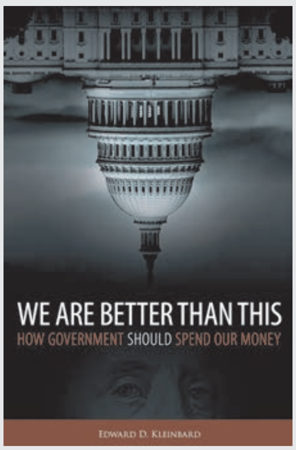
Book Review of Kleinbard's *We Are Better Than This*

Reviewed by David Cay Johnston



We Are Better Than This: How Government Should Spend Our Money, by Edward D. Kleinbard. Published by Oxford University Press (2015). Hardcover, 509 pages. Price: $29.95.

We Are Better Than This: How Government Should Spend Our Money by Edward D. Kleinbard is a comprehensive, thoughtful, and informed volume on taxation and government spending.

This masterpiece of tax, fiscal, and economic policy is richly endowed with philosophical insights from Adam Smith's *Theory of Moral Sentiments* and holds the potential to change our often dogmatic and sometimes toxic public debate over how we tax ourselves and spend our tax dollars into a conversation about how to raise more money with less pain and spend in ways that will produce a happier America.

Kleinbard's book is especially useful in proposing a new way to measure capital incomes and a much smarter way to tax corporate profits. The book does have flaws, not least of which is that he spends more than 260 mellifluous pages laying the foundation for his solidly crafted but brief structure of solutions. The last 150 pages are more valuable after absorbing his rich insights.

Kleinbard deserves our attention because, after decades of being one of the savviest architects of tax avoidance strategies on Wall Street, he has been doing penance as a professor at the University of Southern California's Gould School of Law. He is on a mission to show how we could have a smarter, more efficient, and more effective tax system. Kleinbard is willing to substitute the simplicity and efficiency of rough justice for the ever more finely diced rules progressives have promoted for over a century as the best way to get a fair society. Such fine rules produce the unintended consequence of being material for unexpected pathways through the tax code to what Kleinbard calls stateless income, because no government taxes it.

The book challenges bedrock tax policy assumptions — the marginal utility of income theory; the value of progressive taxation; the idea that regressive taxes are bad and should not be used to fund universal services like healthcare, education and infrastructure; the way we tax capital incomes, especially now that most businesses are pass-through entities, which he calls incoherent.

Consider what Kleinbard says he learned about marginal utility, the idea that each added dollar is less important to the recipient's welfare:

> In my prior life, when I worked a great deal with affluent clients, I found the declining marginal utility of income theory to be violated at every turn. The affluent clients with whom I worked largely shared the view that they sincerely loved money, that money was attracted to them because it sensed their love, that they knew how to take care of money and give it a good home, and that other less affluent individuals would horribly mistreat that money. I sometimes thought that these fortunate individuals stayed up at night ironing their dollar bills, so they would look neat and tidy. If there is such a thing as the declining marginal utility of income, someone forgot to tell these folks.

Most Tax 101 courses, and certainly most Econ 101 courses, never touch this idea, focusing instead on the marginal utility of consumption, often using the old saw about eating a fine dinner at a restaurant that offers a second sumptuous meal directly after at a 90 percent discount.

For those who love money for its power to produce more money, each additional dollar is more, not less, valuable —- an insight rich with possibilities for crafting tax law. Certainly for the Carl Icahns of the world, for whom the size of your cash hoard determines the size and force you can bring to deals, more is better.

Kleinbard also lays a foundation to show why sales taxes and value added taxes, while inherently regressive, can be a boon. Drawing on Smith, Kleinbard shows that "to a first order of approximation, consumption taxes of all species are just more income taxes on wages" and that workers don't much care whether they are hit with income, payroll, or sales taxes.

Kleinbard embraces progressive tax structures as sound policy but then notes that this is neither the all-encompassing philosophy nor the purpose of tax. He says a good dose of regressive taxation to fund universal services like healthcare, education, and transportation infrastructure would be good for economic growth — as well as happiness. He argues, in essence, that when a society makes use of joint purchasing power and universal risk sharing, it is reasonable to tax in a way closer to per capita costs than on the basis of economic gains. This important distinction may finally cause liberals and conservatives to think about tax structure in a sophisticated way.

He notes that "technically, increasing marginal rates are not a necessary component of a progressive income tax" and derides the New Deal era effort to use progressive tax rates to remediate income inequality, citing Tax Analysts historian Joseph J. Thorndike's work. Kleinbard writes that in retrospect, "the idea that high taxes on the rich" are socially desirable "in and of themselves — an income inequality remediation program — was an authentically terrible innovation." Kleinbard explains to Joe and Joan Taxpayer, who pay America's taxes, which are the lowest rates among the 34 countries in the Organization for Economic Cooperation and Development, why taxes feel so painful. "The United States is a tax expenditure junkie," spending $1.2 trillion annually on taxes not collected because of favors that often make no sense — like subtly subsidizing both fossil fuels and green energy, a practice he likens to mental illness.

"Our *tax rate structure* operates as if we collected more than $2 trillion in income tax, not $1 trillion and then ran additional government spending programs that cost more than $1 trillion/year," Kleinbard writes.

Government spending, in Kleinbard's analysis, matters as much as taxing. He argues that in terms of societal stability and growth, they cannot be separated. He decries the fall in net government investment from more than 3 percent of the economy in 1967 to less than 1 percent today, arguing that we must invest much more or else inevitably become less affluent than we are today. "Public investment yields high returns both in straight economic terms and in respect to the ultimate purpose of government, which is the happiness of society," Kleinbard said.

Instead of looking at progressive taxation in the abstract, we should be "asking which tax systems most neatly complement our collective investment and social insurance objectives."

How to Tax Capital Incomes

Kleinbard provides elegant solutions built on a solid foundation of explanation. One of the few areas where he fails to call upon his earlier work is the damage done by tax deferral, which allows inflation to erode the sum ultimately collected while making what amounts to 0 percent interest loans. This huge stealth subsidy deserves attention, especially in a book that explains the difficult concept of the time value of money in plain English.

Fundamental tax reform would be nice, Kleinbard writes, adding that "there is no need for fundamental tax reform." What we need is a better understanding of how to tax capital and how to tease out the capital component of compensation so that labor and capital are distinct rather than mixed. Kleinbard sees economic incoherence and biases in measuring and taxing capital income that damages the fisc and our souls.

He dismisses the tax distinctions between debt instruments and equity as largely artificial and derides those fine distinctions as "cubbyholes."

The problem of separating capital income from compensation for services arises with owners and managers of companies who can take advantage of the lower tax rates on dividends to avoid properly reporting compensation for their labor. This would not be important but for the policy change since the 1980s that led to most for-profit enterprises being organized as passthrough entities.

The proliferation of passthrough entities in the United States "has greatly complicated the politics of corporate tax reform" because of the assumption that if something is done for corporations to relieve taxes, something must also be done for the passthroughs. Kleinbard rejects this thinking.

He would create "the labor-capital income centrifuge, to tease apart labor and capital income when they are commingled in the hands of a small business owner-manager."

Kleinbard says self-assessment would be easy if we recognize that capital incomes come in three varieties: normal, risky, and economic rents.

To determine normal returns, which would not be taxed at the business level, Kleinbard would institute a simple cost of capital allowance (COCA). It would apply equally to debt or equity, ending the tax system's bias in favor of debt. Kleinbard proposes using the rate for one-year Treasuries to establish the normal profit levels exempt from tax.

Imagine a firm, with $100 million of capital when the one-year Treasury rate is 2 percent. The first $2 million of profit in this scenario is what Kleinbard calls normal returns. He would exempt those normal returns from taxation because they are basically the time value of money. If the firm earned $5 million of profit, it would be taxed only on the $3 million above normal returns.

He says this would make depreciation schedules irrelevant — schedules Congress often tinkers with at the behest of this or that special pleading by investors and businesses whose bundled campaign donations buy these favors that unlevel the playing field.

He also says we need to coordinate the firm-level and individual-level measures of income. This will require, he writes, distinguishing between assets that produce income and financial assets representing ownership of productive capital. "Coordinating the taxation of returns to real and financial assets is one of the great challenges in designing a practical income tax" because many economists conflate real assets with financial assets.

"Because capital income taxation long ago fell out of academic favor, very little work has been done in recent decades in rethinking how we might better define the capital income tax base," Kleinbard says. He faults Treasury's 1992 study (Rita Zeidner, "Treasury Releases Long-Awaited Study Urging Corporate Integration," *Tax Notes*, Jan. 13, 1992, p. 112) proposing a comprehensive business income tax because it assumes that corporate profits are properly measured and taxed between the corporate income tax and individual taxes on dividends and capital gains.

"It is possible to do better than that," he writes, launching into a discussion of his reform proposal.

We also must confront the "realization doctrine" under which investments are taxed only when sold, "even though in an economic sense those profits accrue every day and even though the remainder of our income tax is calculated on an annual basis. The realization doctrine in practice means that the taxation of capital gain — a very important instance of capital income — is essentially optional on the part of the taxpayer."

Building on the model in Nordic countries, Kleinbard would impose what he calls the "BEIT" tax.

The BEIT, pronounced bite, introduces "a feasible system for taxing capital income at a flat rate lower than progressive rates on taxing labor income." Kleinbard's technique would separate the capital returns of an owner-manager from compensation for his labor in a way that he says is easy to self-assess.

Kleinbard's BEIT "adapts to novel strategies. First, unlike other comprehensive income tax proposals, the BEIT splits the taxation of returns to capital by taxing time value of money (normal) returns only at the *investor* level, while taxing extraordinary returns at the *business enterprise* level."

Companies that earn economic rents because of monopolies, patents and unique marketing situations would be fully taxed, but only on the profits they earn above the tax-free level from the COCA.

He refers briefly to a "DUAL BEIT," to point out that labor and capital can be taxed at different rates, an important issue in closely held businesses where the owner can characterize income as compensation for services or as dividends.

We also need "a tax system that eliminates any US tax incentives to retain foreign profits in foreign subsidiaries if the optimal uses of the funds are back in the United States." Such rules, he emphasizes, must also protect against stateless income.

He sees two basic approaches — a "territorial" tax with teeth, by which he means tough rules against this erosion, or a "full inclusion" system for the parent firms of multinational groups.

Territorial with teeth "is more consonant with world norms, but it is extremely difficult to implement anti-abuse rules that accomplished their intended purpose, and no more. The full inclusion method is closer to traditional US norms, is easier to implement, and is much more robust to [blocking] creative tax planning shenanigans."

Readers short of time but well-versed in economic theory would do well to read the Smith quotations that start each chapter and consider the solutions sections but beginning a bit early on page 267 with an examination of the value of government investments. There Kleinbard examines how a social safety net encourages economic growth and risk-taking.

Kleinbard takes on "market triumphalists who systematically confuse" individual freedom with good sense "as if only those cocooned by excessively cushy safety nets and personal cowardice would carry automobile liability insurance or ride a bicycle while wearing a helmet. The result of following their advice would be socially suboptimal levels of risk-taking, along with individual catastrophic outcomes that could've been avoided. Together these drag down the happiness of society far more than do the social insurance premiums we pay, or the moral hazards these programs expose us to."

Kleinbard is just as tough on progressives he says wrongly describe redistribution "as a value-neutral term, when it is not."

Throughout the book, Kleinbard argues taxing and spending are the yin and yang, the alpha and omega, that should always be viewed together. He repeatedly cautions about proponents of every perspective looking at only one side of the coin.

America and American business cannot long prosper if we continue to underinvest in public goods that enable broad prosperity, he argues —- especially education, health, infrastructure, and basic research. Kleinbard argues that progressive tax rates alone will not generate the revenue necessary for the combination of public investments that a complex and risk-taking society requires to prosper in the future.

Creating a happy society, or at least one in pursuit of happiness, is the point of government, Kleinbard writes, noting that, in a recent study of major nations, America ranked 17th in overall self-reported subjective well-being.

In a line targeted at progressives but true for all, Kleinbard says that what we “really should care about is whether government, taken as a whole, enhances the happiness of society by making socially useful investments and by appropriate levels of social insurance. These goods are financed by tax revenues, but the tax revenues are not the point of the system — the goods are.”

David Cay Johnston received the Pulitzer Prize for his coverage of tax policy while at *The New York Times.* He now teaches at Syracuse University College of Law and is the author of three books about taxes — *Free Lunch*, *Perfectly Legal*, and *The Fine Print*.