We Are Better Than This: How Government Should Spend Our Money

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The Book

WE ARE BETTER THAN THIS
HOW GOVERNMENT SHOULD SPEND OUR MONEY
Fiscal Policy in an Age of Inequality

- Government struggles to be effective and efficient
  - So why look to government to solve problems?
  - Why not shrink it to bare bones?
- In fact it is imperative for government to do more
  - **Desirable** – For a more prosperous society and jobs with dignity
  - **Necessary** – To really honor equality of opportunity
  - **Responsive** – To largest socio-economic issue of our times
- Inequality threatens our values and economic future
  - And threatens to become an hereditable gene
  - Government uniquely positioned to respond
Inequality is Real and Corrosive

- Highest adult poverty rate (18-65) in OECD (GDP %)
  - 2011, 4.3% of nonelderly households w/kids in extreme poverty
- Highest ratios of rich to poor in OECD (S90/S10, P90/P50)
- Stagnant male full time worker real wages > 40 years
- CBO: Top 1% doubled its share of national market income 1979 – 2007 (to 21%): *Everyone* else declined
- 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!
Desirable, Necessary + Responsive

• More muscular government is:

• **Desirable** because national economic pie gets bigger when government *complements* private sector through well-designed investment and social insurance
  • Private markets are great, but they inevitably are incomplete in ways that reduce welfare and opportunities

• **Necessary** because government investment + insurance are the only ways to address incomplete private markets, to ensure equality of opportunity

• **Responsive** to soaring income inequality
  • By investing in all of us, and insuring against worst vicissitudes
  • *And can do so consistent with our values and economic growth*
Major Themes of Book

• Positive returns to government investment and insurance
  • Economic as well as social; highly progressive in distribution

• We dishonor values of equal opportunity and mobility

• We are a low-tax small government country
  • Where most resources go to elderly and relatively affluent

• Luck has a lot to do with it
  • Central importance of government as insurer

• Progressive fiscal systems do not require high top rates

• Our fiscal soul is in peril
  • We articulate our values through taxing and spending policies
Returns on Public Investment

- **Government exists to spend, not to tax**
  - Beyond regnal functions, spending is the core of what it does
  - Taxation is just how we finance that spending

- **Government investment and social insurance:**
  - *Complement* the private sector, not compete with it
  - Can grow the economic pie that we all share
  - Are highly progressive in their distributional effects

- Government investment generates large positive returns, just like private investment

- Government insurance programs align with economic theory and reflect the fundamentally contingent nature of our lives and our outcomes
We Put the Cart Before the Horse

• We argue constantly about the harms of taxation

• But how much do we know about opportunity costs of *not* pursuing a social investment or insurance project?

• We should focus on *opportunities net of their costs*
  • That is, the net effect of the totality of spending and taxing
  • Including both narrow economic returns to spending and larger social returns (jobs with dignity, opportunities to succeed)

• Large positive returns to government spending belies false narrative of makers vs. takers
  • The pie gets larger, and the servings are more broadly shared
  • Government is not a zero-sum game!
Our Largest Investment Opportunity - I

• Our largest asset class is *ourselves*
  • Our lifetime incomes and satisfaction are directly tied to our investments in ourselves through education
  • And the country gets richer when we do so

• Equality of opportunity demands comparable investments in comparably able kids, regardless of parents’ wealth

• Government necessarily must be the investor here
  • Private markets do not and cannot invest directly in people
  • Form of government investment in education of course can vary
Our Largest Investment Opportunity - II

• Recent study: 10% > spending K-12 = 7.25% higher wages for a lifetime

• Yet here are the facts:

  • School test scores track median home prices in the area
  • Top quintile spends 7x on enrichment vs lowest quintile
  • Academic achievement gap 30 – 40% > 20 years ago
  • Reason: we are one of 4 OECD countries to spend more on public education of rich kids than poor kids
    • We keep company with Slovenia and Turkey
Our Largest Investment Opportunity - III

- **Systematic differences in human capital investment convert income inequality into an hereditable gene**
  - Mediocre rich kids get into top colleges and earn more
  - Mobility suffers

- **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
    - Across generations
    - And within one generation
A Low-Tax Small Government Country I

- Total tax burden *lowest* in OECD as percentage of GDP
  - Includes federal, state and local
  - And those taxes in fact shared across all income levels
- Total tax system is modestly progressive
- Government is big spender in only two areas
  - Defense: As much as next 14 countries combined
    - 42% of world spending
  - Healthcare – Most inefficient system in world
    - USA – 17.7% of GDP (public and private)
    - Netherlands (#2) – 11.9% of GDP
  - If we spent at Dutch rate, savings >$10 trillion over decade
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 ≈ $1.5 trillion in 2014 (50% of tax revenues)
- USA is 29th in OECD in total social spending (GDP %)
  - And 29th in income security programs
  - Income security spending 2015: 1.7% of GDP; in 2023: 1.3%
- Net investment in infrastructure ≈ zero
- Total nondefense discretionary spending trending towards lowest levels in modern history
We Are Drowning in Pseudo-Economics

- Private markets are great, but they also are incomplete in fundamental and systematic ways
  - Example: Children of the poor receive systematically less investment in themselves than do children of the affluent
- The “Market Triumphantalist” worldview is simplistic, because it posits perfect markets, always.
  - It professes to deliver 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.
- The Growth Fairy low-tax narrative is mythology masquerading as science.
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 Triumphalism misreads market outcomes as efficient outcomes
  • It ignores the pervasive role of luck in our lives, and the incomplete nature of markets in the real world
  • Government insurance mitigates the consequences of bad luck, in areas that private insurance cannot reach

• Gov’t insurance can increase risk-taking, not laziness
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!
Two Percent Solution

• We do not need to become France to do better

• Increasing federal government spending by about 2 percent of GDP would open up many new opportunities

• Spending in the range of 24 rather than 22 percent of GDP

• Numbers very sensitive to wars and healthcare spending

• Not a very big change in our relationship to government!

• But doesn’t government often fail?

• Of course it does, but we have reason to work to do better
Tax is Easy: The Better Base Case

- Clinton-era income tax rates (no change at top)
  - Eliminate AMT and keep child tax credit at current rates
  - Keep dividends and cap gains at 20%
- Cap personal itemized deductions @ 15% benefit
- Eliminate cap on social security contributions
- 2009 estate tax rules ($3.5 million exclusion, 45% rate)
  - But more important, close loopholes so some tax is collected
  - About 5,000 returns/year currently pay estate tax
- Increase gas tax by $0.35/gallon and index
- Done!
Reclaiming Our Fiscal Soul

- When we choose how government should spend and tax, we open a window into our national "fiscal soul"
  - Thinking about our “fiscal soul” reminds us of 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
Advice from a Dead Moral Philosopher

• “Power and riches contrive only to produce a few trifling conveniencies to the body. They keep off the summer shower, not the winter storm, and leave a man always as much, and sometimes more, exposed than before to anxiety, and to sorrow; to diseases, to danger, and to death.”

• “[W]hat improves the circumstances of the greater part [of society] can never be regarded as an inconveniency to the whole. No society can be flourishing and happy, of which the greater part of its members are poor and miserable.”

– Adam Smith
Appendix I

OUR DISMAL REPORT CARD
The United States is a Low Tax Country (2014 Projections)
Tax Distribution is Not Lopsided

Includes state and local taxes
(Source: CTJ)
U.S. Gap Between Rich and Poor is Wide

S90/S10 Ratios of household disposable incomes (2010)

U.S. Accepts Much More Poverty

Poverty Rate, Poverty Line 50%, Population Ages 18–65, after taxes and transfers (2010)

Male Workers’ Median Earnings Flat for 40 Years

Figure 2.
Female-to-Male Earnings Ratio and Median Earnings of Full-Time, Year-Round Workers 15 Years and Older by Sex: 1960 to 2013

Earnings in thousands (2013 dollars), ratio in percent

- Female-to-male earnings ratio
- Earnings of men
- Earnings of women

Note: Data on earnings of full-time, year-round workers are not readily available before 1960. For more information on recessions, see Appendix A. For information on confidentiality protection, sampling error, nonsampling error, and definitions, see <ftp://ftp2.census.gov/programs-surveys/cps/techdocs/cpsmar14.pdf>.

Median Household Incomes Have Only Crept Up

Median Household Market Income, 1979 to 2010 (2010 Dollars)

O.5% Per Annum Compounded Growth Over 30 Years
Existing Transfers Largely Fund the Elderly

![Graph showing the proportion of transfer programs funding elderly, childless, and household with children from 1979 to 2007.](Image)
Distribution of Positive Changes in Income Shares After Taxes And Transfers

1. Take shares of market incomes by quintile
2. Compare to shares of post-tax and transfer incomes
3. Top 2 quintiles are net transferors
4. Among bottom 3 quintiles, what fraction of net transfers does each quintile capture?

Source: CBO and Author’s Calculations
U.S. Invests Almost Nothing in Infrastructure

Net government investment in infrastructure as percentage of GDP
Appendix II

• RISING INCOME INEQUALITY IS REAL
Rising Inequality Is Real

Summary Measures of Income Inequality, With and Without Transfers and Federal Taxes

Gini Index

- Market Income
- Market Income Plus Transfers
- Market Income Plus Transfers Minus Federal Taxes

Rising U.S. Income Inequality Really is About the 1 Percent

Growth in real after-tax income 1979 - 2007

- Lowest Quintile
- Second Quintile
- Middle Quintile
- Fourth Quintile
- 81st-99th Percentiles
- Top 1 Percent
Everyone Has Lost Ground Relative to 1%

**Shares of Market Income, 1979 and 2007**

(Percent)

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<td>Middle Quintile</td>
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<td>Fourth Quintile</td>
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<td>Highest Quintile</td>
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Source: Congressional Budget Office.
U.S. vs OECD Income Inequality Trendline

(Source: OECD, *Divided We Stand: Why Inequality Keeps Rising*, Country Note: United States)
Healthcare Subsidies Change Little

**Effect of Health Insurance on Income Inequality Measures**

(Gini index)

- **Market Income Plus Nonhealth Transfers**
- **Market Income (With ESI)**
- **Market Income Without ESI**
- **Market Income Plus Transfers Including the Average Cost of Medicare, Medicaid, and CHIP**
- **Market Income Plus Transfers Including the Fungible Value of Medicare, Medicaid, and CHIP**

Source: Congressional Budget Office.

Notes: For information on income definitions, the ranking of households, the allocation of taxes, and the construction of inequality indexes, see "Notes and Definitions" at the beginning of this study.

ESI = employer-sponsored health insurance; CHIP = Children’s Health Insurance Program.
Appendix III

FROM PROGRESSIVE TAX TO PROGRESSIVE FISCAL SYSTEM
U.S. Does Little “Redistribution”

- Comparing the Gini coefficient [a standard measure of inequality] 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 (*CBPP 5/14*)

- Example: US and Germany have similar market income inequality, but very different disposable income inequality:

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<tbody>
<tr>
<td>USA</td>
<td>0.508</td>
<td>0.389</td>
</tr>
<tr>
<td>Germany</td>
<td>0.506</td>
<td>0.293</td>
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</table>
## Gini Coefficients of Market and Disposable Incomes, Working Age Populations, Late 2000’s

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Income Gini</th>
<th>Disposable Income Gini</th>
<th>Percent Decrease In Inequality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>0.4647</td>
<td>0.3342</td>
<td>28%</td>
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<tr>
<td>UK</td>
<td>0.4559</td>
<td>0.3446</td>
<td>24%</td>
</tr>
<tr>
<td>USA</td>
<td>0.4527</td>
<td>0.3701</td>
<td>18%</td>
</tr>
<tr>
<td>France</td>
<td>0.4310</td>
<td>0.2920</td>
<td>32%</td>
</tr>
<tr>
<td>Germany</td>
<td>0.4197</td>
<td>0.3000</td>
<td>28%</td>
</tr>
<tr>
<td>Australia</td>
<td>0.4180</td>
<td>0.3236</td>
<td>22%</td>
</tr>
<tr>
<td>Canada</td>
<td>0.4158</td>
<td>0.3283</td>
<td>21%</td>
</tr>
<tr>
<td>Japan</td>
<td>0.3916</td>
<td>0.3235</td>
<td>17%</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.3723</td>
<td>0.2269</td>
<td>39%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.3380</td>
<td>0.2902</td>
<td>14%</td>
</tr>
</tbody>
</table>

Source: OECD, *Divided We Stand* (2011), Fig. 6.1 supplemental tables
USA:
A Progressive Tax But Unprogressive System

Effect of net fiscal system on mitigating inequality (vertical) vs income tax progressivity (horizontal)
Adding Consumption Taxes to the Mix


**Figure 6** Overall progressivity of tax structure (including sales tax).
Nerdy Notes on Distributional Data

- Index of tax progressivity usually is income tax only
  - But see previous slide; more work here would be great
- OECD and CBO disposable income is pre-VAT or sales tax
  - Apparently difficult to merge income and consumption data
- OECD vs CBO definition of household market income
  - Both include employer share of payroll taxes (OECD Framework p. 82)
  - OECD ignores capital (“holding”) gains (Id. p. 86), but CBO does not
  - OECD ignores undistributed corporate income and tax; CBO imputes corporate tax but not undistributed corporate income (!) [Trends p. ii]
  - OECD ignores life insurance and other lumpy payouts (also inside buildup)
- Different modes of delivering healthcare subsidies
  - CBO “market income” includes ESI; OECD seems to follow
  - Government health insurance programs treated as taxes out and transfers in, so reflected in disposable income but not market income
  - In-kind health services (VA, National Health Service) [“STIK”] ignored, except in OECD “adjusted” disposable income, which isn’t used much
Why Isn’t Our Progressive Tax Doing More?

• Assume for the moment that rising inequality is an issue that should be addressed by the fiscal system

• By some measures the U.S. has the “most progressive” tax system in the OECD

• But our high market income inequality is not remediated very much through our tax system

• Why not? Can the tax system do more? Or is there a missing piece to the puzzle?

• The answer lies in our relative inattention to the spending side of the ledger
What is a “Progressive” Tax Anyway?

• The technical definition of a progressive income tax is one where the effective [i.e., average] tax rate goes up as income goes up
  • Same principle of course can be extended to a consumption tax

• Increasing tax rate brackets (step-ups in marginal rates) get you there
  • But so does a single tax rate with an exemption of the first $X of income
  • Or even tax brackets with declining rates for income beyond a certain level, so long as the lower marginal rates were higher than the effective rate when those marginal rates kicked in
Competing Measures of Progressivity

- **Kakwani Index – a dangerous measure**
  - Measures progressivity of a tax system in the abstract
  - Tax concentration compared to income concentration
  - Small tax imposed on the most affluent is scored as highly progressive
  - The US personal income tax is very progressive, *by this measure*

- **Reynolds-Smolensky Index**
  - A true ‘before and after’ measure
  - Compares standard inequality measure (Gini index) before and after handprint of government
  - Ideally compares market incomes with after-tax/after-transfer incomes
  - *Three* variables: the progressivity of the tax system in the abstract, the size of the tax system, and how the resulting revenues are spent.
Why Might We Want Progressive Taxation?

• Several implausible or circular theories

• Benefits theories

• “Ability to pay” (fair allocation of burdens)

• Declining marginal utility of income?
  • Declining marginal utility of pineapple consumption is easy to accept, but does that apply to all uses of income?

• Dime-Store Rawls: Insurance salesman behind the veil?

• Because our real interest is inequality as such?
Different Theories Point in Different Directions

- Declining marginal utility of income
  - Still some positive utility!
  - Really different from just asserting a preference for equality?
  - Leaves the size of government as an exogenous preference

- Insurance theories
  - Refocuses debate on how much insurance we want to buy
  - Progressive tax itself becomes the logical expression of the insurance program
    - Premiums in arrears
    - Or more simply, progressivity as the vehicle for delivering some insurance benefits (tax relief via lower rates as insurance payout)
Progressive Tax as Inequality Antidote

- Sets up impossible political economy debates
  - How much redistribution is enough?
  - “Class warfare” etc
  - Frames issue as zero sum debate
- Puts Cart Before Horse
  - Shifts focus away from the returns to government spending
    - Economic (in narrow sense) as well as social returns
    - And shifts focus away from distribution of that spending
- Self-defeating because self-limiting in unintended ways
  - Adverse incentive effects and political economy constraints
What Drives Progressive Fiscal Systems?

• Spending Not Taxes!

Source: Joumard et al, Less Income Inequality and More Growth – Are They Compatible? Part 3 (OECD WP # 926 (2012)), Fig. 2
CBO Data Consistent With Role of Transfers

- Transfers move the Gini Index more than taxes do

<table>
<thead>
<tr>
<th></th>
<th>Lowest Quintile</th>
<th>Second Quintile</th>
<th>Middle Quintile</th>
<th>Fourth Quintile</th>
<th>Highest Quintile</th>
<th>Gini Index</th>
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<tbody>
<tr>
<td>Average Market Income</td>
<td>12,600</td>
<td>36,100</td>
<td>59,500</td>
<td>89,900</td>
<td>240,800</td>
<td>46.50</td>
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<tr>
<td>Market Income Minus Taxes</td>
<td>10,000</td>
<td>29,600</td>
<td>47,700</td>
<td>70,200</td>
<td>172,700</td>
<td>44.34</td>
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<tr>
<td>Market Income Plus Benefits Minus Taxes</td>
<td>26,600</td>
<td>40,300</td>
<td>58,100</td>
<td>82,900</td>
<td>201,900</td>
<td>38.38</td>
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</table>

(Source: CBO, *The Distribution of Federal Spending and Taxes*, and author’s calculations.)

- And of course there is more to spending than transfers
Regressive Taxes Can Fund Progressive Fiscal Systems
The Size of the System Drives The Results
And Large Tax Systems Are Not Very Progressive
What Do We Know About the Progressivity of Our Fiscal System?

• Not that much! First CBO analysis November 2013

• Highlights
  • 40% of government spending is undifferentiated
  • Transfers reduce inequality less in 2007 than in 1979
  • Elderly childless households capture ~70% of transfer payments
  • And elderly get NET ~$20,000/household [all benefits* – taxes paid]

• Lowlights
  • Unconvincing methodologies for distributing undifferentiated spending
  • Ignores large tax expenditures, like employer-sponsored insurance, as having unique distributional consequences
  • Does not deal with intergenerational distributional issues

* “Benefits” includes undifferentiated spending allocated by market incomes
Progressivity Lessons

• There are *two levers of progressivity*!
  • Taxing and spending follow separate trajectories
  • Practical and incentive effect reasons to limit progressivity of tax system
  • Which leads to reliance elsewhere on larger but non-progressive tax systems plus progressive social investment
• Larry Summers’ VAT joke doesn’t get it quite right
• VAT – a regressive tax but a progressive fiscal instrument