University of Wisconsin-Madison

IRP Discussion Papers

Sheldon Danziger
Eugene Smolensky

ABRUPT CHANGES IN SOCIAL POLICY: THE REDISTRIBUTIVE EFFECTS OF REAGAN'S BUDGET AND TAX CUTS

DP #725-83

Institute for Research on Poverty
Discussion Paper 725-83

Abrupt Changes in Social Policy: The Redistributive Effects of Reagan's Budget and Tax Cuts

Sheldon Danziger
Eugene Smolensky
Institute for Research on Poverty
University of Wisconsin-Madison

December 1983

This paper was originally prepared for the International Institute of Public Finance Conference on Public Finance and Social Policy, Budapest, Hungary, August 22-26, 1983. Funding for this research comes from the Graduate School of the University of Wisconsin-Madison and the Alfred P. Sloan Foundation. We are grateful to both. We also appreciate the comments of Anton Bakhoven, Peter Gottschalk, Robert Haveman, Robert Lampman and Barbara Wolfe on an earlier draft. Sole responsibility, however, remains with the authors.

Abstract

President Reagan proposed a dramatic reallocation of federal budget priorities. Taxes were cut, defense expenditures increased, and social welfare expenditures reduced. After reviewing recent trends in poverty and inequality, we provide estimates of the distributional effects of these changes. We conclude that changing the income distribution through government budgets proves to be as difficult when the welfare state is contracting as when it is expanding. The same cannot be said for poverty. Small changes in the income distribution are associated with large changes in poverty.

Abrupt Changes in Social Policy:
The Redistributive Effects of Reagan's Budget and Tax Cuts

INTRODUCTION

Seven years ago Reynolds and Smolensky posed the question: "Has it become more difficult to alter the distribution of net income through government budgets?" [14, p. 69]. Those authors had in mind the consequences of further extensions of the welfare state, for they then wrote:

> Although we do not imagine that the tax system will drift toward further regressivity, the tendency of expenditure programs to move toward distributional neutrality as they age and grow in scale makes it easier to envision a modest narrowing in the pre- and post-fisc wedge rather than a widening (p. 80).

At least a part of what was unimaginable for the United States just a few years ago would appear already to have taken place, and not just in the United States. The U.S. tax system is undoubtedly becoming more regressive and transfer systems less progressive. What will happen to the wedge between the pre- and post-fisc distributions of income as households respond to the changing incentives of the tax-transfer system is less clear. A modest narrowing of the wedge as Reynolds and Smolensky expected is likely, but it is rather more likely that post-fisc inequality has increased.

From a strictly accounting viewpoint, the degree of post-fisc inequality depends upon four factors: the distribution of pre-fisc income, the relative size of government, the distribution of expenditure benefits, and the distribution of tax burdens. The distribution of benefits and burdens, in turn, depends upon the composition of expenditures and taxes over time, as well as changes in the incidence pattern for each component. We consider only the composition of taxes and transfers in detail during the remainder of this paper. First, however, we describe in general terms what President Reagan has proposed and the U.S. Congress has accepted so that the overall coherence of the president's program can be appreciated.

REAGANOMICS DESCRIBED

Reaganomics has been concisely described by Kimzey [7] as follows:

> The president's program contained four specific parts. The first, and perhaps most important to the president's overall goals, was a substantial cut in personal income tax rates. The second was a cut in nondefense expenditures, accompanied by an increase in the outlays for defense. The third was a program to reduce the regulatory burden on business, and the fourth was to encourage the Federal Reserve to maintain its Monetarist policies of slowing the rate of growth in the supply of money (p. 44).

As Kimzey goes on to say: "The overriding objective was to reduce both the absolute and relative size of the federal government" (ibid). Even proportionate and across-the-board cuts in taxes, transfers, and purchases could have a sizable impact on the distribution of income. Since these proposed reductions were not proportional and across-the-board, but targeted so as to encourage increased labor supply and savings, the distributional consequences could be substantial. Changes in effective tax rates were by any measure sizable. Relative to projected revenues, tax changes involved a revenue loss to the federal government from individuals of $377 billion over the 1982-85 period. Spending cuts were much smaller. The spending bill passed in 1981 reduced outlays to persons by $66 billion over the same period. Tax changes involved proportional cuts in personal income tax rates of 25 percent over three years (except for an immediate drop in the highest bracket from 70 to 50 percent) and inflation-indexing to begin in 1985. The maximum rate on long-term capital gains was lowered; and corporate income tax revenues were cut by no less than a third. The estate tax and the gift tax were made substantially less.

Expenditure cuts (other than elimination of a proposed pay raise for government workers) came almost entirely from working low-income households, since they were made primarily in such areas as food and nutrition, aid to single-parent households with children, public service jobs and training programs, medical aid to the indigent, and assistance to workers displaced by foreign trade. (Remaining cuts were equal to about one-half the reduction in the major food program alone.) Expansion in defense expenditures was to more than offset the announced cuts. The net effect of all of these changes, coupled with the recent recession, has been a deficit that is projected to reach 7 percent of GNP during fiscal year 1983, and to remain at almost 6 percent of GNP through fiscal year 1988.

To list the major changes in tax and transfer programs is sufficient to convey the distributional direction in which the president intended to take the country.[1] One observer put it this way: The president's "message is not about economics, but of growing weakness, dependence and decay--which he attributes to misguided paternalistic economic policies. His solution is to concentrate wealth in the hands of the affluent and lead the United States toward plutocracy" [6, p. 1]. A supporter of the president makes the case in a somewhat different way:

> At the center of the Reagan Administration's economic program is an attempt to limit redistribution of income to a social "safety net." The program proposes to turn us away from an evolution, partly unintentional, that was in the process of transforming our system of government fiscal devices into a general system for redistribution of income. . . . Its policies have focused on restoring incentives . . . to produce income and wealth and raise the _absolute_ level of income on average [1, p. 31].

While the direction of the distributional consequences of the Reagan changes is clear, three factors make the magnitude difficult to measure. First, while tax cuts were indeed substantial, in part they were cuts relative to tax increases that would have resulted from existing law.

For example, the ratio of federal taxes to GNP was 20.9 percent in 1981, and would have risen to 22.4 percent by 1986 if the pre-Reagan 1981 tax laws had remained unchanged. The ratio is projected to be 18.8 percent under current law in 1986. Households will rise into higher marginal tax brackets due to inflation before indexation in 1985 and scheduled and accelerated increases in the social security tax. This will offset the tax rate reductions for most. Second, the budget cuts and the administration's resistance to increased countercyclical spending as unemployment rapidly increased may have intensified the recent recession. Although downturns have traditionally been thought to increase inequality, in recent years the effect of the business cycle on inequality has become an unsettled research area [2]. In any case, it is quite difficult to gauge what the distribution of earnings would have been under some counterfactual macro policy of another administration. Third, the deficits resulting from the Reagan changes enacted in 1981 produced a backlash which led to a retreat by the Congress from the path planned by the president. Expenditures were cut by less than the president requested in 1982, and some taxes were increased despite presidential opposition. And Congress did not act on his proposals for additional budget reductions for the 1984 fiscal year.

The first two columns of Table 1 demonstrate a growth in the ratio of federal spending to GNP from 18 to 23 percent and show the changes in budget shares that took place between 1965 and 1981 (the last pre-Reagan budget). The swing away from defense and toward income security, education and training, and especially health is apparent, and was the focus of the Reagan reallocation of the budget. Column 3 indicates the planned

Table 1

The Composition of the Federal Budget, 1965, 1981, 1986
(in percentage terms)

Category	Fiscal Year: Actual 1965 (1)	Actual 1981 (2)	Reagan's budget proposal for 1986 as presented in 1981 (3)	February 1983 CBO estimates for 1986 (4)
National defense, international affairs, and veterans' benefits and services	50.4%	29.5%	40.1%	34.9%
Transportation, community and regional development, and revenue sharing	6.5	6.0	3.7	4.6
Natural resources and environment, energy, and agriculture	5.8	4.5	2.5	2.4
Income security	21.7	34.3	32.8	31.6
Health	1.4	10.0	11.2	11.6
Education, training, employment, and social services	1.9	4.8	2.5	3.0
General government, interest, general science, space and technology, other	14.8	15.5	11.6	13.7
Offsetting receipts	-2.6	-4.6	-4.4	-1.9
Total	100.0	100.0	100.0	100.0
Total outlays as a percentage of GNP	18.0	23.0	19.0	24.1
Total outlays (billions of current dollars)	$118.4	$657.2	$912.0	$999.0

Source: Office of Management and Budget, The United States Budget in Brief, Fiscal Year 1975 (Washington, D.C.: U.S.G.P.O., 1975), p. 48. Council of Economic Advisers, Economic Report of the President, January 1981 (Washington, D.C.: U.S.G.P.O., 1981), p. 315. Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1984-1988, Part II (Washington, D.C.: U.S.G.P.O., 1983), p. 74.

Note: Some slight errors may exist due to reclassification of categories between 1965 and the present.

reduction in changes in the budget's magnitude and the changes in priorities which Reagan put forward during the winter of 1981 by projecting budget shares to 1986, when all planned changes would be in place. Defense was to be expanded toward percentages prevailing in the early 1970s while education and training were to be rolled back to the lower levels of that same period.[2] The income security expenditure share was to be cut 10 percent and the expansion in health expenditures was to continue but at a much more modest pace. This latter growth is due to the growing numbers of elderly and to price increases of medical care, not to increases in benefit levels. Other government expenditures were to be reduced to shares lower than those that prevailed in 1965.

What actually has been enacted by the Congress is somewhat different, as can be seen by comparing columns (3) and (4). Column 4 presents February 1983 estimates of the 1986 budget size and shares assuming that current laws and policies, including those proposed by Reagan <u>and</u> already enacted by Congress, remain unchanged. Obviously he has not yet gotten all of his expected defense increases. The 1983 Social Security Amendments provided somewhat larger cuts in income security then originally anticipated. This outcome was not reflected in the 1981 (column 3) budget projections. The health share is projected to rise above expectations because a proposed health cost containment package has not yet been enacted. Training costs will fall less than expected because of a new program introduced to combat the long recession. And the ratio of the budget to GNP is even higher than it was in 1981, partly because not all the planned spending cuts were enacted, and partly because tax revenues are lower than expected because the recession was longer and deeper than had been projected.

On the expenditure side, then, Reagan and the Congress have slowed the expansion of the welfare state and stepped up military expenditures. In dollar terms, or even in terms of shares of the budget, as Table 1 indicates, expenditure changes other than defense have _not_ been large. We should not expect, therefore, to see large distributional effects flowing from these changes. As we shall see later, the way these changes were made lessens even further the adverse redistributional effects of expenditure changes.

One might think that more significant effects would be found on the tax side, where the aggregate change was large and where each component of change was decidedly regressive. However, to foreshadow what lies ahead, here too we will find that the redistributive effects are not large.

We should not conclude from these findings that Reagan has been unsuccessful. The changes that have been adopted represent a clear departure from the policies of the past twenty years, policies that partly reflected the view that public expenditures should directly assist the poor. The Reagan approach is that public transfers for the working poor should be decreased to permit tax cuts and increased defense spending. It has proven particularly effective to set transfers and defense as competitors when, of course, there is no economic sense in which they actually compete. Defense absorbs real resources; transfers do not. By setting a target for the entire government budget, rather than purchases of goods and services, as a percentage of GNP, distributive and allocative expenditures are added together and set as a ratio to national allocative expenditures (GNP) alone. This is not good economics, but it apparently makes effective rhetoric.

Robert Lampman [8] has argued that the declaration of the War on Poverty had an immediate and far-reaching effect--it required all existing programs and proposals for policy changes to address the question, "What does it do for the poor?" The Reagan economic program asks instead, "What does it do for the incentives to work and to save?" As a result, we share Lampman's [9] judgment that the fundamental effect of the declining rate of growth of federal revenues, the reordered domestic versus military priorities, and the vast projected budget deficit mean "that it is extraordinarily difficult to initiate new social spending measures in the field which the President has set. In that sense, the President's design for calling a halt to the growth of welfare statism seems to have won the day" (p. 381).

REAGANOMICS: THE BACKGROUND TO THE DISTRIBUTIONAL CHANGES

The data with which to create firm quantitative estimates of the distributional effects of the Reagan program will not be available until late 1984, when income data for 1983 will be made available. For now, therefore, we must rely on inferences which can be drawn from the recent history of inequality in the United States and from what we know about the incidence of particular transfers and taxes.

The Distribution of Census Money Income

The trend over time of inequality in the United States is somewhat sensitive to the income concept (e.g., pretransfer, posttransfer, or posttax). The longest time series of readily available data reports inequality of "census money income" separately for families and single-person households. Census money income is really personal cash receipts: market income plus public and private cash transfers. (Note that direct taxes, private contributions for social insurance, and in-kind transfers are not included in the data.) As Table 2 indicates, the data for families suggest a modest trend toward less inequality between 1950 and 1966 that was offset by an equally modest trend toward increasing inequality thereafter. Because the Reagan budget cuts did not go into effect until late 1981, the increase in the Gini coefficient between 1979 and 1981 mostly reflects the business cycle. A similar change is apparent during the 1960-61 recession, and a smaller change during the 1973-75 recession. And part of the increase between 1981 and 1982 was also due to recession.

Virtual stability in the distribution of census money income perturbed by a shallow cycle is the outcome of a variety of factors. Danziger [3] summarizes them as follows:

- Demographic Change. Demographic alterations have largely been in the direction of slowing mean income growth and raising inequality. The total number of households has grown much more rapidly than the total population. Husband-wife families and especially families headed by prime-aged men are a sharply declining proportion of all households. The latter group declined from 58 percent of households in 1965 to 45 percent in 1981. The growth of households composed of a single person,

Table 2

The Trend in Income Inequality, Selected Years, 1950-1982

	Share of Census Money Income Received by Quintile					Gini Coefficient
	1	2	3	4	5	
All Families						
1982	4.7	11.2	17.1	24.3	42.7	.382
1981	5.0	11.3	17.4	24.4	41.9	.370
1979	5.2	11.6	17.5	24.1	41.7	.365
1975	5.4	11.8	17.6	24.1	41.1	.358
1973	5.5	11.9	17.5	24.0	41.1	.356
1972	5.4	11.9	17.5	23.9	41.4	.360
1970	5.4	12.2	17.6	23.8	40.9	.354
1966	5.6	12.4	17.8	23.8	40.5	.349
1965	5.2	12.2	17.8	23.9	40.9	.356
1961	4.7	11.9	17.5	23.8	42.2	.374
1960	4.8	12.2	17.8	24.0	41.3	.364
1955	4.8	12.3	17.8	23.7	41.3	.363
1950	4.5	12.0	17.4	23.4	42.7	.379

Source: U.S. Department of Commerce, Bureau of the Census, Money Income of Households, Families and Persons in the United States: 1981, Current Population Reports, Series P-60, no. 137, March 1983, Table 17, p. 47. For 1982 quintile shares, Series P-60, no. 140, July 1983. For 1982 Gini coefficient, computations by authors from March 1983 Current Population Survey data tapes.

and then headed by the young, women, and the old, implies a lower rate of growth of family income and greater dispersion in income.

- Wives' Earnings. Earnings of wives continue to have an equalizing effect on family inequality (a reduction in the Gini coefficient of about 5 percent in 1978), even though in recent years wives of husbands with earnings above the median have been the most likely to take a job outside the home.

- Men's Earnings. There has been a slow and persistent rise in male earnings inequality at least since the mid-sixties (an increase in the Gini coefficient of about 8 percent between 1966 and 1977). The trend is well-documented but little understood, although important factors include ever-higher unemployment rates and reduced labor force participation rates during the postwar period. These factors do not, however, fully account for the trend.

- Government transfers. Transfer income has been the dominant factor offsetting the demographic and male earnings trends, as will be discussed below. It is the only one of the four factors that is directly affected by the Reagan program.

Census Money Income Less Transfers

Census money income less cash transfers has become more unequal in recent years for most demographic groups.[3] For example, between 1965 and 1981, the Gini coefficient of pretransfer income for families headed by prime-aged men increased by 11 percent. But when cash transfers are included, the increase is only 6 percent. During the same period, the reduction in the Gini due to cash transfers increased for nearly all demographic groups (see Table 3). This reduction in the Gini coefficient due to cash transfers is generally found to be the largest single factor working toward reducing inequality. Not surprisingly, the effect is largest for the aged and for female household heads, who are the primary beneficiaries of transfer programs. The inequality-reducing effects of transfers increased from 1965 to 1974 and was about the same in 1981 as it was in 1974.

The Distributional Effects of Cuts in Transfers

The legislated benefit reductions for the period 1981-86 should not be expected to have a large effect on inequality, for two reasons. First, the cuts were small relative to current spending levels--they averaged about 6 percent for all income transfer programs. Second, the cuts were structured in a way that reduces their inequality-increasing impact. It is the structure (as opposed to the level) of the cuts that we emphasize now.

The philosophy behind the cuts was to transform certain income security programs from a general support system encouraging simultaneous receipt of wages and welfare to a "safety net" that forced a choice between work and welfare. Generally speaking, those who did not work lost only a small portion of their benefits. The biggest losers were the "working poor" and not the "poorest of the poor," who are out of the labor force.

In 1980, about 45 percent of all persons lived in households receiving some type of cash or in-kind transfer. Welfare recipients were about 20 percent of all transfer recipients and about half of them worked

Table 3

Percentage Change in Gini Coefficient
Due to Cash Transfers, 1965, 1978, 1981

	Change in Gini Coefficient[a]		
	1965	1978	1981
Families headed by			
Young men	-2.1%	-3.8%	-5.0%
Prime-aged men	-3.2	-7.2	-7.4
Aged men	-32.6	-37.5	-38.1
Young women	-25.3	-32.4	-25.0
Prime-aged women	-22.4	-21.6	-19.4
Aged women	-24.4	-37.3	-37.3
Individuals who are:			
Young men	-2.6	-3.8	-3.6
Prime-aged men	-7.8	-6.8	-8.6
Aged men	-46.9	-45.7	-37.9
Young women	-0.5	-4.3	-5.8
Prime-aged women	-10.8	-13.9	-13.3
Aged women	-44.0	-49.5	-48.9
All households	-11.1	-14.5	-14.7

[a]Defined as 100 x (posttransfer Gini - pretransfer Gini)/pretransfer Gini.

Source: Computations by authors from Current Population Survey data tapes.

at some point during the year. Thus, our judgment is that less than 10 percent of all transfer recipients (about 4.5 percent of all households) will experience substantial nominal income reductions because of the cuts implemented as of this date.

Those who were mixing work and welfare were closest to the poverty line. The benefits that they lost were small relative to the average benefit received. Thus, only if large proportions of beneficiaries chose to give up working altogether to become zero-earners could there be any discernible impact on the income distribution. The preliminary evidence is that only a small minority of recipients took this route. For example, in Wisconsin, only about 15 percent of those whose benefits were terminated were back on welfare 14 months later. We can be fairly certain, then, that the impact on inequality of the Reagan benefit reductions was quite small. On the other hand, the effects on poverty are likely to be substantial.

Table 4 shows the percentage of persons living in households with cash incomes below the poverty line, using three measures of income for selected years between 1965 and 1982. Each shows that poverty declined over the 1965 to 1978 period and then increased rapidly in the 1978 to 1982 period. For the whole 1965 to 1982 period, poverty in the absence of transfers, given the assumption of no labor supply responses (column 3), would have increased. The official census measure (column 1) that includes cash transfers shows a decline of less than 4 percent, while the adjusted income measure (column 2), which also accounts for in-kind transfers received and federal taxes paid, shows a decline of about 27 percent.

Table 4

Persons Living below Official Poverty Lines,
Selected Years, 1965-1982
(percentages)

	Census Money Income (1)	Adjusted Income (2)	Census Money Income Less Transfers (3)
1965	15.6%	12.1%[a]	21.3%
1968	12.8	9.9	18.2
1970	12.6	9.3	18.8
1972	11.9	6.2	19.2
1974	11.6	7.2	20.3
1976	11.8	6.7	21.0
1978	11.4	6.1[a]	20.2
1980	13.0	n.a.	21.9
1981	14.0	n.a.	23.1
1982	15.0	8.8[a]	24.0
Percentage change			
1965-78	-26.9	-49.6	-5.2
1978-82	+31.6	+44.3	+18.8
1965-82	-3.8	-27.3	+12.7

Source: Sheldon Danziger and Robert Plotnick, "The War on Income Poverty: Achievements and Failures," in Welfare Reform in America, edited by P. Sommers (Boston: Martinus Nijoff, 1982); adjusted income for 1968-1976 is from Timothy Smeeding, "The Antipoverty Effect of In-Kind Transfers: A 'Good Idea' Gone Too Far?" Policy Studies Journal, 10, 1982, 499-521.

[a]1968 is the first year and 1979 the last for which Smeeding has detailed data on adjusted income. This is his estimate for 1965, and Gottschalk and Danziger's [4] for 1982. The figure shown for 1978 is Smeeding's result for 1979.

n.a. = Not available.

The direct effect of budget cuts is to increase poverty. That is, if pretransfer poverty in the short run remains fixed, fewer persons will be taken out of poverty by the reduced transfers. However, backers of the administration's position have argued that the budget and tax cuts will stimulate labor supply and hence reduce pretransfer poverty. Gottschalk and Danziger [4] have used the administration's July 1983 estimates of unemployment rates, price levels, and social spending to project poverty rates. They find that the gains that are projected to trickle down to those at the bottom of the income distribution are not large enough to offset the direct losses from the reduced transfers. They predict that poverty in 1984--whether based on money income (14.6 percent) or with in-kind transfers added (8.2 percent)--will be higher than it was when Reagan took office.

The Distributional Effects of Taxes and Tax Cuts

The distributional effects of tax changes are more difficult to evaluate than are changes in cash transfers. Census money income less transfers can be calculated from census tapes by simple subtraction of transfers, but the census tapes do not report taxes paid. However, reasonable approximations of direct taxes can be simulated. Using the evidence available concerning the distributional consequences of tax changes during the 1970s, one can make some conjectures about the effects of the Reagan tax cuts.

According to Reynolds and Smolensky [14], the federal personal income tax (47 percent of federal revenues) was somewhat progressive in 1961, reducing the Gini coefficient of factor income by .015 on a base of about

.436. A decade later, personal income taxes were less progressive, reducing the Gini by about .008 on a base of .446. During the 1970s, the tax moved back toward a somewhat greater progressivity through two contradictory forces--inflation on the one hand and statutory changes in tax rates on the other [15]. Inflation pushed growing proportions of the poor into paying taxes, as exemptions and deductions were eroded. The middle class was pushed into ever-higher real marginal tax brackets. Consequently, the tax burden rose from 10.9 percent of personal income in 1961 to 12.6 percent in 1979. During the 1970s a succession of changes in the tax law exempted substantial amounts of income from the tax, but not as much as was exempted in 1961. Steuerle and Hartzmark [15] report that 43 percent of personal income was taxed at a positive rate in 1961, 51 percent in 1969, and 46 percent in 1979. The poor benefited disproportionately from these changes.

Okner's [11] simulation analysis of the tax cuts of 1964, 1969, and 1975 showed that about 40 percent of the cuts were received by the bottom 50 percent of tax filers. The top 10 percent of filers received about 10 percent of the 1964 cuts, 1 percent of the 1969 cuts, and actually paid increased taxes after the 1975 tax cut. Congress rejected, however, a 1978 Carter administration tax-cut proposal that would have continued this string of progressive tax reductions. In its place, the 1978 act allocated only about 5 percent of the tax cut to the bottom 50 percent of taxpayers, and about half of the cut to the top 10 percent. Okner and Bawden [12] show that while the Reagan cut reduced total tax revenues by a much larger amount than the 1978 cut, its distribution is similar. The Reagan cut is mostly proportional with respect to taxes paid, and hence regressive with respect to household incomes. That is, a proportional tax cut does not affect low-income households that pay no taxes.

One way to illustrate the negative effects of recent tax changes on the poor is to examine the federal direct (payroll and income) tax bill for a family of four with earnings at the official poverty line (Table 5). Between 1965 and 1974, the effective (average) tax rate ranged between 5 and 8 percent. It then dropped dramatically to about 1 percent in 1975 and stayed below 3 percent until 1979, partly because of increased deductions and personal exemptions, and partly because of the Earned Income Tax Credit (EITC), an earnings subsidy for low-income households with children. Because inflation has eroded all these devices to aid the poor, the tax burden for this family increased to 9.6 percent in 1982 despite the Reagan tax cuts.

REAGANOMICS: THE DISTRIBUTIONAL EFFECTS SIMULATED

The U.S. Congressional Budget Office [16, 17, 18] has simulated the effects of tax and benefit reductions proposed and enacted for households in different income categories. These estimates are shown in Table 6. The first column shows the distribution of households by income class. Column (2) shows how the large combined reductions in benefits and taxes enacted during the administration's first year in office will be distributed to households by the end of 1983. Tax reductions for individuals of $82.1 billion were offset by benefit reductions of $17.5 billion, for a net gain of $64.6 billion, or an increase of about 3.0 percent in average after-tax incomes. However, the benefits were skewed toward the wealthy--the top 1.2 percent of households received almost one-quarter of

Table 5

Federal Direct Tax Bill for a Family of Four with Poverty-Line Earnings, 1965-1982[a]

	Official Poverty Line (1)	Personal Income Tax[b] (2)	Social Security Tax (Employee's Share) (3)	Total Federal Tax (4)	Effective Tax Rate[c] (5)
1965	$3223	$ 31.22	$116.83	$148.05	4.4%
1969	3743	104.02	179.66	283.68	7.6
1971	4137	54.18	215.12	269.30	6.5
1973	4540	33.60	265.59	299.19	6.6
1974[d]	5038	3.32	294.72	298.04	5.9
1975	5500	-250.00	321.75	71.75	1.3
1977	6191	-180.90	362.17	181.27	2.9
1978	7430	-318.00	455.46	137.46	1.9
1982	9860	285.00	660.62	945.62	9.6

[a]Assumes a married couple with two children not living on a farm. Only one earner per family; all income is from earnings.

[b]From 1975 to the present includes the earned income tax credit. A negative entry represents a refund to the family.

[c]Defined as total federal tax as a percentage of family income.

[d]The Tax Reduction Act of 1975 rebated $100 of 1974 personal income taxes to a family at this income level.

Table 6

The Distributional Effects of the Reagan Budget and Tax Changes for Households in 1983

Household Income	% of Households in Income Class (1)	Percentage Distribution of Net Changes in Benefits and Taxes: Enacted for FY 1982 (July 1981) (2)	Administration's Proposals for FY 1983 (3)	Enacted for FY 1983 (July 1982) (4)	Net Changes in Income($) (5)[a]
$<10,000	22.5%	-7.0%	-53.7%	-17.9%	$-310
$10,000-20,000	24.8	7.3	-20.0	-11.5	+190
$20,000-40,000	35.2	38.0	-18.4	-32.2	+740
$40,000-80,000	16.3	37.0	-17.2	-17.7	+1610
≥$80,000	1.2	24.6	-0.9	-20.1	+13,730
All households	100.0	100.0	100.0	100.0	+660
Changes in benefits[b]		-$17.5	-$10.8	-$1.7	-$19.2
Changes in taxes[b]		+$82.1	-$.08	-$5.3	+$76.8

Source: Computed by authors from data in U.S. Congressional Budget Office [16, 17, 18].

Note: A minus entry denotes a reduction in benefits or an increase in taxes that reduces household incomes; a plus entry denotes a reduction in taxes that increases household incomes.

[a]These changes in 1983 household incomes are the sums of the tax and benefit changes already enacted for FY 1982 and FY 1983 (column 2 plus column 4).

[b]In billions.

the increased income, while the bottom fifth of households were net losers. This translates into about a 7 percent increase in income for the top 1.2 percent and about a 2 percent decrease for the bottom quintile.

Column (3) shows that the administration proposed further benefit cuts of $10.8 billion for 1983 and individual tax increases of only $800 million. Instead, Congress, partly in reaction to press reports of the hardship caused by the first-year budget cuts and their perceived inequity, reduced benefits by only $1.7 billion and raised individual taxes by $5.3 billion. These changes dramatically shifted the redistributive effects--the bottom quintile absorbed less than 20 percent rather than about half of the income losses, while the top 1 percent absorbed 20 percent rather than 1 percent. Column 5 shows the average dollar change of the sum of the cuts enacted thus far. The first year dominates, hence the gains increase with, but substantially more rapidly than, income.

The Congressional response leads us to the view that most of the distributional change likely to be effected by the administration has already occurred. Just as it proved hard to further redistribute income toward the poor after the initial impact of the War on Poverty, it will prove hard now to further redistribute income away from them.

CONCLUSION

Reynolds and Smolensky [14], taking continued growth of the welfare state as a given, discussed various reasons why "explicit income redistribution makes for bad politics" (p. 78) in the United States and concluded that "We foresee little to offset the lack of voter enthusiasm for further reductions in post-fisc inequality" (p. 80). They also showed that it is technically difficult to change the income distribution when most households are both taxpayers and beneficiaries of spending programs. We find that their conclusions are quite robust--they seem to hold after the most significant reversal of U.S. social welfare policies in 50 years.

While the voters clearly called for a retrenchment of the welfare state by electing Reagan, they have shown no enthusiasm for large increases in poverty. And even though the Reagan administration has cut back the scope of the welfare state, it has not abandoned its primary goals--the provision of minimum levels of cash, nutritional, medical, housing, and educational assistance for a substantial portion of the population.

During its first year in office, the administration proposed drastic cutbacks in most social programs. But because so many households (about 45 percent) are direct beneficiaries of at least one program, widespread voter and Congressional opposition developed. This was particularly true for programs with the broadest range of recipiency across the income distribution (e.g., social security, educational financing programs for college students). As a result, only a small portion of the cuts were in programs whose benefits were widely distributed. The large cuts were in income-tested welfare programs that provide benefits only for those toward the bottom of the income distribution. But because they serve fewer recipients, and because the benefits of the poorest were least affected, budgetary savings as a percentage of the budget were small.

One way to assess the distributional impact is to extend Table 2 through 1983 and compare the effects of the Reagan changes with the recent experience. Table 7 shows the actual income distribution and official poverty incidence for 1979 and the actual changes in quintile shares, the Gini coefficient, and the poverty incidence between 1979 and 1981. We also present our estimates, calculated from data presented by the Congressional Budget Office [16, 17, 18] and Levy and Michel [10], of the total changes for the 1981-83 period. We decompose them into two mutually exclusive components--one due to the tax and budget changes, and one due to other factors. These other factors include primarily the decline in inflation and increased unemployment that accompanied the recession and then the recovery that began in mid-1983. We attribute to the budget and tax cuts roughly one-third of the estimated relative losses of the bottom two quintiles, about one-third of the increase in the Gini, and a one percentage point increase in poverty.

Some of the remaining increases in the Gini and reductions in the income shares of the lowest two quintiles might also be attributed to Reaganomics. For example, we believe that countercyclical transfers would have been further increased in response to the recession under another administration. But, just as transfers would probably have been higher and unemployment lower, inflation would probably have been higher and real GNP growth lower. While the inequality-increasing effects of higher unemployment exceed those of higher inflation, the effects of real growth on inequality are not clear. Because we have not developed a method for specifying and estimating the macroeconomic effects of the

Table 7

Estimated Distributional Effects of the
Reagan Budget and Tax Changes

	Quintile Shares[a]					Gini Coefficient[a]	Official Incidence of Poverty[b]
	1	2	3	4	5		
1. 1979 Actual	5.2	11.6	17.5	24.1	41.7	.365	11.6%
2. 1979-81 total changes, Actual	-0.20	-0.30	-0.10	0.30	0.20	+.005	+2.4
3. 1981-83 total changes, Estimates[c]	-0.40	-0.30	-0.10	+0.10	+0.70	+.015	+0.6
4. 1981-83 changes due to tax and budget changes, Estimates[c]	-0.15	-0.05	+0.08	+0.03	+0.09	+.005	+0.8
5. 1981-83 changes due to other factors, Estimates[c]	-0.25	-0.25	-0.18	+0.07	+0.61	+.010	-0.2

Source: Tables 2 and 4 for actual values for 1979 and 1981. Authors' estimates for 1983 calculated from data provided in Congressional Budget Office [16, 17, 18] and Levy and Michel [10] for income quintiles, and Gottschalk and Danziger [4] for poverty. A memo detailing these calculations is available from the authors.

[a]All families.
[b]All persons.
[c]Each measure shown in Row 3 equals the sum of the corresponding measures in Rows 4 and 5.

Reagan program, we treat all effects not directly attributable to the tax and budget cuts as due to other factors.

Several additional qualifications are in order. Because the requisite data for measuring the actual impacts of the Reagan program are not available, we ignored some distributional changes that have probably been induced. For example, most state governments have raised taxes in the past two years, partly in response to the recession and partly to reductions in the federal funds they receive. Since state taxes are in general more regressive than the federal personal income tax, this has further increased post-fisc inequality. We have also not accounted for changes in factor prices induced by the increased defense expenditures, or by the financing of the large deficits; nor for changes in wealth induced by the estate tax revision or a new agricultural commodity support program. The net distributional effects of these changes are less clear.

In sum, we judge the net redistributive effects of the large cuts in welfare programs that benefit the working poor, the small cuts in programs that benefit the middle class, and the large tax cuts for the wealthy to be of the order of magnitude of a modest postwar recession. But, of course, they come on top of a deep recession and result from secular policy changes. However, what has been accomplished now limits the administration's ability to get additional budget cuts enacted. Indeed, it is now clear to the administration that the technical and political problems that make large distributional changes difficult are synergistic. In its defense of the fiscal year 1984 budget proposals, the administration stated:

> By definition, entitlement programs develop vast networks of dependency that cannot be precipitously altered without unacceptable social and human costs. As a consequence, their claim on the budget and national economy tends to become relatively permanent and can be reduced only slowly over long periods of time [19, Chap. 3, p. 9].

Changing the size distribution of income through the fisc proves to be as difficult when the welfare state is contracting as when it is expanding. The same cannot be said for poverty. Small changes in the income distribution are anticipated to be associated with large changes in poverty.

FOOTNOTES

[1]At one point, budget-cutting plans extended to, in the words of David Stockman, Director of the Office of Management and Budget, a set of "equity ornaments" that "you'd never see a Republican administration propose." These included elimination of the oil depletion allowance, an attack on tax-exempt industrial bonds, user fees for owners of private airplanes and barges, and some others amounting to total budgetary savings of about $20 billion. They were quickly dropped, however [5, pp. 25-26].

[2]Palmer and Sawhill [13] suggest that by the late 1970s Congress had begun to support increased defense spending, and that some increases would have been passed even if a Democratic administration had been in office.

[3]Pretransfer income is calculated by subtracting government transfers from posttransfer income. While this definition assumes that transfers elicit no behavioral responses, transfers do induce labor supply reductions, which reduce earnings. As a result, recipients' net incomes are not increased by the full amount of the transfer and the pre/post comparisons made here will provide upper-bound estimates of the redistributive effects of transfers.

REFERENCES

[1] Boskin, Michael, "Reaganomics and Income Distribution: A Longer-Term Perspective," Journal of Contemporary Studies, 5, Summer 1982: 31-44.

[2] Budd, Edward and Whiteman, T. C, "Macroeconomic Fluctuations and the Size Distribution of Income and Earnings in the United States," in Zvi Griliches et al., eds., Income Distribution and Economic Inequality. Frankfurt/Main, Campus Verlag; New York, Halstead Press, 1978: 11-21.

[3] Danziger, Sheldon, "Poverty and Inequality under Reaganomics," Journal of Contemporary Studies, 5, Summer 1982: 17-30.

[4] Gottschalk, Peter and Danziger, Sheldon, "Changes in Poverty, 1967-1982: Methodological Issues and Evidence," University of Wisconsin-Madison, Institute for Research on Poverty Discussion Paper no. 737-83, September 1983.

[5] Greider, William, The Education of David Stockman and Other Americans, New York, Dutton, 1981.

[6] Hester, Donald, "Appearance and Coherence in Recent U.S. Macroeconomic Policy," Department of Economics, University of Wisconsin-Madison, mimeo, 1983.

[7] Kimzey, Bruce, Reaganomics, St. Paul, Minnesota, West Publishing, 1983.

[8] Lampman, Robert, "What Does It Do For the Poor? A New Test for National Policy," Public Interest, Winter 1974: 66-82.

[9] Lampman, Robert, "Review Article: Economic and Social Policies under the Reagan Administration," Journal of Social Policy, 12, July 1983: 378-386.

[10] Levy, Frank and Michel, Richard, "The Way We'll Be in 1984: Recent Changes in the Level and Distribution of Disposable Income," Urban Institute Discussion Paper, November 1983.

[11] Okner, Benjamin, "Distributional Aspects of Tax Reform During the Past Fifteen Years," National Tax Journal, 32, March 1979: 11-27.

[12] Okner, Benjamin and Bawden, Lee, "Recent Changes in Federal Income Redistribution Policy." Paper prepared for the 1983 Symposium of the National Tax Association, May 16-17, 1983.

[13] Palmer, John and Sawhill, Isabel, editors, The Reagan Experiment, Washington, D.C., The Urban Institute Press, 1982.

[14] Reynolds, Morgan, and Smolensky, Eugene, "Why Changing the Size Distribution of Income Through the Fisc Is Now More Difficult: Hypotheses from U.S. Experience," In Rechtenwald, Horst Claus, (ed.), Secular Trends of the Public Sector, Paris, Editions Cujas, 1978: 69-81.

[15] Steuerle, Eugene and Hartzmark, Michael, "Individual Income Taxation, 1947-79," National Tax Journal, 34, March 1981: 145-166.

[16] U.S. Congress, Congressional Budget Office, "The Effects of Tax and Benefit Reductions Enacted in 1981 for Households in Different Income Categories," Special Study, February 1982a.

[17] U.S. Congress, Congressional Budget Office, "Effects of Changes in Taxes and Benefit Payments Proposed in the Administration's 1983 Budget for Households in Different Income Categories," Staff Memorandum, April 1982b.

[18] U.S. Congress, Congressional Budget Office, "Effects of Changes in Taxes and Benefit Payments Enacted in Fiscal Year 1982 for Households in Different Income Categories," Staff Memorandum, November 1982c.

[19] U.S. Office of Management and Budget, Budget of the United States Government, Fiscal Year 1984, Washington, D.C., U.S. Government Printing Office, 1983.