What’s a Government Good For? Fiscal Policy in an Age of Inequality

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Abstract

The debate surrounding the Tax Cuts and Jobs Act demonstrated the intellectual bankruptcy of U.S. fiscal policy debate. The TCJA has serious flaws as a matter of narrow tax policy, but it is more fundamentally flawed when viewed through the proper policy lens, which is overall fiscal policy – the net of government taxing and spending. The TCJA greatly exacerbates already untenable budget deficits. Its tax prescriptions are even more regressive when the spending cuts contemplated by the legislation itself are reflected. And the law’s regressivity is compounded further when plausible financing paths for these large deficits are included in the analysis. In particular, the “dynamic” growth analysis whose tax ramifications were part of the debate leading up to the law was predicated on enormous cuts to future transfer payments, and confused GDP growth with enhanced welfare.

This presentation urges a more holistic approach to fiscal policy debates. Fiscal policy is an exercise in applied economics, but also in applied moral philosophy. We define ourselves as a country through the covenantal bonds we construct for our society by means of the fiscal policies we adopt. Neither perspective is well served by the metrics applied today to legislation like the TCJA.

Tax policy is overstudied and overemphasized; sensible fiscal policy, by contrast, in particular the spending side of the equation, can address fundamental social problems like economic inequality, the stagnant incomes of the middle class, and disappointing economic mobility. Greater government investment in human capital leads to inclusive growth (more broadly shared growth) and faster growth than does the path that the United States now is following. Inclusive growth mediated by government investment thus yields a double dividend. A greater role for government insurance is economically efficient, by resolving the pervasive problem
of adverse selection in private insurance markets and the impossibility of private markets insuring more existential fortuities. Government insurance also responds to the moral imperatives that animate the covenantal bonds through which we define our society. In the end, brute luck has more to do with the outcomes of our lives than most like to admit; well-designed insurance modulates the worst of these fortuities. The Market Triumphantist view that dominates much current debate rests on the denial of luck; what is required instead is the humility that comes with acknowledging the role of fortune, and with it a commitment to a more empathetic economy.
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Overview of Talk
Fiscal Policy is Everyone’s Business

• Government exists to spend, not to tax
  • We posture about the harms of taxation – e.g. the TCJA debate
  • But tax revenues are not simply consumed by bonfires: they purchase public investment and insurance

• Fiscal policy means thinking about the net effect of government spending and taxing
  • Both returns to spending and larger social returns, net of their costs
  • We should focus – but rarely do – on net effects on our welfare

• Fiscal policy can respond to pressing social issues:
  • Inequality
  • Stagnant incomes of middle class
  • Long-term, broadly-shared economic growth
  • The “covenantal bonds” that bind us to each other
Investment and Insurance

• Government investment generates *inclusive growth*
  • Pie gets larger, *and* the servings are more broadly shared
    • Which in turn is accretive to welfare
  • The *only* instrument that ensures genuine equality of opportunity

• Government insurance is economically efficient . . .
  • Responds to adverse selection and more existential fortuities
  . . . And responds to the moral implications of the irreducible role of brute luck in our material outcomes
    • Reorients us from the *denial of luck* that lies at the heart of Market Triumphantalism
    • Reintroduces an *economics of empathy* at the heart of our covenantal bonds with fellow citizens

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Government is Not a Zero-Sum Game

• Government investment and insurance complement the private sector, not compete with it
  • By responding to necessarily incomplete markets
• Large positive returns to government spending belie false narrative of makers vs. takers
• Standard metrics don’t capture the social returns to government spending
• Government spending is highly progressive in its distributional effects
  • Which means we can obtain a more progressive fiscal system without steeply higher progressive tax rates
• But we must revisit our inadequate tax base!
Fiscal Policy Background
U.S. Fiscal Policy

- Two sides to fiscal policy
  - TCJA demonstrated a myopic focus on taxes, not fiscal policy
  - And an even more myopic framing of “growth”

- Unsustainable federal deficits color everything
  - Greatly exacerbated by TCJA (December 2017)
  - *Now projected to average 5% of GDP over next 10 years*
  - Even with 3% growth, deficits projected to swallow the world
  - Future financing of deficits will have material welfare implications

- Deficits have no information content by themselves
  - Are taxes too low, or spending too high?
  - Or are both inadequate to our needs?
A Low-Tax Small-Government Country

- U.S. tax as % of GDP *lowest* of major OECD countries
  - Includes federal, state and local
  - OECD average (2016): 34.3%; USA: 26%
  - CBO Jun. 2017: federal tax revenues = 18.2% GDP next 10yrs
  - And post-TCJA federal revenues ≈ 17.5% GDP
- Those taxes are shared across all income levels
  - Total tax system is *modestly* progressive
- Government is big spender in only two areas
  - Defense: As much as next 8 countries combined
    - 36% of world spending (reflects China’s build-up)
  - Healthcare – Most inefficient system in world
    - USA – 17.2% of GDP (public and private)
    - Switzerland (#2) – 12.4% of GDP. If we spent at Dutch rate, savings >$11 trillion over decade
Tax Distribution is Not Lopsided

Includes State & Local Taxes

Source: Institute on Taxation and Economic Policy (ITEP) Tax Model, April 2017
A Low-Tax Small Government Country II

- 70% of existing transfers go to elderly
  - And elderly as % of younger adults will almost double by 2040
  - SS + Medicare ≈ $1.6 trillion in FY 2018 (44% of tax revenues)
- USA is 23rd in OECD in total social spending (GDP %)
  - Includes Social Security & Medicare
  - And far below average in most income security programs
  - Income security spending 2018: 1.5% of GDP; in 2027: 1.3%
- Net investment in infrastructure ≈ zero
- Total nondefense discretionary spending trending towards lowest levels in modern history
Fiscal Policy and Inequality
Our Political Environment, Explained

(All data scaled to 1985 = 100)

- **Real GDP Growth**
- **Real median household incomes**
- **Real median full-time wages (Men)**

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So Who Captured the Growth?

Pretax income growth in the United States
1980–2014

Source: Piketty et al, 2016
U.S. Inequality is Real and Corrosive

• Top 1% more than **doubled** their share of total national income from 1979 – 2014 (to 21% of pie)
  • And top 0.01% **tripled** their share (to 5%)

• Top 1% now control **42%** of national wealth
  • And Top 0.01% own >**11%** of all national wealth

• Highest adult poverty rate (18-65) in OECD (GDP %)

• Among the highest ratios of rich to poor in OECD

• **USA is unique in OECD:** high income + high inequality

• “Redistribution” does less in USA than in other rich countries
  • Because we do so little of it!
U.S. Is an Inequality Outlier

Note: The Gini index ranges from zero (perfect equality) to one (one individual or household receives all the income and the others receive none). Data for France and Ireland refer to the mid-2000s instead of the late 2000s.

Source: OECD Income Distribution and Poverty Database, OECD Social Expenditure Statistics (database)
Costs of Inequality

• To begin: inequality is *always* a relative concept
  • From Smith to Veblen to Frank
• Inequality yields immobility
  • Inadequate investment in human capital of lower income kids turns inequality into an *hereditable gene*
• Rent seeking behavior
• Concentration of political and market power
  • Unequal bargaining in marketplace
• Erosion of fundamental social bonds
  • Stagnation in face of acceleration in top incomes
  • Suspicions that system is rigged in some fashion
  • Conversely, conflation of market success with moral merit
Sidebar on Data Sources

• Measuring income & wealth inequality highly contentious
  • Different data sources and measures

• Most recent work converges on consistent findings
  • CBO, Fed Reserve, OECD, IMF, LIS

• Several charts that follow are from Piketty, Saez & Zucman, Distributional National Accounts: Methods and Estimates for the United States, Q. J. Econ. (2018), 1–57.
  • Novel ”top-down” approach that starts with NIPAs and distributes all national income to individuals
  • Very comprehensive measure
  • Responds to criticism over use of tax returns only
Post-1982 Increasing Household Incomes Largely a Story of Second-Earner Spouses

Top 1% Income Share Has Soared

Bottom 50% Income Share Has Fallen

Wealth Distribution Even More Top-Heavy

Source: Saez and Zucman (2016)
Fiscal Intervention Modulates Pre-Tax Results, But Not as Much as in Other Countries

Income Distribution - Gini Measure (2014)

U.S. Does Little “Redistribution”

- Comparing the Gini coefficient of *market incomes* to the Gini of *disposable incomes*, yields a rough picture of effect of tax + transfer system on inequality remediation
  - Market income = cash income + ESI + employer share payroll taxes
  - Disposable income = After-tax, After-transfer income
- By this measure US does little redistribution
- Example: US and Germany have similar market income inequality, but very different disposable income inequality:

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>USA</td>
<td>0.508</td>
<td>0.394</td>
</tr>
<tr>
<td>Germany</td>
<td>0.500</td>
<td>0.289</td>
</tr>
</tbody>
</table>
How Does Germany Do More “Redistribution”?

All taxes (national + subnational) as percentage of GDP - 2014

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>36%</td>
</tr>
<tr>
<td>USA</td>
<td>26%</td>
</tr>
</tbody>
</table>

[Graph showing comparison of tax percentages across various countries]
Fiscal Responses to Deficits and Inequality: Taxation
Fiscal Challenges Summary

- Greatly inadequate tax base for current spending path
- No evidence that the U.S. is the drunken sailor of government spending
  - Except healthcare!
- Social costs of increasing economic inequality
- How should tax policy respond?
  - More revenue is more important than more progressivity!
  - Progressivity addressed through better capital income taxation
    - And revitalized estate tax for the very top end
- But remember tax is only half of fiscal policy
Two Levers of Progressivity

- The left’s preoccupation with progressive income tax (higher marginal rates) is self-limiting and self-defeating
- Well-designed public spending by itself is progressive in practice – the benefits of that spending are broadly shared
- Steeply progressive tax rates thus are not necessary to finance progressive fiscal systems (the net of spending and taxing)
- Other countries have figured this out
  - Germany or the Nordics have more regressive taxation, but a much more progressive net fiscal system, because their commitment to public investment and insurance is larger
- The spending side dominates – mildly regressive taxes can fund progressive net fiscal systems!
More Tax Revenues

- Carbon tax raises $1 trillion over 10 years
  - Kleinbard, WSJ, Sept. 24, 2017
- Only large economy without a national VAT
- Coherent capital income taxation!
- Many mistakes post-TCJA need rectifying
  - “Pass-through” giveaway = $415 billion/10 years
  - Corporate rate (21%) + expensing + interest deductibility is much too generous
    - Right place is 25% + expensing + no interest deductibility
  - Top individual tax rate bracket starts much too high ($600K)
  - Charitable contribution deduction has lost its mooring
    - Donor-advised funds = $85 billion in 2016
  - Estate tax riddled with easy avoidance
    - And double benefit of tax-free step-up w/o estate tax liability
New Political Economy of Capital Income Tax

- We need the eggs
  - Capital income = 40% GDP (including owner-occupied homes)
- Capital income tax addresses top-end income inequality
  - Wealth of course is highly concentrated
  - In turn, capital income tax ≈ periodic wealth tax
- Kleinbard Dual BEIT is revenue-raiser vs. Post-TCJA law
- And is a coherent and comprehensive proposal
Nibbled to Death by Ducks – In a Good Way

• A flat rate annual capital income tax preserves symmetry (ex-post risky return efficiency)

• And is progressive along the relevant margin of time
  • Capital income very top weighted of course
  • Flat rate tax collected annually has increasing effective rate over time – the dreaded “Tax Wedge” in fact is a feature, not a bug
  • Tax must be measured and collected annually though

• An annual income tax can raise same revenues with lower nominal rates than an excise tax structure (cap gains today, consumption tax proposals) (”realization”)

• An annual tax is less susceptible to tax holiday concerns
The Dual BEIT, Tweet-Sized

• "Dual" from Nordic dual income taxes
  • Rejects notion that "ideal" income tax necessarily imposes identical rates on labor and capital income
  • In simplest form, low flat rate on capital income, progressive rates with higher top marginal rate on labor income

• "BEIT" from my fevered imagination
  • Business Enterprise Income Tax (proposed rate: 25%)
  • "Cash flow equivalent" firm tax using capital account allowance
    • Economics ≈ post-TCJA corporate tax @25% + full expensing, BUT no interest deduction
  • Similar mechanism (rate x investment) to determine normal returns includible in investors' income, regardless of cash (again @25%)
BEIT Results

• BEIT economics:
  • Firm-level profits tax
  • Plus investor tax on normal returns
  • Equals comprehensive and consistent tax on all capital income from business – de facto “integration”

• Political economy benefits of BEIT:
  • Optically closer to current law than a cash flow tax
  • Corporate managers happy
  • Moves normal return tax to least mobile taxpayers
  • More robust than cash flow tax to changes in tax rates, and easier transition (depreciation retained, COCA for interest)
  • Radical simplification of tax M&A etc.
What About the Growth Effects of Tax Cuts?

- Most macro tax models = neoclassical GE growth models
  - Greater after-tax returns to labor + capital induce more of each
  - Do *not* model distribution of burdens or benefits—more generally, welfare
  - Growth effects can come by taking from the poor to give to rich
- Called “dynamic scoring” in budget context
  - Modeling future economic growth induced by tax bill, and knock-on implications for tax revenues
- Competing theoretical models, all relying on handful of “representative agents” and highly stylized economy
  - Highly sensitive to economic assumptions (e.g. Fed response)
  - Do not model strategic responses by other countries
Macro Models & Deficits

• Problem post-TCJA is size of deficits
  • Deficits @5% of GDP (CBO 1-2018) in world of 3% or even 4% growth mean that deficits will devour the world!
  • Deficits mean that macro models *must make up* “counterfactual” fiscal policy, including in TCJA analysis
    • [I]n the OLG model there is no equilibrium solution when Federal budget conditions appear unsustainable in the long run. *It is necessary to create counterfactual stable ratios of debt to GDP within both the baseline and policy simulations of the OLG model.*” JCX-22-14.

• Real growth requires actual implementation of those counterfactual policies, with real distributional consequences

• In TCJA work, counterfactual policy was slashing transfer payments starting in Year 30

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Macro Scoring – Whose Growth?

- GDP/GNP growth ≠ aggregate growth in welfare
  - “In the . . . simulations, . . . people work and save more over the first ten years in anticipation of a future loss of valued spending or tax increases [in the distant future], because they recognize the need to accumulate more assets against the anticipated lean period later in their life cycle.” – JCX-19-06
  - I.E., promising to make people poorer in future induces them to work more now to make up for future losses, so GDP goes up
  - Is working longer hours and saving rather than consuming to make up for a loss in “valued” benefits welfare enhancing?
  - Growth is easily measured, but net welfare gains are not
  - Promises of growth often elide over implied redistribution from poor to rich
Macro Scoring vs Distributional Analysis

- Macro scoring says *nothing* about Americans’ welfare
- Distributional analysis is JCT’s nod in direction of welfare
  - But it ties into conventional estimate, not macro estimate
  - It does not distribute the burden of legislated cuts in government services – it is not even a simple *fiscal policy* distributional analysis
  - And it completely ignores distribution of future deficit financing
- Deficits + assumption of future spending cuts mean that “dynamic” score is strongly misleading guide to fiscal policy
  - If government is not drastically pared back, then model is hiding large future tax increases
    - *Whose future tax liabilities go unstated*
  - And if services drastically pared, those are real burdens to some
    - *And again those burdens go unstated*
Tax Distribution Tells Only a Fraction of Fiscal Story
(positive number = more tax or lower benefits)
(Does not include financing of incremental deficits)

TCJA Distributional Analyses
2025

<table>
<thead>
<tr>
<th>INCOME CATEGORY</th>
<th>JCT</th>
<th>CBO</th>
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<tbody>
<tr>
<td></td>
<td>($mm)</td>
<td>($mm)</td>
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<tr>
<td>Less than $10,000 ........</td>
<td>314</td>
<td>8,790</td>
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<td>$10,000 to $20,000 ......</td>
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<td>$20,000 to $30,000 ......</td>
<td>2,980</td>
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<td>$40,000 to $50,000 ......</td>
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<td>-590</td>
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<td>$500,000 to $1,000,000 .</td>
<td>-13,623</td>
<td>-13,790</td>
</tr>
<tr>
<td>$1,000,000 and over ...</td>
<td>-9,600</td>
<td>-9,960</td>
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<tr>
<td>Total, All Taxpayers ....</td>
<td>-145,581</td>
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</tbody>
</table>

Positive number = more tax or lower benefits
(Does not include financing of incremental deficits)
Fiscal Responses to Deficits and Inequality: Inclusive Growth Strategies
Our Largest Investment Opportunities

- Our largest asset class is *ourselves*
  - 60+% of GDP is derived from labor
  - Our lifetime incomes and satisfaction are directly tied to our investments in ourselves through our *health* and our *education*

- Government necessarily must be the investor here
  - Private markets do not and cannot invest directly in people
  - Yet today we are one of 4 OECD countries to spend more on public education of rich kids than poor kids

- Similar Arguments for Infrastructure
  - Public goods (net of financing) are a progressive move
  - Positive social spillovers (jobs with dignity) equally important
Our Largest Investment Opportunities - II

• **Systematic differences in human capital investment convert income inequality into an hereditable gene**
  - Equality of opportunity demands comparable investments in comparably able kids, regardless of parents’ wealth
  - Yet mediocre rich kids get into top colleges and earn more
  - Good health a prerequisite to our welfare, yet we rely heavily on private financing (private taxation)

• **Our mobility outcomes worse than Canada or much of Europe**
  - Top and bottom of income distributions are much stickier in USA than in Canada or much of Europe
    - Both across generations and within one generation
Our Largest Investment Opportunities - III

- These investment opportunities (education, health, public infrastructure) are best exploited by government
- Government investment here yields *inclusive growth*
  - We now all can reach our full potential
- And long-term faster, more sustainable, growth
  - Ostry et al, (IMF) *Redistribution, Inequality and Growth*
  - “[E]ducation and anti-discrimination policies, well-designed labour market institutions and large and/or progressive tax and transfer systems can . . . yield a double dividend in terms of boosting GDP per capita and reducing income inequality.” OECD Going for Growth (2012)
Fiscal Responses to Deficits and Inequality: What’s Luck Got to Do With It?
Luck Has *Everything* to Do With It

- Life’s outcomes are highly contingent
  - We control less of our personal destinies that we like to admit. Our health, accidents (good and bad), wholly fortuitous events – all these change our outcomes.
  - And we do not choose the lives into which we are born – not our parents, not our personal attributes.

- Market Triumphantalism = *the denial of luck*

- It misreads market outcomes as efficient outcomes
  - It ignores both fortuities and incomplete real world markets.
  - It professes objective and scientific advice, but does so for the benefit of a world other than the one in which we actually live.
  - And it is immature in its political philosophy, in claiming an identity between marketplace freedoms and political liberties.
Insurance ≠ “Transfers”

- Government insurance mitigates the consequences of bad luck, in areas that private insurance cannot reach
  - Healthcare one obvious example, where USA fights against the current of adverse selection
  - But accidents of birth are also within purview of a government focused on overall welfare of its citizens
  - We cannot mitigate every unfairness, but that doesn’t mean that we should do nothing at all
- Gov’t insurance can increase risk-taking, not laziness
- Progressive income tax itself is a form of insurance
  - Necessarily payable in arrears rather than up-front
- Not zero-sum game, any more than is private insurance
Brute Luck as a Gateway to Moral Philosophy

• An honest appraisal of the role of brute luck in our lives
• ... Leads to humility in place of Market Triumphalism
• ... And greater empathy towards fellow citizens
  • Feeling others’ pains, understanding their motives
  • Sharing values that we believe define us as a country
• Actualized through accepting the centrality of insurance as a governmental function
• Which in turn institutionalizes an empathetic economy
• All the more urgent with 330 million Americans
  • ....with very different backgrounds
Cultivating Our Fiscal Soul

• When we choose how government should spend and tax, we open a window into our national fiscal soul

• Thinking about our larger obligations, and our opportunities to increase the happiness of society, in the real world – one removed from theoretical models of perfect markets and perfectly rational economic actors

• Fiscal policy thus is about applied moral philosophy as much as it is a story of incentives and preferences

• Both conservatives and progressives get things wrong: We need more government, not less, but we do not need steeply higher top marginal income tax rates to yield a richer, more equal, and happier society
“[W]hat improves the circumstances of the greater part [of society] can never be regarded as an inconvenience to the whole. No society can be flourishing and happy, of which the greater part of its members are poor and miserable.”

– Adam Smith