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Fiscal Policy in an Age of Inequality

Edward D. Kleinbard
Johnson Professor of Law and Business
ekleinbard@law.usc.edu

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Every new tax is immediately felt more or less by the people. It occasions always some murmur, and meets with some opposition.

—Adam Smith, *The Wealth of Nations*, Book V, chap. III

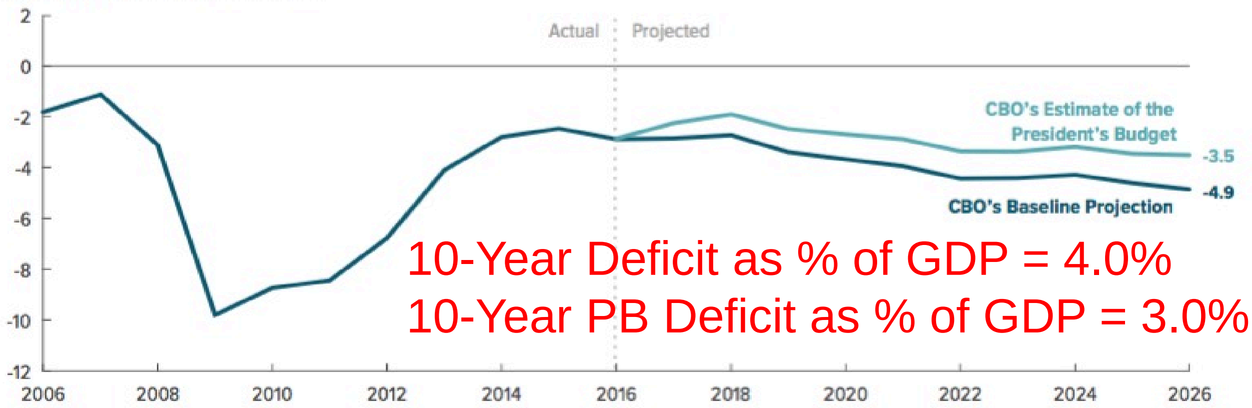
The Book


WE ARE BETTER THAN THIS
HOW GOVERNMENT SHOULD SPEND OUR MONEY

Federal Debt and Deficit in Pictures

Deficits Projected in CBO's Baseline and Under the President's Budget

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

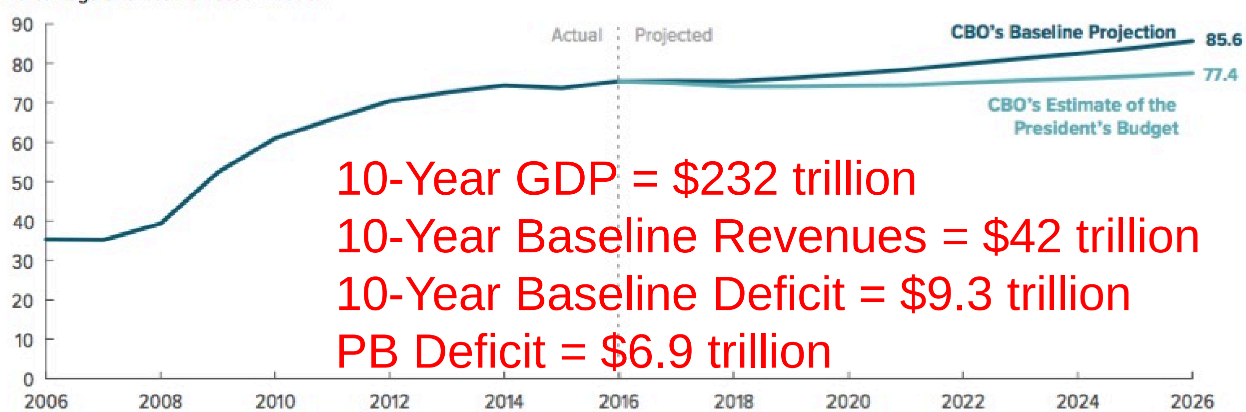
2016-2018 is a window of budget opportunity

Figure 2.

Return to Reference

Federal Debt Held by the Public Projected in CBO's Baseline and Under the President's Budget

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

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Federal 10-Year Deficit in Numbers

Comparison of Projected Revenues, Outlays, and Deficits in CBO's Baseline and Under the President's Budget

Billions of Dollars

	Actual, 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	Total 2017-2021	Total 2017-2026
CBO's March 2016 Baseline														
Revenues	3,250	3,364	3,508	3,645	3,772	3,931	4,082	4,247	4,423	4,615	4,825	5,042	18,937	42,089
Outlays	3,688	3,897	4,058	4,194	4,482	4,729	4,972	5,290	5,504	5,709	6,051	6,385	22,434	51,373
Deficit	**-438**	**-534**	**-550**	**-549**	**-710**	**-798**	**-890**	**-1,043**	**-1,080**	**-1,094**	**-1,226**	**-1,343**	**-3,497**	**-9,283**
CBO's Estimate of the President's Budget														
Revenues	3,250	3,369	3,672	3,871	4,035	4,205	4,377	4,541	4,713	4,920	5,155	5,395	20,161	44,885
Outlays	3,688	3,897	4,105	4,254	4,554	4,790	5,028	5,332	5,539	5,733	6,072	6,367	22,732	51,774
Deficit	**-438**	**-529**	**-433**	**-383**	**-518**	**-585**	**-651**	**-791**	**-826**	**-813**	**-917**	**-972**	**-2,571**	**-6,889**
Difference Between CBO's Estimate of the President's Budget and CBO's Baseline														
Revenues	n.a.	5	164	226	264	275	296	294	289	305	330	353	1,224	2,795
Outlays	n.a.	*	48	61	72	61	56	42	35	24	21	-18	298	401
Deficit[a]	**n.a.**	**5**	**116**	**165**	**192**	**213**	**240**	**252**	**254**	**281**	**309**	**372**	**926**	**2,394**
Memorandum:														
Deficit as a Percentage of GDP														
CBO's baseline	-2.5	-2.9	-2.8	-2.7	-3.4	-3.7	-3.9	-4.4	-4.4	-4.3	-4.6	-4.9	-3.3	-4.0
CBO's estimate of the President's budget	-2.5	-2.9	-2.2	-1.9	-2.5	-2.7	-2.9	-3.4	-3.4	-3.2	-3.5	-3.5	-2.5	-3.0
Debt Held by the Public as a Percentage of GDP														
CBO's baseline	73.6	75.4	75.5	75.4	76.2	77.2	78.3	79.8	81.2	82.4	83.9	85.6	n.a.	n.a.
CBO's estimate of the President's budget	73.6	75.4	74.9	74.1	74.1	74.3	74.4	75.0	75.7	76.1	76.7	77.4	n.a.	n.a.

Sources: Congressional Budget Office; staff of the Joint Committee on Taxation.

GDP = gross domestic product; n.a. = not applicable; * = between zero and $500 million.

a. Positive numbers indicate a decrease in the deficit in relation to CBO's baseline.

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U.S. Fiscal Policy

- Two sides to fiscal policy
  - Taxes, of course, but also public spending
- Annual deficits are a real issue
  - Exacerbated by 2015 corporate subsidies, a/k/a tax extenders
  - But deficits have no real information content by themselves
- Are taxes too low, or spending too high?
  - Or are both inadequate to our needs?
- And who speaks for *fiscal* policy?
  - What bar or accounting association? What other group?

Three Paramount Economic Issues

- Fiscal policy is at the heart of our most pressing issues:
  - Inequality
  - Stagnant incomes of middle class
  - Long-term growth
- In response, government should do more, not less!
  - Only government can assure genuine equality of opportunity
  - Government investment projects offer jobs with dignity
  - Complementary investment is accretive to growth
- Which means we must revisit our inadequate tax base!

We Put the Cart Before the Horse

- We argue constantly about the harms of taxation
  - But tax revenues are not simply consumed by bonfires: they purchase public investment and insurance
- How much do we know about the returns to public investment and insurance?
  - Or the *opportunity costs* of *not* pursuing a public investment or insurance project?
- Fiscal policy means thinking about the *net effect* of the totality of spending and taxing
  - Including both returns to spending and larger social returns (jobs with dignity, opportunities to succeed)

Reframing Government

- *Government exists to spend, not to tax*
  - Taxation is just how we finance that spending
  - Fiscal policy means measuring returns to government spending net of costs of financing it
- Government investment:
  - *Yields* large economic returns
  - *Complements* the private sector, not competes with it
    - The *only* vehicle to ensure genuine equality of opportunity
    - Private markets are great, but they inevitably are incomplete in ways that reduce welfare and opportunities
- Government insurance:
  - Aligns with theory and reflects the contingent nature of our lives

Government is Not a Zero-Sum Game

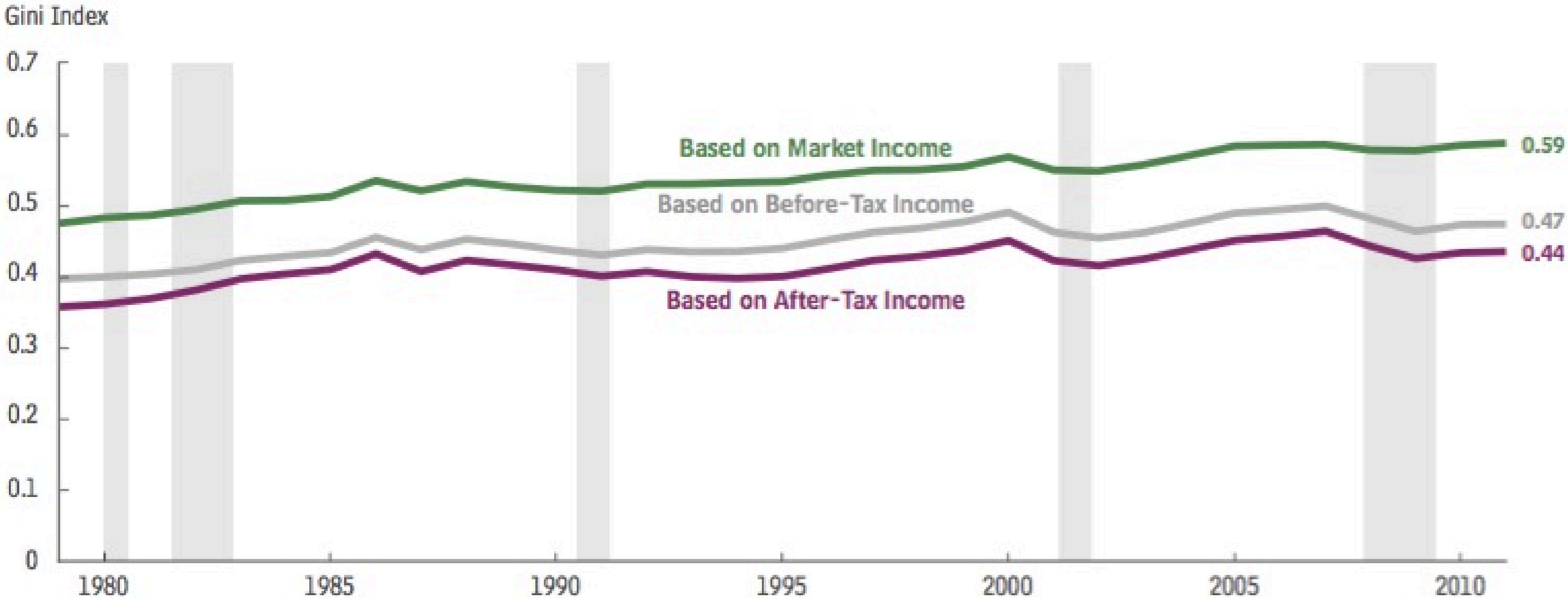
- Large positive returns to government spending belie false narrative of makers vs. takers
  - The pie gets larger, and the servings are more broadly shared
  - Both narrow economic returns and important social returns
    - Think infrastructure jobs, investment in early childhood education
- Government spending is highly progressive in its distributional effects
  - Which means we can obtain a more progressive *fiscal system* without steeply higher progressive tax rates
- Government is not a zero-sum game!

Inequality is Real and Corrosive

- Inequality threatens our values and economic future
  - And threatens to become an hereditable gene
  - Government uniquely positioned to respond
- Highest adult poverty rate (18-65) in OECD (GDP %)
- Highest ratios of rich to poor in OECD (S90/S10, P90/P50)
- CBO: Top 1% doubled its share of national market income 1979 – 2007 (to 21%) [16.9% in 2011]
- 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!

Rising Inequality Is Real

Gini Indexes Based on Market, Before-Tax, and After-Tax Income, 1979 to 2011



Source: Congressional Budget Office.

Notes: The Gini index is a measure of income inequality that ranges from zero (the most equal distribution) to one (the least equal distribution). Gini indexes are calculated using income measures adjusted for household size.

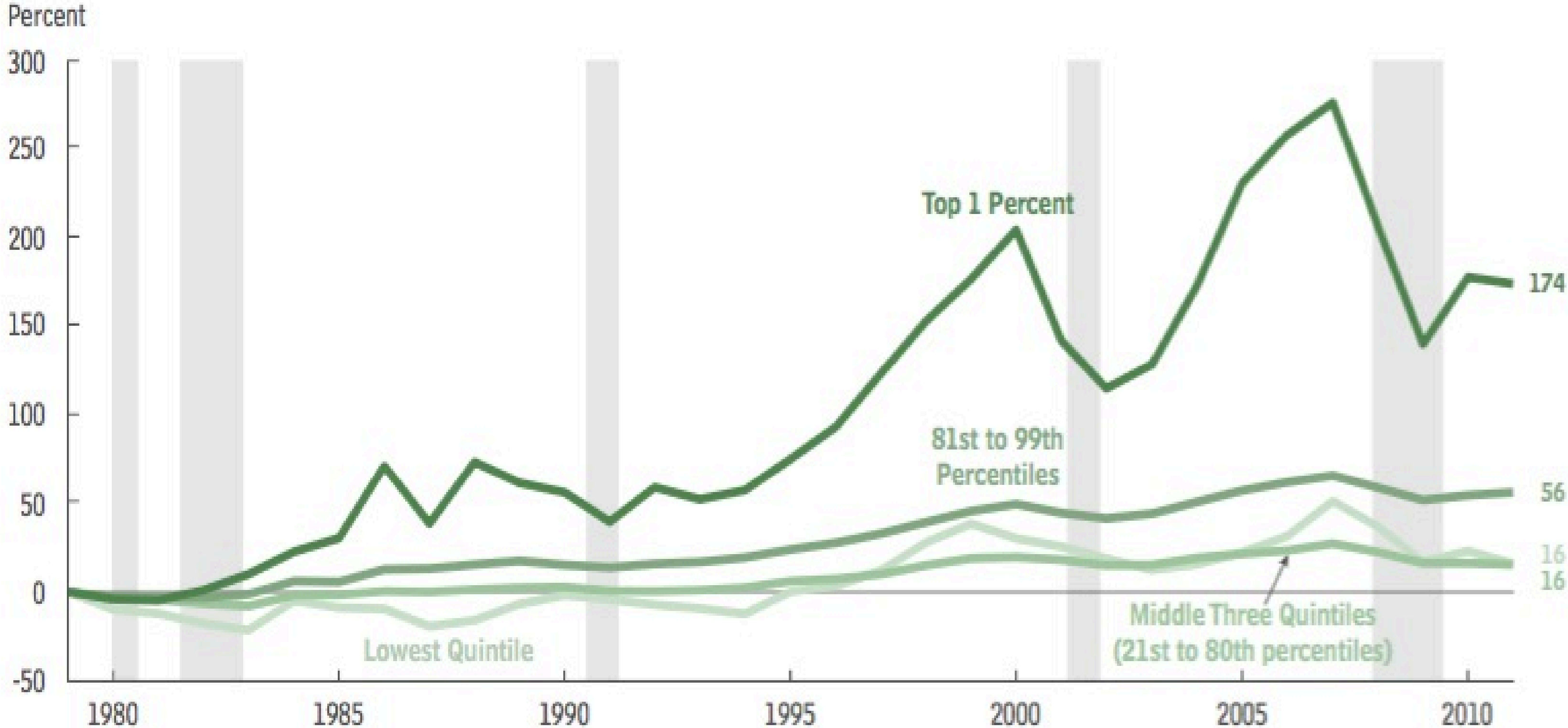
Market income consists of labor income, business income, capital gains (profits realized from the sale of assets), capital income excluding capital gains, income received in retirement for past services, and other sources of income.

Before-tax income is market income plus government transfers. Government transfers are cash payments and in-kind benefits from social insurance and other government assistance programs. Those transfers include payments and benefits from federal, state, and local governments.

After-tax income is before-tax income minus federal taxes. Federal taxes include individual income taxes, payroll taxes, corporate income taxes, and excise taxes.

Everyone Has Lost Ground Relative to 1%

Cumulative Growth in Average Inflation-Adjusted Market Income, by Market Income Group, 1979 to 2011



Source: Congressional Budget Office.

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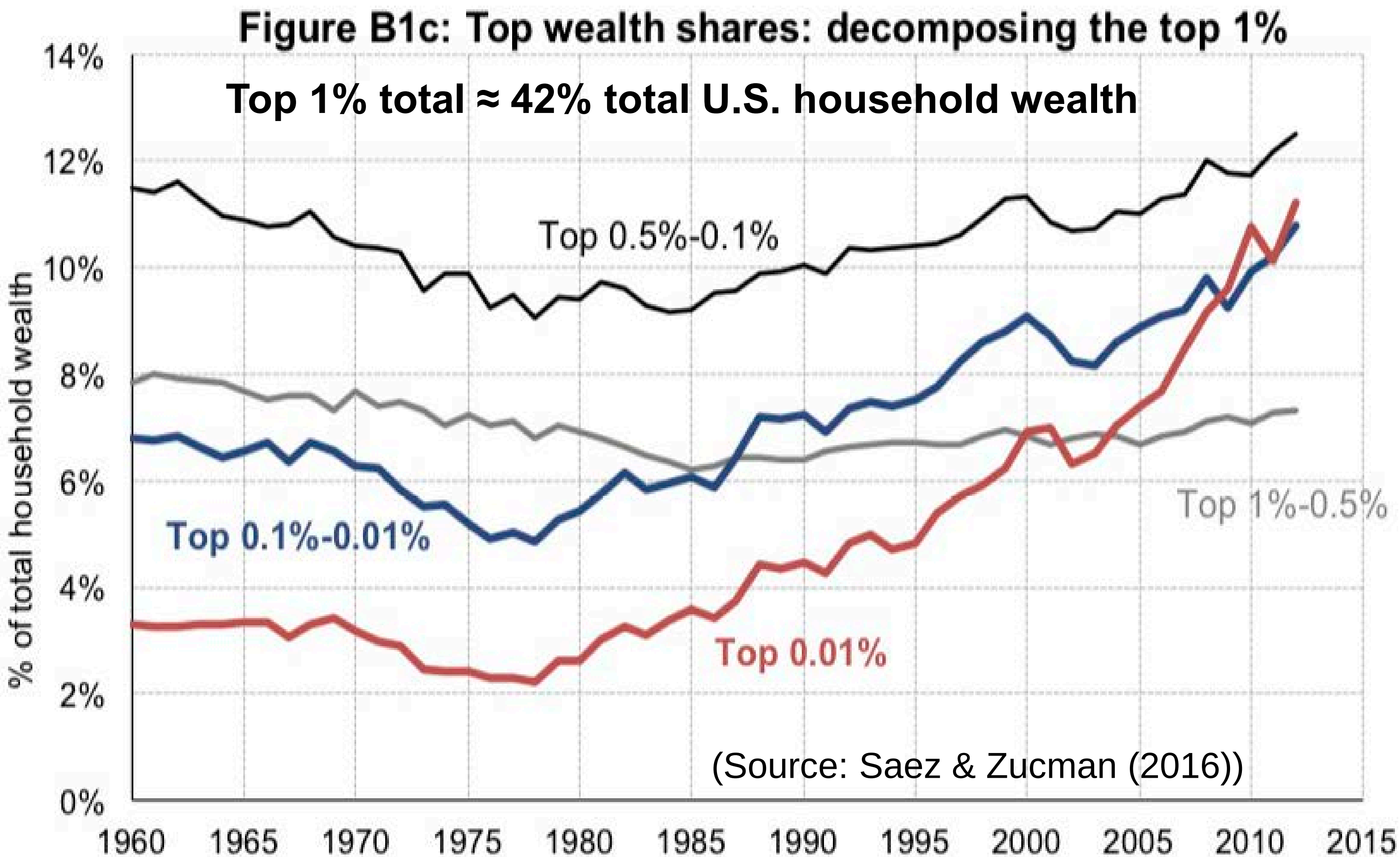
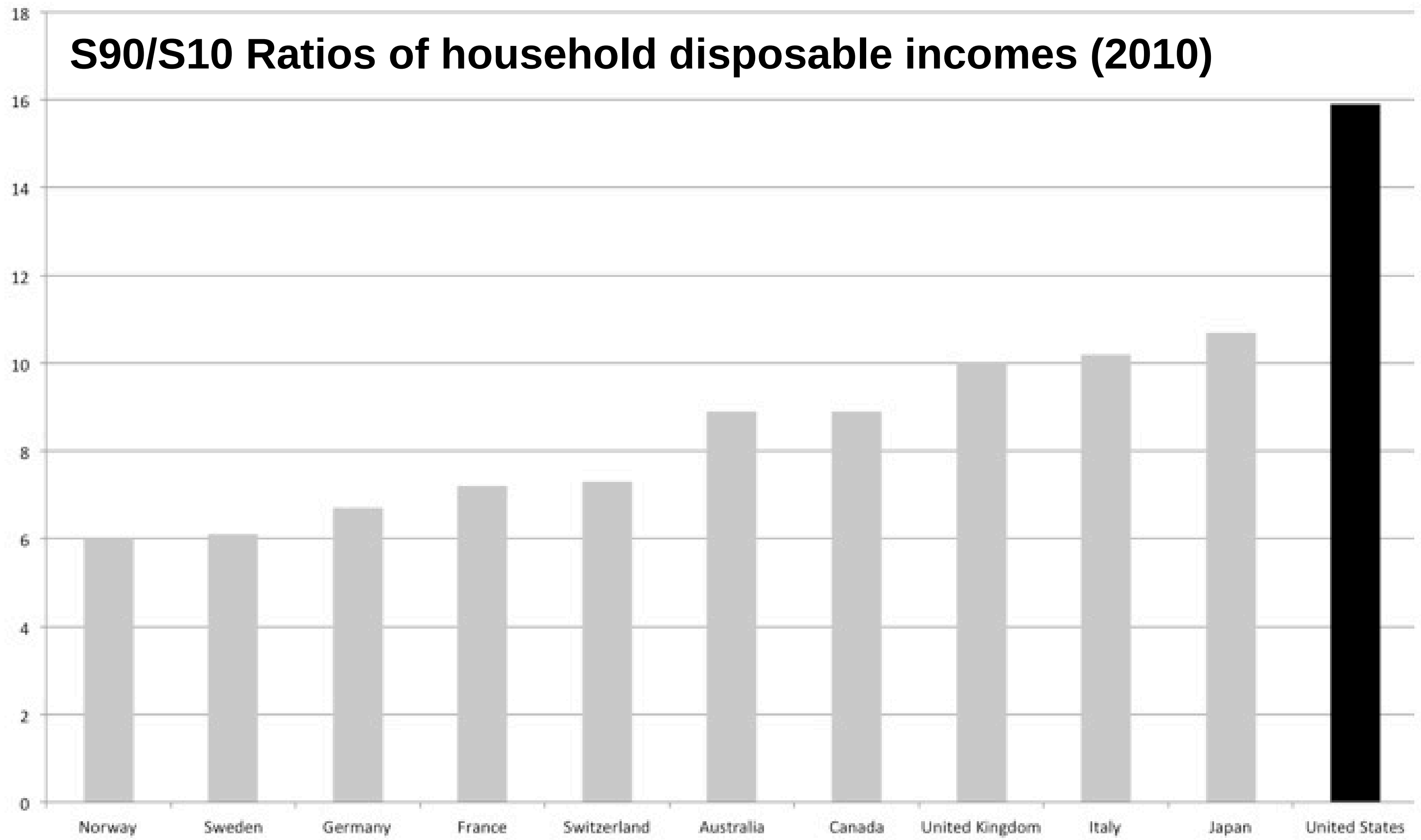
Wealth is Very Highly Concentrated



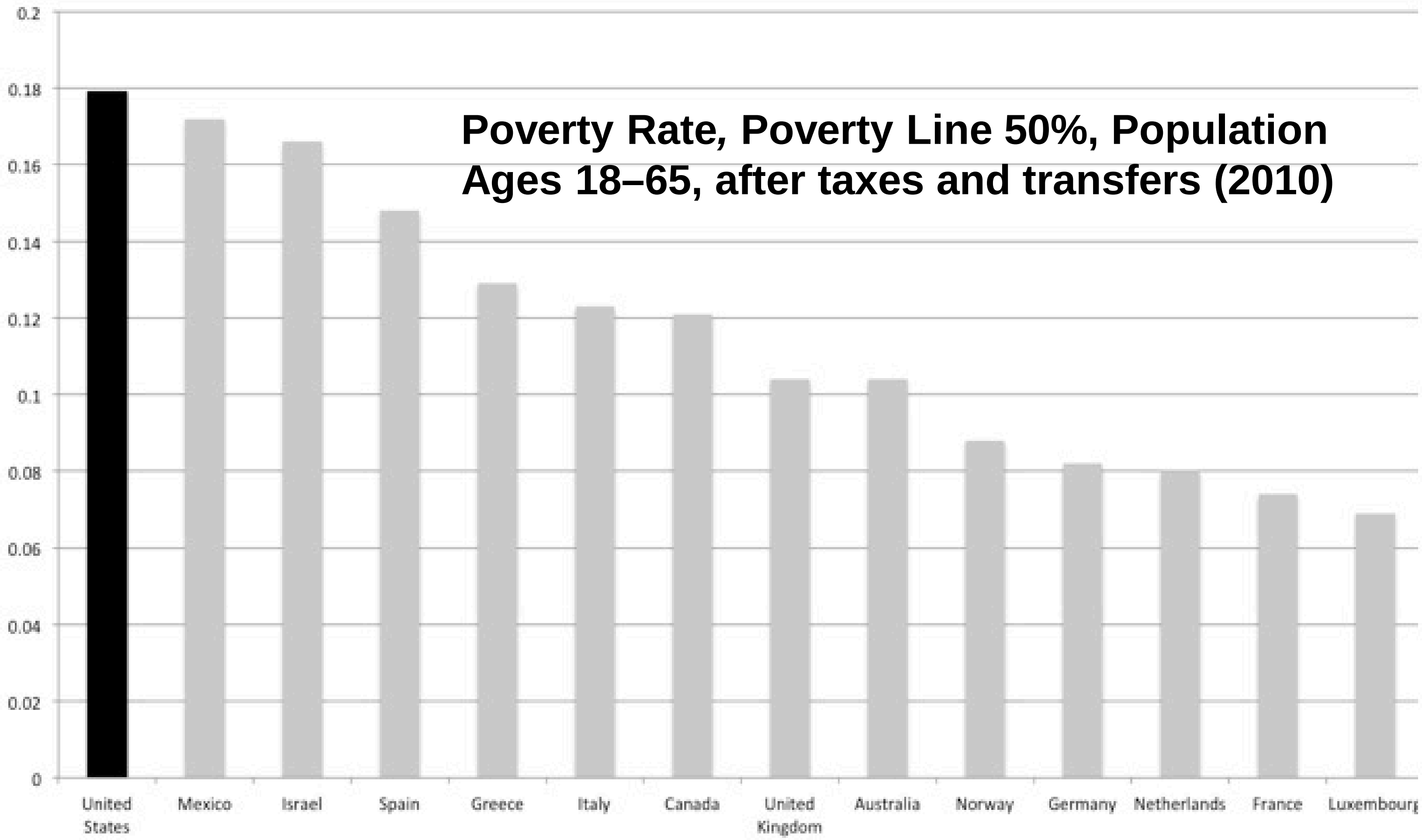
This figure depicts the share of total household wealth held by the richest families, as estimated by capitalizing income tax returns. All of the upswing in the top 1% wealth share since 1960 is due to the rise of the top 0.1%. Source: Appendix Table B1.

U.S. Gap Between Rich and Poor is Wide



(Source: OECD, *OECD Factbook 2011-2012: Economic, Environmental and Social Statistics* (2012), doi:10.1787/factbook-2011-en)

U.S. Accepts Much More Poverty



(Source: OECD, *StatExtract: Income Distribution and Poverty MetaData: By Country – Poverty* (accessed 2013))

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:

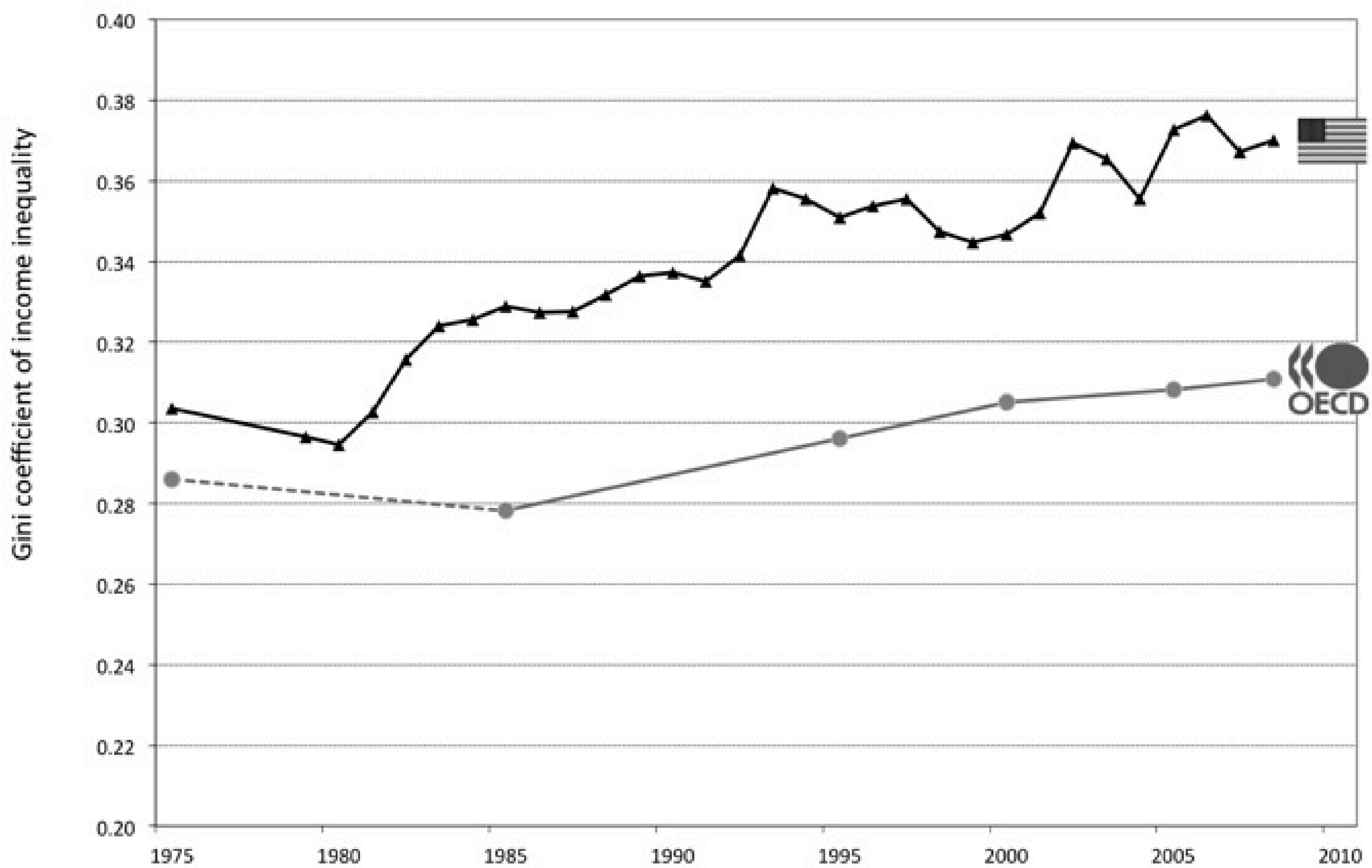
Country [year 2011]	Market Income Gini	Disposable Income Gini
USA	0.508	0.389
Germany	0.506	0.293

Gini Coefficients of Market and Disposable Incomes, *Working Age Populations*, Late 2000's

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

Source: OECD, *Divided We Stand* (2011), Fig. 6.1 supplemental tables

U.S. vs OECD Income Inequality Trendline



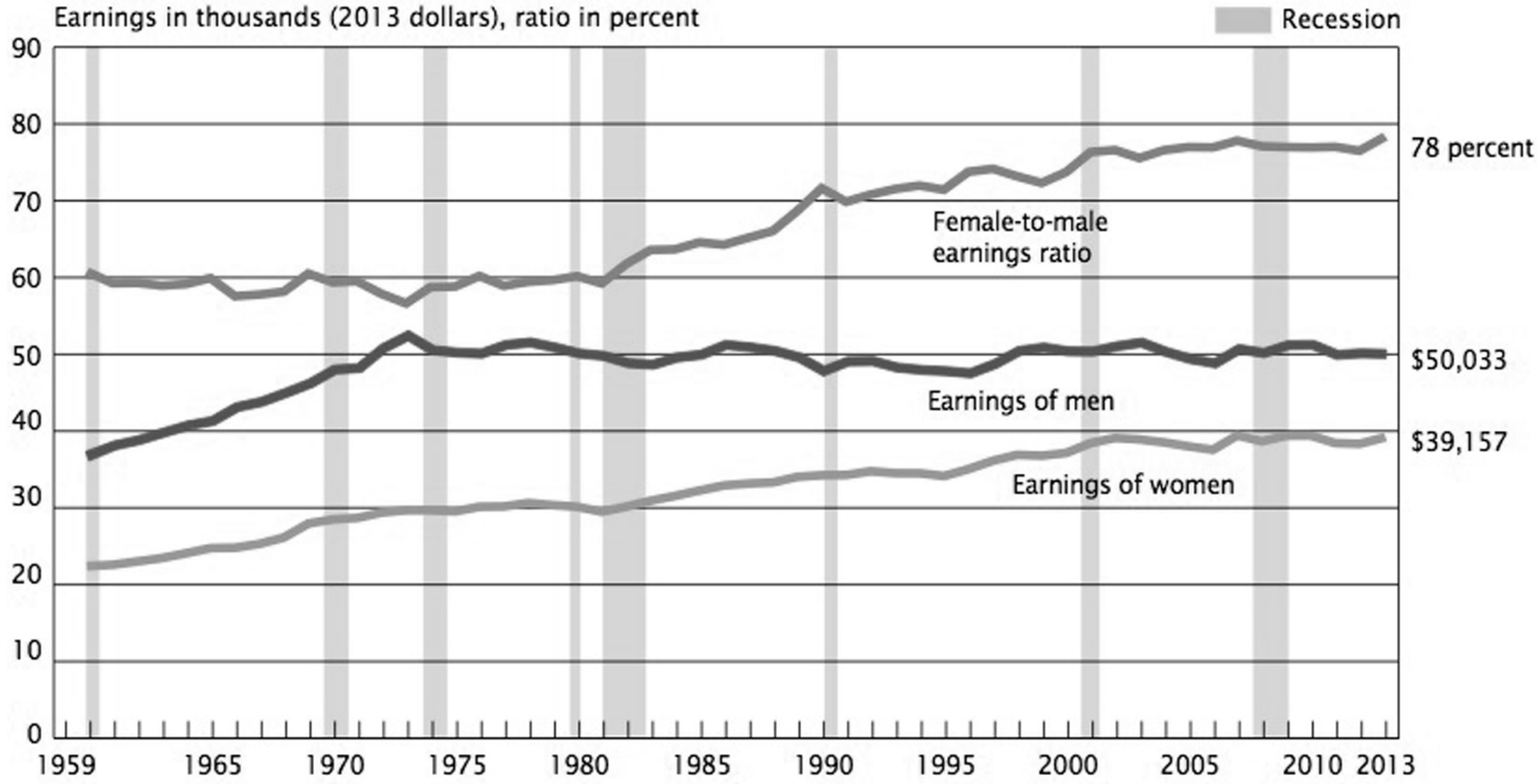
(Source: OECD, *Divided We Stand: Why Inequality Keeps Rising*, Country Note: United States)

The Middle Class is Right to be Angry

- Male worker median earnings flat for 40 years
- Modest family income gains attributable to women
  - Long-term trend of women's entry into workforce
  - And slow improvement in wage gap (still unacceptable)
- Where are jobs with dignity?
  - Not everyone will be a software engineer!
  - Importance of construction and allied fields – public investments
- Median adjusted household income (2011 dollars):
  - 1998: $35,600
  - 2011: $35,200

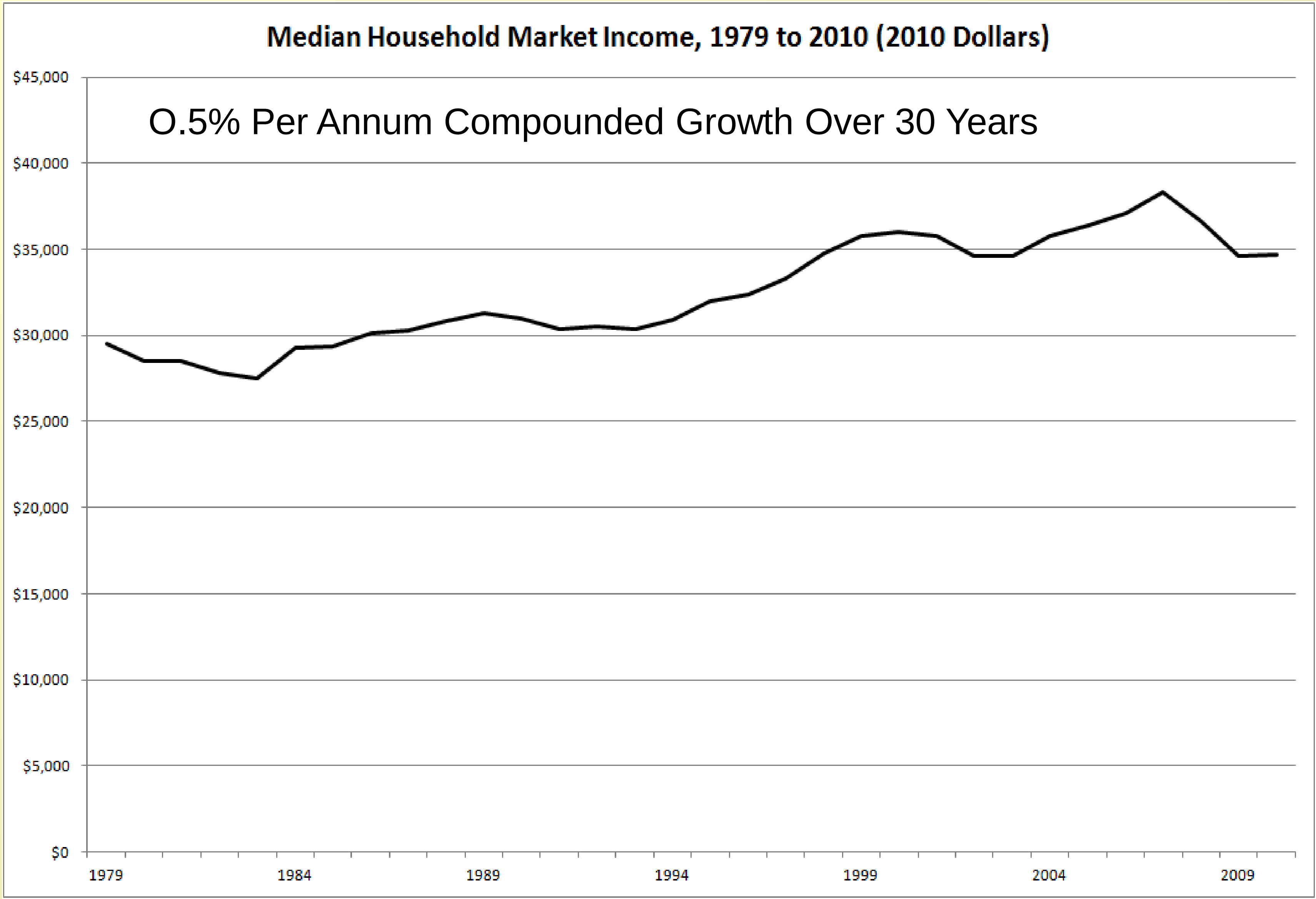
Male Workers' Median Earnings Flat for 40 Years

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

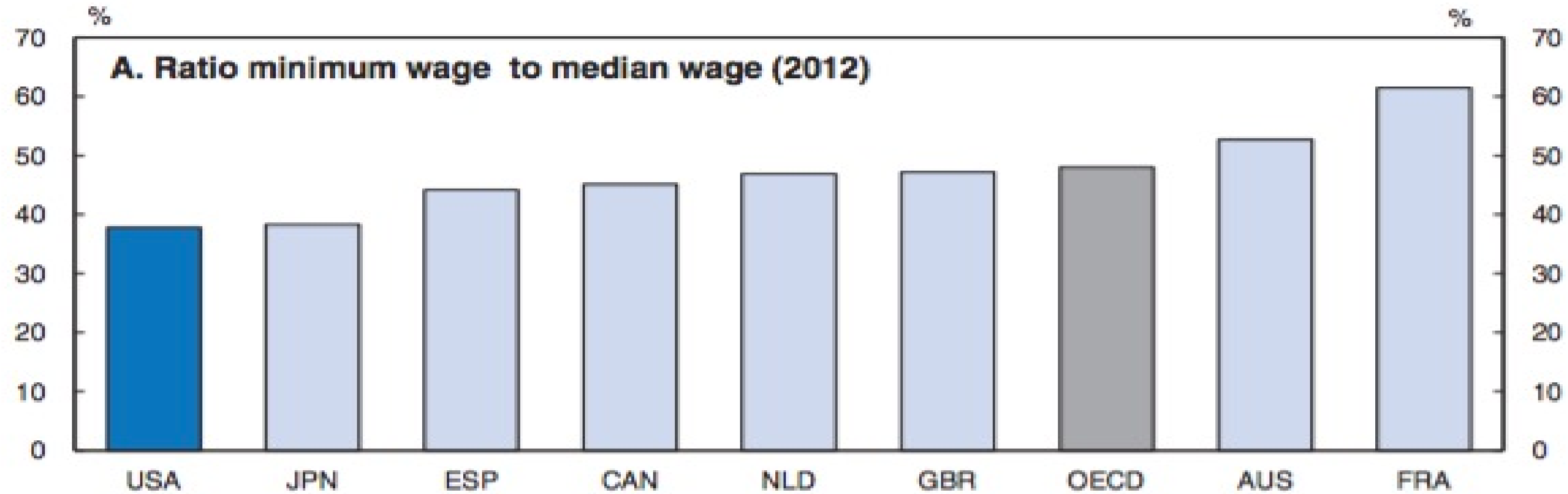


Note: Data on earnings of full-time, year-round workers are not readily available before 1960. For more information on recessions, see Appendix A. For information on confidentiality protection, sampling error, nonsampling error, and definitions, see <ftp://ftp2.census.gov/programs-surveys/cps/techdocs/cpsmar14.pdf>.
Source: U.S. Census Bureau, Current Population Survey, 1961 to 2014 Annual Social and Economic Supplements.

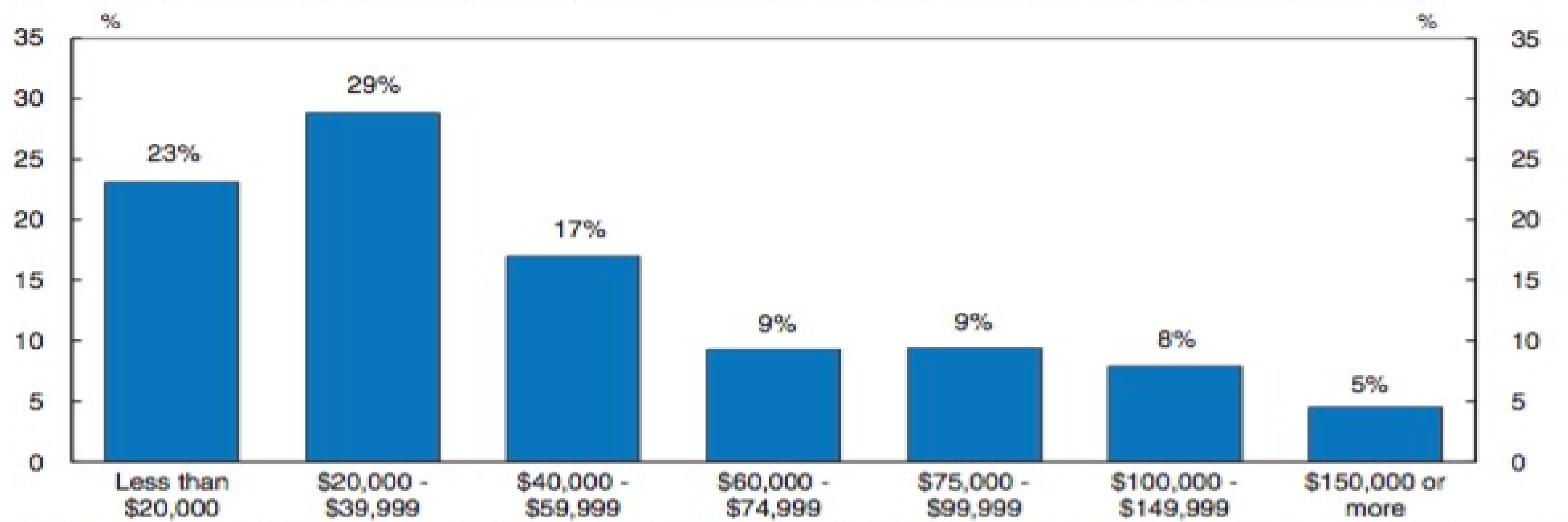
Median Household Incomes Have Only Crept Up



Minimum Wage Does Little But Could Help Many



Share of affected workers by raising the federal minimum wage to USD 10.10 by July 2016

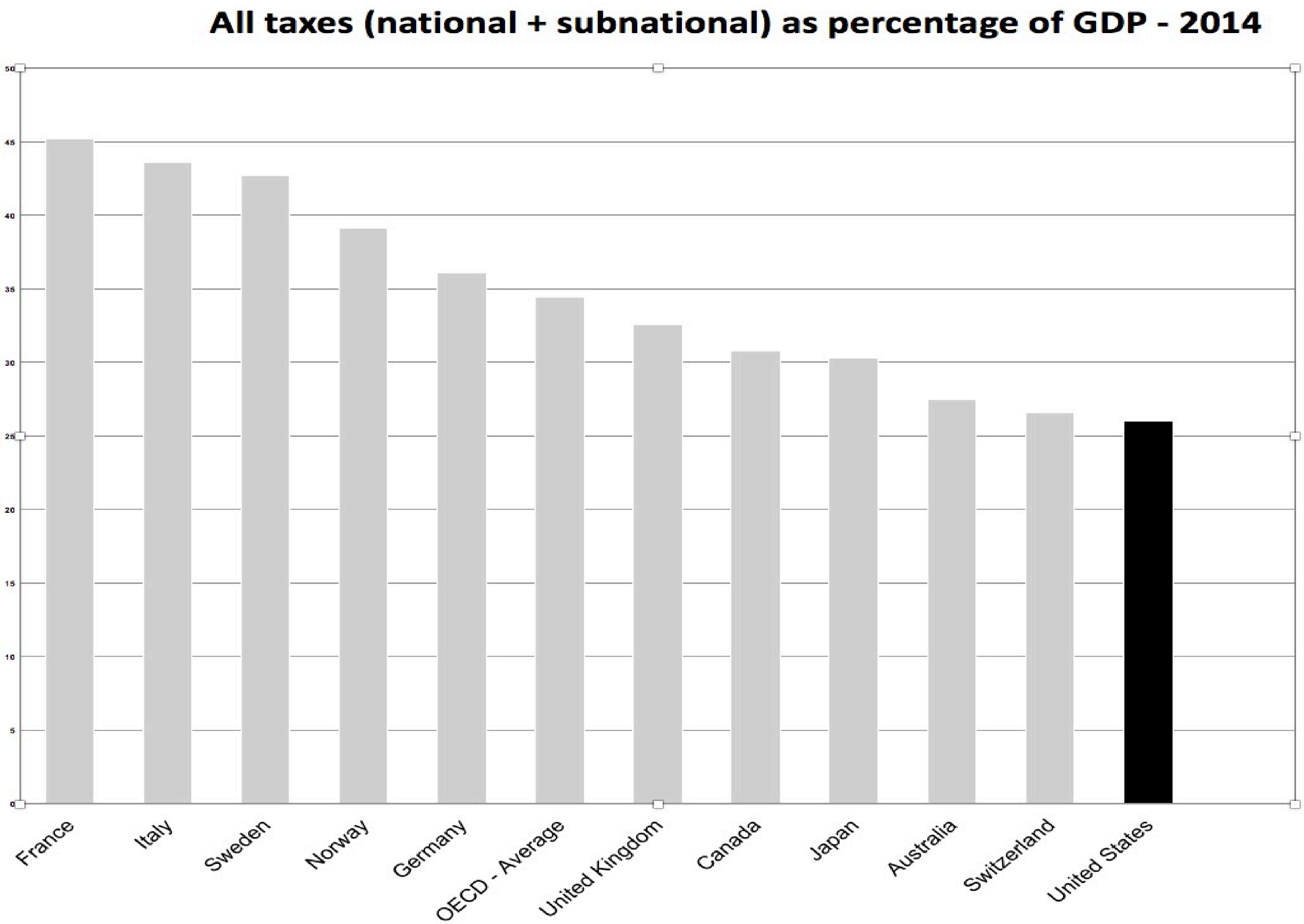


Source: Cooper, D. (2013). "Raising the federal minimum wage to USD 10.10 would lift wages for millions and provides modest economic boost", *Briefing Paper*, No. 371, Economic Policy Institute.

A Low-Tax Small Government Country I

- U.S. tax as % of GDP *lowest* of major OECD countries
  - Includes federal, state and local
  - CBO Jan. 2016: federal tax revenues = 18.1% GDP next 10yrs
- 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

The United States is a Low Tax Country



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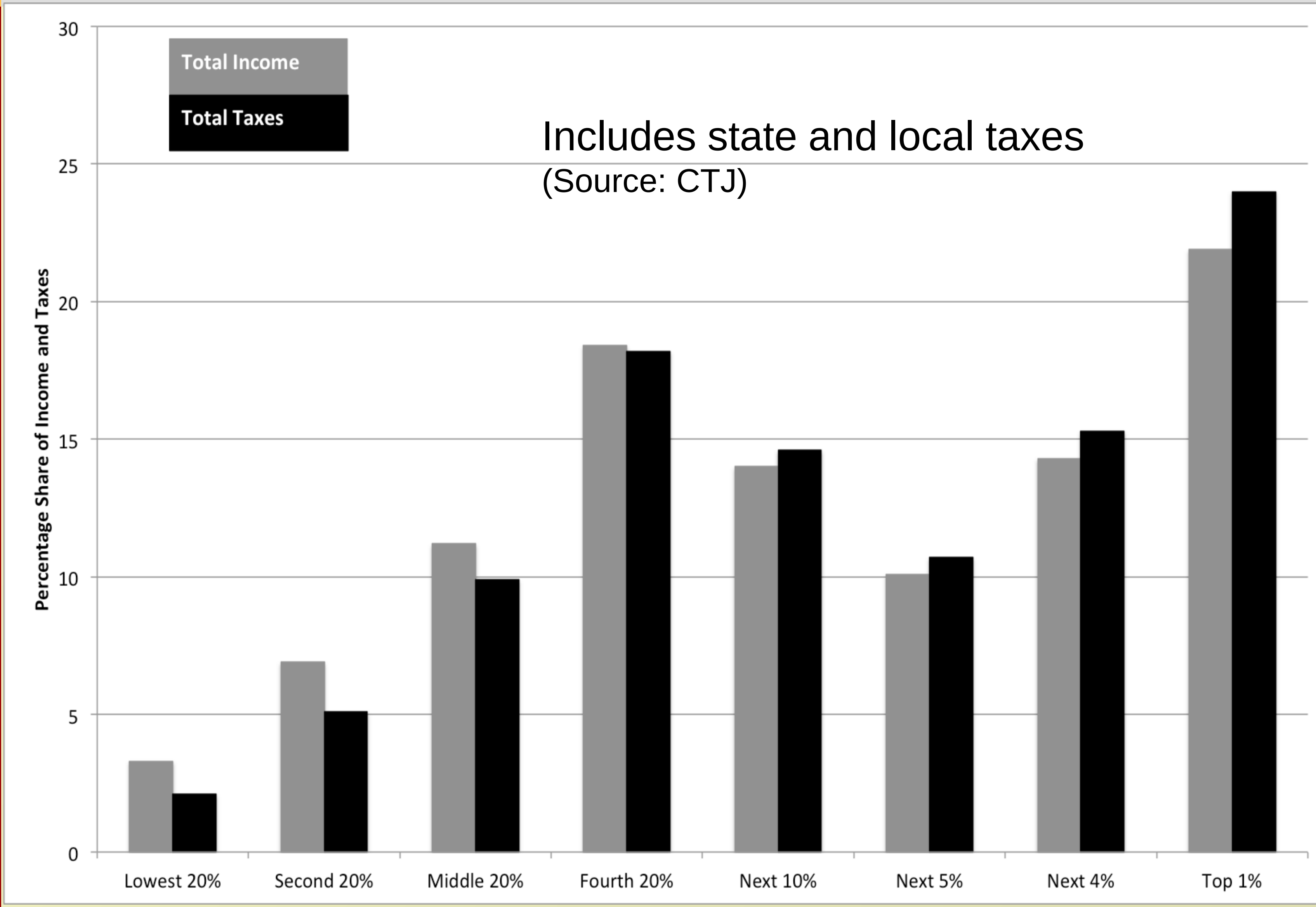
Tax Distribution is Not Lopsided



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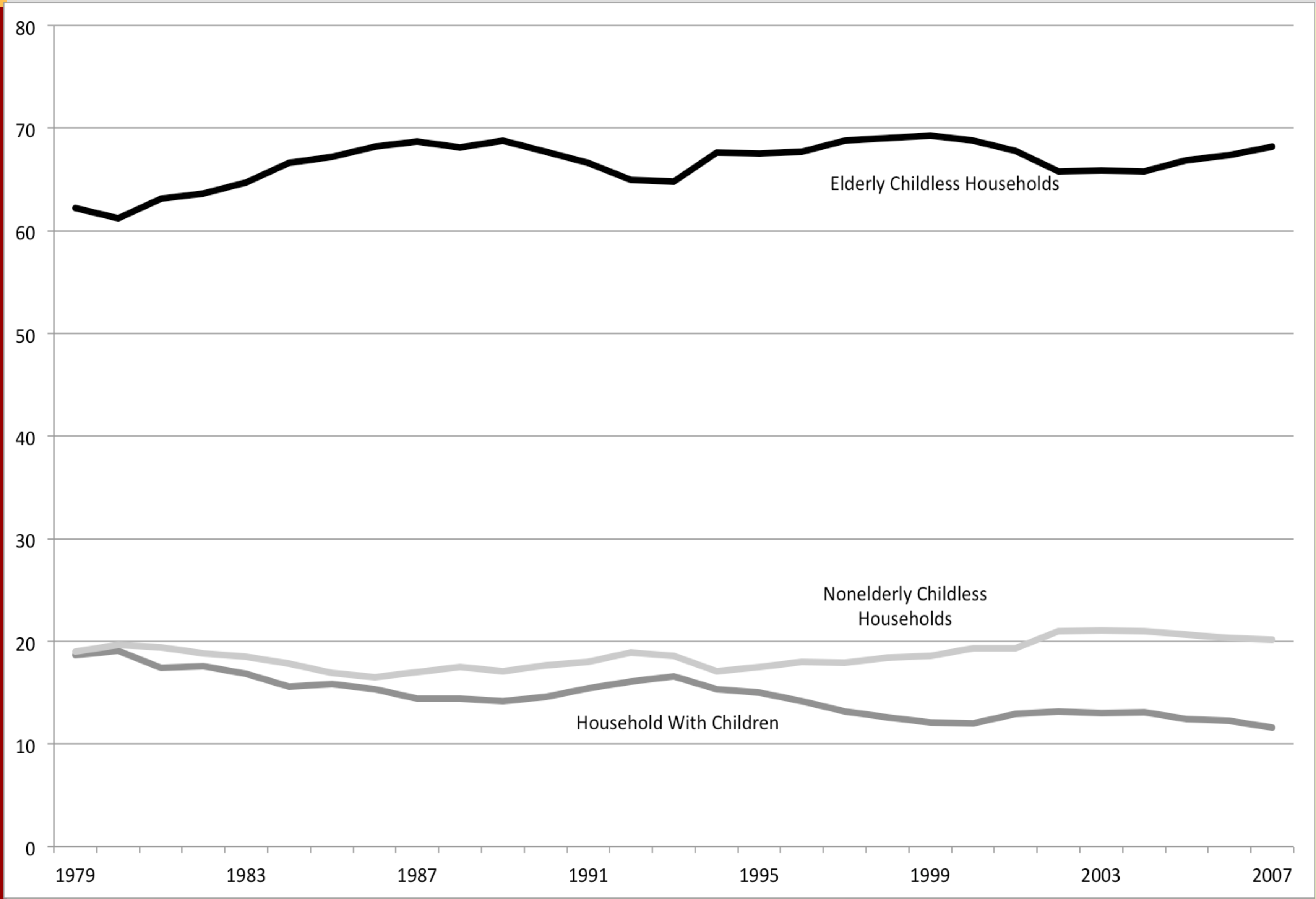
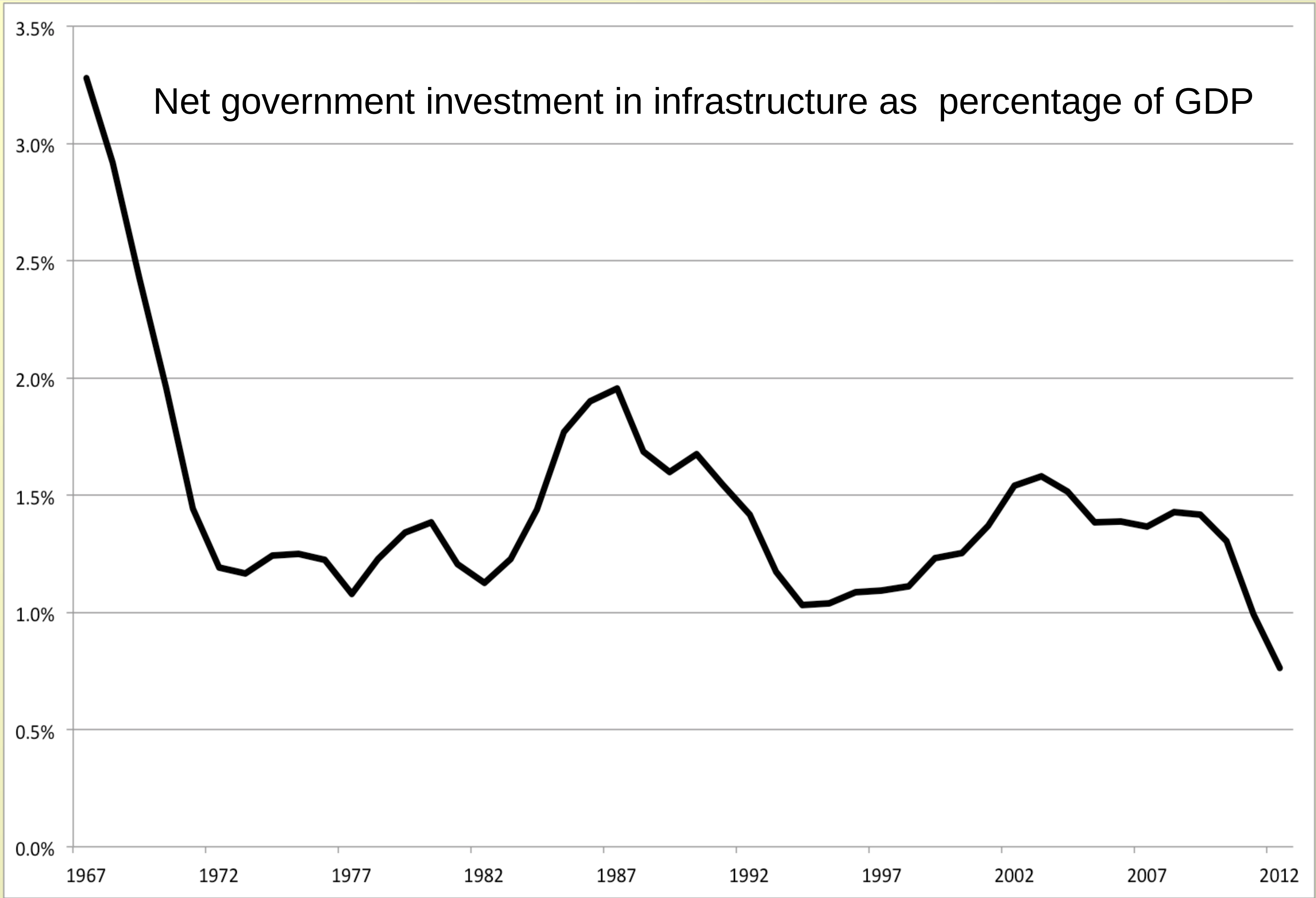
A Low-Tax Small Government Country II

- 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

Existing Transfers Largely Fund the Elderly



U.S. Invests Almost Nothing in Infrastructure



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

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 Triumphalist” 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 12,000 estate tax returns filed in 2014
- 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