How Progressives Drive Income Inequality

The Obama years proved that transfer payments reduce incentives to work and lower incomes. Yet Clinton and Sanders are eager to go the same route.

By
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Hillary Clinton and Bernie Sanders are promising all types of programs to make America a more equal country. That's no surprise. But when you look at performance and not rhetoric, the administrations of political progressives have made the distribution of income more unequal than their adversaries, who supposedly favor the wealthy.

The Census Bureau releases annual updates on income distribution in the U.S., publishing three technical statistical measures—the Gini index, the mean logarithmic deviation of income (mean log deviation for short), and the Theil index—each of which represents inequality levels on a scale of 0 to 1 (zero signifies perfect equality and 1 indicates perfect inequality). By all three measures, inequality rose more under Bill Clinton than under Ronald Reagan. And it wasn't even close. While the inequality increase as measured by the Gini index was only slightly more during Clinton's two terms, the Theil index and mean log deviation increased two and three times as much, respectively.

Barack Obama's administration follows this pattern, despite the complaints he and his supporters have made about his predecessor. The mean log deviation increased 37% more under Mr. Obama than under President George W. Bush, although when this statistic was released, Mr. Obama had only six years as president compared with Mr. Bush's eight. The Gini index rose more than three times as much under Mr. Obama than under Mr. Bush. The Theil index increased sharply during the Obama administration, while it fell slightly under Bush 43.

Sure, no president intends to raise inequality. And the spin doctors for Messrs. Clinton and Obama may insist that it wasn't their fault.

But consider their policies. Both Democratic presidents presided over bubble economies fueled by easy monetary policy. There is no better way to make the rich richer than to run policies that push up the price of financial assets. Cheap money is a boon to those who have access to it. Interest rates were also too low under Bush 43, but that bubble was in housing, and the effects were therefore more evenly distributed than under Mr. Clinton's stock-market bubble or Mr. Obama's credit bubble.

Money matters, but so do other policies, such as the long, historic sweep of the expanding welfare state. In 1968, government transfer payments totaled $53 billion or roughly 7% of personal income. By 2014, these had climbed to $2.5 trillion—about 17% of personal income. Despite the redistribution of a sixth of all income, inequality measured by all three of the Census Bureau's indexes is far higher today than in 1968.

Transfer payments under Mr. Obama increased by $560 billion. By contrast private-sector wages and salaries grew by $1.1 trillion. So for every $2 in extra wages, about $1 was paid out in extra transfer payments—lowering the relative reward to work. Forty-five million people received food stamps in mid-2015, an increase of 46% since the end of 2008. Similarly, 71.6 million individuals were enrolled in Medicaid and the Children's Health Insurance Program, an increase of 13.3 million since October 2013.

In 2008, during the deepest recession in 75 years, 13.2% of Americans lived below the government's official poverty line. The Great Recession officially ended in June 2009, but in 2014, after five years of economic expansion, 14.8% of Americans were still in poverty. The economy was better, and there were a lot more handouts, but still poverty rose.

The structure of American households shows how this happened. From 2008 through 2014, the most recent year for which we have data, the number of two-earner households declined. These two-earner households have become the backbone of the American middle class.

Research by the Hamilton Project and the Urban Institute show that when families with children making between $20,000 and $50,000 attempt to have a second earner go back to work, the effective tax rate on the extra earnings—including lost government benefits such as food stamps, the earned-income tax credit, and medical support payments—is between 50% and 80%. This phaseout of the ever increasing array of benefits has created a "working-class trap" instead of a "poverty trap" that is increasing inequality and keeping the income of these households lower than they might otherwise be.

While the number of two-earner households declined during the first six years of the Obama presidency, the number of single-earner households rose by 2.6 million and the number of households with no earners rose by almost five million. In other words, two thirds of the increase in the number of families under Mr. Obama was accounted for by households with no one working. This is the reason the middle class has shrunk, and the reason inequality has increased. And unless we increase the number of people wanting to work and the number of jobs through economic growth, inequality will only increase.

The flip side of the progressive agenda to redistribute income to those with less is to raise taxes on the "rich." The data show that it is also an ineffective way to reduce inequality.

President Clinton increased the top tax rate on higher earners—yet inequality rose during his administration, and faster than under the tax-cutting Ronald Reagan. The same happened under President Obama. Tax rates went up on upper-income earners. Inequality rose too, and more than under his tax-cutting predecessor.

A recent Brookings Institution study—whose authors include Peter Orszag, President Obama's director of the Office of Management and Budget—found that boosting the top tax rates even more, as Sen. Sanders suggests, would have little or no effect on inequality. The paper explored the effects of raising the highest marginal income-tax rate to 50% from 39.6%. Assuming no behavioral effects, the expected revenue was then distributed directly (and in theory costlessly) to the bottom 20% of income earners.

The $95 billion in extra taxes and transfers reduced the Gini Coefficient by only 0.003. To put that in perspective, that reversed only one fifth of the increase in inequality during the Obama presidency.

There was a catch. When the authors assumed that there might be a behavioral response by higher income taxpayers, inequality fell—but for the wrong reasons. Less work, saving, investing and more tax sheltering reduced the taxable income of higher earners and therefore meant less revenue to redistribute. So the rich got poorer, by their own choice, but the poor got less in benefits. A true lose-lose situation.

None of this should really be surprising. If the socialist ideal of "from each according to his ability, to each according to his need" worked in practice, the Berlin Wall might still be standing. Of course, one of the reasons it came down is that a new ruling class emerged to take from the productive and give to those in need, siphoning off a cut of the swag along the way. Ruling classes always have sticky fingers.

Redistribution through the political process is not costless—even in a perfect world there would be a large bureaucracy to feed. Special-interest elites also emerge when so much money is being moved around. They take their cut, introducing even more inefficiency into the system.

Presidential contenders who boast of their plans to reduce inequality might ponder the fact that providing more free things is not the answer. Even free college and free health care are paid with taxes that discourage people from increasing their work, savings and entrepreneurship.

Attacking the rich and running against inequality may be a sensible political strategy. But in the end the programs to implement this strategy make the problem worse. Yet advocates come back and demand the same programs. That is perilously close to the definition of insanity attributed to Einstein: doing the same thing over and over again and expecting different results.

The repeated failure of political promises has another downside—increasing voter alienation and cynicism. The appeal of redistribution is understandable, but voters who think the progressives running today are going to reduce inequality are falling into the same trap as people entering fifth or sixth marriages—the triumph of hope over experience.

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