift the Gini coefficient from the pretax (and after-transfer) level of about 0.47 to a level as high as about 0.57 and as low as about 0.35. Note that the current tax system generates an after-tax Gini coefficient of 0.43 as of 2007—or about 8% below the pretax Gini of 0.47. The range of Lorenz curves is shown in Figure 3.

FIGURE 3
RANGE OF OUTCOMES—HYPOTHETICAL SYSTEMS



On the one hand, this demonstrates that the tax system can have a significant effect on inequality. At the same time, it shows that, if the system is limited to about 20% of total U.S. income, the decision as to

cut) and 2.5% by 2015. *Id.* The TPC figures, however, do not appear to take into account the effects of health reform's tax credits that will become effective in 2014. See *id.* If those were included, that should drive effective tax rates back in the other direction.

how to distribute the tax burden is of somewhat limited impact. Furthermore, as the next Section describes, the range of outcomes is in practice much more limited than that. We are very unlikely to ever have a tax system that is either a poll tax or one in which the very richest Americans pay all taxes (and where the effective tax rate on the top 1% reaches 65%). As a result, in practice, the effect of the tax system on inequality has been held to a relatively narrow band.

C. The System in Practice: Experience of the Last Thirty Years

Figure 4 captures the effect of the tax system on inequality over the last thirty years using the CBO data.⁸¹ It shows a tax system whose effect on inequality in this country has varied relatively little over time. In 1979, the tax system as a whole reduced the Gini coefficient by 0.039 (or nearly 10% compared to the pretax Gini coefficient).⁸² In 2009, it reduced the Gini coefficient by, again, 0.039 (or, about 8%—with the percent change in the Gini coefficient being somewhat smaller than in 1979 because of the increase in pretax income inequality).⁸³

In that period, the reduction in the Gini coefficient due to the effects of the tax system varied from a high of about 0.041 in 1996 to a low of 0.023 in 1986, according to the CBO data.⁸⁴ In other words, over the last thirty years, the effect of the tax system has ranged by 0.018 in terms of change of the Gini coefficient.⁸⁵ Note, though, that the effect on inequality has been relatively constant at the current level since the mid-1990's. This is at the same time as the before-tax Gini has varied by a total of 0.103—with the low in 1979 of 0.397 and a peak in 2007 of 0.500.⁸⁶

Looking at the individual income tax specifically, the effects are not all that different than the federal tax system as a whole. That is be-

⁸¹ See CBO, note 8, Supplemental Data Spreadsheet tbl. 9.

⁸² *Id.*

⁸³ *Id.*, Supplemental Data Spreadsheet tbl.9. Note that these CBO calculations take into account federal individual income taxes, corporate income taxes, social insurance taxes, and excise taxes. See *id.* at 1. This represents about 95% of total federal receipts. Office of Mgmt. & Budget, Exec. Office of the President, Fiscal Year 2013 Historical Tables, Budget of the U.S. Government 34-35 tbl.2.3 (2012), <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist.pdf> [hereinafter FY 2013 Historical Tables]. Importantly, though, this does not take into the estate and gift tax. Over the last several decades, the estate and gift tax composed about 1% to 2% of total federal receipts. *Id.* at 34-35 tbl.2.3, 45-46 tbl.2.5. While that is a small share of the whole, the estate and gift tax is focused almost entirely on the very top of the income spectrum and has now been phased down. If that were included in CBO's calculations, the pattern may differ somewhat from what is shown here.

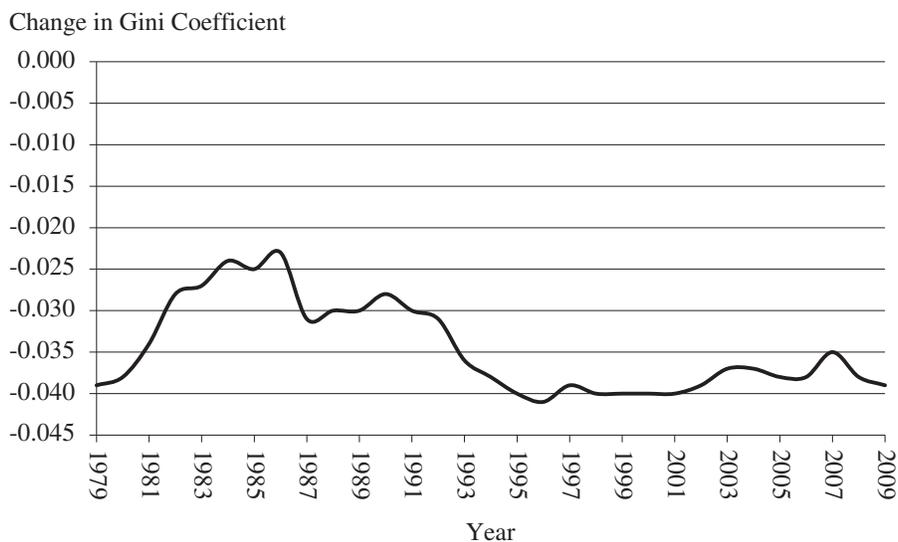
⁸⁴ CBO, note 8, Supplemental Data Spreadsheet tbl.9.

⁸⁵ *Id.*

⁸⁶ *Id.*

cause, while the individual income tax represents only half the total tax system, it is also among the elements that concentrates payments most at the top of the income distribution. The income tax reduced the Gini coefficient by 0.031 (or 8%) in 1979 and 0.038 (or 8% again) as of 2009.⁸⁷ And, like the tax system as a whole, the effect of the individual income tax on the Gini coefficient ranged by about 0.015—from a low in the mid-1980's to a high in the late 1990's and 2000.⁸⁸

FIGURE 4
EFFECT OF FEDERAL TAX SYSTEM ON INEQUALITY



There are several takeaways from this spate of numbers. First, the tax system as a whole and the individual income tax specifically are progressive, though only mildly so. To put the system in perspective: Compared to the “extreme” example of a tax system in which the entire burden is borne by the top 20%, the system reduces inequality by about 40% as much, as measured by the Gini coefficient.

Second, changes in the tax system’s progressivity are small relative to broader economic trends. As noted, the tax system’s effect on the Gini coefficient has varied within a relatively tight band—of about 0.015 (and is now at about the same level as in 1979, even if a bit lower in percentage terms). This is at the same time that before-tax inequality has varied by 0.103, or roughly 20% (and increased over the period from 1979 to 2007 by 0.068).

⁸⁷ Id.

⁸⁸ Id.

The effect of the tax system on inequality has been held to this relatively tight band despite significant changes in the tax system over that time.⁸⁹ These changes include Reagan's major tax cuts in the beginning of the 1980's (which helped bring the progressivity of the tax system to its modern low point⁹⁰); the rewriting of the Code in the 1986 tax reform featuring lower ordinary tax rates, higher capital gains tax rates, and significant base broadening; the tax increases of the 1990's that increased taxes on the highest income Americans, while cutting taxes at the bottom with the expansion of the Earned Income Tax Credit; and, finally, the significant tax cuts enacted over the last decade that cut taxes across the board (but with those at the top seeing the largest gains in after-tax income⁹¹). Or to put this in terms of marginal tax rates: There was little change in the system's effect on overall inequality even as the top ordinary income tax rate varied from 70% (in 1979) to 28% (from 1988 to 1990)⁹² and the top capital gains rate varied from 35% (in 1979) to 15% from 2003-2012.⁹³

Note that, unlike in the hypotheticals explored earlier, the size of the tax system is not held constant over time with all of these changes. So, it is not only relative shares of the tax burden by income class that are varying but also the size of the tax system itself. The smaller the tax system, the less effect that system will have on income inequality in any given year, all else being held equal. And, as of 2009, the federal tax system had fallen to its lowest level as a share of the GDP since the 1950's⁹⁴ though the level is expected to recover as the economy recovers, stimulus measures expire, and rates rise on the highest income Americans.

The changes in the size of the tax system lead again to the question of whether these distributional estimates are incomplete. A smaller tax system means either that spending must be commensurately smaller or deficits larger (and, at the moment, the result appears to be larger deficits). In turn, larger deficits will translate into some combi-

⁸⁹ For a brief summary of major tax legislation passed in recent decades, see generally Urban Brookings Tax Pol'y Ctr., Summary of Major Enacted Tax Bills, 1940-2009 (2009), http://www.taxpolicycenter.org/taxfacts/Content/PDF/major_bills_discription.pdf.

⁹⁰ See CBO, note 8, Supplemental Data tbl.9 (showing the tax system's effect on the Gini coefficient falling to a relative low point in the period from 1983-1986).

⁹¹ See, e.g., Urban-Brookings Tax Pol'y Ctr., Table T11-0208, Individual Income and Estate Tax Provisions in the 2001-10 Tax Cuts, With AMT Patch, Distribution of Federal Tax Change by Cash Income Percentile, 2011, <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3089&DocTypeID=2> (showing that the highest income classes received the largest tax cuts as a share of their incomes).

⁹² Urban-Brookings Tax Pol'y Ctr., Historical Individual Income Tax Parameters (2013), <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543>.

⁹³ CCH, A Historical Look at Capital Gains Rates (2012), <http://www.cch.com/wbot/2012/029CapitalGains.asp> (last visited Aug. 31, 2013).

⁹⁴ FY 2013 Historical Tables, note 83, at 34-35 tbl.2.3.

nation of higher future taxes or lower spending. In short, the changes in size must have distributional effects that are not captured here.

There is something to this objection, but it is also not one that can readily be resolved. Including the spending side of the budget in the distributional estimates does not address this—since the changes in the size of the tax system might have, for the moment, translated into larger deficits rather than lower spending. This means that the deficits will affect *future* spending and taxes, and with an unknown distribution. In short, the changes in the progressivity of the tax system in a given year is telling only a partial story, but it is the part of the story that we know.

The bottom line is that, even as the tax system has been changed numerous times and, often, significantly (or certainly what commentators and policymakers considered to be significant changes), the tax system's effect on overall inequality has varied little. This is to say that, within the bounds of what Americans or the political system have been willing to accept, modern changes in the tax system have had a relatively small effect on overall inequality—certainly relative to broader economic forces. That is the lesson from history, and, as the next Section explores, the much-debated 2013 tax deal only gives this more credence.

D. The 2013 Tax Deal

Changes in the tax system continue, and, in January 2013, Republicans and Democrats reached agreement on major tax legislation that allowed taxes to increase on the highest income Americans, while continuing most of the tax cuts for those with lower incomes.⁹⁵ This resolved what was perhaps the leading tax debate over the last decade—the fate of the 2001 and 2003 tax cuts. And, yet despite all of the headlines and the considerable debate about how these tax cuts have widened inequality, the effect of the deal on inequality was, in fact, decidedly limited, just like the other tax changes in recent decades.

Among other things, the 2001 and 2003 tax cuts broadly cut tax rates, reduced taxes on capital gains and dividends, gave tax relief to married couples, and expanded both the child tax credit (CTC) and earned income tax credit (EITC).⁹⁶ The tax cuts were first scheduled to expire entirely at the end of 2010 but were temporarily extended in

⁹⁵ See generally American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313.

⁹⁶ For an overview of the major provisions in the 2001 and 2003 tax cuts, see William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001-2004*, 45 B.C. L. Rev. 1157, 1160-68 (2004).

a bipartisan deal in December 2010 through the end of 2012.⁹⁷ At the time these tax cuts were enacted, progressives described them as disproportionately skewed toward helping the highest-income Americans, giving these high-income Americans the largest absolute tax cuts and the largest tax cuts relative to their incomes;⁹⁸ conservatives defended their distribution by noting that the share of taxes paid by upper-income Americans actually rose.⁹⁹ And, many voices in this discussion (especially on the progressive side) have invoked the issue of broader inequality—and how these tax cuts may have widened the gap.¹⁰⁰

In recent years, the Obama Administration defined one side of this debate. It called for the expiration of the tax cuts for families with adjusted gross income in excess of \$250,000 (\$200,000 for a single individual)—as well as additional tax increases on high-income Americans.¹⁰¹ By contrast, Republicans called for extension of all of the tax cuts (except for later expansions in the CTC and the EITC that were proposed by President Obama and enacted in 2009).¹⁰²

The January 2013 tax deal represented something of a compromise. Democrats and Republicans agreed to make permanent most of the 2001 and 2003 tax cuts, but to allow rates to rise for families making over \$450,000 in taxable income (or \$400,000 for single individuals)

⁹⁷ Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296.

⁹⁸ See, e.g., Isaac Shapiro & Joel Friedman, *Ctr. on Budget & Pol'y Priorities, Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts 17-30* (2004), www.cbpp.org/files/4-23-04tax.pdf (criticizing the 2001 and 2003 tax cuts as disproportionately benefiting high-income Americans).

⁹⁹ See, e.g., Brian M. Riedl, *Heritage Found., Ten Myths About the Bush Tax Cuts 11-12* (2007) www.heritage.org/research/reports/2007/01/ten-myths-about-the-bush-tax-cuts (arguing that “[t]he rich are now shouldering even more of the income tax burden.”). For an analysis of the various conflicting measures of tax progressivity (and why each may or may not be meaningful), see generally David Kamin, *What Is a Progressive Tax Change?: Unmasking Hidden Values in Distributional Debates*, 83 *N.Y.U. L. Rev.* 241 (2008).

¹⁰⁰ See, e.g., Chye-Ching Huang & Nathaniel Frentz, *Ctr. on Budget & Pol'y Priorities, Bush Tax Cuts Have Provided Extremely Large Benefits to Wealthiest Americans over Last Nine Years* (2012), <http://www.cbpp.org/files/7-30-12tax.pdf> (describing how the 2001 and 2003 tax cuts disproportionately benefited the highest income Americans); Michael Linden, *Ctr. for Am. Progress, The Federal Tax Code and Income Inequality: How Federal Tax Policy Changes Have Affected and Will Affect Income Inequality* (2012), http://www.americanprogress.org/wp-content/uploads/issues/2012/04/pdf/tax_code_inequality.pdf (noting the effects of changes in tax policy in recent decades and proposals for reform on overall income inequality).

¹⁰¹ See Office of Mgmt. & Budget, *Exec. Office of the President, Fiscal Year 2013 Budget of the U.S. Government 217-225, tbl.S-9* (2012) (listing the Administration's proposed revenue measures).

¹⁰² See, e.g., *Job Protection and Recession Prevention Act of 2012, H.R. 8, 112th Cong. §2* (as passed by the House, Aug. 1, 2012) (continuing all of the 2001 and 2003 tax cuts for another year, but not the refundable tax credits expanded in President Obama's stimulus package).

and to allow some tax increases (such as a limitation on itemized deductions) to extend down to the threshold of adjusted gross income of \$300,000 for a family (and \$250,000 for a single individual).¹⁰³ They also continued the later expansions of CTC and EITC that the Republicans had opposed, but only for a period of five years.¹⁰⁴ To be clear, the tax debate still continues—the Administration is seeking further tax increases on high-income Americans,¹⁰⁵ while Republicans are calling for rate-reducing tax reform.¹⁰⁶ But, the January 2013 deal still represents a major move.

So, how did this move affect overall inequality? Based on Urban-Brookings Tax Policy Center (TPC) data, the answer is not by much.¹⁰⁷

¹⁰³ See Staff of Joint Comm. on Tax'n, 112th Cong., Gen. Explanation of Tax Legislation Enacted in the 112th Cong. 88 tbl.3, 90 (Comm. Print 2013).

¹⁰⁴ For an explanation of the provisions in the January deal, see *id.* at 86-228.

¹⁰⁵ See Office of Mgmt. & Budget, Exec. Office of the President, Fiscal Year 2014 Budget of the U.S. Government, 201 tbl.S-9 (2013) (proposing nearly \$600 billion in additional high-income tax increases as part of a budget deal).

¹⁰⁶ See Comm. on the Budget, House of Representatives, *The Path to Prosperity: A Responsible, Balanced Budget*, Fiscal Year 2014 Budget Resolution, 23-24 (2013) (setting a goal of fundamental tax reform that reduces the top individual income tax rate of 25%).

¹⁰⁷ Author's calculations, similar to those described in note 72. Unlike the previous calculations, these use TPC data on the income distribution and the effects of the tax system under different scenarios, rather than data from CBO. (CBO's data are purely historical; TPC, by contrast, estimates the distributional effects of various tax changes.) TPC calculated the effects of the 2013 deal relative to various baselines, including 2012 tax law and current law and also separately estimated the effects of continuing the 2009 expansions of the CTC and EITC. For data used by the author, see Urban-Brookings Tax Pol'y Ctr., TPC Estimates from 2012, T12-0429, T12-0425, T12-0248, T12-0246, www.taxpolicycenter.org/numbers/recentestimates.cfm?year=2012.

These TPC tables split tax units among quintiles for the bottom 80% of the population and finer groups at the top: 80th–90th percentiles, 90th–95th percentiles, 95th–99th percentiles, 99th–99.9th percentiles, and the top 0.1%. *Id.* I then use the World Bank's POVCAL program to estimate the Gini coefficient from this grouped data. For more details, see note 72.

FIGURE 5
EFFECT OF FEDERAL TAX SYSTEM UNDER DIFFERENT PLANS

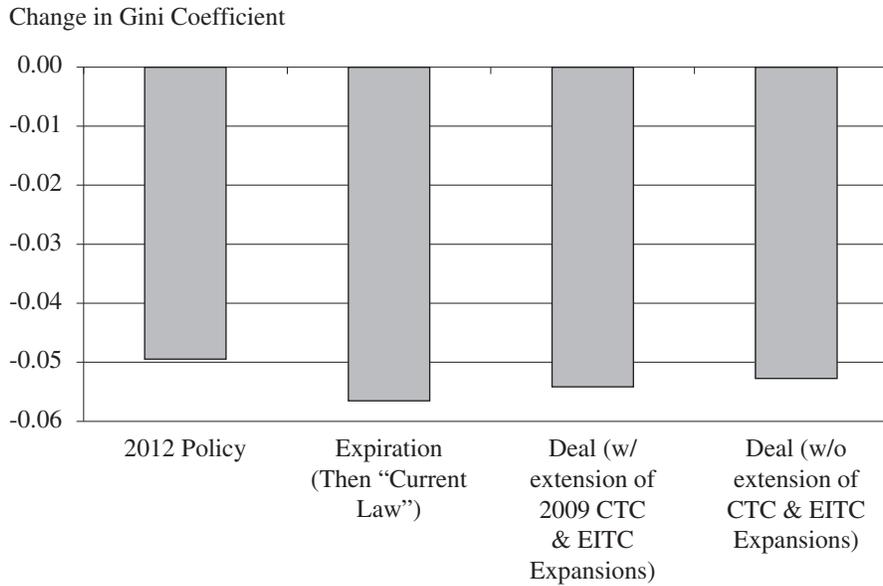


Figure 5 illustrates this comparing the following: (1) 2012 tax policy. This features the 2001 and 2003 tax cuts fully in effect, as well as the payroll tax cut in place then. (2) Current law before the deal. This includes full expiration of the 2001 and 2003 tax cuts and payroll tax cut as was scheduled to occur, as well as the start of health reform's high-income surtax. (3) The deal that was struck, with expiration of the high-income tax cuts and the payroll tax cut, as well as imposition of the high-income surtax (but continuation of the 2009 expansions in the CTC and EITC). (4) The deal that was struck with expiration of the 2009 expansions in the CTC and EITC (scheduled to occur after five years under the deal).

In terms of the effect on the Gini coefficient, the variation between these outcomes is less than 0.01.¹⁰⁸ Or, put differently, the federal tax system in 2012 reduced the Gini coefficient by about 0.05 based on TPC data. If the tax cuts had entirely expired, that effect would have approached about 0.06. The actual deal is then (and perhaps not surprisingly) between these two points. To put this in yet other terms, the top quintile would have earned 47.4% of income based on 2012 law; if the tax cuts had entirely expired, they would have earned 46.7% of income; and, under the actual deal, they will earn around 47% of income.¹⁰⁹

¹⁰⁸ Id.

¹⁰⁹ Id.

There are several take-aways. First, the 2013 tax deal kept the tax system in the same range in terms of its effect on income inequality as seen over recent decades. Second, even at the extremes, these are relatively small changes relative to overall inequality. The less than 0.01 difference in the Gini coefficient between the most extreme outcomes in this debate is equal to less than 2% of overall inequality—and is significantly smaller than the change in inequality over the last thirty years. In short, the 2013 tax deal reinforces the idea that even hotly debated progressive tax changes are unlikely to significantly affect overall income inequality. As explored in the next Part, this is in contrast to the effect on poverty.

E. What Could This Be Missing?

The preceding description—that changes in the tax system have had relatively little effect on overall inequality—stands in contrast to an influential literature, led by the eminent economists Thomas Piketty and Emmanuel Saez, suggesting that the Code is of much greater import when it comes to changes in inequality.¹¹⁰

In part, this results from differences between Piketty and Saez and CBO in analyzing historical U.S. tax data and the direct effects of the Code. To take comparable time periods: In one of their papers, Piketty and Saez conclude that from 1979 to 2004, the top 1% saw its federal effective tax rate fall by 15 percentage points, whereas the average drop for the population as a whole was only about 3 percentage points.¹¹¹ By contrast, CBO finds that the top 1% saw its effective federal tax rate drop by 5 percentage points over this same period, in contrast to a drop of about 2.5 percentage points for the total population.¹¹² (Notably, according to the CBO figures, the middle quintile saw its effective rate drop by slightly more than the top 1% over the

¹¹⁰ See, e.g., Thomas Piketty & Emmanuel Saez, *How Progressive Is the U.S. Federal Tax System? A Historical and International Perspective*, *J. Econ. Perspectives*, Winter 2007, at 3, 11-16, (describing trends in the progressivity of the U.S. tax system and its effect on the income distribution); Thomas Piketty, Emmanuel Saez & Stefanie Stantcheva, *Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities 1-5* (Nat'l Bureau of Econ. Research, Working Paper No. 17616, 2011), available at www.nber.org/papers/W17616 (among other things, theorizing how increases in the top tax rate can reduce incentives of high-income taxpayers to bargain for rents); see also David Grusky & Emmanuel Saez, *Taxing Away Inequality: A Conversation with Emmanuel Saez*, *Boston Rev.*, Feb. 28, 2013, available at http://www.bostonreview.net/BR38.1/emmanuel_saez_david_grusky_income_inequality_taxes_rent Seeking.php (detailing Saez's view that the tax system can and should be used to ameliorate inequality).

¹¹¹ Piketty & Saez, note 110, at tbl.A3.

¹¹² CBO, note 8, Supplemental Data Spreadsheet tbl.1.

same period¹¹³—consistent with the result that changes in the tax system did not have much effect on inequality over the period.)

The reasons for the large difference in these figures are not entirely clear but appears to come down to methodology. In some part, it is a question of coverage. Piketty and Saez include the effects of the estate and gift tax. CBO does not.¹¹⁴ The estate and gift tax, however, has comprised only about 1% to 2% of federal receipts over the last several decades (and somewhat less than this going forward),¹¹⁵ limiting the total impact of changes in this tax. Piketty and Saez find that the estate tax is responsible for 3 percentage points of the drop in the effective rate from 1979–2004 for the top 1%.¹¹⁶ Thus, the majority of the difference between Piketty and Saez and CBO results from inconsistent approaches to distributing the same taxes. Piketty and Saez find much larger drops in effective personal and corporate income taxes rates than does CBO for the top 1%, and for reasons that are not clearly evident.¹¹⁷

This suggests a certain amount of uncertainty in what changes in the tax system over the last several decades have actually done to the income distribution. On the one hand, the data from Piketty and Saez include the estate tax—an advantage over CBO; on the other hand, the CBO effective tax rate data are regularly updated, intended to be relatively comprehensive, and have certain advantages to the data from Piketty and Saez—such as including types of income not reported on tax returns and adjustments for the size and composition of households.¹¹⁸ This Article cannot resolve the methodological differences. The point is that the description of the historical effects of the tax system is, to some degree, a function of source, and another reputable one comes to somewhat different conclusions than the CBO data emphasized here—and for reasons that are not entirely clear.

Beyond the direct effects of the Code, there is also a question whether the tax system has indirect effects on inequality by changing behavior. Piketty and Saez have expanded the literature on such effects—beyond the traditional effect of people working less in response to higher tax rates—by describing how increasing the top tax rate might reduce the incentive for those toward the top of the income

¹¹³ Piketty & Saez, note 110, at 8.

¹¹⁴ Cong. Budget Office, *Trends in the Distribution of Household Income Between 1979 and 2007*, at 29 n.38 (2011).

¹¹⁵ FY 2013 Historical Tables, note 83, at 34-35 tbl.2.3, 45-46 tbl.2.5.

¹¹⁶ Piketty & Saez, note 110, at tbl.A3.

¹¹⁷ Compare Piketty & Saez, note 110, at tbl.A3, with CBO, note 8, Supplemental Data Spreadsheet tbl.1.

¹¹⁸ See Chad Stone, Danilo Trisi & Arloc Sherman, *Ctr. on Budget & Pol'y Priorities, A Guide to Statistics on Historical Trends in Income Inequality 8* (2012), www.cbpp.org/cms/?fa=view&id=3629 (comparing CBO and Piketty-Saez as sources for data on inequality).

distribution to bargain for “rents.”¹¹⁹ (Rents are profits above and beyond what they would actually demand for their services and with each dollar gained being a lump sum transfer from others). This, to some degree, comes back to the question of static versus dynamic estimates of inequality. As discussed previously, whether static or dynamic estimates are superior is unclear in measuring the effects on inequality—and at least, in some circumstances, static estimates may actually be better.¹²⁰ But, to the extent one believes that dynamic estimates are of importance in assessing inequality, that is a key limitation of this analysis—and the types of possible effects identified by Piketty and Saez highlight this further.¹²¹

¹¹⁹ See Piketty et al., note 110, at 36 (“[I]t is difficult to obtain compelling direct evidence that the surge in top incomes did come at the expense of lower earners. The US evidence over a century is consistent with this scenario. International evidence since 1960 is also consistent with this scenario. Our CEO pay evidence is also suggestive of bargaining effects.”). But see Steven N. Kaplan & Joshua Raugh, *It’s the Market: The Broad-Based Rise in the Return to Top Talent* (unpublished manuscript), available at <http://faculty.chicagobooth.edu/steven.kaplan/research/krtop.pdf> (“A related theory of extraction argues that high earners have a greater incentive to extract from lower earners when marginal tax rates are low, because they get to keep a larger share of the returns from this bargaining activity. . . . Our evidence that the wealthiest individuals in the U.S. are increasingly populated by technology entrepreneurs is not directly consistent with this, as the fortunes of the developers of new technologies are arguably quite insensitive to the strength of their bargaining against lower wage workers.”).

¹²⁰ The basic intuition is that, in working less or bargaining for fewer rents in response to higher tax rates, people also make gains that would not be captured in dynamic distributional figures—namely, they have more leisure and can expend less effort in pursuing rents. For further discussion of static versus dynamic estimates, see note 76 and accompanying text.

¹²¹ However, a new study—which does incorporate behavioral effects—also suggests that the substantial majority of the increase in inequality seen over the last thirty years is not attributable to the tax system. The study takes an alternative approach by trying to isolate the effects of changes in tax policy by holding the pretax income distribution constant and then calculating the effect of changes in federal and state income and payroll taxes. This approach may or may not be better than simply looking at the actual effect of the tax system in a given year, and, in itself, this methodology increases the role of the tax system relative to changes in pretax income. But, putting that to the side, the study concludes that—not taking behavior into account—changes in income and payroll tax policies account for roughly 10% to 20% of the change in income shares for most income classes from 1979 to 2007. Under their maximal behavior response scenario, that range increases to 20% to 30%. So even using their maximal dynamic analysis, the substantial majority of the change in income shares over this three-decade period is not attributable to the income and payroll tax systems, though it is certainly more than in the absence of behavioral changes. Olivier Bargain, Mathias Dolls, Herwig Immervoll, Dirk Neumann, Andreas Peichl, Nico Pestel & Sebastian Siegloch, *Partisan Tax Policy and Income Inequality in the U.S., 1979-2007*, at 18 tbl.1 (Inst. for the Study of Labor, Discussion Paper No. 7190, 2013), available at <http://ftp.iza.org/dp7190.pdf>.

IV. POVERTY: TAX SYSTEM'S SUBSTANTIAL EFFECT

A. *The Stubborn "Official" Poverty Rate*

In 2011, the official poverty rate in the United States stood at 15%, with more than 46 million Americans living in poverty, the last year for which data were available when most of the numbers in this article were finalized.¹²² (For children—a group that tends to be of particular concern to those worried about poverty—that rate stood at about 22%.¹²³) Looking at the pattern of poverty rate over time, there are at least two striking patterns: First, the official poverty rate has been stubborn. After falling from a rate in the low twenties in the early 1960's, the poverty rate has varied between about 11% and 15%—with it standing now at the high end of that range.¹²⁴ Second, poverty tends to increase significantly in times of broader economic distress. The jump in the poverty rate in the wake of the Great Recession repeats the pattern seen after other economic slowdowns.¹²⁵

These trends in poverty have elicited significant commentary. The fact that the poverty rate has varied little over a thirty-year period (and now stands at the high end of the range) leads some to declare that the “war on poverty” has failed—and that it is time to move on to other approaches to reducing poverty.¹²⁶ Still others see it as reason for further strengthening the safety net.¹²⁷

This is not the place to delve deeply into the history of poverty and efforts to combat it. Instead, this is to say that poverty remains a sig-

¹²² U.S. Census Bureau, note 37, at 50 tbl.B-1. After most of the numbers in this Article were finalized, the Census Bureau released poverty numbers for 2012. The official poverty rate for 2012 was unchanged from 2011, standing at 15%. Carmen DeNavas-Walt, Bernadette D. Proctor & Jessica C. Smith, U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage in the United States: 2012*, at 52 tbl.B-1 (2013), <http://www.census.gov/prod/2013pubs/p60-245.pdf> (last visited Dec. 31, 2013).

¹²³ *Id.* at 56 tbl.B-2.

¹²⁴ *Id.* at 50-55 tbl.B-1.

¹²⁵ See *id.* at 50-55 tbl.B-1 (showing historical poverty trends); Nat'l Bureau of Econ. Research, *U.S. Business Cycle Expansions and Contractions*, <http://www.nber.org/cycles/cyclesmain.html> (last visited Sept. 1, 2013) (giving dates of peaks and troughs in economic cycle).

¹²⁶ See, e.g., Michael D. Tanner, CATO Inst., *The American Welfare State: How We Spend Nearly \$1 Trillion a Year Fighting Poverty—and Fail* (2012) (“News that the poverty rate has risen to 15.1 percent of Americans, the highest level in nearly a decade, has set off a predictable round of calls for increased government spending. . . . Clearly we are doing something wrong. Throwing money at the problem has neither reduced poverty nor made the poor self-sufficient.”).

¹²⁷ See, e.g., Sheldon Danziger, Koji Chavez & Erin Cumberworth, Russell Sage Found. & Stanford Ctr. on Poverty & Inequality, *Poverty and the Great Recession* (2012), <https://www.stanford.edu/group/recessiontrends-dev/cgi-bin/web/sites/all/themes> (“The last time poverty was as high as it is now was in the early 1980s. . . . It follows that poverty will remain a major social problem of our time unless either (a) economic growth is far stronger and more widely distributed than one would currently expect, or (b) public policies that have been shown to reduce poverty are expanded.”).

nificant problem in the United States and that, according to the official poverty measure, poverty today stands at one of the highest levels seen in recent decades.

And, here, one comes to an important issue of measurement—the official poverty measure does *not* take into account most of the effects of the tax system.¹²⁸ As described below, those effects are significant and have been changing over time. When they are taken into account (that is, accounted for in the poverty measure), the federal tax system—or at least the income and payroll tax systems, which are the parts that most affect low-income Americans—is shown to have gone from adding significantly to poverty to not doing so any more. So, even as the tax system’s effect on overall inequality has been relatively constant, its effect on poverty has differed substantially.

B. Tax System’s Size and Poverty

In the prior Part, I explored the practical limits of the tax system’s effects on income inequality—beginning with two extreme examples (a poll tax and the tax entirely concentrated at the top of the income spectrum) and the size of the tax system held constant. When it comes to poverty, these same examples produce greater effects. That is because the tax system is quite large relative to the incomes of those at the bottom, and so decisions about how to distribute the tax burden can have profound effects on the number of Americans in poverty.

To repeat the numbers cited earlier: The total federal tax system generates revenue equal to about 20% of U.S. GDP, and the income tax system, in particular, raises in the range of 10% of total income.¹²⁹ By contrast, the bottom quintile earns about 5% of total income, according to CBO data.¹³⁰ The intuition is that the decision about how to distribute taxes, given the size of the system, can be much more consequential for the welfare of those at the bottom than it is in terms of *overall* income distribution.

¹²⁸ The poverty measure does implicitly take into account some of the effects of the federal tax system. In particular, it accounts for the effect of the amounts paid by employers in federal payroll taxes. (Half of payroll taxes are paid by the employee and half by the employer.) While the statutory incidence of employer-paid payroll taxes falls on the employer, the actual economic incidence of these taxes is widely thought to fall on the employees, reducing their wages. See, e.g., Cong. Budget Office, note 8, at 23 (“CBO further assumed—as do most economists—that employers pass on their share of payroll taxes to employees by paying lower wages than they would otherwise pay.”). As a result, the effects of the employer-paid payroll taxes are taken into account in the current poverty measures, since this shows up as lower reported wages.

¹²⁹ See notes 62-67 and accompanying text.

¹³⁰ Cong. Budget Office, note 8, Supplemental Data Spreadsheet tbl.3.

I return now to some hypotheticals. Imagine that the tax system raised this same amount of revenue via: (1) a poll tax, requiring each person to pay the same amount of tax; (2) a proportional tax; and (3) a tax entirely concentrated on the highest income Americans. The first and the third are the same two hypotheticals introduced earlier in the context of income inequality. The second is new. It was not used earlier since a proportional tax would not have had any effect on income inequality as traditionally measured, but it does have an effect on poverty.

This calculation layers these tax regimes on top of the current official poverty metric for the year 2011.¹³¹ In particular, it subtracts tax liability from cash income and then compares this adjusted measure of cash income to the official poverty threshold.¹³² An alternative would be to use Census's alternative poverty measure, which already takes into account tax liability and substitute in these hypotheticals.¹³³ Doing that has little change on the broad results—that these create dramatic effects. I choose to use the official poverty measure simply as a matter of consistency with the other calculations in this Article, which

¹³¹ For these calculations, I use the microdata from the Annual Social and Economic Supplement of the Current Population Survey, Mar. 2012, conducted by the U.S. Census Bureau for the Bureau of Labor Statistics. The microdata used for these calculations and all others in this Article based on the Current Population Survey were attained using CPS Utilities distributed by the Unicon Research Corporation.

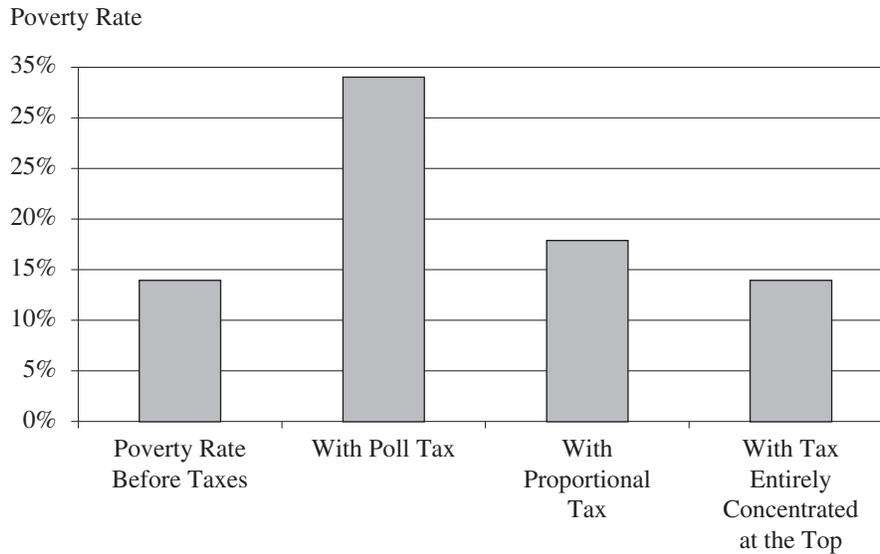
Note that, for the prior set of hypotheticals (on inequality), I employed CBO data from 2009. The CBO data, however, cannot provide information on poverty effects, since they do not release microdata. At the same time, while the CPS does provide information on the income-distribution as a whole, it is widely thought that the information it provides about the top of the spectrum is limited because of a small sample size at the top as well as topcoding of income data. By contrast, the CBO data are based on actual income tax filings. Because of the relative strengths of these two sources of data, I use CBO for the calculations on inequality and the CPS for the calculations with regard to poverty.

¹³² Like with the calculations on the tax system's effect on income inequality, these—and other calculations regarding the tax system's effect on poverty—are “static” estimates in that they assume no change in behavior resulting from these different tax regimes. As with inequality measures, it is not clear in this context which measures are superior. For example, in reaction to a poll tax (and to the extent it was enforced), low income Americans might very well work longer hours. The additional amounts they earn, which would be reflected in dynamic estimates, would offset, to some degree, the monetary loss from the poll tax. Working longer hours, however, would, in itself, leave them worse off (imagine having to take on multiple jobs to pay a poll tax). In that case, a static estimate would seem to better reflect the change in welfare. Static estimates are not always superior, since, as discussed earlier, the case becomes more complicated when changes involve not just “income effects” but also “substitution effects.” But, the point is that these static estimates are not clearly worse than dynamic ones. For further discussion see note 76 and accompanying text.

¹³³ For a description of Census Bureau's Supplemental Poverty Measure, see Kathleen Short, U.S. Census Bureau, *The Research Supplemental Poverty Measure: 2011*, at 1-2, (2012), www.census.gov/prod/2012pubs/p60-244.pdf.

also look back historically at years in which the alternative poverty metric is not yet available.¹³⁴ Figure 6 shows the results.

FIGURE 6
RANGE OF OUTCOMES—HYPOTHETICAL SYSTEMS



To summarize: If the entire federal tax system were a poll tax (the first hypothetical), this would increase the number of those in poverty by roughly 20 percentage points—more than doubling the poverty rate.¹³⁵ Over 40 million Americans would see their family incomes

¹³⁴ The Census Bureau's Supplemental Poverty Measure was first released for 2010 poverty data. *Id.* at 1. Prior to that, the Census Bureau released measures that can be used to build certain "experimental" poverty metrics, though these too are limited in their historical reach. See U.S. Census Bureau, About Experimental Measures, <http://www.census.gov/hhes/povmeas/about/index.html> (last visited Sept. 1, 2013).

¹³⁵ To do this calculation, I start with cash income as used by the Census Bureau in measuring the official poverty statistics. I then add to this the employer's share of payroll tax liability to put these figures on a pretax basis. As explained earlier, the employer's share of payroll taxes—while legally paid by employers—is thought to fall on employees through lower wages. See note 128. I then subtract out the poll tax—a per person tax—and compare the new family income level to the official poverty threshold. For the poll tax, I assume a tax of \$7500 per person. I arrive at this figure based on TPC estimates. I start with TPC's calculation of federal tax liability in 2011—total liability of \$1.9 trillion. See Tax Pol'y Ctr., note 80. Tax liabilities in 2011, however, were unusually low. TPC calculates that this amounts to 18.6% of cash income. TPC estimates that the effective federal tax rate will rise to 22.7% by 2014 (and remain at that level in 2015, after which it would gradually rise). *Id.* So, to reflect a return to high levels of tax, I apply this 22.7% effective tax rate to 2011, arriving at total tax liability of about \$2.3 trillion. I then divide this by the total population in 2011 (of just over 300 million) to arrive at the \$7500 per person poll tax.

entirely eliminated (of course, making it highly questionable whether such a tax could ever be implemented). The effect attributable to the “income tax” portion of this poll tax is, of course, smaller—with it responsible for about one-half the increase in poverty (as it is responsible for about one-half the revenues).

Under the second hypothetical—the entire federal tax system being replaced with a proportional tax (assumed here to be in proportion to adjusted gross income)—the effect on poverty is not as outsized but is still significant. In that case, the federal tax system causes the poverty rate to increase by roughly four percentage points, or a nearly 30% increase in the number of those below the poverty line. And, again, the income tax system would be responsible for about one-half of this.

Finally, under the last hypothetical—the tax burden being entirely borne by those at the top of the income spectrum—there is no effect on poverty because of the tax system. After-tax income for those at the bottom would be the same as before-tax income.

Of course (and as was the case with the effect on inequality), this does not necessarily set the bounds of the tax system when it comes to poverty given its current size. A system could be more regressive than a poll tax (though that certainly would be perverse). More relevant to the world, low-income Americans could face negative tax rates, which would *reduce* poverty rather than simply not increasing it. And, of course, the federal tax system does that now for some families—although note that, as a whole, lower-income Americans face a tax liability close to zero and so the “zero bound” still holds for the average lower-income family.¹³⁶

With these caveats, these hypotheticals still demonstrate that, as the tax system moves from one extreme to another, the effect on poverty is substantial.

C. *A Transformation Over the Last Thirty Years*

What about the effect of the tax system in practice? Over the last thirty years, there has been a remarkable transformation in the system. The federal tax system overall has gone from adding significantly to poverty to no longer doing so. And, the income tax system has been at the core of this transformation.

¹³⁶ See note 80.

FIGURE 7
POVERTY RATE—WITH AND WITHOUT TAXES

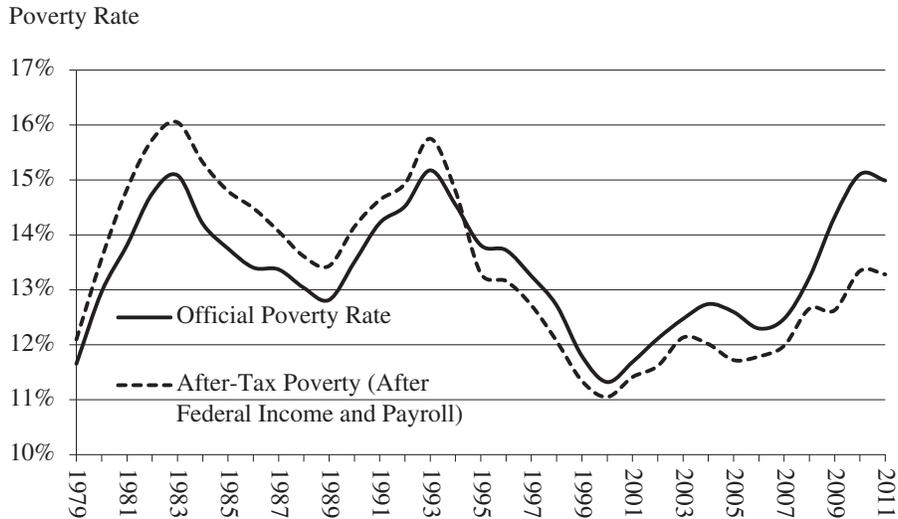


Figure 7 shows the poverty rate from 1979 to 2011, *taking into account* most of the federal tax system based on calculations from the Current Population Survey (CPS).¹³⁷ This includes the effect of federal income taxes and payroll taxes—the two taxes estimated by CPS. Income and payroll taxes represent 80% of total federal revenues.¹³⁸ So, while a fully comprehensive analysis would include the effects of all federal taxes (rather than just income and payroll taxes), doing so is likely to have a relatively small effect on the trend in poverty over time relative to what is shown here.¹³⁹

¹³⁷ These estimates are calculated by the author from microdata from the Annual Social and Economic Supplement of the Current Population Survey, Mar. 1980-2012, conducted by the U.S. Census Bureau for the Bureau of Labor Statistics. See note 131. As part of the data released from this survey, the Census Bureau includes its own estimates of federal income and payroll tax liabilities of those surveyed back to 1979. These estimates of federal tax liabilities are used here to adjust the poverty rate from 1979 through 2011. I take total income tax liabilities plus the employee-side of the payroll tax, subtract this from cash income, and then compare this to the official poverty threshold. (Note that the employer-side of the payroll tax is already implicitly taken into account in CPS income calculations since this is thought to reduce employee wages. See note 128.)

¹³⁸ See FY 2013 Historical Tables, note 83, 30-31 tbl.2.1, 36-44 tbl.2.4 (2012).

¹³⁹ Corporate income taxes are the largest other source of federal revenues, but the vast bulk of these taxes are thought to be paid by upper-income Americans. CBO estimates that, in terms of the economic incidence, the bottom quintile pays less than 2% of corporate income tax liabilities—compared to their pretax income share of 5%. See Cong. Budget Office, note 8, Supplemental Data Spreadsheet tbl.2, tbl.3. After corporate income taxes, excise taxes are the next largest set of federal taxes. Excise taxes, however, represent only about 3% of total federal receipts, FY 2013 Historical Tables, note 83, at 30-31 tbl.2.1, and, as a share of Americans' incomes, have varied relatively little over time. See CBO, note 8, Supplemental Data Spreadsheet tbl.1.

Figure 7 includes two series. One series shows the official poverty rate over this period. (Note that the official poverty rate already implicitly takes into account the employer-side payroll taxes, but not other federal taxes.¹⁴⁰) The second series shows the poverty rate having subtracted out income and payroll taxes (both employee and employer). The main takeaway from Figure 7 is that the federal tax system matters in evaluating the trend in poverty. Whereas the official poverty rate in 2011 was well above the historical level of recent decades, the rate taking into account federal taxes is in fact significantly *below* the average—and that is coming out of the worst recession since the Great Depression. (Figure 7 starts in 1979 since that is the first year for which the CPS includes estimates of federal income and payroll tax liabilities.)

To be clear, in evaluating these figures, what is important is the trend rather than the level. The level of poverty is much more sensitive to how poverty is measured, and, as mentioned, there is significant debate about where to put the threshold and what items of cost and income should be taken into account. However, the trend—and especially the relative effect of the tax system as of thirty years ago versus today—should be less sensitive to these issues of measurement. And, however one measures the income or welfare of those at the bottom of the income distribution, it seems clear that the tax system is doing much more to support their living standards (or less to undermine their living standards) than it was thirty years ago—with a significant effect on their economic well-being.¹⁴¹

¹⁴⁰ See note 128.

¹⁴¹ Even with the effect of federal taxes included, the poverty measure remains incomplete. Perhaps most importantly, it does not take into account noncash (but cash-like) transfer payments from the federal government like food stamps and housing assistance. Also including these in the poverty calculation has a much smaller effect on the trend in poverty over time than the inclusion of the tax system; in other words, with these noncash transfers taken into account, the trend in poverty (even if not the level) looks very similar to that shown here. See Arloc Sherman, A Timely Reminder: Improvements in the Safety Net Have Dampened the Rise in Poverty, Ctr. on Budget & Pol'y Priorities, Off the Charts (Sept. 11, 2012, 3:24 PM), <http://www.offthechartsblog.org/a-timely-reminder-improvements-in-the-safety-net-have-dampened-the-rise-in-poverty/> (showing a historical trend in poverty similar to that shown in Figure 7, and taking into account food stamps and housing assistance in addition to federal taxes).

FIGURE 8
EFFECT OF THE FEDERAL TAX SYSTEM ON
THE POVERTY RATE

Change in Poverty Rate

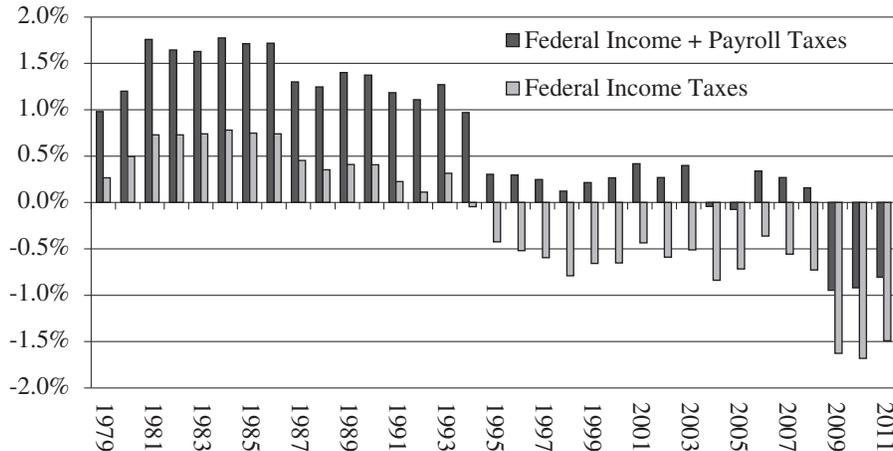


Figure 8 illustrates this in another way. It shows the effect of the federal tax system—in particular, the income taxes and payroll taxes (both the employee and employer sides)—and the income tax system separately on the poverty rate from 1979 through 2011. Note that most of the changes over time reflect differences in tax policy. Some of the year-to-year differences, however, also reflect changes in the economy—and the interaction between that and the tax system.

As the figure shows, the federal income and payroll tax systems of the 1980's added more than 1.5 percentage points to poverty. In recent years, these systems, by contrast, subtracted just under one percentage point from the poverty rate. To put this in other terms, at one point in the 1980's, the income and payroll tax systems increased the number of those in poverty by as much as 13%, while these same systems as of 2011 reduced it by 6%—or roughly speaking a 20% difference in the number of those in poverty.¹⁴²

It should be noted that this trend becomes even more dramatic if the figures are limited to the nonelderly and, especially, to children. In the case of children, the tax system has gone from increasing child poverty by roughly 15% in the 1980's (similar to the adult population) to cutting the child poverty rate by 15% as of 2010—a swing of 30%.¹⁴³

¹⁴² Author's calculations. See note 137.

¹⁴³ Id.

The dramatic shift in the effect of the tax system from the mid-1980's to 2011 can largely be traced to two policies—the expansion in the EITC and creation of the CTC over this period. To roughly calculate the amount attributable to each, I apply the tax law from these earlier years to incomes of low-income Americans as of 2011.¹⁴⁴ This calculation is meant to isolate the effects of changes in the tax law on poverty, as opposed to the interaction between those changes and other economic and social factors. This then allows me to roughly decompose what tax policy changes have driven the transformation of the tax system for low-income Americans over time. In other words, this plays a “what if” game: “What if” the tax law from 1979 were in place in 2011 and so on?¹⁴⁵

The expansion of the EITC is responsible for about 60% of the shift from the mid-1980's to 2011.¹⁴⁶ The history of the EITC has been described in great detail elsewhere. Suffice it to say that, by the 1980's, something approaching a bipartisan consensus had developed to deliver support to working poor families through the Code. This prompted major expansions of the EITC in the 1986 tax reform, the deficit reduction deals of the 1990's, the tax cut in 2001, and, finally, the 2009 Recovery Act.¹⁴⁷

¹⁴⁴ To do this, I use the microdata from the 2012 CPS March Supplement, adjust income items for inflation, and apply the National Bureau of Economic Research's TAXSIM 9.0 model to calculate the tax liability under prior law. For a description of the NBER model, see generally Daniel Feenberg & Elisabeth Coutts, *An Introduction to the TAXSIM Model*, 12 *J. Pol'y Analysis & Mgmt.* 189 (1993). Further information on the model can be found at <http://www.nber.org/taxsim/>.

¹⁴⁵ Others have used this type of “what if” analysis to decompose the effects of changes in tax policy versus other factors on income inequality broadly. See generally Olivier Bargain, Mathias Dolls, Herwig Immervoll, Dirk Neumann, Andreas Peichl, Nico Pestel & Sabastian Siegloch, *Tax Policy and Income Inequality in the U.S., 1978-2009: A Decomposition Approach 1-2* (Inst. for the Study of Labor, Discussion Paper No. 5910, 2011) available at <http://ftp.iza.org/dp5910.pdf> (using counterfactual simulations to analyze how changes in tax law versus other economic factors have affected income inequality). See also the discussion in note 121. The “what if” game has the benefit of isolating the effects of changes in the tax law; with that said, it is also somewhat artificial—and does not take into account interactions between changes in the tax law and changes in the economy and society. The tax law of thirty years ago was in place then; it requires some imagination to ask what it means for that law to be in place today. Among other things, it requires adjusting 2011 income levels to make them comparable to the tax parameters of earlier years. There is some question what the appropriate adjustment factor should be. For the purposes of this calculation, I use inflation. See *id.* at 7 (justifying inflation as an adjustment for purposes of such calculations as consistent with general practice).

¹⁴⁶ Author's calculations based on the CPS March Supplement and NBER's TAXSIM 9.0. See notes 144-45.

¹⁴⁷ For historical EITC parameters, see Urban-Brookings Tax Pol'y Ctr., *Historical EITC Parameters*, <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=36> (last visited Nov. 3, 2013).

The creation of the CTC is responsible for about 30% of the shift in the tax system's effect on poverty between the mid-1980's and 2011.¹⁴⁸ This is now a \$1000 credit per child. It was created in 1997 as a \$500 credit that was largely non-refundable—focusing its benefit almost entirely on middle-income families. The credit was doubled and made partially refundable in 2001, and later legislation, including the 2009 Act, further expanded refundability.¹⁴⁹

D. 2013 Tax Deal

Looking back over the last thirty years, changes in the tax system have translated into relatively significant effects on poverty, at the same time that they have generated relatively small effects on overall income inequality. The same holds true for the policies at issue in the tax negotiation completed in January 2013.

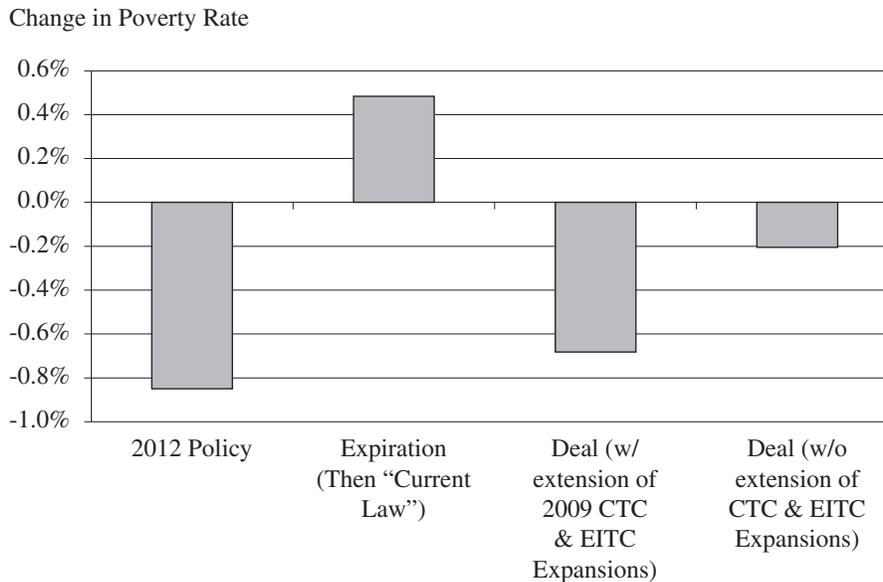
Figure 9 illustrates the effects of various possible policy outcomes on poverty—the same outcomes that were explored with regard to income inequality. To review, this compares: (1) 2012 tax policy; (2) current law for 2013 before the deal, with full expiration of all temporary tax cuts; (3) the deal that was struck, with expiration of the high-income tax cuts and the payroll tax cut (but continuation of the 2009 expansions in the CTC and EITC); (4) same as (3) but with expiration of the 2009 expansions in the CTC and EITC (now scheduled to occur in five years).¹⁵⁰

¹⁴⁸ Author's calculations based on the CPS March Supplement and NBER's TAXSIM 9.0. See notes 144-45.

¹⁴⁹ For historical CTC parameters, see Urban-Brookings Tax Pol'y Ctr., Child-Related Tax Credits: 2000-2013, <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=580> (last visited Nov. 3, 2013).

¹⁵⁰ These changes in poverty under different outcomes for the 2013 tax negotiation are the author's calculations using microdata data from the 2012 CPS March Supplement and running these through different tax scenarios. To calculate the effect of 2012 law and then complete expiration of the then-temporary tax cuts, I use the NBER TAXSIM model. See note 144. For the effect of other changes, I model these using my own program.

FIGURE 9
EFFECT OF FEDERAL TAX SYSTEM UNDER DIFFERENT PLANS



As shown in Figure 9, under these different policies, the combined federal tax system (income and payroll taxes) varies from reducing poverty by 0.8 percentage points (under 2012 law) to increasing poverty by 0.5 percentage points if the temporary tax cuts had been allowed to entirely expire—or a swing of about 10% in the number of Americans in poverty. The deal itself is close to 2012 law, allowing only expiration of the 2 percentage point payroll tax cut, and so, as initially in effect, the income and payroll tax systems would continue to reduce poverty by about 0.7 percentage points. If, however, certain expansions in the CTC and EITC expire as they are scheduled to do after five years, the anti-poverty effect of the system would fall to 0.2 percentage points—or an increase in poverty of nearly 5% relative to 2012 law.¹⁵¹

To put this in perspective and to repeat from before, these same policies have very little effect on overall inequality as measured by the Gini coefficient. For instance, the expiration of the expansions in the CTC and EITC scheduled to occur after five years would barely increase the Gini coefficient. The change in the Gini coefficient resulting from this would be less than 0.002—or an increase of less than 0.4%.¹⁵² This does not seem like a meaningful change in inequality even as it does generate a significant increase in poverty.

¹⁵¹ Id.

¹⁵² See notes 107-08 and accompanying text.

IV. POLICY IMPLICATIONS: A TENTATIVE EXPLORATION

This project so far has largely been descriptive—comparing the effects of the federal tax code on poverty and inequality over time. Based on these observations, this part draws some tentative lessons for policy and analysis. The lessons can briefly be summed up as follows: First, distributional battles over tax changes do matter and are worth engaging. These battles, however, seem unlikely to make much difference in terms of overall inequality but, instead, matter in terms of poverty or other metrics of the welfare of those toward the bottom of the income spectrum—and this is where greater attention should be focused. Second, for those who care about reducing inequality, we should be looking toward other tools in the hopes that they can give greater leverage than the tax system over inequality.

A. Assumption of Limited Policymaking and Analytical Resources

The tentative conclusions reached by this Article make an important assumption: that there are limited policymaking and analytical resources. Otherwise, the descriptive assessment of this Article might have limited (or no) normative impact. Even if the tax system does not do all that much to reduce inequality, one could argue for continuing to pursue ways to reduce inequality through the Code, since doing so would not come at the expense of anything else.

Such resources are limited, however. In other words, there is only so much that policymakers and analysts can pay attention to at any one time when it comes to distributional policy (or any policy for that matter). Because of this, focusing on tax policy's effect on inequality may come at a cost in terms of other policy or analysis forgone, and the cost may not be worth it if the system's practical effect on inequality is, in fact, very limited.

This very conference session exemplifies my point: the effects of the income tax on inequality, which has been the topic of many tax symposia and articles before this. Would policy be better if we—policymakers, analysts, and the public alike—actually focused on the distributional effects that matter most, and not spend time considering the distributional effects that do not matter much at all? That is perhaps a matter of some faith, but I think that it is one as academics that we must all adopt, or else find a better and more fulfilling discipline.

B. Lessons for Policy

In part, this Article seeks to motivate distributional analysis, in light of the fact that the tax system does not have much effect on inequality. Looking at the inequality figures alone—and given limited poli-

cymaking and analytical resources—might lead to the conclusion that we should not be all that concerned about the distribution of tax policy. The top tax rate might rise or fall, but, so long as the tax system remains within the broad parameters of the last several decades, these changes would appear to have a relatively small effect on inequality. Unto itself, this might lead to a certain amount of fatalism when it comes to the tax system and distribution, suggesting that we should spend policymaking and analytical resources on other topics.

This fatalism presumes that small changes in inequality—even relative to historical trends—are not all that consequential. In other words, one way to still motivate a concern for tax distribution is to say that even small changes in measures like the Gini coefficient are very important. My tentative intuition is that is not likely to be true. It seems unlikely to me that small changes in inequality—changes that are small relative to broader economic trends—are likely to have a large effect on the quality of our democracy, economic growth, overall fairness, or whatever else might be motivating the concern with inequality. In short, small changes seem insufficient to motivate a deep concern for the distribution of tax changes.

So, this Article offers an alternative reason to care about these tax distributional fights, that of poverty. For even as changes in the tax system have had little effect on the overall income distribution, they do, as this analysis has shown, have much larger effects on poverty. For welfarists, this could be restated by saying that, even as plausible choices about the tax system have relatively small effects on the overall distribution of resources, they can have significant effects on the welfare of Americans. Whether measured in terms of poverty or some other metric of welfare, changes in the tax system—within the broad parameters that has defined the tax debate over the last several decades—do make a substantial difference.

The next question is whether this difference in motivation when it comes to tax debates—being motivated by not so much the effect on overall inequality but rather poverty—changes the policy decisions we might make, or try to pursue. In other words, this so far has suggested why we should care about tax distribution but not whether any policy decisions would differ relative to being primarily motivated by tax system's effect on inequality.

The answer—I think—is “perhaps” it makes a difference. Take the issue of number of tax brackets—and where the top tax bracket starts. To reduce economic inequality and, especially, to address the growth of incomes at the very top of the income distribution, one would probably want to design a tax system with greater graduation at the top, and where the top tax rate starts at a relatively high threshold. If,

however, one believes that, at the end of the day, changes in the tax system are unlikely to make substantial changes in overall inequality but could make a significant difference in the lives of lower-income and middle-income Americans, one might be more concerned with the tax rates faced by those toward the bottom and middle of the income distribution rather than the graduation of the rates at the very top. Of course, the policies themselves are not mutually exclusive. It is possible to build a tax system with graduated rates at the very top and low rates for low- and middle-class Americans. My argument here is premised on there being trade-offs; devoting political capital to one of these goals could limit the ability to achieve the other—especially in tax negotiations (such as over fundamental reform) where both issues could very well be on the table.

Finally, to the extent one cares about reducing inequality, this Article's description of the tax system's practical limitations suggests that one should look to tools beyond the tax system. This includes tools like financial regulation (to reduce "rents" earned in the financial industry) and education (to increase the number of skilled workers). The point here is not to explore exactly what other tools are available, and so this conclusion is especially tentative because it is unclear the degree to which these other instruments for addressing inequality would be more effective than the tax system, even with its limited effectiveness. Still, given the limited effect of the tax system over recent decades, it certainly seems worthwhile to explore; otherwise, the alternative is for there to potentially be few (if any) good levers for addressing the growth of inequality—at least within parameters that our political system seems likely to accept.

V. CONCLUSION

This Article presents a set of observations about what the tax changes can practically accomplish in terms of reducing inequality (not much) and poverty (much more). From this set of observations, it draws some tentative lessons for analysts and policymakers. The Article is not meant to deny the possibility that changes in the tax system, as a theoretical matter, could significantly reduce overall inequality. The tax system could become much larger than it is now as a share of incomes (making distributional decisions more consequential), or changes could go well beyond the boundaries of tax reforms of the last several decades. What has occurred in the past is not necessarily entirely predictive of what will occur in the future.

Still, the past is at least indicative, and this Article is meant to instill a sense of practicality into the debate about the distribution of the tax burden—and, at least, to suggest what is possible absent radical

change the likes of which we have not seen in our recent history. It concludes that, within these bounds of recent tax changes, debates over the distribution of the tax burden still matter, but not so much because of the effect on overall inequality, which is small, but instead because of the effect on the welfare of those toward the bottom of the income distribution, as measured by a metric like poverty.

Of course, concerns for inequality and poverty are not necessarily mutually exclusive. The problem is that we live in a world of limited policymaking resources, where you have to choose what is most important and what is not. In doing so, it is not only the theory that matters; it is also what is achievable in practice. And, it is these practical concerns that this Article has brought to the fore, in concluding that, in tax distributional debates, we should primarily be motivated by issues like poverty, not overall inequality.