SEARCHING FOR OUR FISCAL SOUL

Edward D. Kleinbard
Johnson Professor of Law and Business
ekleinbard@law.usc.edu
What is a “Fiscal Soul”?  

This presentation is not designed to warm the cockles of your heart.

Instead it is meant to challenge you to grapple with the conference’s theme of empathy in the most difficult setting imaginable. I will ask you to feel empathy for people whom you don’t know, and whom, if you did know, you probably wouldn’t like – which is to say, your fellow Americans.

And to make matters worse, will suggest that the way to express that empathy is to bulk up government, and in turn to sign up for a bit more by way of taxes.

I spent decades trying to make the world a better place by improving tax policy, until I came to realize that tax policy is much less important than I had thought.

What matters more is the other side of that coin – how government spends the money it collects in taxes. That’s fiscal policy – the sum of government spending and taxing.

Democracy is an exercise in empathy towards fellow citizens we scarcely know. We express that empathy primarily through government spending. That’s how we actualize the values we are willing to pay for.

That’s what I mean by our fiscal soul.
From Tax Geek . . .

. . . to Old Testament Fiscal Prophet
A Fiscal Policy Jeremiad

If we want a happier and a wealthier country, we need more government, not less. That’s a hard sell in contemporary America! When I started down this path I would joke that I had been sent on a mission from God, and that God doesn’t have to staff the fun projects – they take care of themselves.

By now I have internalized the joke and can present myself in a manner consistent with my self-conception, which is as an exceedingly minor Old Testament prophet, but one assigned to the fiscal policy beat….

That’s the impulse that motivated We Are Better Than This: How Government Should Spend Our Money (Oxford U. Press 2014)
A Rich Country Filled With Anger

• We have become atomized, mean-spirited and angry about economy and government

• But our GDP and unemployment numbers are the best of any big economy in the world

• So why have we become a nation of jerks?
What Do We Want?

Good pay from meaningful work

*Americans define ourselves through work*

A society imbued with fairness

*Equality of opportunity and economic mobility*

But what do we feel we’re getting?

*Screwed!*
Presidential Politics, Explained

(All data scaled to 1985 = 100)

Real GDP Growth

Real median household incomes

Real median full-time wages (Men)

Source: St. Louis Fed Reserve (FRED)
While Rich Really Are Getting Richer

Cumulative Growth in Inflation-Adjusted Household Market Incomes
1979-2013

- Bottom Quintile
- Middle 3 Quintiles
- Top 1%

Cumulative Percentage Growth From 1979 Baseline
Rich Getting Richer (Background)

This chart shows the cumulative growth since 1979 in the incomes of different slices of society – the poorest fifth of Americans, Americans in the middle class, right up to the 80th percentile of incomes, and the top 1 percent.

You can see here in whose pockets economic growth has landed – it almost all went to the top 1 percent.

And the irony is that the top 1 percent feel just as aggrieved as you do, because the top 1 percent of the 1 percent – the top 1/10,000 of Americans by income – have pulled away from the rest of the 1 percent at an amazing speed. And in turn the rest of the 1 percent can barely see all of us in their rear view mirror.

The chart’s data come from the Congressional Budget Office’s most recent study of income distribution, *The Distribution of Household Income and Federal Taxes, 2013*. Inequality apologists often argue that galloping top-end inequality is overstated, because (1) tax return data are used, which overlooks fringe benefits, employer-provided healthcare, etc.; and (2) household size has changed over time. But CBO includes all income and adjusts for household size.
Top-End Inequality Data are Appalling

- 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
More on Top-End Inequality

Here are some facts and figures to make the previous slide’s points more concrete.

Think about our national income each year as a terrific pecan pie that we all sit down to eat. The pie has never been shared equally of course, but that’s ok – we accept the idea that some people are going to earn more money than others. And the pie isn’t the same size every year – it grows, through national economic growth.

But something strange has happened since about 1980. The top 1 percent have doubled their share of the national income pie. The pie itself has grown larger – that’s what economic growth means – and at the same time, the top 1 percent now take two large slices of the bigger pie, when a generation ago they were fine with one large slice of a smaller pie.

And the top 1/10,000 of Americans take 3 really big servings rather than the one slice they were satisfied with a generation ago.

And wealth is even more top heavy. The top 1 percent today own 42 percent of the country. The top 1 percent of the 1 percent by themselves own more than 1,000 times the amount of wealth that they would own if our national wealth were distributed evenly.
Poverty Remains Our National Shame

- *Highest* adult poverty rate in OECD (GDP %)
  - Organization of Economic Cooperation and Development – 34 countries (most major economies)

- *Highest* ratios of rich to poor in OECD

- 29th in OECD in social spending (GDP %)
  - And 29th in income security programs

**USA is unique: high income + high inequality**
Explicating the Poverty Data

It is useful to benchmark the United States against to how other rich countries grapple with similar issues. The OECD – the Organization of Economic Cooperation and Development produces helpful comparative data, and includes all the rich countries of the world to which we might plausibly compare ourselves.

When you benchmark the United States against our peer countries on important metrics like poverty or social services, you discover that time after time we get some of the worst grades in the class. For millions, life as it is lived in America diverges wildly from the values and practices we preach as expressing ourselves.

For example, the US has the highest poverty rate among adults of any country in the OECD, as a percentage of our national income – which is the standard OECD metric. Yes the poor in America often have refrigerators and TVs, but that sort of talk is cheap and childish. Inequality apologists pick the consumer goods that have plummeted in price over the years, and ignore the goods that have become prohibitively expensive, but that are vital to the lives we live – like decent housing in safe neighborhoods, or healthcare (even after the Affordable Care Act), or quality education, which is the key to economic opportunity.

You see the centrifugal forces tearing apart America when you compare the incomes of our richest to the poorest Americans. In Norway that difference is about 6 times, in Canada 9, and in the UK 10 times. But in the United States, the gap is 16 fold.

The United States has defied the experts, but not in a good way. Economists formerly believed that GDP growth and greater equality went hand in hand – as a country got richer, its society would naturally become more equal in economic terms. But the United States has proved that precisely the opposite outcome is possible.
Economic Issues Drive Social Anger

• Our economy’s centrifugal forces:
  – Rising top-end inequality
  – Fading belief in equality of opportunity
  – Stagnant incomes of middle class

• Lead to:
  – Rage at working harder but falling further behind
  – Conviction that the game is rigged against us
  – Repudiation of connection to fellow Americans

*But these trends are not inevitable*
What Makes a Democracy Functional?

• Our politics depend on our working together
  - Feeling others’ pains, understanding their motives
  - Sharing values that we believe define us as a country
  - Actualizing those values through common action, as intermediated by government
  - In other words, through *institutionalized empathy*

• All the more urgent with 330 million Americans of very different backgrounds

• *Instead . . . .*
We Are Teetering on the Edge

• **Tribalism**
  - Defining our group by denying connection with others

• **Narcissism**
  - How did narcissism become a normal mode of processing all our interactions with the outside world?
  - A Selfie Society?

• **Neo-feudalism**
  - Empathy not so easy when incomes differ by 1,000x
  - *Inequality is becoming a hereditary gene*
Cultivating our Fiscal Soul

• What social glue can institutionalize empathy?
  - For all Americans?
  - Delivering equality of opportunity and other values?

• Government fiscal policy is that social glue
  - Fiscal policy connects us to all our fellow citizens
  - It actualizes the values we care enough to pay for
  - And seizes economic opportunities that private markets cannot

This is our “fiscal soul” in action
It’s The Spending, Stupid

- Government is in business to *spend*, not to *tax*
  - Taxation is simply how we finance that spending
- Tax revenues are not consumed by bonfires
  - They purchase **public investment** and **insurance**
- Public investment:
  - Infrastructure, basic research, education
  - Yields big returns, and creates jobs with dignity
- Public insurance:
  - Reflects fundamentally contingent nature of our lives
Complementary Economy in Action

• Economic pie gets bigger when government complements private sector
  - Private markets are great, but inevitably are incomplete, reducing our welfare and opportunities
  - Public investment and insurance fill the gap

• And the bigger pie is more broadly shared
  - In ways that are consistent with our values
  - This is primary role of government insurance

So it’s not a makers vs. takers game at all
But How Can We Afford To Do Better?

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

- Germany: 36%
- USA: 26%
A Low-Tax Small Government Country

- US taxes: low + shared across all income levels
  - Total tax system is only modestly progressive
- 70% of existing insurance transfers go to elderly
  - And elderly as % of younger adults doubles by 2040
- Net investment in infrastructure ≈ zero
- Total nondefense discretionary spending trending towards lowest levels in modern history
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

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

• Government necessarily *must* be the investor here
  - Private markets cannot invest directly in people
  - 10% more spending on K-12 = 7.25% higher wages for life
Our Largest Investment Opportunity - II

• Yet here are the facts:
  - School test scores track median home prices
  - 850,000 HS students without a school counselor
  - 800,000 students where > 20% of teachers are unlicensed
  - Academic achievement gap 30-40% > 20 years ago
  - International standardized scores mediocre, or worse

• Because US spends more on public education of rich kids than poor kids
Our National Balance Sheet

Think about our national balance sheet for a moment – our country’s assets and liabilities. What are our most important assets? It’s ourselves – the great wealth of this country walks around on two feet. We each have a tremendous amount of wealth invested in us in terms of our formal education, our on the job training, etc.

If investment in human capital is so important, it stands to reason that equality of opportunity demands that we make comparable investments in comparably able kids, regardless of their parents’ wealth.

But who can make those investments in human capital? *Only government*

But because most of country finances public education through local property taxes, the US is almost unique in spending more on the public education of rich kids than poor kids.
Muscular Government or Neo-Feudalism?

- Systematic differences in educational investments convert income inequality into an hereditable gene
  - Mediocre rich kids get into top colleges and earn more
  - Preserving family’s place in pecking order across generations

- US economic mobility outcomes are worse than in Canada or much of Europe
  - Top and bottom of income distributions much stickier in USA
    • Across generations
    • And within one generation
Insurance: Luck Has A Lot to Do With It

• Life’s outcomes are highly contingent
  - We control less of our destinies that we like to admit

• Government insurance alone can respond
  - Insurance ameliorates the financial consequences of “adverse fortuities” – bad luck
  - Government insurance does so in areas that private insurance cannot reach

• Insurance and investment combine to offer all Americans most fulfilling opportunities possible
Robust Insurance or Narcissism of Success?

- We confuse our own success with karmic order
  - We discount others’ investment in our human capital
  - We confuse sheer good luck with our own talents
  - And our skills and parents as things we chose before birth

- Progressive income tax and insurance respond
  - They instantiate a *democratic social compact*
    - We all embark on the adventure of life, and
    - We agree in advance to contribute to the kitty out of future material rewards that come our way
    - Thereby mitigating the worst outcomes
The Takeaway

- We systematically dishonor equal opportunity and mobility
- We are a low-tax small government country
  - Most resources go to elderly and relatively affluent
- Big returns to public investment and insurance
  - Economic as well as social; highly progressive in distribution
- Luck has a lot to do with it

...OUR FISCAL SOUL IS IN PERIL
There’s Lots More to Discover

WE ARE BETTER THAN THIS
HOW GOVERNMENT SHOULD SPEND OUR MONEY