Economic Inequality, Social Safety Nets, and Distributional Outcomes:
Understanding the Stratified Nature of Redistribution Mechanisms in the U.S., 1990-2012

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Abstract

This paper examines the distributional consequences for income inequality and household income packages of the U.S. tax and transfer system from 1990 to 2012. Using household level data from the Current Population Annual Social and Economic Supplement and NBER's TAXSIM program, we examine the contribution of four redistributive mechanisms (national social insurance, decentralized social assistance, state taxes and national taxes) to the household income package, and the reduction of market generated income inequalities for the population as a whole and for different types of households. In preliminary work, we find that while each mechanism reduces inequality, the categorical structure of U.S. tax and transfer policies sorts individuals and households into different tiers of programs that vary by policy design features and structure, and that this sorting results in stratified progressivity in income redistribution which reinforces status differences by sorting lower status households into programs that have the weakest redistributive capacity.

There are few contemporary issues as critical and compelling as growing economic inequality . Prominent political leaders, leading intellectuals, and religious figures have identified inequality as the "defining issue" of our time. There is widespread agreement about the fact that inequality has risen dramatically in the recent decades and substantial research and debate about the causes and consequences.

However, in many ways inequality is not a puzzle. We know that the level of economic inequality in developed countries is a constructed outcome – produced by markets and shaped by government policies that govern labor markets, collect revenue, and structure social benefits. We also know that the U.S. is an outlier, in comparison to comparably rich democracies, for exceptionally high levels of inequality in market incomes and exceptionally limited government actions to reduce economic and social disparities.

Social policy scholars have established, in broad outline, the policy features that limit the effectiveness of specific social welfare programs in the U.S. and the historical origins of these features in political conflict and compromise . What is needed to move our understanding forward is a more complete and nuanced understanding of how these historical and contemporary political conflicts have been institutionalized in the very structure of the U.S. welfare state and how these structural arrangements limit the capacity of government to address inequality in the current period.

A large body of literature examines issues of income redistribution within the U.S. and other rich industrialized countries. This work has addressed two related questions about the net effect of policy on household income and income inequality across households. One question concerns the extent to which government tax and transfer policies redistribute market income. The second question concerns the structure of these policies, including the extent to which responsibility for redistribution is devolved to state and local governments. In this paper we bring together these two concerns to examine the consequences of policy design in the U.S., particularly categorical eligibility structures and partial decentralization of tax and transfer responsibilities, for income redistribution overall and for specific populations. We do this by comparing the impact of different redistribution mechanisms – national social insurance, decentralized social assistance, state taxes and national taxes – on the reduction of market generated income inequalities for the population as a whole and for different types of households.

We make two related arguments: 1) that the categorical structure of U.S. tax and transfer policies sorts individuals and households into different tiers of programs that vary by policy design features (e.g. generosity and redistributive mechanism) and structure (e.g. degree of centralization in financing and administration), and 2) that this sorting results in stratified progressivity in income redistribution which reinforces status differences by sorting lower status households into programs that have the weakest redistributive capacity.

Analysis

We specifically ask four related questions:

- First, what is the contribution of the four redistributive policy mechanisms to the total income package received by the average U.S. household? How do these mechanisms affect the level of market-generated income inequality?
- Second, how does the contribution of each of the redistributive policy mechanisms vary across households depending on their market income and composition? Who benefits most and least from each mechanism, with what consequences for their total household income?
- Third, how do the redistributive policy mechanisms affect income inequality within populations that vary on these same household characteristics?
- Fourth, how do the redistributive effects of the policy mechanisms change over time?

To answer these questions, we use household level data from the Current Population Annual Social and Economic Supplement and NBER's TAXSIM program.

To examine the distribution of income at the household level it is useful to conceptualize income as a "package" of market income, government transfers and taxes. We construct measures of the household income package by sequentially adjusting income based on the four redistributive policy mechanism conceptualization suggested above. We begin with a measure of market income, or pre-tax-and-transfer income, and sequentially add: transfers through centralized programs; transfers through decentralized programs; adjust for state taxes; and finally adjust for Federal taxes. Our final measure of post-tax-and-transfer or disposable income is therefore the sum of market income, centralized transfers, decentralized transfers, state taxes and Federal payroll and income taxes. The difference between the market income and disposable income is the estimated redistributive effect attributable to each of the policy mechanisms.

The measurement of income inequality is complex and the choice of index measure is meaningful and alternative measures of inequality differ both how they weight transfers and their underlying mathematical properties. In this paper we use one of the most familiar measures, the Gini coefficient. The changes in the Gini created by the inclusion of income from each of the four policy mechanisms are calculated as the measures of redistribution attributable to each policy mechanism.

Initial Findings

In our initial work, we find that, examined separately, major tax and transfer policies have the expected progressive distributions. As a whole, however, the system is not only differentiated but stratified, sorting individuals into different tiers on the basis of employment status, household composition, market income and other attributes that reflect existing social and economic status. Because these tiers vary on key structural dimensions, "who gets what" varies systematically in both anticipated and unexpected ways that reduce, reinforce or even exacerbate market generated inequalities by sorting the more and less advantaged into more and less generous programs.

Most strikingly we find that working age households, particularly those with children, are the most poorly assisted. They are less likely to receive benefits, receive less when they do, and benefit least from redistribution. This is due in large part to policy structures that sort these households into the lowest tier of the system, which provides the least generous and most uncertain benefits. We find that the elderly are relatively advantaged in their treatment by the tax and transfer system compared to working-aged households with and without children; and that working-aged households with children are relatively disadvantaged.

To understand the dynamics of redistribution and inequality reduction, we examine how each of the four redistributive mechanisms have performed during a time period that includes economic growth, a mild and major recession, and an extended recovery period. We compare the absolute and relative contributions of each of the mechanisms for reducing inequality overall and within populations that differ in their social and economic status. In preliminary work, we find that the redistributive mechanisms relied on primarily by the working-aged households with children have deteriorated their redistributive capacity the most, resulting in this population experiencing the greatest contraction in government assistance during this time period.

We conclude that the stratified progressivity embedded in the U.S. tax and transfer system leads some of the disadvantaged to remain relatively disadvantaged, while others are relatively advantaged in their treatment. In so doing, the U.S. tax and transfer system not only reinforce status differences across households, but is increasing stratification over time as different types of households are more or less affected by changing economic circumstances, and are differentially supported through our system of redistributive mechanisms.