Personal income up, but are we better off?

March 31 2011

(PhysOrg.com) -- Although U.S. personal income per capita has risen 5.7 percent since 2000, an increase in tax-exempt benefits provided by the government and employers accounted for all of the income growth in the past decade, says a University of Michigan economist.

Thanks to these nontaxable transfer payments, which include Social Security, Medicare, Medicaid, health insurance, unemployment, welfare and disability benefits, inflation-adjusted personal income per capita rose nearly $2,200 since 2000, despite America's worst economic recession since the Great Depression.

But when growth in transfer payments and employer-paid benefits are excluded, U.S. taxable income per capita actually decreased 3.4 percent from $32,403 to $31,303, says economist Don Grimes of the U-M Institute for Research on Labor, Economics, and the Economy.

"Last week, the Bureau of Economic Analysis released preliminary personal income statistics for all states and the data shows that personal income per capita in the United States increased," Grimes said. "But, why don't we feel better off? Because the personal income per capita data includes 'spending' that we don't recognize as contributing to our economic well-being.

"Most people are not going to feel better off if their employer has to pay higher health insurance premiums, even if to government statistics experts it is the appropriate way to measure our well-being, which strictly speaking it is."

Grimes analyzed personal income statistics—both taxable and nontaxable—in the United States going back each decade to 1929. He adjusted the data for inflation and population, and categorized taxable personal income into major component parts: private sector wages and proprietors' income; government wages; and dividends, interest and rent (capital income).

The disparity between the growth in taxable and nontaxable income since 2000 is not new, although it was undoubtedly exacerbated by the recession, Grimes says. In the last 50 years, inflation-adjusted taxable income per capita has doubled ($15,368 to $31,303), while nontaxable income per capita has increased six-fold ($2,007 to $12,528). In 1960, we had taxable income of $14.58 for every dollar of transfer payments, but by 2010 the ratio was down to $4.21 of taxable income for every dollar of transfer payments.

Grimes says that in 1929, the year of the stock market crash, taxable income accounted for 98 percent of adjusted personal income, while nontaxable income was just 2 percent of adjusted personal income. By 2010, taxable income had fallen to 71 percent of adjusted personal income and nontaxable income had risen to 29 percent of adjusted personal income.

"This 80-year-long trend is unsustainable and is now reaching the breaking point," Grimes said. "Between 1929 and 2000, we were able to sustain the growth in transfer payments by increasing the tax rate on higher and higher levels of taxable income. So long as taxable income per capita was increasing, there was a social consensus, more or less, that we would share an increasing proportion of earned income with people collecting transfer payments.

"But, after 2000, taxable income per capita not only didn't grow, it actually declined by 3.4 percent. At the same time, transfers per capita increased 53 percent or $2,567—the largest dollar increase ever recorded. It would have taken a massive tax increase to pay for the additional transfer payments.

"Instead the Bush and Obama administrations cut taxes, but that still left after-tax 'taxable' income only slightly ahead of where it was in 2000. Thus, the federal government had to borrow money to accommodate the growth in transfer payments and, to a much lesser extent, wage and benefit payments to government workers."

Grimes says the good news is that the current economic recovery will help correct this imbalance as it will increase private wages and salaries, proprietors' income and capital income per capita, the ultimate source of all other income. It also will help reduce some transfer payments that respond to the business cycle, such as unemployment insurance, food stamps, welfare payments, and other income support programs—which only accounted for 16 percent of transfer payments in 2009.

"On the other hand, Social Security, Medicare and Medicaid accounted for 73 percent of transfer payments, and these programs will continue to grow, probably at an accelerating pace because of the aging of the baby boomers, unless there is a major policy change," Grimes said. "The benefits from the economic recovery will simply not be enough to correct our fiscal imbalance."

Grimes says policymakers face hard choices between raising taxes or cutting transfer payments and government activity.

"Even if we increase taxes, the hard truth is that the growth in transfer payments is unsustainable," he said. "At some point in the very near future, the growth in transfer payments will have to be limited to being no greater than the growth in 'taxable' income, which will be painful for those collecting transfer payments. The alternative is sharply and continuously increasing taxes on all of the working population.

"The best news is that in 20 years, almost everyone will have a higher income. The policy question will be how to distribute those gains between people collecting transfer payments and those paying for transfer payments."

Provided by University of Michigan