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It's Tax not Trade (Stupid)

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Abstract

Globalization, trade and other free market policies increase wealth. But the gains from trade are not being evenly spread among all citizens. People and politicians rage against foreigners. But it is the United States tax system, not trade, that ought to change, and wealthy Americans, not workers world-wide, who should be sharing the wealth. And it is the form of tax, not just its rate structure, that must reform, so that capital at last bears a meaningful share of the burden.

It's Tax not Trade (Stupid)

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As we approach the political party conventions in the U.S., the Summer of 2016 continues to be one of serious discontent. Middle-class workers worldwide are mad as hell. Pandering populist politicians like Boris Johnson in England and Donald Trump here at home stoke the fires of rage, doing what people in times of peril have done for millennia: blame foreigners. Tear up trade deals, build a wall to keep “them” out (at “their” expense, of course), and your pain will go away, Trump and ilk promise.

That’s half-right.

The people are right to be angry and frustrated. America is indeed getting wealthier, but not all workers are feeling it. Rather than winning from globalization they are losing jobs, money, and, worst of all, hope. Many laborers cannot keep up their current lifestyles, let alone progress through life as their parents and grandparents did.

But the unhappy many are being led to blame the wrong forces for their pain. Their wannabe leaders like Trump, more concerned with profiting from middle-class rage than with actually understanding it or, heaven forbid, helping to lessen it, are doing them wrong.

The simple fact is that globalization and free trade *are* good for economies, as Adam Smith taught us in 1776 and as a decent high school economics class can prove today. The trouble in America is that the gains from trade are not being shared. The rich who can live off their capital or wealth rather than by the sweat of their brows are the big winners from globalization; workers are the big losers.

Spreading the wealth from those who benefit most from social changes to those who are harmed by them is the responsibility of our tax system. Yet tax has failed miserably in this role. In fact, tax as it now stands is not even designed to collect from the wealthy. And no candidate -- on the right, left, or middle -- has any serious plan to change this fact. Indeed, Trump and his fellow Republicans continually vow to *cut* taxes on the wealthiest, further benefitting globalization’s winners while adding to the pain of its losers.

In sum, tax not trade is what ought to be changing, and rich Americans, not workers worldwide, ought to be paying more to help their fellow citizens. Let’s go through things a little more slowly.

First, the facts. As the economist Thomas Piketty's work has shown, the rich are getting richer. Piketty demonstrates that U.S. levels of both wealth and income inequality are approaching those that existed around 1900. The great Wars and economic depressions of the first half of the twentieth century were in part the result of that status quo. These cataclysms levelled wealth. As we rebuilt the economy, we went through a post-War growth period that provided jobs and some share of the growth pie for many.

Flash forward, and we see that America and the world are in fact doing "better" in an age of globalization by many measures. But the gains are not making their way down to the masses. It is easy to blame trade or immigrants -- others -- for this situation. Easy, but wrong.

At the heart of American and other capitalist democracies -- inspired by the teachings of Smith among others -- lies a simple social contract. On the one hand, private markets are generally set free to make as much wealth as possible for individuals pursuing their self-interest. On the other hand, those gains are supposed to, in part, be shared with and help the public sector. The connector is tax. What is good for GM can really be good for the country, because GM, its owners and employees will pay taxes that will benefit all. Hence the central tenet of modern welfare theory -- the overlapping disciplines of law, economics, and political theory that are supposed to help guide policymakers -- is the so-called Paretian principle, which holds that no welfare-improving change should hurt *anyone*. Tax is the vehicle of choice for theory to make this all work. As America collectively benefits from trade, globalization, automation, and other forces of modern times, tax should insure that workers are not left behind.

Only therein lies a considerable rub. The American tax system, writ large, is essentially a *wage* tax. There are two great factors of production in a capitalist economy: labor and capital. You get paid either for what you do, *or* for letting other people use what you own -- whether it be real estate, cash, intellectual property, machines, and so on. The U.S. tax system -- not just the federal income tax, but the payroll tax (which is for some 90% of working Americans the largest tax they pay), sales taxes, and many others -- mainly falls on wages. Taxes on capital are essentially voluntary.

A major social problem is that people don't understand this, and there are lots of (bad) arguments about "double taxing" savings and so on that get in the way of comprehension. I have written books explaining this. But it is hard to explain in short spaces, and it runs into resistance from people who don't want to believe it, whether out of simple ignorance, ideology, or personal or professional self-interest.¹ For the sake of getting across the main points -- what I feel a responsibility for not doing effectively, though I have been writing on these themes for over two decades -- let us proceed by taking my word for this, that the US tax system, most definitely including the income tax, predominantly falls on wages, with taxes on capital easily reduced or avoided.

So what? What follows? It turns out that tax is implicated in a great many of our pressing problems.

¹ For some explanations of how the American tax system is a *wage* tax that falls lightly if at all on capital, see Edward J. McCaffery, *Fair not Flat* (U. Chicago Press, 2002); *Income Tax Law* (Oxford University Press, 2012); *A New Understanding of Tax*, 103 Michigan Law Review 807-938 (2005); *Taxing Wealth Seriously*, forthcoming, Tax Law Review (Spring, 2017), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2738848. See also Edward J. McCaffery, *Taxing Women* (U. Chicago Press 1997).

One, free trade and sensible immigration policies are “good,” in the sense that they comport with basic, even common-sensical, economic principles and help to improve, as Smith knew, the “wealth of nations.” Yet much of the gains from trade go to those capitalists and financiers who largely escape tax. The lingering saga of hedge fund managers’ “carried interest” is about a way that certain elite workers are able to make their gains *look* like capital; other capitalists don’t even need such tricks, benefitting instead as the stock they own rises in value due to trade among other wealth improving principles at work in the global economy today. Without a tax system to take from these fortunate few and share with all, however, the many *can* suffer even as the nation gets wealthier; theory does not hold. Piketty’s data shows this in fact happening. So Trump can blame trade rather than tax -- an “other” rather than an “us.” The same phenomenon plays out with automation, another inexorable force of progress taking away labor jobs. When a machine replaces a human, capital wins, labor loses. Without tax helping out, labor’s loss is uncompensated, and workers can lose hope. Perhaps Trump should ban robots.

Two, the structure of tax pits the working classes against the non-working poor, including the young and elderly. Under the current tax system, it is simply a fact that we cannot pay more for health, education, social security or anything else without raising taxes on labor. And we cannot even raise rates too much higher on the high end, or the upper-income will stop working, or move, or convert their wages into capital ala hedge fund managers. Indeed, the political salience of the income tax and especially its top marginal rate pushes lawmakers to look for other taxes. Thus, for example, the Obama Administration has raised taxes on cigarettes, alcohol and cell phones. These not only add to the burdens on the working classes, but they do so in a hidden form -- ordinary Americans feel like they are falling behind and don’t know why. So Trump can promise to “take money back” from foreigners as an alternative to lowering hidden taxes on workers.

Three, speaking of hidden taxes, that is exactly what protectionist trade policies such as Trump pushes will bring, in the form of higher consumer prices that will inevitably follow from tariffs. Trump is charging the working class for a distraction from its troubles, as opposed to offering a real cure for them.

Four, the rich have enormous power and get to call many of the shots. The problem of wealth inequality (from capital) in America is far greater than that of income inequality (from wages). By not meaningfully taxing capital, we are letting the wealthy and their heirs get richer with their gains unreduced by taxes, while workers hit hard by taxes on all sides are having a hard time crossing over to the capital side of the street. The longer this goes on -- we are at a century of the relevant tax-law doctrines being in effect, and counting -- the harder it gets to change. Capital is even more mobile than labor, and more easily hidden (hence the longstanding attempt of the US to get a better feel for wealthy Americans’ offshore accounts.) Trying to reverse course and tax the rich -- the high wealth, not high income rich -- would be a major change, and one that the rich are happy to pay, in the form of political contributions, to prevent. Since no one understands tax very well at all, this can all be done quietly enough, in a bipartisan fashion. While President Obama did make a proposal in his 2015 State of the Union speech to begin addressing the problem, by repealing the so-called Angel of Death benefit that allows previously untaxed capital appreciation to escape income tax altogether if held until death, no presidential candidate, including Bernie Sanders, endorsed the idea. Democrats like Hillary Clinton and socialist democrats like Sanders are both

far more likely to propose raising taxes on high *income* citizens than to do anything at all about high *wealth* ones. Republicans like Trump, of course, don't even try to raise taxes -- why tax any of us, when there are plenty of "them" to make pay instead?

Five, there are still more social and political consequences of tax as it exists. Tax is huge, taking in more than one-fourth of our national economy, all taxes in. Steep marriage penalties among the poor -- the penalties have been largely eliminated among the rich, who are less troubled by them -- mean that the poor don't marry. Steep tax-induced biases against second workers put stress on working parents everywhere, and help to perpetuate a model among the very elite of the working man and the stay-at-home woman. We talk about the paltry marriage rates among the poor as if this is a result of their "culture" or (im)morality, not understanding that the poor -- just like the rich, just like all of us -- are responding perfectly rationally to economic incentives, in their case *not* to marry.

Is there good news? Yes. It turns out that change is indeed *theoretically* possible. Obama's proposal to tax capital gains on death is one promising start. I have been writing about a progressive spending tax for over twenty years, building on the work of many others before me and joining contemporaries such as the economist and NY Times columnist Robert Frank. Such a tax would fall as and when people spend, and at progressive rates, not when they work, save, marry or die. A progressive spending tax would allow all people to save more readily, while imposing higher tax rates on those who spend a lot, whether out of capital or labor earnings, including spending borrowed funds -- like, say, Donald Trump.

The bad news? It is hard to explain all this, or to get it into the public political discussion. I personally have failed to better popularize the ideas notwithstanding over two decades of killing trees in the cause. The fact of the matter is that until we can fix tax -- change its *form* and not just its rate structure, so that it falls on wealth and not just income -- the rich will keep getting richer, the working class will keep getting squeezed, and we will all wait around for some horrible calamities to reset the dynamic, while politicians, pundits and other ill-informed citizens will continue to lash out at the wrong causes. A demagogue could even riff off the symptoms, blame the wrong people, and propose solutions doomed for disaster.

Sound familiar?