



Statement Prepared for the Joint Economic Committee Hearing on

Income Inequality in the United States

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

I. Introduction

Simply defined, income inequality is the gap between the incomes or earnings of individuals at different levels of the income distribution. A typical way to measure income inequality is to first define how we measure income for a particular household, and then divide households into equal sized groups to compare households at the top of the distribution with households at the bottom or middle of the distribution. Several reports and papers in recent times have argued that there has been an increase in income inequality over the last two to three decades, while others counter that inequality is in fact narrowing by some measures. What is often lost in this back and forth is the focus on the poor, because a change in the income distribution across all households says little about how people are faring in absolute terms at the bottom of the distribution.

The first point made by this testimony is that the issue of income inequality is often complicated by the fact that different studies often provide vastly differing results on the magnitude of the problem since income is not consistently measured across these studies. Second, the testimony questions whether income is in fact the best way to measure increases in inequality. Most economists would agree that consumption is a better measure than income of household welfare since individuals are better able to smooth consumption over their lifetimes than incomes. This happens because while incomes may be low in the extremes of the age distribution and high in the prime working years, individuals can smooth consumption by borrowing in the low-income years and saving in the high-income years. In addition, many redistributive policies support consumption for low-income households and provide transfer payments to them. As a result, consumption is both a better predictor of lifetime or permanent incomes *and* reflects the impact of government transfer programs on household welfare.

While one can argue endlessly about the exact magnitude of the problem, the real issue is not whether the top of the income distribution has incomes that are ten times higher than the bottom, but whether low and middle income people in America are enjoying a decent standard of living. The unfortunate reality is that millions of people in America are living in poverty and facing the very harsh consequences of the worst recession in recent history. As per the latest report from the Census Bureau, 15 to 16 percent of the population can be defined as living in poverty in 2012. That translates to more than 47 million people.¹ We are now in the fifth year of an economic

¹ Current Population Reports, "The Research Supplemental Poverty Measure Nov, 2013.
<http://www.census.gov/prod/2013pubs/p60-247.pdf>

recovery that does not seem like a recovery to most people in the labor market. There are 10.4 million unemployed workers, of which 3.9 million have been jobless for longer than 27 weeks.² In addition, there are another 10 million who are either in involuntary part-time jobs, or discouraged workers. Further, youth and teenage unemployment rates are above 16 percent. Therefore, the focus on income inequality is somewhat misplaced. Fundamentally, this is a problem of poverty.

When high rates of poverty exist in an economy with low economic mobility, the problem is exacerbated. The purpose of this testimony is to summarize some ideas that might help policymakers address the current economic crisis facing families and provide them opportunities to be productive participants in the labor market and rebuild their lives. This testimony however argues that while trying to equalize outcomes for families by attempting to equalize incomes may be an impossible goal, equalizing opportunities for individuals by providing access to good schools and good jobs may be more attainable and realistic.

In the next section, I describe the studies and data on income inequality trends. In Section III, I focus on consumption inequality. In section IV, I discuss economic mobility issues. Section V puts forth some policy suggestions and Section VI concludes.

II. Income Inequality Data and Research

In a recent December 2013 report, the Congressional Budget Office divided all U.S. households into five groups of equal size (quintiles), on the basis of their before-tax income.³ The CBO definition of before-tax income is composed of labor income, business income, capital gains, capita income (excluding capital gains), income received in retirement for past services and other sources of income. It also includes government transfers to these households. Government transfers are cash payments and in-kind benefits from social insurance and other government assistance programs. As per this report, in 2010, households in the lowest quintile (bottom 20 percent) received 5.1 percent of all before-tax income, or about \$24,100 per household. Those in the middle fifth received 14.2 percent or \$65,400 per household. Households in the top quintile received 51.9 percent or about \$239,100 per household. In other

² <http://www.bls.gov/news.release/empsit.nr0.htm>

³ Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2010." Dec, 2013. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/44604-AverageTaxRates.pdf>

words, households in the top income quintile received an income share that was ten times that for the lower income quintiles.

The corresponding numbers for after-tax income are 6.2 percent for the bottom quintile, 15.4 percent for the middle quintile and 48.1 percent for the top quintile.

It is important to note that both the tax code and the transfer system work towards increasing the share of income earned by the lower income groups. As per the same CBO report, households in the lowest quintile received 36.2 percent of the total benefits from Social Security and Medicare (averaging \$14,200 per household), households in the middle quintile received 16.7 percent of those benefits and those in the highest quintile received 11.4 percent of the benefits. Other transfers-including unemployment benefits, payments from Supplemental Nutrition Assistance Programs, and benefits from Medicaid and Children's Health Insurance Program-go even more disproportionately to households in the lower portion of the income distribution. Households in the bottom quintile received 47 percent of benefits from other transfers, households in the middle quintile received 13.3 percent of those benefits and those in the highest quintile received 6.2 percent.

The federal tax system is also progressive. Households in the top quintile paid 68.8 percent of all federal taxes, households in the middle quintile paid 9.1 percent and those in the bottom quintile paid 0.4 percent of federal taxes.

When we consider trends from 1979, households in the bottom quintile experienced an increase of 49 percent in real after-tax income between 1979 and 2010. After-tax incomes for the middle three quintiles in 2010 averaged 40 percent higher than in 1979. For the 81st to 99th percentile, the growth was 65 percent and for the top 1 percent, household income grew 201 percent above 1979 levels.

While the CBO data are reliable and unbiased, one question that plagues the research on income inequality is the lack of a common definition of income. A recent co-authored paper by economists Thomas Piketty and Emmanuel Saez (2013) finds trends similar to the CBO.⁴ They claim that the share of income going to the top 1 percent of the population has more than doubled from 9 percent in 1976 to 20 percent in 2011. In other words, the top tail of the distribution now enjoys an ever-larger slice of the pie than it has historically done so. Piketty and Saez (2012,

⁴ Facundo Alvaredo, Anthony B. Atkinson, Thomas Piketty, Emmanuel Saez. "The Top 1 Percent in International and Historical Perspective." NBER Working Paper No. 19075. May, 2013. <http://www.nber.org/papers/w19075>

2013)⁵ use pre-tax pre-transfer income data from the tax records of filers and include realized capital gains. Thus, they fail to account for transfer payments like Social Security, Medicare, food stamps etc. In addition, it is also worth noting that by focusing on reported taxable incomes, their data are biased by the fact that taxable incomes respond to changes in tax rates.

Other economists however counter these results by using a different definition of income. In a 2013 paper, economists Philip Armour, Richard Burkhauser and Jeff Larrimore contend that by some measures, the growth in incomes at the top has been significantly lower than in incomes at the middle and bottom, such that the income share of the top quintile declined between 1989-2007 while the share of the bottom quintiles increased.⁶ These economists argue that the true measure of income should focus on the Haig-Simons definition of income. In other words, we need to include accrued capital gains on which are defined as increases or decreases in the value of capital assets every year, irrespective of whether the capital gains are realized or not. Neither the Piketty and Saez paper, nor the CBO, include accrued capital gains though they do account for realized taxable capital gains.

In a recent paper, economist Greg Mankiw (2013) posits that perhaps inequality is not a problem as long as the compensation of the top 1 percent reflects their contribution to society—the “just deserts” principle.⁷ If returns to high income individuals reflect largely their economic contributions to society, then taxing high incomes in a confiscatory fashion may be equally unjust.

Hence it would appear that after decades of research on income inequality, we are still unsure of the extent of income inequality, and even whether to view it as a problem, due to the lack of a consistent definition of what constitutes income and what that income represents.

I believe that the real focus of inequality research is not so much about whether the rich are doing better than the poor, but about how low income households are faring and have fared over the last few decades. In the next section, I discuss an alternative approach to measuring inequality that focuses on trends in consumption rather than income.

⁵ Emmanuel Saez and Thomas Piketty, “Striking it Richer: The Evolution of Top Incomes in the United States.” 2012 <http://elsa.berkeley.edu/~saez/saez-UStopincomes-2012.pdf>

⁶ 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 Income Approach.” NBER Working Paper No. 19110. June, 2013. <http://www.nber.org/papers/w19110>

⁷ N. Gregory Mankiw, “Defending the One Percent.” 2013. <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.27.3.21>

III. Consumption Inequality

One thing economists agree upon is that consumption is a better measure of well-being than income. What we buy and consume with our income directly adds to our utility and happiness, and also has a direct impact on our standard of living. Individuals are also better able to smooth consumption rather than income over their lifecycle. While a retired, older individual has low levels of current income, he can still enjoy a high standard of living due to lifetime savings and other forms of wealth. A student with low current incomes can borrow to finance education and household expenses in the hope of earning high incomes in the future from a relatively well-paying job. So one reason why income and consumption are de-linked is the possibility of borrowing and saving. In fact, it is probably rational to assume that at least some part of a poor or low-income family's consumption is being sustained by indebtedness. However, another reason for the mismatch between income and consumption is likely the tax and transfer system. Many redistributive policies support consumption for low income households and provide transfer payments to them. As we discussed previously, most studies of income inequality are unable to get at these transfer payments.

Consumption inequality has also been extensively studied in the literature, though perhaps not as much as income inequality. Results from these papers are also mixed. Krueger and Perri (2005) find that while income inequality increased during the period 1980-2003, consumption inequality did not.⁸ However, Blundell and colleagues (2008) show that income and consumption inequality diverged between the 1970s and the 1990s.⁹ Other papers find that income and consumption inequality have tracked each other closely since the 1980s.¹⁰ In general, the data used in these studies comes from either the Consumer Expenditure Survey (CEX) or the Panel Study of Income Dynamics. There are two problems with using the CEX to measure consumption inequality, however: measurement errors and a lack of information on the

⁸ Dirk Krueger, Fabrizio Perri. "Does Income Inequality Lead to Consumption Inequality? Evidence and Theory," Aug 2005. <http://economics.sas.upenn.edu/~dkrueger/research/consinc.pdf>

⁹ Richard Blundell, Luigi Pistaferri, Ian Preston. "Consumption Inequality and Partial Insurance." *American Economic Review* 2008, 98:5, 1887–1921. <http://www.ucl.ac.uk/~uctp39a/BBP%20AER.pdf>

¹⁰ Orazio Attanasio, Erik Hurst, Luigi Pistaferri. "The Evolution of Income, Consumption, and Leisure Inequality in The US, 1980-2010." NBER Working Paper No. 17982. Apr, 2012. <http://www.nber.org/papers/w17982>

consumption of durable goods. Several authors, including Attanasio et al (2012)¹¹ and Aguiar and Bils (2011)¹², have attempted to account for the measurement errors in this data, by using techniques that enable them to predict expenditures for the less well-measured items by using information on better-measured items. While we do not criticize or applaud their approach, it does imply that in order to get anything meaningful from the CEX data for measurement of inequality, authors need to rely heavily on modeling assumptions and non-standard approaches, as opposed to simply using the raw data.

Precisely for these reasons, in a study that I co-authored with Kevin Hassett, not only did we work with the CEX data but we also supplemented our analysis with the use of the Residential Energy Consumption Survey (RECS) data.¹³ The CEX provides a good overview of nondurables' consumption by American households. In 1984, households in the top income quintile accounted for 37 percent of total expenditures, while households in the bottom quintile accounted for 10 percent. Hence the ratio of top to bottom consumption was 3.7. In 2010, that ratio increased to 4.4. The gap was widest in 2005 when the share of consumption for the top was 39 percent relative to 8 percent at the bottom. In the most recent recession, it appears that households at the bottom increased their share by 1 percentage point while the share at the top either declined or remained steady. In the 2001 recession, the ratio declined as well, suggesting that recessions work towards a more even distribution. On average, over the entire period, the ratio is 4.3 with a standard deviation of 0.22. Therefore, using this measure, we find that consumption inequality has increased only marginally over time.

If we compare these trends in consumption to trends in income using the Current Population Survey data, which is widely used for research on income inequality, we find that the story is strikingly different. As per our analysis, in 1984, pre-tax incomes at the top were more than 11 times incomes in the bottom quintile. In 2010, that ratio rose to 15.4. The average for the entire period is 13.5. Clearly, inequality using annual incomes is significantly higher than when we use consumption, and it has tended to widen over time.

¹¹ Attanasio et al. "The Evolution of Income, Consumption, and Leisure Inequality in the US, 1980-2010." Apr, 2012.

¹² Mark A. Aguiar, Mark Bils. "Has Consumption Inequality Mirrored Income Inequality?" NBER Working Paper No. 16807. Feb, 2011. <http://www.nber.org/papers/w16807>

¹³ Kevin A. Hassett and Aparna Mathur, "A New Measure of Consumption Inequality," AEI Economic Studies, June 2012

As mentioned earlier, the CEX is not a good source of data on durable goods consumption. Therefore, we worked with the RECS data as well. This survey has questions on household use of appliances such as microwaves, dishwashers, computers, printers and other data. What we find is that the access of low-income Americans – those earning less than \$20,000 in real 2009 dollars – to these devices has increased. The percentage of low-income households with a computer rose to 47.7% from 19.8% in 2001. The percentage of low-income homes with six or more rooms (excluding bathrooms) rose to 30% from 21.9% over the same period. Similar increases can be documented for appliances like air-conditioners, dishwashers, microwaves, cell phones and other household items.

In general, we find that people at all income levels now have access to many more material possessions than they did in the 1980s. Moreover, there has been a narrowing of the gap between high and low income classes in terms of ownership of these items. It is hard to argue against the improvement in the standard of living that has accompanied these trends.

Hence, the standard narrative that rising income inequality has somehow hurt the middle and lower income classes is not supported by data. Policies aimed at redistributing incomes from the top to the lower income classes have certainly been responsible for part of this trend. However, we would caution against using this argument for raising marginal tax rates at the top to levels seen in the 1970s. In another co-authored piece,¹⁴ my colleagues and I argue that the Diamond and Saez solution to inequality¹⁵ —a marginal tax rate of 73 percent —is based on unrealistic assumptions relating to how individuals would respond to high tax rates. Their modeling of the optimal rate assumes a “more equality is better” social welfare function and assigns no social value to the marginal dollar of consumption for the rich. Most importantly, it ignores the long-run behavioral responses and consequences of having marginal tax rates that are over 50 percent. In the article, we show that while these assumptions work well in theoretical models that are aimed at catering to an audience of professional economists, these should not be used as the basis of real world public policy formulation.

¹⁴ Aparna Mathur, Michael R. Strain, Sita Nataraj Slavov. “Should the top marginal income tax rate be 73 percent?” Tax Notes. Nov, 2012. <http://www.aei.org/article/economics/fiscal-policy/taxes/should-the-top-marginal-income-tax-rate-be-73-percent/>

¹⁵ Peter Diamond and Emmanuel Saez. “The Case for a Progressive Tax: From Basic Research to Policy Recommendations.” *Journal of Economic Perspectives*. Volume 25, Number 4. Fall 2011. Pages 165–190. <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.25.4.165>

Whether the explanation for improvement in living standards lies in redistribution policies and the growth of the safety net, or technological improvements that allowed prices of electronics and other durable goods to drop, or real improvements in productivity and wages, the bottom line is: people are better off today than they were twenty or thirty years ago. Households are consuming more and the typical low income household possesses many more appliances and gadgets that have traditionally been considered the preserve of the rich, than at any time in history.

Hence consumption data paint a strikingly different picture of household welfare than income inequality studies would suggest. Again, the studies in this section do not attempt to suggest that poverty does not exist-only that the magnitude of the problem may be overstated if we only focus on income data.

IV. Income Mobility

Another issue that frequently comes up in discussions relating to income inequality is income mobility. The idea is that the problems associated with income inequality may be partly offset if there is sufficient economic mobility. In a 2011 public opinion poll, the Pew Charitable Trusts found that 80 percent of Americans identified factors such as hard work, personal ambition and access to education as key drivers of upward mobility. However, most studies suggest that economic mobility i.e. the movement of individuals from lower to higher quintiles is fairly low.

Bradbury and Katz (2002) study transitions between income quintiles across successive one-decade intervals and find that a worker in the top or bottom 20 percent of the income distribution has a 50 percent chance of remaining in that quintile one decade later.¹⁶ On the other hand, there is only a 3 percent chance somebody will move from the bottom to the top or from the top to the bottom. In contrast, they find a large amount of churning among the middle three quintiles, which is to be expected given the year-to-year volatility in earnings. Gottschalk and Danziger (1997) find similar results looking at two-decade spans.¹⁷ They also find no upward trend in

¹⁶ Katharine Bradbury and Jane Katz, "Are lifetime incomes growing more unequal? Looking at new evidence on family income mobility." 2002. <http://www.bostonfed.org/economic/nerr/rr2002/q4/issues.pdf>

¹⁷ Peter Gottschalk & Sheldon Danziger. "Family Income Mobility -- How Much Is There and Has It Changed?," Boston College Working Papers in Economics 398, Boston College Department of Economics, 1997. <http://ideas.repec.org/p/boc/bocoec/398.html>

mobility that would mitigate increased cross-sectional inequality. If anything, they find that mobility has decreased in the last 20 years.

Another interesting issue is that of intergenerational mobility. In a completely egalitarian society, one might expect there to be little connection between a parent's income and that of their children. On the other hand, if human capital is transmitted strongly from parents to their children, then income might be persistent across generations. The literature on income mobility generally cannot distinguish these effects. It can only quantify mobility across generations. Solon (1999)¹⁸ and Bowles and Gintis (2002)¹⁹ provide extensive reviews of the literature on intergenerational mobility. Hertz (2005) studies mobility among income quintiles across generations.²⁰ He confirms the results from Solon and Bowles and Gintis that the intergenerational correlation in income is approximately 0.4. Moreover, he finds that this result is largely driven by black families. In general, the literature suggests that a person who begins life with a low income is likely to stay that way, and this has changed little over the years.

More recent research for the Pew Foundation suggests that the truth is that 70 percent of Americans raised in the bottom two quintiles will never make it even to the middle quintile.²¹ However, there are certain factors that do enable people at the bottom to be upwardly mobile. The first is human capital. College-graduates, dual-earner families and people who did not experience unemployment, were more likely to move up. In particular, 86 percent of college graduates, 84 percent of dual-earner families and 64 percent of people who were continuously employed left the bottom income quintile. By contrast, only 55 percent of non-college graduates, 49 percent of single earner families and 34 percent of people who experienced unemployment moved up from the bottom quintile.

Another important mobility factor highlighted by the study is higher savings, wealth and home equity. Those who left the bottom of the income ladder had six times higher median liquid savings, 8 times higher median wealth and 21 times higher median home equity than those who remained stuck at the bottom. This suggests that families with savings, for example, may be better able to make human capital investments that promote economic mobility, such as higher

¹⁸ Gary Solon, "Intergenerational mobility in the labor market," 1999. <http://ideas.repec.org/h/eee/labchp/3-29.html>

¹⁹ Samuel Bowles and Herbert Gintis, "The Inheritance of Inequality," July 2012.

<http://www.umass.edu/preferen/gintis/intergen.pdf>

²⁰ Tom Hertz, "Understanding Mobility in America," Apr 2006.

<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.107.5196&rep=rep1&type=pdf>

²¹ The PEW Charitable Trusts. "Moving on up." Nov, 2013. http://www.pewstates.org/uploadedFiles/PCS/Content-Level_Pages/Reports/2013/Moving_On_Up.pdf

education or job training, and those experiencing income gains may have more flexibility to save and build wealth, which in turn can support economic security.

This is true across generations as well. Pew research also shows that parental savings can have a significant impact on upward mobility. The parents of those who moved up from the bottom quintile had almost doubled the median wealth of the parents of those who remained at the bottom.

Another factor highlighted by the Pew study is the importance of location.²² In many American communities, families with relatively high incomes tend to live in more affluent neighborhoods while those with relatively low incomes tend to live in less affluent neighborhoods. Across America there is substantial variation in the degree to which the high and low income neighborhoods are segregated from each other. In the New York Metro area for example, there is a much higher degree of segregation resulting in concentrated pockets of wealth and poverty, relative to Bedford, Ma which has fewer neighborhoods of concentrated wealth or poverty. Between 1970 and 1990, there has been steady growth in the degree of neighborhood segregation in a majority of metropolitan areas. The Pew study finds that the more economically segregated a metro area is, the less economically mobile its residents are. This is a new finding in the area of economic mobility and this analysis is one of the first empirical tests of the theory that, in highly unequal areas, there is additional mechanism aside from family background or resources, by which economic advantage and disadvantage can be transmitted from parents to children, leading to lower overall levels of economic mobility. For example, Boston has lower economic segregation relative to other metro areas and higher economic mobility, while New York has high segregation and low mobility.

The findings of this research on economic mobility as well as our earlier discussion on income inequality have important policy implications, which we discuss in the next section.

V. Policy Suggestions

Rising income inequality has been attributed to a number of factors. In a recent review of the papers on this topic, Dew-Becker and Gordon (2008) ascribe a relatively small role to the decline

²² The PEW Charitable Trusts. "Mobility and the Metropolis." Dec, 2013.
http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Mobility-and-the-Metropolis.pdf

of unionization in the increase in inequality starting in the 1970s. This is particularly true for females.²³ They similarly ascribe a small role to trade and immigration. While minimum wages have often been offered as the single biggest explanation for rising inequality, the authors contend that this is unlikely to be true. While there is some correlation between the real minimum wages for women and income inequality for women, there is hardly any response in this inequality measure to an increase in the minimum wage over the period 1989 to 1997 and its subsequent decline in 2005. Further minimum wage changes are hard to disentangle from other institutional factors such as unionization.

The authors do find an important role for skill-biased technical change. In other words, the idea is that with the increasing use of computers and computing technologies in the workplace, there was an increasing wage premium associated with college graduates who were able to use these technologies easily. This widened income inequality starting in the 1980s (Claudia Goldin and Lawrence Katz, 2008) as the demand for skilled college graduates increased.²⁴ Therefore, one policy implication from this is that we need to invest more in college education, skills training and vocational programs for people who lack these skills and therefore are unable to find jobs.

Access to high quality education and schools is extremely important as an investment into children's futures. Poor quality schooling can limit an individual's earning ability.²⁵ Research by some economists has shown that the quality of local public education is improved in areas where there is more competition due to a large number of school districts or a greater availability of nonpublic education.

The labor market poses serious concerns about the future livelihoods of the millions of unemployed workers, particularly those who are long-term unemployed and those who are fresh out of college hoping to get their first job and pay off their student loans. One solution that is being proposed is the extension of unemployment benefits to the long-term unemployed. I believe that the unemployment benefit programs have to be supplemented by skills training and greater help with matching workers to jobs. It is simply not enough to keep extending benefits if

²³ Robert Gordon and Ian Dew-Becker, "Controversies about the Rise of American Inequality: A Survey." April, 2008. http://www.nber.org/papers/w13982.pdf?new_window=1

²⁴ Claudia Goldin and Lawrence Katz, "The Future of Inequality: The Other Reason Education Matters So Much." 2008. <http://ideas.repec.org/p/hrv/faseco/4341691.html>

²⁵ Martin Feldstein, "Income Inequality and Poverty." Oct, 1998. http://www.nber.org/papers/w6770.pdf?new_window=1

at the end of the benefit period, the worker is still unemployed. The goal of any such program should be to train the worker to transition to a new job, rather than to simply provide cash benefits to allow them to meet their basic needs. For a worker who stays unemployed for more than 6 months, the likelihood of finding a job is extremely low and is unlikely to improve without active help. Towards this end, workers who have been long-term unemployed should be provided training and then placed in jobs through wage-subsidy programs that allow some share of the wages to be paid by the employer and the rest to be paid by the unemployment insurance program. This would allow employers to test and see if the match with the prospective employee is a good one, while at the same time it would allow workers to receive on the job training and gain experience with the likelihood that they will be able to keep the job.

Katz (1998) presents some evidence indicating that the Targeted Jobs Tax Credit, the major wage-subsidy program for the economically disadvantaged between 1979 and 1994, did boost employment of disadvantaged youths, and discusses evidence indicating positive and persistent program impacts from Jobs Training Partnership Act when the training was combined with job search assistance, especially for adult female welfare recipients.^{26,27} This leads him to conclude that wage subsidies combined with training and job development assistance can help disadvantaged adults, but based on the evidence on stigma and low utilization, to express more skepticism (while still suggesting modest benefits) of other narrowly-targeted, stand-alone programs. Coupling such programs with training and job search assistance may reduce problems associated with stigma and hence increase the benefits of wage subsidies.

Another idea along the same lines is work-sharing.²⁸ Work sharing arrangements whereby workers continue to be employed for a few hours at their job while claiming unemployment benefits for the remaining hours could work as well.

Raising minimum wages is a particularly bad idea when we think of high youth and teenage unemployment rates.²⁹ Workers under age 25 make up half of those paid the federal minimum

²⁶ Lawrence F. Katz, "Wage Subsidies for the Disadvantaged." NBER Working Paper No. 5679. July, 1996. <http://www.nber.org/papers/w5679>,

²⁷ Also see the Capitol Hill Times, "Wage subsidy outsmarts a \$15 Minimum." Jan, 2014. <http://www.capitolhilltimes.com/2014/01/wage-subsidy-outsmarts-15-minimum/>

²⁸ http://www.edd.ca.gov/pdf_pub_ctr/de8714bb.pdf

²⁹ Further, there is substantial evidence to suggest that there are negative employment effects, particularly for low-skilled workers of raising minimum wages. A recent 2009 paper by David Neumark suggests that employers often take back the increases that come with higher minimum wages in future years by forgoing the usual nominal wage increases that would have happened.

wage (or less). Among employed teenagers paid by the hour, about 21 percent earned the minimum wage or less.³⁰ One option is encouraging vocational training and apprenticeship programs for youth, as happens in Germany. Neumark (2009) reviews different school-to work programs and finds that internship/apprenticeship programs encourage employment and also boost college attendance.³¹

Minimum wages are also not a tool to fight poverty. By some estimates, less than 25 percent of minimum wage workers live below the poverty line based on family cash income.³² An alternative to the minimum wage is the Earned Income Tax Credit program. The EITC arguably is one of the federal government's most efficient means of encouraging work and fighting poverty. As per the Census Bureau, the EITC lifted 5.4 million people above the poverty line in 2010. The \$60 billion program pays low-income workers a wage supplement in the form of a tax credit that can be worth more than \$5000 a year to a family with two children. However, the EITC also has some significant disadvantages. One, the program is not particularly well run. As a new report by the IRS inspector general notes, at least one of every five EITC dollars in 2012 was improperly awarded. That's \$11.6 billion. This does not account for those who got less than they were entitled to, or those who did not apply because they did not know that they were eligible for the EITC.³³ Another issue is that the phase-out range of the EITC imposes significant tax penalties on earners. However, it has been shown to encourage labor force participation for single mothers, and has proven to be an effective anti-poverty program.

VI. Conclusion

The purpose of this testimony is to highlight issue of income inequality. Economists have tended to measure income inequality in different ways leading to a mixed picture of what has been happening to the gap between the rich and the poor over the last couple of decades. A review of these papers finds that some authors contend that income inequality has grown, while others find that income inequality may in fact have narrowed down over time. Another set of

³⁰ <http://www.bls.gov/cps/minwage2012.htm>

³¹ David Neumark, 2009. "Alternative Labor Market Policies to Increase Economic Self-Sufficiency: Mandating Higher Wages, Subsidizing Employment, and Increasing Productivity," NBER Working Papers 14807, National Bureau of Economic Research, Inc. <http://ideas.repec.org/p/nbr/nberwo/14807.html>

³² A back of the envelope calculation by my colleague Abby McCloskey suggests that raising the minimum wage would affect slightly less than 2 percent of the population in poverty.

³³ http://www.treasury.gov/tigta/press/press_tigta-2013-33.htm

papers has focused on consumption as a measure of economic well-being and documented trends in consumption inequality. These papers again yield differing conclusions about consumption for the rich has fared relative to consumption of the poor. My own research finds that consumption inequality has remained fairly constant over the last few decades. Further, it documents an increase in standards of living for people at the very bottom of the income distribution. These improvements in living standards are likely a consequence of the tax and transfer system, wherein low income households have been the beneficiaries of redistribution efforts. However, it is also a consequence of significant price declines in technology items like computers and printers, driven by market competition and research and development efforts.

Despite these improvements in living standards, it is well documented that more than 47 million people live in poverty today in America. Moreover, the recent recession has further caused a decline in employment rates and earning potential of families. Towards the end of this testimony, I provide some policy suggestions that might help alleviate some of these issues. The testimony argues that while minimum wages and unemployment benefits may be the preferred strategies currently employed by policy makers, these may not be the most effective means. Unemployment benefits combined with job and skills training programs as well as wage subsidies to get the long-term unemployed back in the labor market may be more efficient. At the same time, improving the targeting and efficiency of programs such as the EITC, which create the right incentives, in terms of encouraging work, may be extremely important as well. For youth, school-to-work programs that encourage apprenticeships and internships have been shown to be successful as well.