A History of Income Inequality in the United States

By MATTHEW JOHNSTON | Updated Jun 25, 2019

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has been a major topic in the U.S. presidential race, at
:013 the *Economist* published an article claiming that
world the U.S. had the highest after-tax and transfer
:fficient of 0.42.

igh levels of income inequality, it is crucial we figure
uality. Fortunately, history gives us a useful guide to
ıst that. A brief history of income inequality in the U.S.
ıry until the present day shows that the nation's level
government policies concerning taxation and labor.

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Feedback

The Beginning of the Twentieth Century

In 1915, forty years since the U.S. had overtaken the UK as the world's largest economy, a statistician by the name of Willford I. King expressed concern over the fact that approximately 15% of America's income went to the nation's richest 1%. A more recent study by Thomas Piketty and Emmanuel Saez estimates that, in 1913, about 18% of income went to the top 1%.

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Perhaps, it is no wonder then that America's current income tax was first introduced in 1913. Being strongly advocated by agrarian and populist parties, the income tax was introduced under

which requires extra expense, and in doing so, it is nothing more than meting out even-handed justice."

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While there was a personal tax exemption of $3,000 included in the income tax bill that passed, ensuring that only the wealthiest would be subject to taxation, the new income tax did little to level the playing field between the rich and poor. There was never any intention of it being used to redistribute wealth; instead, it was used to compensate for the lost revenues of reducing excessively high tariffs, of which the rich were the main beneficiaries. Thus, the income tax was more equitable in the sense that the rich were no longer allowed to receive their free lunch but had to start contributing their fair share to government revenues.

The new income tax did little to put a cap on incomes, evidenced by the low top marginal tax

was raised to 15%. The top rate was changed subsequently in 1917 and 1918 reaching a high of 73% on incomes over $1,000,000.

Interestingly, after reaching a peak in 1916, the top 1% share of income began to drop reaching a low of just under 15% of total income in 1923. After 1923, income inequality began to rise again reaching a new peak in 1928—just before the crash that would usher in the Great Depression—with the richest 1% possessing 19.6% of all income. Not surprisingly, this rise in income inequality also closely mirrors a reduction in top marginal tax rates starting in 1921 with the top rate falling to 25% on income over $100,000 in 1925.

While the relationship between marginal tax rates and income inequality is interesting, it is also worth mentioning that at the beginning of the twentieth century, total union membership in the U.S. stood at about 10% of the labor force. While this number escalated during the First World War, reaching almost 20% by the end of the war, anti-union movements of the 1920s eliminated most of these membership gains. (To read more, see: *Are Labor Unions Effective?)*

From the Great Depression to the Great Compression

While the Great Depression served to reduce income inequality, it also decimated total income, leading to mass unemployment and hardship. This left workers without much left to lose, leading to organized pressure for policy reforms. Further, progressive business interests that believed part of the economic crisis and inability to recover was at least partly due to less than optimal aggregate demand as a result of low wages and incomes. These factors combined would provide a fertile climate for the progressive reforms enacted by the New Deal.

With the New Deal providing workers with greater bargaining power, union membership would

compensation increased and labor productivity approximately doubled, increasing total prosperity while ensuring that it was being shared more equitably.

Further, during the Great Depression, marginal tax rates were increased numerous times and by 1944, the top marginal tax rate was 94% on all income more than $200,000, which in 2013 inflation-adjusted dollars is $2,609,023. Such a high rate acts as a cap on incomes as it discourages individuals from negotiating additional income above the rate at which the tax would apply and firms from offering such incomes. The top marginal tax rate would remain high for almost four decades, falling to just 70% in 1965, and subsequently to 50% in 1982.

Significantly, during the Great Depression, income inequality came down from its peak in 1929 and was relatively stable with the richest 1% taking approximately 15% of total income between 1930 and 1941. Between 1942 and 1952, the top 1% share of income had dropped to below 10% of total income, stabilizing at around 8% for nearly three decades. This period of income compression has been aptly named the Great Compression.

From the Great Divergence to the Great Recession

The shared prosperity of the decades following World War II would come to an end during the 1970s, a decade characterized by slow growth, high unemployment, and high inflation. This dismal economic situation provided the impetus for new policies that promised to stimulate more economic growth.

Unfortunately, it meant growth would return but the main beneficiaries would be those at the top of the income ladder. Labor unions came under attack in the workplace, courts and in public policy, top marginal tax rates were reduced in an attempt to direct more money towards private investment rather than in the hands of government, and deregulation of corporate and financial institutions were enacted.

In 1978, labor union membership stood at 23.8% and fell to 11.3% in 2011. While the three decades following World War II was an era of shared prosperity, the declining strength of unions has been met with a situation in which labor productivity has doubled since 1973 but median wages have only increased by 4%.

The top marginal tax rate dropped from 70% to 50% in 1982 and then to 38.5% in 1987, and over the past 30 odd years has fluctuated between 28% and 39.6%, which is where it currently sits. (To read more, see: *How does the marginal tax rate system work?*).

increases in income inequality which has come to called the Great Divergence. In 1976, the richest 1% possessed just under 8% of total income but has increased since, reaching a peak of just over 18%—about 23.5% when capital gains are included—in 2007, on the eve of the onset of the Great Recession. These numbers are eerily close to those reached in 1928 that lead to the crash that would usher in the Great Depression.

The Bottom Line

History can be a helpful guide to the present. Far from accepting the current economic situation as inevitable, a brief history of income inequality in the U.S. is evidence that government policies can tilt the balance of economic compensation for the rich or the poor. With the last thirty-five years being disproportionately favorable to the wealthy, and the fact that greater income inequality has been correlated with higher levels of crime, stress, mental illness, and some other social ills, it's about time to start leveling the playing field once again.

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