Columbia Law School
Davis Polk & Wardwell Tax Policy Colloquium

“WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY”

Edward Kleinbard

(These materials are uncorrected page proofs excerpted from the book that was published on October 1. These page proofs should not be cited or redistributed.)

Tuesday, October 28, 4:20-6:10 pm
Jerome Greene Hall, Room 304

Colloquium schedule and papers are available at:
http://web.law.columbia.edu/tax-policy
EDWARD D. KLEINBARD

WE ARE BETTER THAN THIS

HOW GOVERNMENT SHOULD SPEND OUR MONEY

OXFORD UNIVERSITY PRESS
CHAPTER 12

FROM A PROGRESSIVE TAX TO A PROGRESSIVE FISCAL SYSTEM

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.


PROGRESSIVE TAXATION VERSUS A PROGRESSIVE FISCAL SYSTEM

Chapter 11 argued that the Progressive movement in the United States committed three long-term strategic blunders. First, the movement did not adequately communicate that Progressives embrace the virtues of thrift, hard work, and personal responsibility—they just also are sensible enough to see that the collective purchase of reasonable levels of social insurance promotes socially useful risk-taking and enhances the overall welfare of society. Like you, I have automobile insurance, homeowner’s insurance, medical insurance, and life insurance. I also carry social insurance, as do all other Americans, and for the same reason: social insurance does not interfere with individuals taking on all sorts of risks unique to their individual life adventures, but does enable them to pool those risks not central to their personal narratives.

Market triumphalists, by contrast, systematically confuse their totemic invocations of freedom with the smart thing for individuals to do, 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 useful risk-taking, along with individual catastrophic outcomes that could have 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.

Second, the Progressive movement allowed “redistribution” to be viewed as a value-neutral term, when it is not. You can observe this when reading a passage by substituting “social insurance” for “redistribution” every time the latter appears, and then see how the sense of the passage changes.

These first two blunders are two sides of one coin, which is the failure by Progressives to articulate what social insurance is and why it is desirable in economic as well as ethical contexts. Progressives’ third blunder was more strategic. It was their myopic focus on the progressive income tax as their policy goal, to the exclusion of what really is important, which is a progressive fiscal system.

A fiscal system incorporates both the tax and the spending side of government. What Progressives really should care about is whether government, taken as a whole, enhances the happiness of society by making socially useful investments and buying 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. And as this chapter demonstrates, it turns out that to finance the goods that should be at the heart of the Progressive agenda, you do not need a progressive tax system—you just need a big one.

Insisting on progressive taxation as an independent desideratum has the unintended consequence of inevitably capping the size of the fiscal system at too small a level to support the really important social goods that we should be purchasing. It also distorts the analysis of why we might want a progressive tax system at all. The best reasons for progressive taxation are not found in examining tax systems in the abstract, but rather in asking which tax systems most neatly complement our collective investment and social insurance objectives?

This may sound a bit crazy, but that just demonstrates how pervasive is the erroneous view that progressive taxation is our objective. The Nordic countries figured this out a long time ago: their famously progressive fiscal systems, which actually do a great deal to reduce income inequality and to yield a happier society, are funded by mildly regressive taxes. It is the spending that matters most, not the taxing.

This chapter proceeds by first reviewing some of the history of our progressive tax system, and why academic debates surrounding tax system design might be more productive if we were first to begin with a clear idea of what we are trying to finance. At a more practical level, however, our policy discussions remain fixated on tax rate progressivity as an independent problem in need of solution. The second section therefore reviews the distribution of current tax burdens, some of
the technical issues associated with measuring the distributional consequences of changes to the tax code, and the economic and political constraints on significantly higher marginal tax rates to finance government.

The final section of this chapter returns to the critical theme that the right measure of progressivity is with respect to our fiscal system taken as a whole, not simply our tax structures. That section reviews some recent preliminary efforts to measure the distribution of our fiscal system in its entirety, and demonstrates that progressive fiscal systems in practice invariably are financed with tax systems that are less progressive than ours, but much larger in absolute size.

WHAT’S SO GOOD ABOUT PROGRESSIVE TAXATION?

How Did We Get Here in the First Place?

2013 marked the one-hundredth birthday of the modern US personal income tax. In Making the Modern American Fiscal State, Ajay K. Mehrotra recounts the history of the Progressive movement’s early fixation on the progressive income tax. Similar ground has been covered by other modern scholars, and Edwin Seligman, the leading public finance economist a century ago, authored several books that today offer insights into the contemporary justifications for the progressive income tax at the time of its adoption.

The income tax movement culminated in the very rapid adoption of the Sixteenth Amendment in 1913, overturning a famously wrong-headed Supreme Court case that had declared an earlier income tax unconstitutional on technical grounds of no great policy interest. As Mehrotra and other scholars have developed, the underlying populist clamor for an income tax rested on the idea that the rich were escaping paying tax on their “fair share.” The last decades of the nineteenth century and the first of the twentieth century witnessed the birth of great fortunes of almost unimaginable size. The US government financed its (very small) needs through a potpourri of consumption taxes, particularly various import levies. The widely shared view at the time (not necessarily an incorrect one) was that all these levies ultimately were borne by consumers—that is, to reprise the technical language introduced in Chapter 8, the economic incidence fell on consumers. And in turn, since the working class consumed essentially all of its income, while the new generation of capitalists did not, the view was that the working class was disproportionately bearing the brunt of taxation, while the Rockefellers, Mellons, Huntingtons, and other great fortunes could enjoy the rapid compounding of their wealth unencumbered by significant taxes. What was needed, instead, was a tax based on “ability to pay,” which implied a tax base that comprised the entirety of a person’s annual income, not simply the fraction of that income that a person might consume in any given year.
There are two remarkable lessons to be drawn from examining the dawn of the modern American income tax a century ago. The first is that in the years running up to the Revenue Act of 1913 the mainstream income tax movement was not primarily focused on using the tax to address income or wealth inequality directly. “The goal was not to radically redistribute wealth, but rather to ensure that those who had the greatest taxpaying capacity were contributing their fair share.”

The second remarkable fact about the early income tax movement is that this income tax based on “ability to pay” was conceived from the beginning as having a progressive marginal rate structure. Chapter 7 explained the meaning of a “progressive” income tax, but to recapitulate, a progressive income tax is one in which the average tax rate that you pay increases with your income. This means that your tax bill rises as a proportion of your income as your income increases. A proportional tax is one where your tax bill goes up as your income does, but stays at the same proportion of your income.

One of the ways the US tax system implements a progressive structure is to slice your income into different layers, called brackets; the bottom layer of your taxable income is taxed at a low rate, the next layer at a higher rate (without affecting the first layer’s tax rate), and the third layer at a still higher rate, and so on. We also implement a progressive rate structure by exempting a certain foundational layer of income from any tax at all; we do that through personal exemptions and standard deductions, but we could just as well have called that foundational layer of income the zero rate bracket.

Technically, increasing marginal rates are not a necessary component of a progressive income tax. A “flat tax” with a relatively high single tax rate, a large personal exemption, and cash subsidies to the lowest-income households in fact can be more progressive in practice than a tax system that relies on increasing marginal rates alone.

At the end of the nineteenth century the desirability of progressive taxation was the subject of independent vitriolic debate, but by the time the Sixteenth Amendment was adopted in 1913, most people seemed to understand that a vote for an income tax implied a vote for a progressive rate structure—that was what people understood an income tax to mean. Opponents objected to the idea of an income tax at all, wishing instead to preserve “the tariff” (import taxes) as the main source of federal revenue, but there was much less debate than a modern observer might expect over the relative virtues of proportional versus progressive (or “graded”) income tax structures.

Why as a matter of political economy did the income tax imply a progressive rate structure to most participants in the debate? Here a reading of Edwin Seligman is helpful. Today virtually no one reads Seligman, because some of his public finance economic analyses in hindsight border on the ridiculous, and because his writing style was long, discursive, and rooted in history, making his analytical
toolset closer to Adam Smith’s than the modern mathematical style of economics pioneered by his contemporary Alfred Marshall. But when the question is the history of ideas, Seligman cannot be ignored, because he was the dominant public finance figure of the time, and a staunch proponent of the progressive income tax.

In *Progressive Taxation in Theory and Practice*, Seligman argued that the concept of what comprised the “ability to pay” a tax (or one’s “faculty,” to use his preferred term) migrated from a theory of proportionality to one of progressivity as people began to conceptualize the faculty to pay tax as comprising only income above a level necessary for existence. This “entering wedge” implied a foundational layer of exempt income, and further instigated ruminations on the idea that perhaps not all wants were equally compelling:

The conditions which limit faculty are to be found not only in the amount of the income, but in the demands that are made upon the individual in disposing of his income. In other words, the idea of burden, or sacrifice, was introduced….Taxes, in so far as they rob us of the means of satisfying our wants, impose a sacrifice on us. But the sacrifice involved in giving up a portion of what enables us to satisfy our necessary wants is very different from the sacrifice involved in giving up a portion of what enables us to satisfy our less urgent wants.\(^5\)

From this followed the idea that taxation should embrace an ideal of equality of sacrifice. Given that our less compelling wants are sacrificed at lower cost to ourselves than our necessary ones, the case for progressive taxation was made. Seligman then recast this argument into the now-familiar language of the declining marginal utility of income, which is the most common justification to this day for our zero rate foundational bracket of income and increasing marginal rates thereafter. To his credit, Seligman also developed some of the conceptual difficulties in the argument, and concluded that progressive taxation was not inexorably required as a matter of economic logic.

Nonetheless, the intuition underlying the equal sacrifice theory appears to have been firmly grafted onto the general understanding of “ability to pay.” And since the whole purpose of the income tax movement was to fix tax liabilities by reference to individuals’ differing abilities to pay, the income tax and progressive rate structures seem to have been unalterably joined at the hip from the start. As a practical matter, of course, so long as we have a foundational layer of income on which we impose no tax, we technically will have a progressive income tax.

### Progressive Taxation as Inequality Remediation

The idea that the income tax should be the vehicle for inequality leveling as a goal in and of itself came to the forefront later, in the New Deal era. According
to historian Joseph Thorndike, President Roosevelt’s economists “had repeatedly urged the president to lower taxes on the poor…. But the president cast his lot with a different group of advisers: Treasury lawyers more interested in soaking the rich than saving the poor.” These lawyers were led by Herman Oliphant, who believed that “[t]ax policy… could be made the vehicle for fundamental social reform, specifically targeting the accretion of economic power among a small group of companies and the people who ran them.”

In retrospect, the idea that high taxes on the rich should be a social desideratum in and of themselves—an income inequality remediation program—was an authentically terrible innovation. The idea reflects the same sort of instincts that have motivated sumptuary taxes over the centuries—a view that wealth, and how it is displayed, should be directly regulated by government. All sumptuary taxes fail, because the rich just choose unregulated ways of displaying wealth. (The most recent example in the United States probably was the 1990s luxury yacht tax, which was repealed after only a couple of years in place.) The theory runs directly against the grain of most economic work, which emphasizes the social waste attributable to deadweight loss that arises from very high marginal tax rates. It also plays directly into the hands of a long line of conservative thinkers, dating back to the nineteenth century, who have viewed progressive taxation as a stealth weapon of class warfare, waiting to spring upon the affluent if they let down their guard for a moment. As such, conceptualizing progressive taxation as a tool for leveling down just raises the tension level at the demilitarized zone that separates our different political movements.

More generally, in twenty-first-century America, even those of us who are self-described progressives would agree that cutting the rich down to size is not a very sensible business plan, whether for a political movement or a government. It certainly is one that does not resonate with many Americans, who, if surveys are to be trusted, admire the wealthy and are proud that our country is a fertile environment for new fortunes to grow.

If our focus is on the happiness of society, the case for gratuitously making the most successful worse off is a difficult one to win. Robert Frank and others have reminded us that envy is a common and debilitating worldview, but progressive taxation by itself will not reduce envy in practice very much. Nor does progressive taxation, when used as an independent tool to directly regulate affluence, offer a very convincing response to affluent Americans’ ability to insulate themselves from the failures of government, as by flocking to better school districts. The more targeted answer in this last example is to bring up the quality of schools generally. Progressive taxation can be part of how that sensible goal is funded; it is not leveling down that is the agenda, however, but rather educating up.

Most important, using the tax system as a form of direct social regulation to remediate inequality both distracts from and limits the more useful questions...
of how government can complement the private sector through collective investments and social insurance, along the lines developed in the last two chapters. The use of progressive taxation to advance a deliberate agenda of remediating inequality puts the cart before the horse: government is useful for spending money in useful ways, and taxing is just how we finance those goods. Collecting taxes without regard to what the revenues buy is like Keynes’s figure of speech of hiring thousands to dig holes and then cover them up again: that may serve a purpose in extreme times (in Keynes’s example, to serve as economic stimulus during a depression), but in ordinary circumstances just destroys value. Instead of focusing political discourse on the social value that flows from smart government investment and social insurance, we become distracted by zero sum debates regarding how much inequality remediation is enough.

The inequality remediation theory of progressive taxation also unintentionally limits the amount of how much remediation actually can take place. The reasons are economic—the substantial social cost of the deadweight loss attendant on high tax rates—but also political: making the rich very, very angry is costly, in a political sense. As this chapter describes a little later, the secret of funding a progressive fiscal system—one that actually has a measurable impact on inequality as it is experienced—is not through quasi-sumptuary taxation in the form of high marginal tax rates. Instead, the secret sauce is a tax system that is only mildly progressive, or even regressive, but that is large enough to fund the government investment and social insurance programs that change lives.

Government spending is almost always steeply progressive—no government to my knowledge has ever enacted a No Polo Field Left Behind statute. Because the spending side is so progressive, the most important trick is to get the money to fund that useful spending, and so long as the taxing side is not truly wacky, its progressivity in the abstract is not terribly important.

### Why Bother with Tax Progressivity?

From the other direction, it might be argued that if the case presented later in this chapter is convincing that a progressive fiscal system does not need to be funded by a progressive income tax, and if progressive tax rates are a very difficult political mountain to climb, why should we bother with a progressive structure to our income tax at all? One answer of course is that so long as we impose a zero rate of tax on some foundation level of income (whether through personal exemptions and standard deductions, or by an explicit zero rate bracket), we technically will have a progressive tax structure, but that does not explain our deeply engrained preference for increasing marginal tax rate brackets.

The year 2013 was not only the one-hundredth birthday of the modern income tax in America, but also the sixtieth anniversary of the publication of the
monograph version of a famous essay by Walter Blum and Harry Kalven, *The Uneasy Case for Progressive Taxation.* Blum and Kalven reviewed the standard arguments for why progressive tax rate structures were desirable, and concluded that progressivity in fact is not easily defended as a theoretical matter, when compared to a proportional tax.

Blum and Kalven’s monograph has been criticized for not making a positive case for proportional taxation, for not recognizing that a flat tax rate nonetheless could be employed to implement a progressive tax system, and for not carefully distinguishing their objections to “redistribution” as a social goal from their technical economic objections to progressive marginal rates. At a more fundamental level, however, the proportionality–progressivity debate misses the point that all income taxes unavoidably are progressive along the one margin that distinguishes an income tax from consumption taxes, which is the treatment of capital income. The essential distinction between an income tax—any income tax—and a well-designed consumption tax is that an income tax but not a consumption tax burdens capital income: that is, all returns to investment, however denominated. This was not a side effect, but rather an important rationale motivating the nineteenth-century income tax movement in the first place: proponents of the income tax wanted to include capital income (including saved labor income) in the tax base so that the great new fortunes would be taxed according to their overall “ability to pay,” not their current year’s level of consumption.

One of the generally underappreciated aspects of the taxation of capital income is that all such taxation—even a “flat” or proportional tax on capital income—in fact is progressive along the margin of time. Since the only purpose of capital income from an individual saver’s perspective is to fund future consumption (what else is money good for?), this is an important margin along which to examine the progressivity of capital income taxation.

That is, savers put capital aside to shift consumption from the present to the future, but the way annual capital income taxation works is that the longer your time-shift, the higher the income tax rate imposed on you. (Capital gains taxes are different, because they are imposed only once, when a capital investment is sold; the discussion here relates to the taxation of interest income today, or idealized capital income taxes more generally.) In turn, the ability to defer consumption for long periods of time is an attribute of those with ability to pay, because they have both surplus funds and the foresight not to spend them.

Imagine that you hold a savings account whose balance compounds at a fixed interest rate of 10 percent indefinitely into the future, and that the account’s annual interest income is subject to a flat tax of 30 percent, which you pay out of the account’s balance. Your pre-tax earnings compound at 10 percent, but your after-tax earnings compound at only 7 percent. What this means is that the longer your savings account grows and compounds, the larger becomes the difference
between what would have been your account’s balance had it not been subject to tax, and your actual balance. The tax takes a 30 percent bite if you save only for one year, but if you save for 20 years, the bite of this nominally “flat” tax grows to about 42 percent of what you would have earned had there been no tax imposed. Economists call this phenomenon the “tax wedge”; its significance here is that it means that all genuine income taxes (that is, taxes that burden capital as well as labor income, and do so consistently every year) are inherently progressive in this critical respect.

I think it fair to summarize Blum and Kalven as arguing that the two best justifications for progressive taxation in the traditional sense of the term (that is, increasing marginal tax rate brackets) are, first, the declining marginal utility of income point mentioned earlier (in Seligman’s terms, the idea that a principle of equal sacrifice requires a high-income individual to pay a disproportionately larger number of dollars in tax than does a low-income individual), and second, the overt inequality remediation agenda described in the preceding section.

Blum and Kalven’s principal reason for being dissatisfied with the declining marginal utility of income theory is the now generally accepted view that utility cannot be measured in cardinal terms, which is just a fancy way of saying that no one knows the quantum of utility I derive from my next dollar of income, according to some objective scale (like “pounds” or “yards”). As a result, interpersonal comparisons are impossible, which means that one cannot answer the question, how many dollars must we tax the rich fellow to make him feel the same pain that the poor one does when we tax her, say, $100?

In fact, in my prior life, when I worked a great deal with very 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 folk.

Blum and Kalven did a good job (for that matter, so did Seligman decades earlier) showing that the declining marginal utility of income theory did not inexorably justify progressive taxation as a logical or economic matter. Nonetheless, there still is some utility, if you will pardon the play on words, to the declining marginal utility of income theory. We can recast it as an aspirational statement: as I explain to my students, it represents how we all would behave if we had good mothers, to whom we listened. Governments reflect and refocus society’s values, and there is no reason to be ashamed of the idea that the declining marginal utility of income is one such value that reflects how most Americans believe that their lives would
be ordered if their incomes suddenly jumped, even if economists staunchly deny that they can reduce the phenomenon to quantitative measurement. For that matter, economists also cannot measure the labor contribution of angels, but that does not stop a large percentage of Americans from feeling angels’ presences in their daily lives.

Blum and Kalven did not have as strong a technical argument to rebut the inequality remediation hypothesis, because it rests explicitly on a value judgment that less inequality is a good thing. But as the previous section argued, the inequality remediation theory essentially is limited by its own agenda as a matter of economics (the deadweight loss problem) and political economy (incurring the anger of the rich has substantial political costs).

Conversely, if one can sneak in a bit of tax progressivity, why not? If it can be done without paralyzing political discourse, it certainly is a convenient way to fund government spending programs. And since we have today a certain amount of progressivity within the income tax, and that level is tolerable from a political discourse perspective, why throw it away? This leads to a highly practical view of progressivity, which goes back to Jean Baptiste Colbert’s aphorism that one should pluck the goose until its squawking becomes intolerable.\(^\text{12}\)

More recent work in the decades since Blum and Kalven’s monograph, such as a well-known paper by Joseph Bankman and Thomas Griffith, has sharpened both the economic analysis of progressive rate structures and the moral underpinnings of different social welfare functions.\(^\text{13}\) But even this more recent work largely operates within a closed model of tax collections and cash “redistribution.” Indeed, that is the basic outline of how formal optimal tax models operate.

As a result, most of the literature in this area continues to consider tax system design as if that were what we are trying to optimize, when in fact it is simply a mechanism for financing government operations.\(^\text{14}\) If instead we begin with the spending side of things, and in particular government’s opportunities to make useful investments and to write useful social insurance, we can ask the right question, which is simply which financing decision—which tax structures—most effectively complement the purposes of that investment and insurance? In other words, the nature of the public goods a government seeks to acquire should inform the financing structures that it chooses.

To crystallize this fundamental difference in perspective, consider for a moment elementary corporate finance. Corporations do not first design the size and structure of the liability side of their balance sheets (the debt and stock they issue to investors), and then ask what assets they might acquire with the funds on hand. Instead, they look for investment opportunities and ask, which are affordable? And, what financing structures most effectively match up against those assets? When it comes to contemporary government, by contrast, we do things backward along two margins: we start with an arbitrary size of our financing (the
amount of taxes to be raised), and we make no effort to design the structure of
that financing to most effectively complement the purposes to which the money
will be put.

This different perspective leads to several possible related arguments not con-
sidered by Blum or Kalven, or most of the subsequent literature, in support of
progressive tax structures. The first simply would be a special application of old
“benefits” arguments, in the form of a claim that progressive financing struc-
tures complement the purposes of government investment, if you begin with the
assumption that high-income individuals derive a disproportionately greater ben-
efit from investment in public goods than do lower-income taxpayers. I
briefly discuss this question below in the context of some recent early steps at presenting
a distributional analysis of all of government (the spending as well as the tax side),
but intuitively this claim seems a bit far fetched: Taxpayer B, with an income 10
times that of Taxpayer A, may derive greater benefits from roads, schools, or our
military than does Taxpayer A, but it is improbable that Taxpayer B enjoys 20
or 50 times the benefits. Even a proportional argument here is not intuitively
obvious. When it comes to the investment side of government’s operations,
then, one is left simply with the argument that much of such investment (educa-
tion, for example, but probably not roads or the military) is designed to enable
lower-income Americans to overcome market failures that are not problematic
for higher-income taxpayers, and so we should expect high-income taxpayers to
finance the bulk of such market-curing investments.

The more convincing justifications for progressive taxation not developed in
Blum and Kalven follow from the previous chapter, on social insurance. These
begin with my dumbed-down application of John Rawls, in which our society’s
basic terms are discerned by imagining the bargaining among our noncorporeal
predecessors, who agree to be born, but who further recognize the wide array of
possible life situations into which they might be thrown, and who therefore have
the good sense to sign up for some insurance just before embarking on the adven-
ture of life. The only way those noncorporeal beings can pay for that insurance is
in arrears, and since those who make insurance claims cannot generally a-
fford the insurance premiums, those who do well will have to contribute dispropor-
tionately. Proportional taxation does not work well here, because in fact we generally
excuse from tax those whose circumstances require them to make an insurance
claim, even if they have a little income. The progressive rate structure more neatly
describes the post-paid insurance model.

The final justification for a progressive income tax rate structure is similar to
the argument just offered, shorn of Rawlsian pretense. My claim here is simply
that the progressive rate structure by itself is a form of social insurance, in that it
relieves those at the bottom of the income hierarchy of a cash expense they would
face were income taxes collected on a proportional schedule, and does so simply
because their material life outcomes have not been terribly successful. The money
so saved in turn can be spent in enhancing the relatively modest material lives
that these outcomes imply.

In other words, if one accepts the fundamental premise of this book, that mate-
rial outcomes are determined by an undifferentiated porridge of personal efforts
and brute luck, by virtue of which we all have a bit less control over our material
successes than we like to pretend, then some tax rate progression functions as
a broad social insurance program to address the brute luck component. It is a
broad-brush sort of insurance, as its benefits (relative to proportional taxation)
are not delivered with surgical precision only to the most appealing hard-luck
stories, but under most any theory of the utility of income, this arrangement, if
not carried to excess, increases the net happiness of society. And in contrast to
other forms of social insurance, no one on the political right seems to argue that a
progressive rate structure necessarily lulls the modestly successful (or downright
unsuccessful) into lives of state-supported indolence. For this reason of political
economy alone, a moderate approach to progressive taxation is a useful way of
delivering some social insurance benefits to those who need it, when compared
with the proportional tax alternative.

**TAX PROGRESSIVITY IN CONTEMPORARY APPLICATION**

*How Much Tax Progressivity Do We Have?*

Chapter 7 discussed various measures of progressivity. It argued that measuring
the progressivity of a tax system in the abstract is a fool's errand. A tax of $1,000
imposed on each and every billionaire in the United States will score as very pro-
gressive—only the very most affluent Americans will be burdened by it—but the
tax will raise trivial amounts of revenue. What consolation is there in being told
that this tax, although too small to fund any useful government program, is really
highly progressive? There is no virtue to such abstractions.

A better way of eyeballing progressivity in our current tax system is to reprise
Table 8.2 from Chapter 8 (repeated here as Table 12.1), which reproduced the work
of the nonpartisan staff of the Joint Committee on Taxation in distributing the
economic incidence of all federal taxes (other than the estate and gift tax) to the
individuals who bear the burden of those taxes. The JCT staff table shows the
effective (average) all-in federal tax burdens of Americans, by income class, as a
percentage of individuals’ “expanded incomes.”15

What the JCT staff work product demonstrates is that the federal tax system,
taken as a whole, shows a moderately progressive structure, in which tax bur-
dens steadily rise as a percentage of incomes, at least for those earning more than
$20,000/year. The average (effective) tax rate imposed on individuals fortunate

enough to earn over $1 million/year is 32 percent, which based on my random polling is far lower than most people imagine.

As previously observed, the results for the second-lowest income class in particular are skewed by effects of the large “making work pay” subsidies made available through the income tax, particularly in the form of the earned income tax credit and the child tax credit. Both the CBO and the JCT staff treat the portions of these credits that reduce income tax liabilities as tax reductions, thereby pulling down the average tax rates of lower-income Americans. The JCT staff treats cash income tax refunds (credits that exceed tax liabilities, and that result in cash grants to taxpayers) as reductions in total taxes paid by the relevant income group, rather than as income subsidies, while the CBO does the opposite for general budget accounting purposes (but then reverses field and follows the JCT practice in its recent series of household income and tax distributional studies). All these social expenditures delivered through the tax system should be accounted for consistently as spending programs, whether they reduce tax liabilities or result in the receipt of a check. Here again we see how tax expenditures occlude our understanding of the size and functions of government.

Table 12.1  JCT Baseline Distribution of Income and Federal Taxes (2013)

<table>
<thead>
<tr>
<th>Income Class</th>
<th>Number of Returns (thousands)</th>
<th>Expended Income ($ millions)</th>
<th>Tax Liability ($ millions)</th>
<th>Average Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 10,000</td>
<td>18,506</td>
<td>80,476</td>
<td>6,513</td>
<td>8.1</td>
</tr>
<tr>
<td>10,000 to 20,000</td>
<td>18,328</td>
<td>277,369</td>
<td>7,879</td>
<td>2.8</td>
</tr>
<tr>
<td>20,000 to 30,000</td>
<td>20,427</td>
<td>503,472</td>
<td>34,666</td>
<td>6.9</td>
</tr>
<tr>
<td>30,000 to 40,000</td>
<td>15,833</td>
<td>554,348</td>
<td>56,225</td>
<td>10.1</td>
</tr>
<tr>
<td>40,000 to 50,000</td>
<td>14,654</td>
<td>657,243</td>
<td>82,227</td>
<td>12.5</td>
</tr>
<tr>
<td>50,000 to 75,000</td>
<td>24,337</td>
<td>1,503,844</td>
<td>213,051</td>
<td>14.2</td>
</tr>
<tr>
<td>75,000 to 100,000</td>
<td>16,860</td>
<td>1,459,798</td>
<td>237,769</td>
<td>16.3</td>
</tr>
<tr>
<td>100,000 to 200,000</td>
<td>24,334</td>
<td>3,303,188</td>
<td>682,788</td>
<td>20.7</td>
</tr>
<tr>
<td>200,000 to 500,000</td>
<td>6,094</td>
<td>1,708,978</td>
<td>439,925</td>
<td>25.7</td>
</tr>
<tr>
<td>500,000 to 1,000,000</td>
<td>743</td>
<td>497,484</td>
<td>148,679</td>
<td>29.9</td>
</tr>
<tr>
<td>Over 1,000,000</td>
<td>362</td>
<td>1,173,450</td>
<td>375,042</td>
<td>32.0</td>
</tr>
<tr>
<td>Total</td>
<td>160,518</td>
<td>11,719,650</td>
<td>2,284,763</td>
<td>19.5</td>
</tr>
</tbody>
</table>

Source: Staff Joint Committee on Taxation, Modeling the Distribution of Taxes, table 9.
“Distributionally Neutral” Tax Law Changes

To summarize to this point, the United States today has a progressive overall tax structure. The staff of the Joint Committee on Taxation’s 2013 “baseline” tax distribution table (Table 12.1) shows that, when all federal taxes are considered, every income level pays taxes, and effective (average) tax burdens follow a rational progressive rate path. The federal personal income tax when viewed in isolation appears even more progressive, but that misses the point that the personal income tax is only one of a suite of taxes that individuals ultimately bear.

The staff of the Joint Committee on Taxation’s “baseline” 2013 tax distribution table is unusual, in that most JCT staff distributional work is done in the context of proposed changes in tax law. Distribution tables are prepared in this second setting to answer the invariable question asked by members of Congress, which is, are we sharing the benefits of this overall tax cut (more rarely in recent years, are we sharing the burdens of this overall tax increase) in a “distributionally neutral” fashion? Most distributional analysis therefore focuses on the distributional consequences of incremental changes in law, not the baseline.

It turns out that the concept of distributional neutrality in respect of changes in overall tax revenues is much more elusive than one might expect. Putting to one side all the issues discussed in Chapter 4 of what is the right unit to measure (family, household, tax return), and what is the right measure of economic income, the preparation of JCT staff distributional tables in this specific context requires a difficult judgment to be made, which is, are we trying to show the incremental change in the distribution of tax revenues, or of tax burdens? The two measures are very different in some important cases, like gains from sales of stock or other investments (capital gains).

The problem in every case is that changes in tax law induce changes in behavior, and one therefore must decide which new behaviors reflect new economic burdens, and which reflect new economic opportunities; surprisingly, toting up changes in tax collections can mask whether a taxpayer’s economic burdens have gone up or down. To make things even more difficult, if a change in tax law adds to budget deficits, those deficits must ultimately be financed through higher taxes at some future date; how should those indefinite future liabilities be reflected in current-year distributional tables?

Imagine that the capital gains tax rate is slashed for a two-year period from current law (20 percent) to 10 percent. Capital gains of course are very top-heavy in their distribution—one of the many disadvantages of poverty being that one does not have a large portfolio of investment assets—so the change in law would be interesting only to the rich. Affluent investors might rush to sell all the appreciated investment assets they could, and in fact sell so many investments in the tax holiday period that for those two years tax revenues from capital gains go up,
not down. (This is not the same, by the way, as saying that tax cuts pay for themselves: the phenomenon posited in the example is real, but is a one-time response to the new tax environment—an acceleration into the current year of capital gains that otherwise would be harvested in future years. As a result, even if the new rate continued in perpetuity, long-term steady state capital gains tax collections would be lower in the 10 percent tax rate environment than under current law.)

If in this example incremental distributional tables followed tax revenues, then the rich would be shown as assuming a larger share of the total tax pie, and as a result the cut in capital gains taxes would be paraded as “highly progressive.” If, on the other hand, sober-minded economists had their way, and the incremental distributional tables followed the change in tax burdens, then in that case the rich obviously were made better off, not worse, as evidenced by the way they rushed to sell their investments, and the distributional tables would show the most affluent taxpayers’ tax burdens decreasing.

It is not fruitful to describe here the internal debates within Congressional staff over the years regarding how this issue should be resolved. The short version is that the sober-minded economists had their say, but were quickly reversed. The main incremental distributional tables prepared by the JCT staff for use in debating actual tax legislation simply distribute the incremental changes in tax revenues. The effective tax rate columns are the only signal as to whether the distribution of tax revenues accurately tracks economic changes in tax burdens.

Now put this important question to one side, and assume that the distribution of changes in tax revenues parallels the distribution of changes in tax burdens. (Once one moves away from capital gains taxes in particular, this assumption often is good enough for government work.) Imagine that it has been decided that personal income tax collections must rise in the aggregate, but that the tax hike will be allocated among individual taxpayers in a “distributionally neutral” manner. What do those words actually mean? The answer is that a change in overall tax collections is treated as distributionally neutral when every income tier has its tax bill increased (or decreased) by the same percentage.

Here is a simple example. Imagine a typical progressive income tax system comprising three individuals, A, B, and C.

<table>
<thead>
<tr>
<th>INCOME</th>
<th>TAX</th>
<th>EFF. TAX RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$100</td>
<td>$10</td>
</tr>
<tr>
<td>B</td>
<td>$500</td>
<td>$100</td>
</tr>
<tr>
<td>C</td>
<td>$1,000</td>
<td>$100</td>
</tr>
<tr>
<td>TOTALS:</td>
<td>$1,600</td>
<td>$410</td>
</tr>
</tbody>
</table>
It is decided that total tax revenues need to be $500, not $410. This $90 increase in tax revenues represents a 22 percent overall tax hike ($500/410 = 1.22).

A “distributionally neutral” allocation of that $90 is understood to mean that everyone’s effective tax rate goes up by 22 percent. (Alternatively, you can say that A gets a tax increase of his share of the old total tax bill—$10/$410—multiplied by the tax increase—$90.) As a result, A will now pay $12.20 in tax, not $10; B will pay $121.95, not $100, and C will pay $365.85, not $300. The overall tax bill of course will be $500. In graphical terms, if you imagine prior law’s tax rate progression as a curve, then a distributionally neutral tax increase or decrease will move the whole curve straight up or down, without changing its shape.

A distributionally neutral increase in tax revenues thus requires C in my example to pay a new effective tax rate of 36.6 percent (122 percent of his old rate of 30 percent), while A will pay 12.2 percent (122 percent of his old rate of 10 percent). C and his apologists will demand to know why his tax burden has gone up by 6.6 percentage points, while A’s has only gone up by 2.2 points. The answer is, that is what is required to keep C’s share of the overall tax burden constant. But the critical point to note is how much C’s tax rate needs to increase in terms of percentage points, not percentage of total tax burdens: a full 6.6 percentage points.

When confronting a large tax increase in the real world, rather than in my hypothetical example, it may not always be possible, because of economic efficiency concerns or political economy realities, to raise top income taxpayers’ rates as much as would be required to preserve distributional neutrality—that is, to retain the shape of the current tax progression curve. It is as if a pin is stuck into the curve at the top rate, and the rest of the curve must pivot around that point. When that happens, distributional neutrality is lost, and more particularly as the curve pivots around the fixed top rate, the curve becomes flatter, which is to say, less progressive.

This is the inevitable result of the collision between the need for more tax revenues and the fundamental stickiness (whether for reasons of theory or practice) of top tax rates. The next section reviews some of these stickiness constraints.

How Much Tax Progressivity Should We Have?

The earlier discussion in this chapter argued that the original impetus behind the progressive rate structure of the income tax (“ability to pay,” recognizing of course the term’s complete indeterminacy in actual application) was more constructive than the inequality remediation impulses that came to the fore in the New Deal. That discussion also suggested that progressive income tax rate structures could be justified along several margins, such as the declining marginal utility of income (as filtered through the value judgment that this is an appropriate aspirational
norm for a society to adopt), and the consistency of progressive income taxation with social insurance goals.

Finally, as a reminder, we have a progressive income tax today. While increasing its progressivity at the top end would be deeply controversial, the United States is not currently enmeshed in a full bore “flat tax” war of words. To the contrary, when introducing his tax reform initiatives in 2013, Dave Camp, the chairman of the House Ways and Means Committee, was explicit that tax reform should not upset the current distribution of tax liabilities—that is, the progressive tax liabilities achieved under current law.

But all of this begs the question, how much progressivity in tax rate structure is the right amount? This is the sort of question best resolved through the give and take of rational political discourse, as intermediated by Congress. Nonetheless, there are some outer limits to plausible possible outcomes.

One approach to answering this question might be through the lens of history. When I began practicing tax law, the maximum tax rate on “unearned” income (essentially, capital income other than capital gains) was 70 percent, and on “earned income” (labor income) 50 percent, if that labor income qualified for the so-called “maxi-tax.” The corporate income tax was 48 percent. A few years later, for two brief years following the Tax Reform Act of 1986, the maximum tax rate on all forms of capital income (including capital gains) and of labor income was the same—28 percent, and the corporate income tax was reduced to 34 percent. Individual top marginal tax rates increased during the 1990s, until they reached 39.6 percent. Today, most forms of capital income (other than interest income) are taxed at effective marginal rates well below those of labor income, and the top marginal rate imposed on the highest-income individuals is again 39.6 percent—or 43.4 percent, if one includes the Medicare tax on labor income.

All of this suggests that history offers no clear guidance as to what the top rate should be. You can find historical precedent to support any intuition, and if you choose you can draw causal relationships between economic growth in a period and the progressive rate schedule you prefer. But those purported causal relationships are completely unreliable, because they are swamped by omitted variables—exogenous shocks (oil, financial overleveraging, or terrorism for example), demographic factors, large-scale economic developments (the Internet revolution), and the like. Moreover, no amount of inference along these lines can prove the negative—that is, what economic growth would have looked like under a different tax regime.

What I draw from history is that tax law is not like the Ring carried by Frodo—it does not rule us all. History suggests that we all get on with the business of living, and of doing business, under very different tax structures. That is not to say that we should be recklessly indifferent to tax system design, but only that we should not assume that lower tax rates, always, are unequivocably necessary and sufficient conditions to economic growth.
Another approach to dialing in the right amount of income tax progressivity is to start with economic models developed in the theoretical optimal tax literature and then to apply to those models empirical research into individuals’ real-world sensitivity to tax rates, to come up with a considered opinion as to how much progressivity is the right amount. In a very important paper published in 2011, Nobel laureate Peter Diamond and his coauthor Emmanuel Saez did just that.  

More specifically, Diamond and Saez set out to calculate the “optimal” tax rate on the top one percent or so of the income distribution—individuals whose incomes averaged about $1.4 million in 2007, before deductions. By “optimal,” Diamond and Saez meant the tax rate on top incomes that maximizes tax revenues, after taking into account the negative incentive effects of taxation on economic activity. A higher tax rate would reduce economic activity so much that tax collections would go down, not up. A lower rate would mean that lower-income individuals would be required to fund the resulting revenue shortfall. Diamond and Saez effectively embraced the declining marginal utility of income as a social norm; in fact, their specification of the “social welfare function” apparently put a value of zero on the last dollar earned by the most affluent American. As a result, a lower than “optimal” tax rate on the most affluent Americans, and a concomitant shifting of the burden to lower-income Americans, would reduce overall social welfare.

Putting matters differently, regardless of the level of revenues that government requires, Diamond and Saez would argue that one should develop an optimal tax rate progression by starting from the optimal (i.e., revenue-maximizing) rate on the very top of the income distribution. With that number fixed in every case, one then could scale tax rates further down the income ladder to satisfy government’s budget needs.

Diamond and Saez concluded that the “optimal” tax rate on the top one percent of the income distribution is 73 percent (including state and local taxes). This estimate was not greeted with universal enthusiasm across the entire political spectrum.

Diamond and Saez’s core estimate that the optimal tax rate on very high incomes is 73 percent is sensitive to the porosity of the tax base—that is, the ease with which higher taxes can be avoided. Using a different set of tax elasticity estimates than their preferred specifications and current law’s definitions, deductions, and exclusions, Diamond and Saez nonetheless computed an optimal rate of 54 percent, including state and local taxes, or about 48 percent for federal income taxes only. This rate is still higher than the top tax rate imposed from January 1, 2013, onward, although not by as much as was true when Diamond and Saez published their paper in 2011. At the low end, Diamond and Saez essentially concluded that subsidizing low-income wage earners—as we do today, through the earned income tax credit—was logically consistent with optimal tax theory.
Finally, Diamond and Saez concluded that taxing capital income was not such a bad idea after all. This last conclusion responds to a large body of theoretical literature arguing that it is a mistake to impose any tax on the basic (“normal”) returns to capital. This debate is extremely interesting to theorists, but as a political economy matter the entire purpose of the income tax from the time of its adoption was to tax capital income. Moreover, to my knowledge no country wholly exempts capital income from its income tax base, and as Diamond and Saez point out (here following rather than leading the lawyers in their analysis), in many practical cases it is very difficult to tease apart capital from labor income. For all these reasons, this book does not develop this debate in any detail.

Diamond and Saez’s paper does not definitively resolve the practical application of optimal tax theory to real-world behaviors; that is not how empirical research in the social sciences works. Nor are the premises of optimal tax theory universally accepted—in particular, its reliance on utilitarian social welfare norms that have at their core a theory of the declining marginal utility of income. The market triumphalists described earlier in this book might argue, for example, that individual liberty is the overriding social norm, which would in turn lead to different conclusions about top tax rates. Finally, others might specify a different “social welfare function” than that adopted by Diamond and Saez, with its steeply declining marginal utility of income, which again would change their results.

The critical point, however, is that the work of these two highly regarded academics is roughly congruent with both the overall character and the actual numbers employed in the construction of our current progressive income tax rate structure. We are not required fully to embrace Diamond and Saez’s invitation to try a little more progressivity at the top to take some comfort from that fact. A progressive income tax looking roughly like the one we have today may not have the same status as Newton’s laws of gravity, but contrary to the rhetoric of market triumphalists, it is a principled place to be.

The third leg in triangulating our progressive income tax rate structure is to benchmark the United States against other countries. Table 8.4 in Chapter 8 did that. What it showed was, first, that most peer countries impose marginal personal income tax rates on their highest-income citizens at levels hovering just below 50 percent, or in a few cases a bit above that figure. Second, many countries begin to impose that top rate at incomes far lower than in the United States. By both standards, the United States is nowhere near the top of the heap in taxing its highest-income citizens.

To summarize, the top marginal personal income tax rate draws support from history (but then again, so does most any top rate one can imagine). Following the January 1, 2013, “fiscal cliff” deal, our top marginal rate is not terribly different from that of other peer countries, although we reserve that top rate for incomes at a higher level than do many other jurisdictions. And finally, academic research
into both optimal tax theory and real-world responsiveness to increasing tax rates argues that the top marginal personal income tax rate is well within the envelope of revenue- and welfare-enhancing possibilities. That top rate could drift a little higher and still satisfy both standards—but only a little higher, under the more conservative of the specifications employed by Diamond and Saez, or under the political economy pressures evident everywhere in the world that turning the tax odometer past 50 percent is very difficult to accomplish.

The tax progressivity well is simply not as deep as progressives like to imagine. Adverse incentive effects start to erode the revenue pickup from higher rates, and incurring the hatred of the rich paralyzes the political process. There is a reason that most every peer country finds that its top marginal personal income tax rate should be a two-digit number beginning with a 4! So long as we allow the political debate to be shaped solely in terms of preserving (or increasing) the progressivity of the tax system at the top, we inadvertently are capping the size of government well below its optimal level.

And this in turn has major implications for tax rate progressivity in the context of changes in overall tax collections. If (as Chapter 6 argued) we need to find additional revenues on the order of 2 percent of GDP per annum, or perhaps a bit more, it will be very difficult to do so by raising taxes on the highest-income Americans alone. And if tax rates at the highest income levels cannot go up very much further, then any substantial increase in total tax revenues collected through the income tax will reduce, not increase, overall progressivity. The tax distribution curve will rotate around a pin stuck at a top rate not very different from current law’s top rate, as explained in the prior section of this chapter.

Raising more tax revenues reasonably efficiently necessarily points in the direction of increasing tax burdens on Americans with incomes well below the top. But as the next section shows, doing so can still be consistent with progressive values, because the resulting net fiscal system can be materially more progressive than our current fiscal environment.

TWO LEVERS OF PROGRESSIVITY

Tax revenues must rise. We can huff and puff about this until we faint from exhaustion, but it is an inescapable fact, in light of our painfully inadequate current revenue base, as documented by the Congressional Budget Office, our surging population of elderly Americans, our commitment to a military that spends roughly 45 percent of the world’s aggregate defense budgets, and our collective waste of almost $1 trillion every year in excess healthcare spending, both before and after the implementation of the Affordable Care Act. And all this is before considering the productive investments and social insurance that government
can buy, which opportunities are inexcusable as a straightforward business matter to leave unfunded.

In turn, because top tax rates are sticky, the inevitable conclusion is that as tax revenues increase, the tax system will grow less progressive. To argue that our future tax system will be somewhat less progressive than current law’s distribution of burdens does not mean, however, that the personal income tax should be abandoned, or that a consumption tax (for example, a value added tax of the sort employed elsewhere in the world) necessarily must be adopted. To the contrary, as the next chapter demonstrates, a great deal of revenue can be raised without introducing new taxes or raising the top marginal rate materially. But doing so does require raising marginal rates on lower-income tax brackets—for example, by restoring the bulk of the pre-2001 tax rate structure.

The unavoidable conclusion that the collision of higher tax revenues and sticky top rates means that our future tax system will be less progressive leads many progressive pundits to despair, but this despondency is largely the result of an inappropriate fixation on the tax side of things, to the exclusion of the goods that government delivers to its citizens. The important question is not the progressivity of our tax system, but rather the progressivity of our country’s fiscal system—the net of its spending and taxing. Once we free ourselves from our fixation on taxation as the entirety of fiscal policy, we discover that we can in fact fund a more progressive fiscal system.

Debating the progressivity of a tax system in the abstract thus is a meaningless distraction from serious discourse. Yet in every aspect of our fiscal debates, we compartmentalize the tax and spending functions and wrangle over each separately. Different committees in Congress handle each, economists and pundits alike analyze the structure of each separately, and no institution is charged with presenting a holistic picture of the net distributional consequences of our combined taxing and spending programs.

Distributional Analyses of the Fiscal System

Measuring the progressivity of a fiscal system is a much more difficult concept than standard tools capture. Taxing and spending each have distributional consequences, and the two are bound to each other by the fact that taxing funds spending.

To present a more complete picture of the distributional consequences of government intervention, we need to capture three variables: the progressivity of the tax system in the abstract, the size of the tax system, and how the resulting revenues are spent. In turn, determining how money is spent for purposes of a fiscal system distributional analysis means that we must determine who are the beneficiaries of each program.
Some spending can be associated with specific recipients, but a large fraction of government spending (military, roads, education, and so on) falls into the category of “public goods”—goods that are generally available to everyone (technically, “non-excludable” goods), and that generally can be used by one person without precluding their use by others (“non-rivalrous” goods). Once a new public road is built, anyone can drive on it, and one person’s driving on it does not preclude another from doing so too. Nonetheless, a comprehensive fiscal system distributional analysis requires assigning the value of the government investment in that road to someone, on some basis. In November 2013 the Congressional Budget Office estimated that about 40 percent of all government spending in 2006—some $1.1 trillion—fell into the category of public goods.

Finally, once we move from the distribution of tax burdens to a complete picture of the “gives” and “gets” of our fiscal system, in the broadest sense, we no longer are tied to comparative incomes as our metric. When the subject is the distribution of tax burdens, income and wealth are the obvious ways of ordering people: it does not make much sense to distribute tax burdens according to our heights. But when we look at the totality of government spending and taxing, we in fact might want to see distributional consequences by reference to attributes other than income. We might, for example, want to know how the elderly are making out relative to younger Americans, and so on. Implementing all this requires answering questions that official scorekeepers have not previously had to face.

As a first cut, we could look at the distributional consequences of the sum of our tax and transfer systems. The Reynolds–Smolensky progressivity index described in Chapter 8 can be used for this purpose, provided it is applied starting from a base of market incomes, and ending with a base that is after taxes and transfer/benefits payments. (The CBO measure of “after-tax” income does capture the latter.) By doing so, we would be comparing the Gini index (the standard measure of inequality) of pure market outcomes in the economy to the Gini index of where we actually end up, after all the taxes and highly targeted transfer payments that are intermediated through government.

For several years, the Congressional Budget Office has extended its distributional work on the tax side of the equation to include direct transfer and entitlements benefits (that is, spending that can be traced to benefits received by a specific individual). This category includes not just transfer programs like SNAP or housing benefits for the poor, but also Social Security payments, and the value to participants of the Medicare or Medicaid coverage they enjoy. This measure still excludes public goods, however.

The trend has been for targeted transfer and entitlements spending to become less progressive over time; as a result, their impact in reducing income inequality materially decreased from 1979 to 2007. The reasons are twofold: first, poverty-related transfer payments in fact have been on a long-term downward
A PROGRESSIVE FISCAL SYSTEM

trajectory as a percentage of GDP (interrupted, of course, by the economic and jobs crisis in which the United States is still mired), and, second, Medicare and Social Security benefits, which are not means-tested, have taken a larger fraction of total targeted benefits spending. The increased spending for Medicare and Social Security thus has not been as effective as are programs like SNAP or the earned income tax credit at reducing inequality.

You can see from Figure 12.1, which covers the period from 1979 through 2007 (that is, just before the economic collapse of the Great Recession), how the lowest-income quintile of Americans obtained a substantially declining share of entitlements benefits, while the other quintiles, including the highest-income group, all increased their shares. The principal reason is that the largest entitlements (Social Security and Medicare) are not means-tested, and have consumed an ever-increasing share of the total entitlements pie.

Most transfer payments and entitlements benefits have always gone to the elderly, whose benefits are largely not means-tested, and their share has been on a steady upward trajectory for decades. Many of the elderly are low-income households, but some are not. In any event, elderly childless households now absorb roughly 70 percent of all entitlements spending (see Figure 12.2).

The net effect has been that transfers and entitlements benefits, taken as a whole, had in 2007 a materially smaller impact on mitigating income inequality.

![Figure 12.1](image)

**Figure 12.1** Share of Total Transfers, by Market Income Group

*Source: CBO, Trends in the Distribution of Household Income, 24.*
than was true in 1979. Focusing on tax progressivity alone (which, as it happens, displayed the same long-term trend of doing less and less to mitigate income inequality) misses the larger of the two government instruments that affect income inequality, and distracts from the important story of how entitlements programs have become increasingly devoted to the elderly, regardless of need.

Figure 12.3 presents another way of visualizing how our fiscal policies have been redirected over time from helping the lowest-income Americans to subsidizing those in the middle. Using data from 1979 to 2009, I observed households ranked by their market income and then split into five equal groups (quintiles). I followed each quintile before and after government involvement by calculating its share of pre-tax market income and comparing that to its share of income after both taxes and transfers. The two most affluent quintiles typically had lower shares of total national income after taxes and transfers than they had of total pre-tax market income; the reverse was true for the lower three quintiles. This is expected in a progressive fiscal system: higher earners are taxed more, and some of those proceeds are invested in lower earners.

Figure 12.3 goes a step further, by showing what percentage of the share of national income surrendered by the two highest income quintiles was captured by each of the lower quintiles. Figure 12.3 does not reflect the absolute size of the shares of national income given up by the upper two quintiles, but does show...
how much of the pie (whatever its size) each of the lower three quintiles has been consuming over time.

Since the 1980s the lowest income quintile has gone from capturing almost 80 percent of the fraction of national income given up by the two highest quintiles to less than 60 percent. Because the shares captured by all three of the lower quintiles must add up to 100 percent of what is given up by the upper two quintiles, the lowest quintile necessarily lost at the hands of the second and middle quintile. Why as a society do we choose to use fiscal policies to subsidize the middle class, and to do so more extensively than in the past? The middle class is not doing as well as it might, were government to seize the opportunities to invest in Americans more comprehensively, but most of those households have reasonably adequate resources. That is not the case for many households in the lowest quintile.

Very little empirical work has been done to date on measuring the distributional consequences of the entirety of our fiscal system, and in particular incorporating the large fraction of government spending that goes toward acquiring public goods. The OECD has attempted to do this from time to time, by including the value of public education and other public services in their calculations of

**Figure 12.3** Income Capture by Lower Quintiles (1979–2009)

after-tax and transfer inequality, but the OECD does not regularly publish such

data. Nonetheless, this approach would paint a fairer picture of the progressivity
our overall fiscal system than we have available today.

The Congressional Budget Office released its first tentative effort along these
lines only in November 2013, in the form of a distributional analysis of substan-
tially all federal spending and taxes for 2006. That effort raised as many ques-
tions as it answered, but it is an important first step, and should be encouraged.

The CBO in this new study divided government spending into three catego-
ries: “cash and near-cash transfers” (both income support transfers and Social
Security benefits), health care transfers (Medicare, Medicaid, etc.), and “spend-
ing on other goods and services” (public goods). Given the large size of the third
category (40 percent of spending), the first question is, who benefits from it? The
CBO here wisely puntedit, and offered two scenarios: one in which the benefits of
public goods are shared per capita, and one where those benefits are shared in
proportion to market incomes.

The idea behind the second distribution method is that the affluent drive more
than do the poor, have more stuff to be protected by the military, and so on. More
empirical work here might narrow the range of plausible assumptions. My own
intuition is that the right answer is probably somewhere between the two cases
modeled by the CBO. In this regard, recall an earlier discussion in Chapter 4
of how the CBO assumes that the cost of running a household increases by the
square root of household size, so that a family of four is thought to have twice the
needs of a family of one. That rule of thumb is based on research conducted in
that specific context, but nonetheless might be as useful a place as any other to
start. That is, the household with four times the income of another probably calls
on public goods more than does the poorer household, but under my suggested
starting point, would be treated with receiving twice the distributional benefits of
spending on public goods as the poorer household, not four times as much. This
reflects the idea that, for example, the affluent might use public roads more, but
surely that greater utilization does not expand linearly with income.

For the CBO, distributing tax burdens of course is old hat, but in this new
context it actually raises important questions that previously had been ignored
in distributional analyses. For example, the CBO presents a chart showing the
distribution of the $480 billion in federal healthcare transfer payments in 2006,
measured by type of household (elderly/non-elderly), as well as a separate chart
showing the distribution of the $175 billion in healthcare transfer payments
received by non-elderly households, measured by income quintiles. But those
charts simply ignore the $250 billion or so in federal transfer payments baked
into the tax code, in the form of the tax expenditure for employer-sponsored
healthcare, as discussed in Chapter 9. That spending is top-heavy in its income
distribution, and would if included lead to a dramatically different picture of the
distribution of healthcare transfer payments to the non-elderly, ordered by income
quintiles, than that shown in the CBO study. Here again we see how tax expendi-
tures distort almost every effort to grasp what government does, and who pays
for it.

The CBO has already developed the methodologies to distribute the benefits of
tax expenditures across the population of taxpayers, and doing so here for the large-
est tax expenditures would materially improve the accuracy of the CBO’s analysis
of government’s total distributional effects on our lives. A complete effort would
require essentially unbundling the tax code, to start with “gross” (pre-hidden
spending) tax revenues, and then to distribute as spending programs the various
major tax expenditures. The resulting presentation would not tie in directly
with official budget line items, but the purpose of this distributional analysis
is to communicate a different kind of information; the budget line items follow
Congressional authorization procedures, which are just not relevant to commu-
nicating the relative net burdens or benefits received from the sum of all govern-
ment spending and taxing.

The CBO’s preliminary work is summarized in 12.4 and Table 12.2. Figure 12.4
and is a standard tax distribution table for 2006, showing the average tax burden
per non-elderly household for each income quintile (so elderly households are

![Figure 12.4](image-url)

**Figure 12.4** Taxes Paid and Net Benefits Received per Non-elderly Household, by Incomes

*Source: CBO, The Distribution of Federal Spending and Taxes, exhibit 23, supplemental tables.*
ignored), but with a new set of data side by side: the combined effect of government spending for the benefit of such households, allocated according to market incomes, minus the taxes paid by those households.

Figure 12.4 graphically illustrates what we already knew, which is that the average household in the lowest income quintile receives a share of total government spending, net of taxes paid, that exceeds that household’s small stand-alone tax liability. This of course is exactly what one would expect in any country that has social insurance programs. What is more surprising is the top end. There we see that the average household in the highest income quintile receives an effective rebate of 43 percent of the taxes it pays, in the form of its share of government spending on its behalf.

The CBO presentation contains only five data points, but it nonetheless is possible to use the CBO’s innovative work here to construct rough and ready Gini indexes that sketch how government intervention affects inequality among non-elderly Americans. Table 12.2’s rightmost column does just this.

What Table 12.2 suggests is that within the non-elderly population, tax burdens have only a small affect on income inequality—the Gini indexes of the population based on their pre-tax market incomes, and on their after-tax market incomes, are very close. It is the spending side of things (market income, plus benefits, minus taxes) that introduces some real progressivity relative to the starting point of pre-tax market incomes. Within the population of the non-elderly, it is the spending side of things that is the principal driver of progressive outcomes. This is consistent with the theme of this chapter that focusing on progressive taxation simply misses the more important lever of government intervention.

Figure 12.5 is a similar summary to Figure 12.4, but this time the relevant metric is elderly versus non-elderly households.

Table 12.2 Effect of Government on Gini Indexes of Non-elderly Household Incomes

<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>
</tr>
</thead>
<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>
</tr>
<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>
</tr>
<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>
</tr>
</tbody>
</table>

Source: CBO, The Distribution of Federal Spending and Taxes, and author’s calculations.
Figure 12.5 confirms that points made a little earlier, that the elderly are the overwhelming winners in any analysis of the combined effects of government taxes and spending on behalf of households.

Notwithstanding its methodological difficulties, the holistic perspective evident in the CBO’s first attempt to distribute almost all government spending and taxes is important, because our current fixation on the progressivity of the tax system in the abstract fundamentally distorts policy options. This myopic focus leads to claims from market triumphalists that the highest income tax rates should come down, because our tax system is “very progressive,” without any understanding of how small our total tax burdens in fact are, or the net progressivity of the entire taxing and spending function of government. This misbegotten focus further means that we pay inadequate attention to how entitlement benefits spending has become less progressive over time, and the relative sharing of burdens and benefits between the elderly and non-elderly populations. And finally, this misplaced emphasis on tax progressivity by itself leads policymakers from a progressive point of view to rule as unacceptable facially regressive tax instruments that can in fact be employed to advance progressive agendas.
Regressive Taxes Fund Progressive Fiscal Systems

It is common in the OECD for regressive taxes to fund progressive overall government systems. In particular, European value added taxes are regressive when viewed in the abstract, but they also raise huge sums of money. European countries spend those revenues in highly progressive ways, and thereby achieve progressive overall systems.13

Figure 12.6 uses OECD data from the first decade of the 2000s to show the correlation between the progressivity of a country’s tax rate structure and its impact on reducing after-tax inequality. Inequality reduction is measured by the percentage decrease in the Gini index between pre-tax and transfer (market) income inequality and post-tax and transfer (disposable) income inequality. Progressivity is measured by the Kakwani index, which as described earlier measures the progressivity of a tax in the abstract (that is, without regard to how much money the tax raises).

Surprisingly, the progressivity of a tax system’s rate structure is negatively correlated with the overall reduction in inequality that a country achieves. The United States has the most progressive income tax rate structure, viewed in the abstract, yet it has by far the smallest overall impact on income inequality.

Figure 12.6 Effect of Tax System on Reducing Inequality
This trend remains constant when including publicly provided services, such as public health care and education. Figure 12.7 is the same as Figure 12.6, except that the effect of the overall tax and transfer system is measured by the percentage decrease in the Gini index after taxes, transfers, and the imputed value of public services. This is the closest OECD analogue to the new CBO work summarized a few paragraphs earlier.\textsuperscript{34}

By contrast, there is a clear positive correlation between the overall size of a country’s tax collections and its success at reducing inequality through the intermediation of government. Figure 12.8 again uses OECD data from the first decade of the 2000s to make this point. As in Figure 12.6, this figure charts the percentage decrease in the Gini index for income inequality between pre-tax and transfer income and post-tax and transfer income, but this time as a function, not of the abstract progressivity of the tax system, of the overall amount of revenue collected, measured as a percentage of each country’s GDP.

The United States is the lowest-tax country among the countries surveyed, but achieves by far the smallest reduction in income inequality.

Both as a matter of political economy and of economic theory, there are limitations on how much tax revenue can be raised by highly progressive taxes, because at some point (although economists disagree as to exactly where that point is) the deadweight losses associated with high marginal tax rates make further attempts at progressivity self-defeating, and because the squawks of the

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure12.7.png}
\caption{Effect of Tax System on Reducing Inequality (after Public Services)}
\end{figure}
affluent geese as they are being plucked become intolerable. As a matter of practical necessity, therefore, every country sooner or later discovers that a high level of tax collections requires a less progressive overall tax system, as Figure 12.9 shows.

In sum, advocates for more progressive tax rates are wrong to assume that progressive rates, alone, in practice will lead to greater reductions in inequality. The figures above make clear that the overall size of a tax system is much more important in achieving a substantial change in levels of inequality, after all aspects of a fiscal system are considered. The observation that the size, not the progressivity of the rate structure, is the most important characteristic of a tax system from the standpoint of reducing inequality has an important implication: government spending, not the manner in which revenue is raised, decreases inequality. This explains why countries with regressive taxes, including the European countries that rely heavily on value added taxes (economically the same as sales tax) achieve the most redistribution. In these countries, taxes are not particularly redistributive by themselves, but large revenues are raised, allowing governments to lower inequality through significant social investment and insurance programs.
As Adam Smith reminded us, the purpose of inquiries such as this book is to increase the happiness of society. It is therefore appropriate to pause for a moment and ask whether there is any evidence suggesting correlation between progressive fiscal systems (with their attendant larger tax demands) and the happiness of the societies that have embraced those systems.

The answer is yes. The body of research in this area actually is very large, and includes important contributions by Nobel laureate Daniel Kahneman, Richard Easterlin, Jeffrey Sachs, and many other highly regarded social scientists. The research considers all the obvious impediments to reaching robust conclusions, like cultural differences, changing incomes over time, and other potential obstacles to interpersonal comparisons. (Can anyone expect the dour Germans ever to say they are happy? That sort of thing.) In the end, this is a serious and important area of social science research, not a touchy-feely invitation to tune in and drop out.  

My colleague at the University of Southern California, Thomas Griffith, conducted a careful review of the relationship between progressive taxation and happiness a few years ago. His review of the happiness research concluded that, among wealthy nations, equality of outcomes was more important to overall

![Total Tax Revenues versus Tax System Progressivity](image_url)
happiness in a society than was the rate of a country’s economic growth. From a happiness perspective, rapidly increasing inequality unfortunately plays directly against human nature, even if incomes rise in absolute terms, because of our rapid adaptation to whatever income level we experience (assuming that it is well above subsistence levels) and our wants for “positional goods.” Were Griffith to repeat that work today looking at the distribution of the entirety of the fiscal system, rather than just the tax structure, my intuition is that his results would be even more dramatic.

Benjamin Radcliffe, an academic at Notre Dame, has recently published a book reflecting his substantial empirical research in this area, *The Political Economy of Human Happiness: How Voters’ Choices Determine the Quality of Life*. In it he explicitly addresses the issue underlying this chapter, and indeed this book, which is, does a larger government, with its progressive spending and higher tax burdens, lead to greater or lesser well-being (the more inclusive term for happiness, in its most meaningful sense)?

The book analyzes surveys and other data from industrialized economies generally, and separately from the United States. Radcliffe concludes that public investments in important goods like education, and well-functioning social insurance, lead to higher overall reported levels of happiness, in the meaningful sense of life satisfaction, not momentary jolliness:

In the argument between Left and Right over the size of the state, I demonstrate that “big government” is more conducive to human well-being, controlling for other factors. Indeed the single most powerful individual- or national-level determinant of the degree to which people positively evaluate the quality of their lives is the extent to which they live in a generous and universalistic welfare state. Put differently, the greater the “social wage” that society pays its members, the happier people tend to be…. Overall, it is clear that the quality of human life improves as more of the productive capacity of society comes under political—which is to say…democratic—control. The subordination of the market to democracy thus appears to promote human happiness…

It is equally important to note that all of the factors…contribute to greater well-being without particular regard to socioeconomic status. While some of the relationships are indeed stronger for working- and middle-class citizens, in every case, higher-status persons also benefit.

The thrust of my book is to emphasize the complementary role of government to private markets in two areas where private markets fail—investment in public goods and social insurance. I therefore shy away from broader invocations of the virtues of “political control” over the market. But I think it plain that Radcliffe’s
research is entirely consistent with my more modest claims for restoring the role of government as a partner in those areas where private markets have demonstrated that they cannot go it alone.

Many other papers reach similar conclusions. For example, in a recent large-scale review published by the United Nations (although the work of private experts, not a UN agency), the United States placed 17th in overall self-reported subjective well-being, which if you think about it is a remarkably unimpressive showing for the richest large economy in the world. What is more, subjective well-being fell more in the United States than it did in most other countries during the Great Recession. Denmark, Norway, and Switzerland were the top medalists, but the Netherlands, which actually is a more diverse society than outsiders sometimes suspect, finished fourth, followed by Sweden and Canada. Canada’s materially higher subjective well-being score is particularly relevant, given its many similarities to the United States, but its commitment to a much larger role for government.

In another recent paper, researchers relying on a large-scale survey concluded that, looking only at the United States (so as to avoid any possible cross-country cultural differences), Americans on average were happier in years with less rather than more income inequality, even where the greater inequality years were also years with higher GDP. The researchers concluded that the reason was not the rise in income inequality itself, but rather the erosion of perceived fairness and general trust that survey respondents identified as correlated with higher inequality in our society.

The overall thrust of the research is more or less what you would expect, had you chosen to listen to your mother: money is important, but it does not buy all forms of happiness. Caring for others enriches your soul. Mental health is critically important, even if roundly ignored by much public and private health insurance. Being out of work stinks. Opportunities for life satisfaction must themselves be meaningful to change long-term perceptions of life satisfaction. Participating in a society where the rules of life seem to be fair leads to greater satisfaction, regardless of one’s particular outcomes. And so on.

I have chosen not to emphasize any of this research in this book. Instead, I have tried to make the affirmative business case for public investment, where the economic and social returns on our money are conspicuously high, and the business case for social insurance, because sensible business people buy insurance against the perils they cannot control, in order to concentrate more fully on the risks that they want to take on. I have done this because in my view it is pointless to try to convince anyone that the United States should be more like Denmark, or even Canada, because those countries score higher on life satisfaction surveys than we do.

As proof, I point you to an excellent column written by Michael Hiltzik of the Los Angeles Times reviewing Benjamin Radcliff’s new book in this area, but
more particularly to the comments posted under it in the online edition. Those comments fall into three predictable buckets: the Nordic countries are small and homogeneous, so of course they are happy; the United States was founded on the single principle that we are promised the freedom to pursue our own happiness by government getting out of our way, because that is what “freedom” means; and finally, all that government can do is guarantee the pursuit of happiness, not its attainment. This of course is a Bowdlerized summary: the most telling actual comment was that we should repeal Obamacare promptly so that we can get on with the business of thinning the herd.

The difference between climate change denial and happiness research is that most people are at least dimly aware that there is something called climate change science, even if they are not so sure about its conclusions, given that it was cold out just the other day. The happiness research seems to be rejected at a deeper, more troubling level, as simply impossible to contemplate. The rejection does not even rise to the level of a conscious repudiation of a body of work susceptible of analysis or criticism.

Franklin Delano Roosevelt had it right when he implied that freedom is a more nuanced word than most Americans appreciate. Both freedom and the pursuit of happiness are distant aspirations when one starts the adventure of life far behind one’s counterparts, because of the accident of your parents’ poverty, and the greater social enrichment and education to which the children of the affluent are exposed. So long, however, as millions of Americans think that absolute atomism is all that “freedom” can mean, there is no point spitting into this headwind.

It may be that my emphasis on returns to social investment and on the desirability of insurance to address the unavoidable perils encountered in the adventure of life is a similarly doomed enterprise, but it has the virtue of couching matters in terms drawn from our everyday commercial experience, without any explicit moralizing. And should through some alignment of the planets a bit of common sense seep into our political discourse, and we begin to take advantage of the investment and insurance opportunities that surround us, it is good to know that as best as the researchers can tell, we are indeed likely to move our society a little bit further along the happiness spectrum.

**PROGRESSIVE FISCAL SYSTEMS AND EFFICIENCY**

At every turn in this book I have tried to develop the economic efficiency case for government investment in public goods and for social insurance as value-generating activities, both from a narrow GDP perspective and when a broader view of social returns is considered. These activities complement private markets in arenas where private markets invariably are incomplete. Why imagine a world where private markets magically fill vacuums they have left empty for
generations, when a more immediate and straightforward market participant is at hand?

Similarly, I have reviewed at several points the economic research on how individuals respond to taxation, and have shown that the more extreme descriptions of allergies to taxation are based on political propagandizing to defend an obvious interest group (the rich), or represent slightly pathological behavior, like severe agoraphobia or other anxiety disorders. In every case we try to help those who suffer, but we do not structure the entirety of our society around their idiosyncratic reactions. I further have argued for a moderate approach to the taxation of top incomes that falls well short of the outer limits suggested by the work of Diamond and Saez.

Combining the two strands essentially changes nothing, except that it becomes easier to apply traditional cost-benefit analysis when both the cost of funding a collective investment or social insurance program and its financial and social returns can be considered together. When we do, we see a grand tableau of opportunities spreading out before us. We could enhance our wealth as well as our happiness were only we to appreciate that government performs useful work when it complements markets in areas that private participants habitually leave incomplete.
CHAPTER 13

THE BETTER BASE CASE

All those different orders and societies [that comprise a state] are dependent upon the state to which they owe their security and protection. That they are subordinate to that state, and established only in subserviency to its prosperity and preservation, is a truth acknowledged by the most partial member of every one of them. It may often, however, be hard to convince him that the prosperity and preservation of the state require any diminution of the powers, privileges, and immunities of his own particular order or society.

—ADAM SMITH, The Theory of Moral Sentiments,
Part VI, Sec. II, Chap. II.

FOCUS OF THE BETTER BASE CASE

This chapter offers a way forward for our country’s fiscal policy over the next decade or thereabouts, which I call the Better Base Case. The Better Base Case contemplates unwinding the Budget Control Act’s spending corsets, adding incremental infrastructure programs, and raising tax revenues sufficient to keep those revenues within hailing distance of the recalibrated outlays. The ideas do not involve grand bargains or unprecedented tax reform, but nonetheless would fundamentally reorient fiscal policy for the better.

The Better Base Case essentially puts the country on a fiscal path closer to where we were at the end of the Clinton administration than where we are today. Spending would be somewhat higher than our current trends, due in part to the repeal of the sequestration and other Budget Control Act constraints, and tax revenues would be significantly higher, due principally to the readoption of Clinton-era tax rate schedules. (The Better Base Case then makes a number of
surgical adjustments around this new base, described at length below.) The 2013 fiscal cliff tax deal did just this, but only for the very highest-income taxpayers; what I am proposing here is to raise taxes throughout the income distribution by returning to pre-2001 tax rate schedules more generally.

The spending side of the Better Base Case follows from points developed in earlier chapters. We cannot run a government that delivers core services that support the rule of law and basic norms of decency, supervises the largest economy in the world, marshals a military almost as large as the rest of the world’s put together, and indulges itself in the most inefficient healthcare system ever invented, all while spending less on government resources as a percentage of our GDP than any other developed economy. Pundits on the right of the political spectrum are quick to tote up the efficiency costs of more taxes, but ignore the welfare costs to our society as a whole from allowing basic functions of government to wither from lack of funding.

In turn, we know how to raise almost enough revenues without fundamentally rethinking our tax system. The pre-2001 personal income tax rate tables that would apply today, were it not for the American Taxpayer Relief Act of 2012, were in fact commensurate with our ongoing revenue needs. There are some efficiency costs to these higher tax rates when viewed in the abstract, but there are many reasons to believe that on balance this move is welfare-enhancing, because those efficiency costs are not overwhelmingly large, and the public goods purchased with the resulting revenues will have large and important positive welfare implications.

As developed in Chapters 5 and 8, an extensive body of economic research suggests that a return to pre-2001 personal income tax policies would have only a modest effect on the decisions and effort level of taxpayers. High-ability US taxpayers will not be taxed at high rates by worldwide norms. And most research suggests that labor effort (particularly of the primary wage earner in a household) is relatively inelastic to changes in tax rates of the magnitudes at stake when crossing from 2013’s tax rate structure to pre-2001 rates—particularly given that the highest-income taxpayers, who presumably have particular sensitivity to tax rate changes, already face the pre-2001 top rate, thanks to the January 1, 2013, compromise.

The Congressional Budget Office in fact investigated this very question in 2012. It concluded that a return to the pre-2001 personal income tax rate structure would raise tax rates on capital income and labor earnings, which would decrease private saving and the supply of labor; those responses, by themselves, would reduce future output. However, the effects of those responses would probably be outweighed by the impact of the substantial decrease in budget deficits, which, by itself, would increase future output by a growing amount over time. Hence, by CBO’s estimates, the policy changes scheduled [as of 2012] to occur under current law [i.e., the return
to pre-2001 rates] would, on balance, have a positive medium- and long-term effect on the economy.

In other words, the net effect of the higher tax revenues contemplated by the Better Base Case will be good for the economy, not a drag on future economic progress. This point is made even more persuasive by the fact that we already have absorbed whatever deadweight losses were incurred in raising the top tax rates on the highest income Americans, as a result of the American Taxpayer Relief Act of 2012.

The Better Base Case presented here emphasizes a medium-term time horizon—a decade or thereabouts—for four reasons. First, I have found that terrifying readers about what the fiscal environment will look like in 50 or 75 years tends only to elicit existential despair and disengagement. Second, relatively modest steps taken today can make the long-term picture much more easily addressed. It is simply an artifact of the compounding of money—or in this case, the absence of money, in the form of deficits—over time that some measurable contributions to a more robust fiscal path in the medium term will greatly mitigate our fiscal problems in the long term.

Third, the medium term should serve as the on-ramp to more sustainable long-term mandatory spending pathways, because whenever important “entitlement” programs are changed, those changes must be phased in slowly. This is not code for slashing Social Security, or turning Medicare into a voucher system, but rather a marker that we need to rethink comprehensively how we deliver healthcare in the United States. Medicare actually points in the right direction, in that it is single-payer system with low administrative costs. It is an extremely indulgent single payer, of course, which is a significant part of the problem, but the largest problem is that healthcare for the non-elderly is delivered through a crazy patchwork of overlapping systems in which national affordability, administrative efficiency, and health outcomes are all the losers.

The fourth reason to focus on a reasonably foreseeable time horizon is that I do not believe that there is such a thing as a steady state fiscal policy. Our economy rapidly evolves, our national security needs evolve, and so do our needs and wants as citizens. Fiscal policy must also evolve to suit the exigencies of the times.

My medium-term time horizon base case does not rely on a political “grand bargain,” or on new tax instruments. One reason is that, having watched Congress in action from the inside, I do not believe that the institution can digest that large a meal. The other is that a grand bargain is unnecessary as a first step, and insisting on developing a grand bargain before moving forward on any other front is simply a promise of paralysis. The next decade or so should serve as the ramp to a different mix of fiscal instruments, but, again, whenever major changes are contemplated to our large spending programs, like Social Security or Medicare, those changes must be phased in slowly, so as to be fair to settled expectations. What we
need in the meantime is to finance the government we have, and to do so in ways that do not starve our own future, whether through excessive deficits or through failure to invest in ourselves.

By the same token, I fully appreciate why some economists might like to see a value added tax (VAT) (basically, a national sales tax) replace at least some of the revenues collected by the income tax, and I understand the economic logic behind a large-scale carbon tax to address the “externalities” of pollution and global warming, while raising significant revenues. But new large-scale new tax programs again are so politically paralyzing as to guarantee only stasis.

The reality is that our fiscal problems are not unprecedented, and they do not require fundamental revamping of our basic fiscal instruments, at least for a decade or more. What we do need is to put to one side our culture of fiscal narcissism, in light of the demographic and other realities described earlier, and accept tax burdens that we ourselves—not our grandparents, but most of the readers of this book—found completely unexceptional 15 years ago.

**RIGHT-SIZING SPENDING**

As Chapter 6 summarized, as recently as 2012 our fiscal future looked almost rosy, at least over the medium term. In February 2012, the Congressional Budget Office estimated that the fiscal year 2021 deficit would be only 1.2 percent of GDP; overall, in the 2017–2022 period, deficits would have been sufficiently small to lead to a paydown every year of total federal debt outstanding as a percentage of GDP.

One year later, CBO forecast that the fiscal year 2021 deficit would be triple the 2012 estimate, at 3.6 percent of GDP, and debt held by the public would climb as a percentage of GDP in every year after 2018. Chapter 6 further demonstrated that the decline and fall of our medium-term fiscal forecast was entirely due to the January 1, 2013, “fiscal cliff” tax deal (the American Taxpayer Relief Act).

At the same time, CBO’s 2012 and 2013 budget forecasts for 2021 were unrealistically optimistic in respect of their deficit predictions. Most urgently, those forecasts assumed (as CBO is required to do) that all of the strictures of the Budget Control Act of 2011 on the size of the federal discretionary budget would continue in force. (The Budget Control Act also imposes some significantly smaller caps on Medicare-related payments.)

I begin with the opposite assumption, which is that, for all the reasons developed in Part II of this book, we are throttling our own future prosperity and the happiness of our society if we allow the sequestration and other constraints of the Budget Control Act to continue. So for purposes of my Better Base Case, I assume that government spending will grow at the rate of inflation from its 2012 base, so
as to stay flat in real terms over time. In 2012, CBO calculated that the difference between fiscal year 2021 projected discretionary spending, determined by assuming that 2012 spending would grow at the rate of inflation, and the maximum permitted under the Budget Control Act, would be about $165 billion. Over the 10-year period 2014–2023, eliminating those constraints will cost roughly $1.5 trillion. This additional spending will need to be financed, which is why the other side of the Better Base Case is a higher level of tax revenues.

If we as a country can agree on government spending reductions that make sense to us, then taxes can be lower than those I suggest in this section. As it happens, I do not believe that this can or should happen, because of the demographic headwinds we face, our inability to rethink healthcare delivery systems (at least in the short run), and all our pressing opportunities for collective investment and social insurance. Nonetheless, if there are pots of money now being spent by government that we do not need to spend, I am all for taxing myself less rather than more. But to argue for lower taxes because that will lead to lower spending is like arguing that by buying clothes that are too small, one is sure to lose weight.5

Chapter 10 made the case for a much more substantial commitment to public investment in infrastructure. The restored levels of spending made possible by unshackling ourselves from the Budget Control Act’s self-imposed constraints contemplate more infrastructure investment than that possible under the Budget Control Act’s constrictions, but would fall short of an optimal long-term target. Public nondefense investments at all levels of US government combined are now at the lowest levels, as a percentage of GDP, since World War II.6

The American Society of Civil Engineers and a report prepared in 2010 by Our Fiscal Security, a joint venture among Demos, the Economic Policy Institute, and the Century Foundation,7 both recommended incremental public investment in infrastructure in the range of $200–$250 billion per year. (By way of context, the federal government in 2012 spent $126 billion on nondefense physical capital investments, and $64 billion on nondefense research and development; total government spending (mostly at the state and local government level) on surface transportation projects, which are the largest segment of public physical capital infrastructure investments, runs about $200 billion per year.8) This figure is aspirational, of course, but gives a sense of the opportunities currently being forgone. As Chapter 10 demonstrated, those increased investments in turn will lead to higher welfare, both through increased employment opportunities for millions of Americans not destined to engineer the next big mobile app, and through the positive economic returns generated by those investments.9

Some of this incrementally higher public investment can come from reshufflings within the resuscitated federal budget, but investment at these levels will require new financing sources and a national infrastructure bank, as described in Chapter 10. A plan by which the federal government invests an incremental
$50 billion per year directly and indirectly in infrastructure should be sufficient to fund infrastructure investments at the right order of magnitude. Amounts at this level would enable the federal government to increase somewhat its direct infrastructure funding, including grants to sub-national government, and to subscribe over time to the stock of a new national infrastructure bank, in a total commitment of $200 billion (roughly the same book value equity capitalization as JP Morgan Chase). The national infrastructure bank in turn can provide significant additional financing for public projects by accessing the private debt capital markets.

The CBO’s 2013 forecast of all government outlays in fiscal year 2021 was $5.2 trillion ($5,200 billion). My two spending suggestions above would bring that total to a little over $5.4 trillion. That gives us a revenue target to shoot for, as opposed to the usual Procrustean process in Washington, of starting from an arbitrary revenue level and cutting spending to suit. And like a game of horse-shoes, we do not need to hit the target precisely to declare ourselves winners; a deficit in the range of 1 to 1.5 percent of GDP ($235 billion to $355 billion in 2021) is close enough for purposes of my rough cut illustrations.

RIGHT-SIZING REVENUES

We need to size our revenues to the inescapable realities of the demands properly placed on the government of the world’s richest and most powerful large economy, which means that our government must spend at the levels suggested in the preceding section.

To finance this spending, the inescapable conclusion is that we need higher revenues than those we can collect under our current tax system. The most straightforward way to do this is to revert to the personal income tax rate schedules in effect before 2001, which is exactly what would have happened on January 1, 2013, but for the fiscal cliff tax deal, which allowed the 2001 temporary tax rate schedule to expire only for the most affluent taxpayers. In 2012, CBO estimated that this level of collections (about 21 percent of GDP in fiscal year 2021, prior to taking into account the recent restatement of GDP described in Chapter 6) was sufficient to bring projected revenues close to projected spending, leaving a projected deficit of 1.2 percent of GDP. In turn, we need to top up that level of revenues a bit to accommodate my suggested incremental programs of loosening of the Budget Control Act’s shackles, and a larger commitment to infrastructure investment.

The conclusion that revenue collections must rise significantly sits badly with some. They like to point out that high taxes impede economic growth and job creation. It is true that, all things being equal, lower taxes are better than higher taxes, and lower marginal tax rates are better than higher marginal tax rates. But these sorts of nostrums have as much policy utility as the old adage that, all other
things being equal, it is better to be rich and healthy than poor and sick. Tax revenues need to increase not because higher taxes are desirable as an independent goal, but because there is no other choice as part of a transition from current policies, which in turn have been shaped by both political parties over many decades.

In fact, we begin with such a low level of taxation in the United States (Chapter 8) that we have plenty of room to increase tax revenues without materially affecting efficiency goals. And while recourse to history always is fraught, because at any point in time many things are going on beyond fiscal policy, it is the case that in the last years of the 1990s the economy was very robust, and this country ran government surpluses. We cannot guarantee that future economic performance will mirror those years, but we can fairly assume that human beings have not evolved very much in the last 15 years or so. Since labor market participation and savings were strong in the 1990s, it is not realistic to maintain that a reversion to comparable tax rates today will lead Americans to pack it all in and become a nation of beachcombers.

Research and history alike, including the Congressional Budget Office analysis quoted at the outset of this chapter, suggest that the deadweight losses associated with moving to pre-2001 across the board tax rates would not be terribly large, especially given the very low rates from which we would move, and the fact that the highest-income Americans already face pre-2001 rates on their last dollars of income. Indeed, the CBO analysis concluded that the move would be welfare enhancing, because higher tax revenues would reduce the economic costs of increasing government borrowings crowding out private investment. Moreover, in this setting, where the alternative is to starve government at levels unprecedented in our own recent history or in the experience of other developed economies, any residual private efficiency losses would be swamped by the welfare gains from the government spending programs that could be funded at rational levels.

It turns out, however, that there are good reasons beyond a simple aversion to higher taxes to be unenthusiastic about the return of the specific tax system that was in place before 2001. That tax system had several conspicuous design defects. The individual alternative minimum tax (AMT) was one; by (perverse) design, it was not indexed to inflation, and so applied to more and more taxpayers with every passing year. But there were other major flaws as well.

In response, the Better Base Case contemplates some surgical nips and tucks to deliver about the same level of revenues as would have been the case had we on January 1, 2013, simply reverted to pre-2001 tax law, while correcting the flaws of that older law. In 2012, a co-author and I published a paper analyzing the revenue consequences of this package of improvements, using the Tax Policy Center’s microsimulation tax model, similar to that used by the staff of the Joint Committee on Taxation to produce the official revenue estimates on which Congress relies.\(^\text{10}\) (The CBO incorporates JCT tax projections when the CBO
produces its overall budget forecasts.) The Better Base Case is approximately revenue neutral over a 10-year time horizon, relative to the 2012 “baseline”—that is, the assumption that on January 1, 2013, all the temporary personal income and estate tax rules had lapsed, and we had turned back the clock to pre-2001 law. This means that the Better Base Case delivers about the same level of revenues for fiscal year 2021 as the CBO contemplated when it prepared its 2012 baseline projections.

Specifically, the Better Base Case begins by reintroducing all the tax rate brackets that applied before 2001. It then addresses the principal structural flaws in pre-2001 tax law by proposing the following revisions to those rules:

1. Permanently repeal the individual alternative minimum tax. The American Taxpayer Relief Act of 2012 (ATRA, the January 1, 2013, fiscal cliff tax deal) instituted a permanent AMT “patch,” but under this half-solution tens of millions of Americans would still be subject each year to the AMT. The Better Base Case goes further and eliminates the AMT entirely.

2. Retain the child tax credit at its 2012 level. (ATRA did this as well.) The child tax credit is extremely important to most middle class families; moreover, like the earned income tax credit, the refundable portion of the child tax credit is a “making work pay” incentive, in that it is only available to the extent taxpayers have earned income. The pre-2001 credit was half as large and had more limited refundability.

3. Keep the tax rate on dividends the same as the tax rate on capital gains (20 percent), rather than reverting to a system where dividends are taxed at full ordinary income rates. (ATRA did this as well.)

4. Reinstate 2009’s estate tax rules, which means a $3.5 million exclusion (permanently indexed for inflation) and a 45 percent maximum tax rate. This is much more generous than the pre-2001 estate tax laws assumed in the CBO’s 2012 baseline revenue projections; those rules provided a non-indexed $1 million exemption and a top rate of 55 percent. (ATRA was still more generous: it enacted a $5 million exclusion, indexed for inflation, and a 40 percent top rate.)

The estate tax is extremely important to ensuring over the long term an open society not dominated by vast concentrations of dynastic family wealth. Pre-2001 law missed this point, and hit families that saw themselves as decidedly middle class. The 2009 levels of taxation allow for a reasonable amount of wealth to pass tax-free on the death of the second-to-die spouse (estate tax basically is not imposed on the death of the first-to-die of a married couple).
Since the right focus of the estate tax should be on dynastic wealth, safeguards against estate tax avoidance actually are more important than the exclusion amount. These avoidance opportunities abound under current law, and are reflected in the JCT and CBO revenue forecasts for the estate tax under all its recent permutations. A comprehensive cleanup of the estate tax (not reflected in the Better Base Case’s revenue projections) would raise significant revenue and reorient the tax toward accomplishing its purpose. Those revenue pick-ups were not reflected in the estimates in our 2012 paper, but could be substantial, particularly in light of some of the large Internet-spawned fortunes created in the last two decades.

These four tax tweaks all cost the government money relative to the CBO 2012 baseline—that is, relative to pre-2001 tax law. Even the estate tax proposal I just made costs money relative to that baseline; while it is true that the Better Base Case’s estate tax rates and exclusions are less favorable than 2013 law, they are more generous than pre-2001 law, and as a result score as revenue losers against the CBO 2012 baseline.

The Better Base Case therefore acknowledges that our ongoing tax revenue needs require collections comparable to the revenues that would be raised under unimproved pre-2001 law. This means that the four tax tweaks must be paid for through a new revenue stream—one totaling about $1.5 trillion over 10 years (as of our 2012 estimate). Eliminating the AMT and the other improvements listed above are expensive to repair.

One way to scrounge up the $1.5 trillion needed to correct the structural flaws of pre-2001 tax law would be to raise marginal tax rates beyond those that prevailed before 2001. This is a poor idea, if one’s goal is to have a prayer of actually effecting change. First, as a matter of political economy, a narrative grounded in reverting to the same tax brackets under which we all prospered in the 1990s has resonance; marginal rates higher than those would abandon this compelling narrative. Second, the sticker shock relative to 2013-level tax brackets would be too great for any electorate to absorb, no matter how articulate the explanation.

Third, there are always efficiency costs to higher marginal tax rates in particular (see Chapters 5 and 8).11 As explained in those earlier chapters, economists believe that it is the marginal tax rate—the tax on the next dollar of income—that most directly influences our behavior. If the government forgoes $1.5 trillion in potential tax revenues over 10 years to correct the four structural flaws listed above, and then raises marginal tax rates on top of the move to pre-2001 rates sufficiently to restore total tax collections by that same $1.5 trillion, there would be no apparent net effect on tax revenues (or in Congressional jargon, we would have found a “pay for” to cover the taxes forgone), but beneath the surface society would have suffered a new incremental deadweight loss.

While the deadweight losses attributable to the higher tax rates contemplated by pre-2001 tax law might not have been visible or disabling, when netted against
the deficit reduction welfare gains and welfare gains from government spending programs that those higher taxes would fund, these deadweight losses did exist. Adding still higher marginal tax rates on top of the pre-2001 structure would exacerbate those (modest) deadweight losses, but because deadweight loss increases more than linearly with tax rate hikes, this second layer of tax rate hikes would incur materially more deadweight loss, per dollar of revenue raised, than did the move to the pre-2001 tax rate structure.\textsuperscript{12}

As a result, the better path to raising the \$1.5 trillion to fix pre-2001 tax law is to find inframarginal tax revenue streams—techniques to increase the average taxes, to compensate for the tax forgone through the four tweaks outlined above, without raising the marginal tax bracket rates. Inframarginal revenues introduce less deadweight loss than do marginal tax rate hikes. For example, the Congressional Budget Office has written that:

\begin{quote}
increasing revenues by raising marginal tax rates on labor (the rates that would apply to an additional dollar of a taxpayer’s income from work) would reduce people’s incentive to work and therefore reduce the amount of labor supplied to the economy, whereas increasing revenues to a similar extent by broadening the tax base would probably have a smaller negative effect, or even a positive effect, on the amount of labor supplied.\textsuperscript{11}
\end{quote}

Fortunately, there is an important inframarginal revenue stream waiting to be tapped, through the curbing of personal itemized deductions.\textsuperscript{14} Along with our disjointed subsidies for healthcare, these are the largest and least defensible tax expenditures, which were the subject of Chapter 9.\textsuperscript{15} There is a widespread bipartisan consensus that the current personal itemized deductions are perverse, inefficient, and unaffordable.\textsuperscript{16} For example, the subsidies for investment in one’s home profoundly distort individuals’ investment decisions and home prices.\textsuperscript{17} Scaling back these existing distortions is welfare-enhancing (reduces deadweight loss baked into current law), because by doing so the tax system would no longer put its thumb on the scale of an individual’s decisions as to how to invest her money.

The Better Base Case therefore contemplates paying for the four tax tweaks to pre-2001 tax law outlined above by raising \$1.5 trillion, or thereabouts, over 10 years through capping both personal itemized deductions and the standard deduction to a 15 percent tax rate benefit. The standard deduction invariably gets a free pass when tax expenditures are examined, but the standard deduction has all the same “upside-down subsidy” characteristics as do itemized deductions, and has no greater justification as a normative income tax matter.

Imagine that you are a high-income taxpayer facing a marginal personal income tax rate of 39.6 percent. If you deduct \$100 in mortgage interest expense, you save \$39.60 in federal income tax. Under the Better Base Case, you would
get a $15 tax savings from this deduction—just as would taxpayers in the 15, 25, 28, 33, or 35 percent tax rate brackets. The Better Base Case thus addresses the upside-down nature of the current deduction structure by capping those personal deductions at a constant 15 percent tax rate benefit, so that wealthy Americans are not subsidized disproportionately compared to middle-income taxpayers. At the same time, a 15 percent benefit cap leaves in place more than one-half aggregate value of the personal itemized deductions under pre-2001 rate tables, which minimizes transition concerns.

Curbing personal itemized deductions along these lines raises revenues without raising statutory tax rates. By happy coincidence, this move independently addresses the fact that the most expensive of the personal itemized deductions—those relating to subsidizing homeownership—are themselves particularly distortionary subsidies that have had clear negative effects on the allocation of investment capital in the United States. Doing so also moderates the inefficiencies by which we provide these subsidies to those who would have bought their homes (or made charitable contributions, or chosen to live in high-tax states) regardless of the tax incentives. Capping the tax preferences for these items also will add to the progressivity of the tax system, because itemizers generally have higher pre-tax incomes than do taxpayers claiming the standard deduction. (Only about one-third of tax return filers are eligible to claim itemized deductions today.)

The reason to curb all the personal itemized deductions is that it is impossible to choose among them. Each can be defended as an incentive for one desirable goal or another. Our only practical hope is to round up and corral all these sacred tax cows at once.

As discussed in Chapter 9, I recognize the appeal of the charitable contribution deduction, and the argument that this deduction in fact serves useful policy goals, by subsidizing in an open and democratic fashion welfare-enhancing activities that in other countries are entirely state-financed. By subsidizing donations, the charitable contribution deduction no doubt induces more charitable giving than otherwise would be the case. One recent review of the economic literature, however, concluded that the forgone tax revenues from operating the subsidy exceed the amount of this induced giving, and that observed responses in charitable giving to changes in tax rates are largely transitory timing effects. This would mean that scaling back the charitable contribution deduction would have some immediate transition effects (accelerating large contributions into the year before the effective date of any change, and artificially depressing giving in the following year), and probably would dampen charitable giving somewhat in the long term, but would be more than made up in increased tax revenues.

The debate on the charitable contribution deduction often is conducted against the background of an imaginary ideal. In fact, the charitable contribution
deduction has significant design flaws in common with the other personal itemized deductions, in the upside-down nature of the subsidy and in the fact that much of the subsidy goes to charitable giving that would have occurred regardless of the deduction. The upside-down structure of the subsidy is particularly apparent in this setting, because the charitable contribution deduction is the most top-heavy of the personal itemized deductions. What is more, the charitable contribution deduction has its own unique set of problems, including exotic gaming of the rules (donor-advised funds, charitable remainder unitrusts), outright fraud (inflating values of contributions of tangible property, like art), and thinly veiled vanity projects (the Kleinbard Museum of String). The charitable contribution deduction is not the blushing bride of personal itemized deductions.23

At bottom, the personal itemized deductions, as the name implies, are all personal expenses. Scaling them back to a uniform 15 percent tax benefit would make the tax system more progressive, more efficient, less distortive, and simpler. (The first three of these reasons apply as well to converting the standard deduction to a 15 percent tax credit.) Doing so also would raise a great deal of money without adding unduly to the deadweight loss from taxation, and raising a great deal of tax revenue in general is something that we have no choice but to embrace.

**ADDITIONAL REVENUES**

The presentation of the Better Base Case in the preceding section demonstrated how we can resuscitate government from its incipient near-death experience, without recourse to novel tax policies or crushing burdens. The restored levels of spending will enable sensible policies to proceed, and the revised tax system, including the elimination of the hated Alternative Minimum Tax, is fairer and more efficient than current law.

Incremental infrastructure investment of the magnitude suggested here can be funded through the gasoline excise tax; this makes particular sense, given that surface transportation projects account for such a large share of total public infrastructure investment. As currently structured, the gasoline excise tax is a fixed tax per gallon of gasoline, and therefore is neither tied to increasing prices at the gas pump nor indexed to inflation more generally. As a result, the tax has effectively grown smaller and smaller with every passing year. An increase in the gasoline tax by 35 cents per gallon and indexation of the tax going forward from there would by itself raise over $450 billion over the next 10 years—around $50 billion in fiscal year 2021.24

One of the reasons for the deterioration in our deficit projections at the end of the 10-year period on which this chapter concentrates is that spending on Social Security is projected to outstrip Social Security payroll taxes and other trust fund revenue sources. The most effective response is to phase out completely the cap
on taxable earnings; even allowing benefits accordingly to rise under the current schedule, this step alone assures Social Security solvency for the next 70 years.\textsuperscript{25}

What is more, doing so improves the overall progressivity of the tax system; as described in Chapter 12, that is not our only goal in fiscal policy, but it makes achieving a progressive fiscal system all the easier.

Looking just at fiscal year 2021, this move would bring in almost $130 billion in new net revenue in that year—almost enough to completely fund the repeal of the Budget Control Act’s constraints for that year.\textsuperscript{26} The resulting assets would belong to the trust funds and would entitle taxpayers to increased benefits (which have been reflected in the net revenue figure just suggested), but as described in Chapter 6, trust fund assets indirectly fund current-year spending, because those assets are lent to the Treasury’s general fund. Public Treasury debt outstanding is affected by revenues in, and cash outlays out, so these additional revenues would have exactly the same deficit reduction consequences as an increase in any other tax revenue stream.

It is true, of course, that removing the cap on taxable wages for Social Security purposes would add to the tax burden on labor income at the top end of the scale, but given that the remainder of the package has no effect on the top end, this might be forgiven. Moreover, the resulting trust fund assets will ensure that, under current law, the trust fund can continue to pay current levels of benefits for the indefinite future to all workers, regardless of their pre-retirement wages. Finally, a labor income tax is a consumption tax by another name, and arguably this might be a less economically inefficient move than materially increasing capital income tax burdens.

There are a number of important technical problems in current law in distinguishing labor income from capital income; basically, the great sport among the affluent is to disguise labor income as capital income, because the latter is more lightly taxed. If we properly characterized labor income in the first place, rather than allowing it to masquerade as capital gains in particular, the Social Security base would be greatly enhanced, and we could lower payroll tax rates a bit to reflect that. The last section of this chapter talks about how one might do this, but it is not a trivial technical exercise.

Health care remains our greatest fiscal and ethical dilemma. The Congressional Budget Office has assembled a long list of possible fiscal patches,\textsuperscript{27} but none of the proposals by itself makes the problem disappear, and some popular ideas (e.g., tort reform) actually have derisorily small fiscal consequences. What is needed, of course, is to abandon the current tax subsidies for employer-provided healthcare (amounting to roughly $3 trillion in income and payroll tax costs over the coming decade), to abandon the Affordable Care Act’s Byzantine layering of insurers upon insurers, and to do what every other country does, which is to run a single-payer system.
We could save roughly $10 trillion over the next decade if only we were to bring down our national private and public healthcare spending to the same level as the second-most profligate country in the world. Not even the United States is rich enough to throw away this much money every year. But this issue is extraordinarily fractious, and our commitment at both ends of the political system to magical thinking about it runs very deep. In the absence of any consensus as to even the cardinal point of the compass toward which we should head, I think it best for the prospects of the Better Base Case that this sensible package of proposals not be mired in a bottomless pit of angry healthcare debates. Perhaps in a couple of years the environment will be less poisonous, and we then can get to work on this urgent project.

There is nothing particularly “fundamental” about the Better Base Case, or even corporate tax reform of the sort summarized in the next section. Both are classic exercises in base broadening, in the individual case accompanied by higher income tax revenue collections, and in the corporate case accompanied by lower rates. Tax policy wonks are much too quick to describe incremental maintenance work to the tax code as fundamental tax reform.

Some might criticize this presentation for being too quick to rely on old taxes, in particular the income tax, rather than looking to a major new revenue source, either as a replacement for existing taxes or in addition to them. For example, a tax on greenhouse emissions used to finance a payroll tax reduction might make good sense, because it directly addresses a negative externality—the long-term cost to society of greenhouse gases—and because it lowers the immediate tax wedge on labor. (More formally, this is largely an illusion, in that payroll taxes ultimately burden consumption, and so do taxes on various greenhouse gases, albeit over a narrower range of consumption goods, but illusion is a more powerful force in determining how taxes actually affect behavior than is sometimes appreciated.) A value added tax—basically, a sales tax—used to finance healthcare under a single payer system would be another example.

I have shied away from new taxes deliberately, however. Old taxes have two great virtues. One is that they are well understood; the other is that they are baked into prices and behaviors. Moving to large-scale new taxes can alter relative prices or change behaviors in ways that are profoundly unsettling. Given that new taxes are not necessary to accomplish our fiscal objectives over the next decade, I do not rely on them for the Better Base Case, notwithstanding their appeal. Over a longer-term horizon, of course, the analysis might be different.

Every other developed economy in the world relies on a national VAT (a sales tax by another name) to fund government. VATs can raise great sums of money, and to a first order approximation are thought to be more efficient than income taxes, because VATs do not burden the day-to-day (“normal”) returns to saving, and therefore do not distort the intertemporal decision of whether to consume today or to consume tomorrow.
In the United States, however, a VAT is viewed as a sort of Fiscal Sauron. Larry Summers has a VAT joke that he has deployed at so many talks that it can now safely be recorded in print without depriving him of the element of surprise. Whenever he speaks, Summers is asked when the United States will have a VAT. He responds that the problem with a VAT is that the Democrats fear that it is highly regressive, while Republicans object that it is a money machine for the government. But, Summers continues, once the Democrats figure out that the VAT is a money machine, and the Republicans tumble onto the fact that the VAT is regressive, why then we’ll get a VAT!

As Chapter 12 developed, this clever syllogism turns out to be false: in fact regressive VATs fund progressive fiscal systems elsewhere in the world. A VAT therefore actually can play an important role in a real-life progressive construction of government. But VATs remain mired in bipartisan disdain. Every now and then the Senate approves, by truly overwhelming margins, a nonbinding resolution that the United States will never have a VAT. It is comforting to see senators reaching across the aisle in this manner, but by the same token there seems to be little point in my advocating truly doomed causes.

FUNDAMENTAL TAX REFORM—NICE BUT UNNECESSARY

There is a school of thought inside the Beltway that, whatever the problem, fundamental tax reform (always spoken in the solemnest tones) must be the solution. Because I am by training a tax law specialist, I should be a disciple of this school of thought, but as the outline of the Better Base Case just demonstrated, there is no need to invoke anything terribly fundamental to restore government and our budget alike to good health. Nonetheless, there are two areas of tax reform that deserve more comment. The discussion that follows gets a little technical.

Corporate Tax Reform

Corporate income tax revenues are about one-quarter as large as personal income tax collections, but nonetheless are important in absolute terms ($5 trillion over the next 10 years), and impose large economic efficiency costs. There is a surprising amount of consensus as to what needs to be done to improve matters in this area.

The federal corporate tax rate—nominally, 35 percent—is much too high, relative to world norms. The right corporate rate is in the range of 25–28 percent. Most economists agree that the corporate income tax is the tax most likely to succeed at introducing significant deadweight loss into the tax system, so reducing the statutory tax rate without sacrificing total tax revenues should be a high priority. What this implies is “revenue neutral” corporate tax reform: the tax rate
should be lowered, and the base—the measure of taxable income to which the tax applies—should be broadened.

Every country that has reduced its corporate tax rate (as many have in the last decade or so) has done so by scaling back its business tax expenditures, starting with accelerated tax depreciation. Under current US law, the combination of accelerated tax depreciation on new equipment purchases and the deductibility of interest expense on debt incurred to purchase that equipment actually yields a negation effective tax rate. This means that we collectively pay companies to make those investments. In addition, the tax code is stacked to the rafters with other business tax subsidies, each resting on a more dubious policy justification than the last. If we throw all these business tax expenditures into the pot, we can get into the right range for corporate tax rates. And if the rate itself falls squarely in the middle of world norms, the political case for all these distortive incentives dissolves.

The largest issue in corporate tax reform is what to do about international taxation. American multinational firms have established themselves as world leaders in global tax avoidance strategies, through the generation of what I have termed “stateless income.” The result is that many well-known US multinationals today enjoy single-digit effective tax rates on their foreign income.

Stateless income planning is not just about shifting profits from the United States to foreign tax havens, thereby depriving the United States of the tax revenues that should be associated with the value added work of US firms performed in the United States; it also (and this was underappreciated until recently) is about shifting profits from high-tax foreign jurisdictions to low-tax foreign jurisdictions. Business lobbyists like to present stateless income tax planning as required for “competitiveness” and similar buzzwords, but the fact is that there are no countries in the world where US multinationals both face significant numbers of real customers and have tax rates hovering around 5 percent. More important, there are large efficiency costs to a tax system that unintentionally encourages US firms to prefer investing in high-tax foreign jurisdictions over investing in the United States, because it turns out that for technical reasons it is easier to shift profits from high-tax foreign countries to tax havens than it is to shift profits from the United States to tax havens.

The problem of stateless income planning is not unique to US multinationals, but we can take a perverse pride in the knowledge that US firms have been world leaders in developing the requisite tax technologies. The situation is now so out of control that in 2012 the G-20 group of countries deputized the Organisation for Economic Co-operation and Development to propose on an extremely accelerated timetable a concrete set of action plans to address what the OECD calls “Base Erosion and Profit Shifting” (BEPS) problems.

At the same time, US tax law (but not that of most other countries) effectively induces US multinational firms to keep their surplus low-taxed foreign profits in
their foreign subsidiaries, because the US parent would be required to pay full US tax on the “repatriation” of those earnings (less a credit for any foreign income taxes already paid). As a result, by late 2013 US firms held about $2 trillion in so-called “permanently reinvested” offshore earnings.

It is a great overstatement, popular in the business press, to claim that this rule leads to “trapped cash,” or that the repeal of current law would lead to a wave of business reinvestment in the United States. First, a US multinational’s offshore cash hoard invariably is invested in the US economy, in the form of investments in dollar assets (US Treasury obligations, money market funds, commercial paper, and bank deposits). Second, as Apple Inc. demonstrated in 2013, there are ways of accessing offshore earnings without incurring a tax cost, starting with simply borrowing in the United States and using the earnings on offshore cash to pay the interest costs. Third, we in fact held a corporate offshore tax amnesty in 2004; more than $300 billion over and above the usual level came back to the United States from foreign subsidiaries of US firms. Most studies, however, have concluded that the cash went to prop up stock prices through stock buy-backs or dividends, not to invest in productive capacity (as the law nominally required). Nonetheless, there are efficiency costs to suboptimal allocations of offshore earnings, and as a result there is a bipartisan consensus that a revised corporate tax system should eliminate this defect.

What is needed, then, is 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, but that also addresses stateless income planning. My goals in my academic work in this area, and the OECD’s goals in its BEPS project, simply stated, are that firms should report income in the jurisdiction to which that income has the strongest economic nexus. Such a rule would lead to a superior allocation of resources around the world, because tax planning would not drive the location of physical or financial assets, and because in the tug of war between multinational firms and fiscal authorities around the world, multinational firms would not keep all the marbles. In this regard, it is important to remember that corporate profits that end up being taxed nowhere require that the resulting tax revenue shortfalls must be shouldered by ordinary individuals in all the affected jurisdictions. Once a jurisdiction has decided that a corporate income tax makes sense (as basically all major jurisdictions have done), then it is important that the corporate tax system in fact reach the income it was nominally designed to burden.

There are two basic strategies for accomplishing these objectives. One is to adopt a “territorial” tax system, where a multinational group’s genuine business profits earned outside the parent company’s jurisdiction are not taxed again by the domicile of the parent company when the profits are repatriated; this model in turn must be accomplished with powerful anti-abuse measures. I summarize this approach as “territorial with teeth.” The other strategy is for the domicile of a multinational group’s parent firm to impose a reasonably low corporate tax rate,
tax the worldwide profits of multinational groups on a consolidated basis (just as the public financial statements of those firms are prepared), and grant a tax credit against parent country tax liabilities for the income taxes paid by foreign subsidiaries. I call this a “full inclusion” method.

The territorial-with-teeth strategy is most consonant with world norms, but it is extremely difficult to implement anti-abuse rules that accomplish 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 creative tax planning shenanigans. Its “competitiveness” standing, however, rests entirely on the domicile of a multinational group choosing a moderate tax rate, by world norms. (One implication of this is that a jurisdiction that follows the full inclusion model effectively loses some control over where it sets its corporate tax rate.)

This is a classic Hobson’s choice. Either approach, if taken seriously, would be a large step forward from current (2013) US corporate tax law. On balance, I have advocated the full inclusion approach, for the reasons developed in my academic papers referenced in the notes.

One encouraging development in this area—which, to emphasize, lies at the heart of corporate tax reform—came in late 2011, when Congressman Dave Camp, chairman of the House Ways and Means Committee, released a “discussion draft” for international corporate tax reform legislation. The release of a discussion draft was important as a process matter, because it meant that these technically complex proposals could be aired and debated by interested parties in an orderly manner, as opposed to the House Ways and Means Committee’s prior penchant for releasing full-blown legislation essentially immediately before voting on it.\(^{32}\) It was also important as a substantive matter, because while the draft (as expected) embraced a territorial tax regime, the draft disappointed many in the business community by recognizing that a territorial tax system must be accompanied by anti-abuse rules, and by proposing some. Those anti-abuse rules (known as Options A, B, and C) were not sufficiently robust in the form originally proposed, but the fact that serious anti-abuse rules were proposed at all was to my thinking the first signal that comprehensive bipartisan corporate tax reform was a realistic aspiration.

In late 2013, Senator Max Baucus, then the chairman of the Senate Finance Committee, responded with his own detailed and ambitious package of possible corporate international tax reforms. Chairman Baucus’s proposal also was drafted in the alternative; apparently anxious to have the last word, he denominated his options as Option Y and Option Z. Option Y contemplated a territorial tax system, but relied on a relatively high US minimum (or “soak-up”) tax on foreign income, under which foreign income would always be taxed at a rate no less than 80 percent of the US rate. Option Z was a variant on a full-inclusion system, except that only 60 percent of the income from bona fide foreign business activities directly conducted by foreign subsidiaries through their own personnel would be taxed in the United States.\(^{33}\)
The United States is unique among major developed countries in that more than half of all US business income is earned by non-corporate business entities, such as partnerships and limited liability companies. This business income is treated as earned by, and therefore is taxed to, the owners of these unincorporated businesses. (By contrast, corporate profits are taxed to the corporation, and shareholders pay tax again—albeit at a preferential 20 percent rate—when corporate profits are distributed as dividends.) As a rule of thumb, publicly owned companies (US and foreign) must be treated for US tax purposes as corporations, so the unincorporated sector basically comprises private businesses—some of which can be very large.  

The existence of the large unincorporated domestic business sector has greatly complicated the politics of corporate tax reform. The problem has been the premise that, if Congress “does something” for corporations, it must do something by way of tax cuts for the unincorporated business sector as well. It is not difficult to see the logical errors in this claim. First, the reason to do something about corporate tax reform is that the corporate rate is too high relative to the world norms, and our international tax system is perverse, by anyone’s measure. As a result, the United States is a less attractive environment for inbound investment than it should be, and we endure all the distortions attendant on our bizarre international tax system that were briefly summarized above. These issues are not particularly relevant to the domestic unincorporated business sector. Second, the corporate tax is a two-stage tax: a corporate tax rate of 25 percent, and a dividend tax rate of 20 percent applied to after-corporate tax profits (i.e., 20 percent x 75 percent), yields a combined tax rate on currently distributed profits of 40 percent—just about the same as the tax rate on unincorporated businesses.

Third, if unincorporated firms wake up one morning and find that Congress has bestowed on corporations an attractive new tax regime, the unincorporated sector has a remedy—incorporate! It is tax-free to do so.

It is true that none of my logical objections responds to the political realities of the moment. I would turn this on its head, though, and observe that if we live in a world where political demands as conspicuously fatuous as these gain currency, we collectively need to invest a great deal more in educating ourselves about these issues, and in hiring a better class of legislator.

**REALLY FUNDAMENTAL INCOME TAX REFORM**

Capital Income Is the Problem

The other direction for fundamental reform, and the one more interesting to me in terms of my professional work, is to think about genuinely fundamental income tax reform.
There are only two important kinds of income: returns from labor and returns from capital. When tax law professors teach Tax 1, we like to discuss cases involving cash stuffed into a piano bought at a secondhand shop, or treasure trove, but these are not important contributors to economic output.

It turns out that we know a good deal about how to tax labor income, and in general do a pretty good job of it. But when it comes to taxing capital income, we perform very poorly. We are inconsistent in how we measure capital income, depending on the formal labels that different investments take, and we likewise are inconsistent in the tax rates we apply to that capital income that does come to our attention. More fundamentally, we do not have a coherent underlying theory of what we are trying to accomplish.

As described earlier in this book, “capital income” comprises all returns to capital, in the narrow, traditional sense of the term “capital.” The term is not synonymous with “capital gain”; the latter is just one instance of capital income. Capital income includes, by way of example, interest and dividend income, property rental income, and royalties, as well as capital gains.

Capital income also includes most net business income. Business firms of course bring both labor and capital to bear in generating net income; at least in the case of publicly held corporations, however, the labor component is fully compensated and deducted from the business tax base. As a result, the remaining business tax base contains only capital income. (The problem of the closely held business, where an owner-entrepreneur puts both her own capital and her labor to work, and where the net income of the firm cannot through simple inspection be divided into labor and capital income components, is considered below.)

Simply measuring capital income is famously difficult in theory, and nearly impossible in contemporary practice. To do so requires uprooting at least four deeply engrained practical hurdles in our tax system.

First, we must confront the “realization doctrine.” This is the rule under which we tax profits from the sale of investments only in the year of sale, 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.

Second, we must deal with the different conceptual cubbyholes into which tax law places debt instruments (bonds, debentures, loans), on the one hand, and equity instruments (stock), on the other. By virtue of this largely artificial distinction, completely different income measurement tools apply to financial instruments that might be economically similar, but that give rise to different formal legal rights and obligations.

In essence, our rules for taxing investments fall into two categories: debt, and everything else. Returns on debt generally are measured fairly accurately and are
taxed annually, regardless of whether paid out in cash. Moreover, interest expense is deducted by the obligor and included in income by the investor, so that the business profits of a firm used to service its debt are not taxed to the firm at all, but only to the investor (which in turn might well be a tax-exempt institution, so that the business income used to service that interest expense might in the end escape all taxation). Returns on many other investments (raw land, corporate stock) are not measured and taxed annually, except to the extent that cash is received (land rents or dividends). In turn, we do not coordinate at all the taxation of stock investors and the firms in which they invest.

This leads to the third challenge, which is that we must address the (non)coordination of firm- and investor-level measures of the same real incomes. Economists traditionally equate capital (and therefore the measurement of returns to capital) with “real” assets employed in a business, by which they mean investments in tangible, greasy machinery, or buildings, or land, or even intangible assets like patents, trademarks, or goodwill, but not financial assets such as stocks and bonds. In a more quotidian sense, however, capital income is earned in respect of investments in both real assets and financial assets that, in the broadest sense, are indirect claims on those real assets. Coordinating the taxation of returns to real and financial assets is one of the great challenges in designing a practical income tax on capital; progress here has not been helped by many economists’ breezy dismissal of financial assets as unimportant to our thinking about capital income.

Fourth, we must address our arbitrary tax depreciation and expense capitalization rules. This sounds excessively tedious, even by the standards of this section of the book, but depreciation and capitalization go to the heart of whether capital income, in the form of net business profits on firm income tax returns, is accurately measured. The next section elaborates.

Even if we were to overcome the capital income measurement issues outlined above, we still would not have a complete approach to capital income tax reform. We would need to establish a theory to explain the rate(s) at which capital income is to be taxed. And, assuming that capital and labor incomes will be taxed at different rates (as is the case today, sometimes), we would face a new and important question: How do we distinguish the two? For example, an entrepreneurial chef decides to open a new restaurant. She invests her life’s savings of $500,000, and works there 16 hours a day, six days a week, taking out no salary. Five years later, the restaurant is a great success, due in part to her culinary skill. What fraction of the current annual profits is attributable to her labor contributions, and what to the capital she has invested?

This last point was particularly underappreciated until the controversy surrounding the taxation of “carried interest” received by investment fund managers forced our collective attention to the issue. (This refers to the shares of an investment partnership’s capital gains that are awarded to fund managers in return for
their agreement to run the investment partnership.) We need an administratively reliable means to distinguish labor from capital income in cases where the two are hopelessly intermingled.

Carried interest turns out not to be a difficult case; despite all the huffing and puffing on the issue, carried interest plainly is just labor income earned by investment managers for managing other people’s capital; the fund manager’s capital income, properly construed, is the income from his investment in developing his own management company. But the problem is pervasive in small businesses, where an owner–manager earns net business income attributable to the combination of her personal effort and the capital she puts at risk. So long as we apply different tax rules to labor income and capital income, this indissolubly intermingled income is likely to be characterized by taxpayers in whichever way minimizes their tax liabilities (these days, as capital income).

Fundamental income tax reform thus must accomplish two objectives. First, it must introduce what I call a “labor–capital income centrifuge,” to tease apart labor and capital income when they are commingled in the hands of the small business owner–manager (or other cases). Second, a reform package must adopt a coherent theory of capital income taxation, and then measure returns to capital consistently, no matter the form of the business organization through which they are earned, or the label of the financial instrument through which an investor holds her claim.

Decomposing Capital Income

Relatively recent academic work has brought new clarity to the understanding of the components of capital income. In turn, these academic insights can usefully be employed in designing a capital income tax base as part of genuinely fundamental income tax reform. In other words, the place to begin is by adopting a coherent theory of the economic components of capital income—not the formal labels we attach to returns on investment—and then developing administrable means to identify and tax those economic components at tax rates consistent with our economic theory.

Modern economic literature basically divides the returns to capital into three categories. First are time-value-of-money returns (termed “normal” returns), which represent the core risk-free return from postponing consumption of one’s wealth. To an economist, all capital earns this normal return. Second are risky returns, the higher returns that one expects to obtain for accepting the risk of uncertain rewards. (Actual risky returns, of course, may be negative in individual cases.) Finally, taxpayers also can earn what economists call “economic rents” or “inframarginal returns”—the supersized returns that come from a unique and exclusive market position or asset, such as a valuable patent or trade name.
Rental income from renting an undeveloped lot for use as a parking lot typically would represent a normal return on one’s capital; economic rents, by contrast, are jumbo returns that are not attributable simply to taking on lots of risk.

A well-designed income tax should systematically measure and tax normal returns—the dull, plodding, interest-like returns that one might expect to earn, for example, by investing in a savings account or a Treasury bond. Indeed, this is the key difference between a well-designed income tax and a consumption tax: by design, the former taxes time-value-of-money returns, whereas the latter exempts them from the tax base.39

In theory, both income taxes and consumption taxes burden economic rents, because in one case they are taxed as income, and in the other those returns fund consumption (which is all that money is supposed to be good for). It is the normal return to savings—the compensation received for the delay in consumption from today until tomorrow—that an ideal income tax reaches, but an ideal consumption tax does not.

And even more surprising, in theory neither an ideal income tax nor an ideal consumption tax imposes any burden on pure risk-taking. The theory is that you can always scale up your bet to reflect the tax hit (assuming losses are fully refundable). Many counterexamples might leap to mind (if I am already working full-time to run one restaurant, I can’t just open a second one), but these counterexamples often in fact demonstrate a confusion between labor and capital income, not a bona fide example of being unable to increase an investment wager.

It turns out that the current tax code does an absolutely terrible job measuring normal returns, perhaps reflecting the modest understanding of the importance of taxing these returns when the tax model was first constructed some 100 years ago. More surprisingly, however, systematically measuring and taxing these time-value returns are much more difficult than they appears. Much of the complexity of any business income tax stems from this fact.

If one focuses exclusively on real assets and economic concepts of income, then by definition, an investment in a “marginal” asset is one that generates net economic income each year equal to the normal return applied to the investor’s unrecovered investment.40 This almost self-evident observation means that, in a world consisting entirely of direct equity-funded investments in real assets, one would calculate normal returns on investment—and taxable business income—solely through economically accurate depreciation schedules. This thought in turn is surprising to many non-economists, who associate time-value-of-money concepts exclusively with financial instruments, and who think of depreciation as some arbitrary allowance that is wholly unrelated to measuring an investor’s normal returns.

An income tax system will properly measure and tax time-value-of-money (normal) returns on real assets only if two conditions are satisfied. First, the tax system
must develop comprehensive rules to capitalize, rather than deduct, expenditures
that create or enhance the value of a real asset (for example, expenditures to build
a factory or to establish a brand name). This problem is pervasive in the current
tax system, where, for example, all advertising expenses are currently deductible,
even if they are incurred to develop a valuable brand name.

Second, the tax system must permit recovery of the cost of such investments
through economic depreciation schedules—that is, schedules that comport with the
actual depreciation in value of those assets from year to year. Viewed from this
perspective, accelerated depreciation systems “encourage” overinvestment in real
assets for the simple reason that, by design, they undertax the returns from those
investments relative to economic measures of income.41

Unfortunately for this simple presentation, taxpayers do not invest their capital
exclusively in real assets; they also acquire financial assets, such as stocks, bonds,
options, and other, more obscure instruments. As described earlier, economists
sometimes ignore financial assets as background noise, on the theory that financial
assets in the aggregate are simply indirect claims against all the real capital
invested in business. No practical income tax system, however, ignores financial
assets. The current tax code therefore taxes businesses on the returns derived
from capital invested in real assets (through capitalization and depreciation rules)
and taxes households on the income derived from capital invested in financial
assets.42

As briefly described above, one very difficult challenge in designing an income
tax system that properly measures capital income is to coordinate and allocate
tax liabilities at these two different levels—the financial investor holding financial
capital instruments, and the business enterprise investing in real assets and
earning net business income—to advance the fundamental objective of imposing
a single comprehensive and constant tax burden on normal returns. The current
tax system fails utterly in this critical exercise.

There is no simple answer to the coordination and allocation dilemma, although
virtually every possible permutation has been explored. Yet the exercise of coordi-
nation and allocation between investors holding financial assets and business
enterprises holding real assets is critically important if the resulting system is to
be economically neutral—that is, if it is to impose a comparable tax burden on all
returns to capital, regardless of the form in which an investment is made.

As a starting point, whatever the tax rate structure that may be agreed on, a
coherent capital income tax would burden all “normal” returns (the basic “return
to waiting,” or the time value of money) at a consistent rate, regardless of the
legal form in which that income is earned. For risky returns, economists argue
that the most important consideration is to treat losses as symmetrically as pos-
sible with gains, so as to avoid a systematic bias in the tax law against risk-taking.
The actual rate here is less important, because again investors can just scale up
their bets (in theory) to put themselves in the same after-tax position as if the tax had not been imposed. And finally, supersized returns also must all be taxed at a consistent rate, regardless of the legal form in which that income is earned. As a logical matter, however, that rate need not be the same as the rate imposed on normal returns.

But at What Rate?

The foregoing discussion decomposed capital income into three constituent elements (normal returns, risky returns, and economic rents), but did not answer the obvious question, at what rate should they be taxed? And how should that rate relate to tax rates on labor income? Put risky returns to one side, on the theory that symmetry between gains and losses is more important than nominal rate. That leaves us with normal returns and economic rents.

Economists are surprisingly cheerful about high taxes on economic rents. The theory is very simple—these are supersized returns not generally available in the market. They are neither replicable nor scalable. An owner is thrilled to receive economic rents, and so long as she is left after taxes with more than she could get by way of normal returns, the theory goes, why should she complain?

From the other direction, and although the consensus is not quite as complete here, most economists are uncomfortable with taxing normal returns at high rates, including rates as high as the rates imposed on labor income. At the same time, risk-adjusted normal returns should form the bulk of returns on capital, so getting the rate on normal returns right is arguably even more important than squeezing the last dollar of tax revenues out of economic rents.

For a great many reasons of administrative efficiency and political economy, I believe that the right place to begin in designing an income tax on capital is by adopting a “dual income tax” of the sort actually employed by some of the Nordic countries at one point or another in the recent past. Dual income tax systems are income taxes that explicitly reject the ideal of a single rate of tax on all income from whatever source derived, and instead impose different rates on capital income, on the one hand, and all other income (principally, labor income), on the other. Typically, a dual income tax adopts a relatively low flat rate of tax on capital income, and progressive rates on labor income, where the highest labor income rate is materially greater than the flat capital income rate, but other rate structures are possible.

The hallmark of a “dual income tax” is its two-pronged schedular design, under which all capital income (or at least any normal return) is taxed more lightly than is labor income. Norway has been the leader in designing dual income taxes; it has implemented different systems that alternatively have taxed all capital income at one flat rate, or that more recently have taxed normal returns at a low rate while endeavoring to tax economic rents at basically the top rate on labor income.
There are good reasons to adopt what might be thought of as “first generation” dual income tax principles. Under this approach, all returns to capital would be taxed at one low flat rate, while labor income would be taxed at increasing marginal rates to a top rate considerably higher than the capital income tax—say, 25 percent in one case, and 40 percent in the other. (Technically, capital income of taxpayers whose marginal tax bracket is lower than 25 percent would be taxed at the lower rate, but it turns out that capital income, because it appertains to capital, is highly concentrated among the affluent.) By doing so, the dual income tax implements a tolerable compromise that avoids drawing a line between normal returns and rents. The theory of normal returns, risky returns, and rents is beguiling, but telling one from another in practice is a difficult undertaking.

Many economists believe that the income tax itself is a flawed norm, and that economic efficiency can be enhanced (without impairing equity concerns) by adopting a progressive consumption tax as the US model. As previously explained, a consumption tax does not burden normal returns (the basic return on investment that compensate for deferring consumption from today to the future). A low flat-rate income tax on normal returns can be understood as moving in the direction of a consumption tax, even if such a system does not fully achieve all the purported efficiency ends of a consumption tax. Importantly, a low flat-rate tax on normal returns does so while largely avoiding the extraordinarily difficult transition issues that would be raised by the replacement of our capital income tax with a consumption tax.

A low flat-rate tax on normal returns might cynically be described as a Solomonic compromise between two warring camps divided over whether a positive tax on normal returns to capital is desirable. It is fairer, however, to see the underlying principle at work as a recognition that capital and labor income are sufficiently different that a desirable tax scheme for one is not necessarily optimal for the other, and that the best evidence to date argues in general for moderation in the taxation of capital income.

The logical alternative is to argue that economic rents, like labor income, in fact can bear a higher tax rate than normal returns, and that the right move here is to ensure that economic rents are exposed to full labor-income marginal rates. This alternative is consistent with economic logic, and in fact was the basis for the most recent (2006) revision of the Norwegian dual income tax system, but raises many difficulties. Among other problems, it inadvertently would lose some efficiency, by exposing risky returns to asymmetrical after-tax outcomes, as when years of small losses lead to one hugely successful investment, and it would greatly complicate the novel but perfectly feasible approach to taxing capital income that I outline below. Such a move also has obvious political economy problems, in light of global trends in headline corporate rates.
We start from a place where capital income often is untaxed, or taxed at wildly different effective rates. To move to a world where all capital income is taxed consistently would be an enormous accomplishment; if doing so required undertaxing economic rents somewhat, I would argue that the result still would be good enough for government work.

THE DUAL BUSINESS ENTERPRISE INCOME TAX

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. Moreover, some of the leading capital income tax reform ideas that have been proposed, such as the Comprehensive Business Income Tax (CBIT), proposed by the US Treasury Department in 1992, assume away the problem, by assuming that the tax base (e.g., corporate net income) is accurately measured, and presenting the issue as simply one of coordination between firms and investors.

It is possible to do better. That is the purpose of the Dual Business Enterprise Income Tax (Dual BEIT). The “dual” part of the name reflects the proposal’s debt to Nordic dual income taxes. As just described, their fundamental insight was that there is no economic or policy reason to assume that an ideal income tax would burden labor income and capital income under the identical rate schedule. The Business Enterprise Income Tax, or BEIT (pronounced “bite,” like a tax bite) part, is the mechanism I developed to introduce a feasible system for taxing capital income at that flat rate in a consistent manner.

A dual income tax, in which capital income is taxed more lightly than labor income, brings squarely to the front the necessity of developing a new tax tool, 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 (or other cases). Having done so, a dual income tax must be implemented in a way that measures returns to capital consistently, no matter the form of the business organization through which they are earned, or the label of the financial instrument through which an investor holds her claim.

Nordic dual income tax systems point toward one answer to the question of tax rates, and further resolve a specific element in defining the capital income tax base, which is the separation of capital income from the labor–capital matrix in which it often is found in nature. But dual income tax systems do not assure that capital income is measured accurately. That is, other than in the one area of segregating capital from labor income, dual income tax systems by themselves do not define the capital income base. That is the purpose of the BEIT part of things.
A Labor–Capital Income Centrifuge

An explicit dual income tax—that is, any regime that taxes capital income at one rate, and labor income at another—requires a labor–capital income centrifuge, to divide business income between labor and capital components in those cases where the suppliers of labor and capital cannot be relied on to specify those returns accurately by themselves. Given the shoddy work we have made of the issue in the past, a mechanical solution of the sort adopted (at least for a period of time) by the Nordic countries, in which a reasonable return to capital is imputed, and the remaining income treated as labor income, can hardly be faulted as inexcusably imprecise. Moreover, the solution is self-assessable and universally applicable.

The idea of the labor–capital income centrifuge is straightforward. In those cases where markets cannot be expected reliably to separate labor from capital income—that is, in the case of closely held private companies—an owner–manager of a firm determines the portion of her total returns that are attributable to her capital invested in the firm by multiplying that capital by a fraction (which typically could be determined by a formula tied to one-year government securities); the result would be deemed the return to capital, and the remainder deemed the return to her labor. Actual Nordic implementations rapidly grew more complex, for example to deal with whether the asset base should be a net or gross asset concept, and how to determine when a company was sufficiently closely held as to invoke the labor–capital income centrifuge, but as these questions have been considered in great detail elsewhere, they will not be repeated here.

A New Measure of the Capital Income Base

The BEIT is a novel proposal for measuring capital income much more accurately than has been true in the past, but it has only a handful of new components, built on top of existing income tax concepts.

Here is a high-level view of how the BEIT would work. For simplicity, I present the BEIT as it would apply to a public company, in which by hypothesis labor and capital income have already been teased apart through market pricing of labor inputs. The principles can be extended to closely held private firms as well, with the introduction of a labor–capital income centrifuge and other adaptations.

The BEIT adopts two 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. By doing so, the BEIT sidesteps the problems that plague CBIT and similar comprehensive entity-only
income tax proposals, all of which accurately tax normal returns only if they get economic depreciation precisely right.

Second, the BEIT seeks to reduce the realization principle to its smallest possible component. By taxing normal returns to investors rather than business enterprises, the BEIT takes advantage of the intuition that financial investments turn over more rapidly than do noninventory real assets, so that the base for determining normal returns is closer to the economic ideal. For the same reasons, the BEIT repeals numerous exceptions to the recognition of income and requires mandatory income accruals with respect to normal returns. The result is a system where reported taxable income tracks economic income much more closely than under current law.

The BEIT requires only a few new operative rules to accomplish these results. First, all business enterprises are taxed as entities. Second, firm-level interest deductions are disallowed, and replaced by a new Cost of Capital Allowance (COCA). The annual COCA rate is set by statute at a formula rate that varies with one-year Treasury rates. A firm’s annual COCA deduction is simply its adjusted basis in its assets multiplied by the COCA rate. Thus, the COCA deduction is available regardless of whether a firm’s real assets are financed with debt or equity.

The effect of the COCA allowance is that the BEIT at the firm level operates as a consumption tax, in which normal returns are tax-free, and only net risky returns and economic rents are taxed. The BEIT operates as a consumption tax because the COCA deduction in respect of a firm’s unrecovered investment in its assets (its tax basis in those assets) has the same present value as an immediate deduction for capital investment (assuming the COCA rate is set properly). This means in turn that the value of the COCA deduction is unaffected by tax depreciation schedules; Congress can meddle as much as it chooses without changing the economic burden of the tax to a firm. A similar economic result could be achieved by simply allowing the expensing of all capital investment, but the COCA mechanism has a number of practical advantages over that approach.

Third, investors include in income annually an amount equal to the same COCA rate multiplied by their adjusted tax basis in their investments (the Includible Amount). They do so regardless of whether they receive cash returns from their investment in a given year. Includible Amounts function much like the rules governing original issue discount for debt instruments under current tax law: the investor’s tax basis goes up by the amount of her Includible Amount, and down in respect of cash received on her investment (e.g., dividends or interest). Cash returns thus are relevant only insofar as they affect an investor’s remaining adjusted tax cost in her investment.

The COCA inclusion at the investor level means that investors are taxed on the normal returns to their investments every year. In more formal terms, the BEIT is designed to tax economic rents and risky returns from business
enterprises at the firm level, and “normal” returns to capital at the investor level. The aggregate result is that all the components of capital income are taxed once, and only once.

In other words, the BEIT adds an investor-level tax on normal returns on top of a firm-level consumption tax. The combination of the two amounts to a unified income tax on capital (which by definition burdens normal returns as well as economic rents and risky returns). It is this allocation of returns (normal returns only to investors; rents and risky returns to firms) and the use of the COCA mechanism to accomplish these results that are the novel contributions of the BEIT.

In comparative tax law terms, the BEIT can be explained at the firm level as a superior implementation of an Allowance for Corporate Equity (ACE) system of the sort actually adopted by some European countries, because unlike ACE systems, the BEIT offers the same deduction (the COCA) regardless of whether real assets are financed with debt or equity. The BEIT thus removes the temptation to issue equity-flavored debt instruments, which still remains in ACE systems where the “interest” rate on the hybrid instrument exceeds the ACE allowance.

The BEIT achieves neutrality in other dimensions as well. It taxes all business operations identically (by taxing enterprises, regardless of legal form, consistently). Second, it renders tax objectives irrelevant to the choice of an issuer’s capital structure because the capital the issuer employs, not the security issued, determines its cost of capital allowance. Similarly, the tax liabilities of investors are driven by the capital they invest and the cash returns they earn, not the label of the instruments they hold.

Finally, the BEIT, although an income tax, offers corporate managers a consumption tax environment in which to conduct business. This in turn can be used to advantage in integrating the BEIT with a worldwide tax consolidation approach to business enterprise taxation going forward. This should resonate with managers who today express concern about international “competitiveness,” and further means that those managers will be able to pursue acquisitions and divestitures without regard to substantial tax consequences. (The papers referenced in the notes elaborate on these themes.)

The BEIT is exactly the right move for making the United States an attractive place for foreign as well as domestic investors to invest. Because foreign investors in US corporations will face a domestic corporate consumption tax, those investors will enjoy the benefits of the reduction in business tax burdens. And at the same time, US resident investors will bear the full burden of capital income tax on the normal returns to all their investments, wherever located. Since the capital of multinational firms is generally held to be much more mobile than the residence of individual citizens of the United States, the result will be a more attractive environment for investment in the United States, and a reduction in the impetus to move capital out of the United States.

54
To summarize, for a tax system that purports to tax capital income and that could in fact be implemented in a large modern economy, the BEIT does a remarkably good job. Most fundamentally, it taxes all capital income once, and only once, without cumbersome (and frequently abused) integration schemes or the like. Economic rents are taxed to the enterprise, and normal returns to investors. By definition, the BEIT eliminates the debt–equity distinction, neutralizes the importance of different depreciation or capitalization regimes, automatically coordinates firm-level and investor-level incomes, and mitigates (but does not wholly eliminate) the consequences of the realization doctrine. What is more, the BEIT moves a large fraction of capital income to the level of investors, rather than firms, a development that has important helpful ramifications in light of the relative international mobility of capital, compared to people. For all these reasons, the BEIT is an extremely attractive vehicle for imposing a successful capital income tax.

At the same time, the BEIT by itself is largely agnostic about tax rates. The concept originally was conceived primarily as a vehicle for the accurate measurement of capital income, and it can be adjusted to tax normal returns, on the one hand, and rents and risky returns, on the other, at the same or different rates, which rates in turn can be the same as or different from those applied to labor income. Dual income tax principles and the BEIT thus are complementary. The former offer a device for accurately teasing apart labor and capital income in those cases where they otherwise form an indissoluble matrix, and a theoretical hook from which to hang a reasoned view of the appropriate tax burden on all capital income. The BEIT picks up from there, and ensures that all capital income is taxed once, and only once, through its consistent and comprehensive design of the tax base.
CHAPTER 14

WE ARE BETTER THAN THIS

In this [last part of my] book I have endeavored to show, first, what are the necessary expences of the sovereign, or commonwealth; which of those expences ought to be defrayed by the general contribution of the whole society; and which of them, by that of some particular part only, or of some particular members of it: secondly, what are the different methods in which the whole society may be made to contribute towards defraying the expences incumbent on the whole society, and what are the principal advantages and inconveniences of each of those methods: and, thirdly and lastly, what are the reasons and causes which have induced almost all modern governments to mortgage some part of this revenue, or to contract debts, and what have been the effects of those debts upon the real wealth, the annual produce of the land and labour of the society.


MOVING FORWARD

Readers may be disappointed by the modesty of my substantive recommendations. I contemplate tax revenues and federal government spending levels roughly commensurate with those at the end of the Clinton administration, which most readers of this book lived through and emerged unscathed. I do not propose replacing the income tax with a value added tax, or anything else. I do not have in my back pocket a 10-point plan to reform the delivery of healthcare services in the United States, recommendations on the number of nuclear aircraft carriers the Navy should deploy, or proposals to rewrite any of our income support
programs. What is the explanation for this uncharacteristic modesty in expres-
sion and ambition?

One answer is that I am not an expert simultaneously in military strategy,
healthcare institutions, and all the other topics to which this book has adver
ted. I respect the work of genuine experts in the field, and defer to them on tech-
nical questions of how government’s work in their respective disciplines can be
enhanced. The more fundamental answer, however, is that the United States of
America is not broken. Our fundamental fiscal health is not in crisis. Our chal-
lenge are real, but highly tractable. What we collectively require are, first, better
information; second, a more holistic approach to public debates on fiscal policy,
by which I mean that our emphasis should be on the consequences of fiscal poli-
cies in the aggregate; and third, a broader understanding of the obligations and
opportunities to which government can respond on behalf of the entirety of the
citizenry of the United States.

The United States remains the largest and most dynamic economy in the world.
Our outstanding federal debt grew substantially during the Great Recession, but
that is exactly what our fiscal automatic stabilizers were designed to do. Our
national income is more than adequate to service that debt, and to begin paying
it back down. Our only crises in this regard are those we choose to artificially
impose on ourselves, through a political process dominated by fear, sloganeering,
and misinformation.

Our current wealth and future prosperity are driven primarily by private mar-
kets. No sensible person disagrees with that. But markets are not perfectly com-
plete everywhere, all the time, and as a result government has critically important
complementary roles to play, as an investor in our infrastructure and our fellow
citizens, and as an insurer against the worst vicissitudes of life.

This book has examined how we are doing in investing in ourselves, and in
offering coherent social insurance programs. The answer is not very well. We
starve ourselves of investment in infrastructure, and we underinsure ourselves
in many respects. The result is a less happy society, to return to Adam Smith’s
injunction to us, and also a less prosperous one. Well-designed social insurance
programs increase our appetite for economic risk, rather than depress it, and
public infrastructure investments yield positive economic returns, just as private
investments do. These are the functions that our government is good at and to
which this book has been addressed. Once one moves beyond police powers and
the like, what we call government spending and taxing in many respects is really
investing and insuring, with those investments and insurance premiums col-
lected through the mechanism of taxation.

The book has further considered whether we have reached some natural limit
on our ability to finance collective investment and insurance through the inter-
mediation of government. The answer is no. We face budget deficit issues today
because we have chosen systematically to undertax ourselves since 2001, not because the engine of our economy cannot supply any more revenues than those we currently collect.

In short, for the last decade or more we have allowed the existence of deficits to determine the contours of our government spending—the uses to which we put our government. This is backward. What this book has urged is that the right way to think about things is to ask this question: What investment and insurance opportunities are there for all of us, acting together, to advance the happiness of our society? In answering this question, we need to be mindful of a great many dynamics—the frustration and unhappiness that comes with paying taxes, the deadweight loss of taxation, the estimated positive economic and social returns on that collective spending, the limited competencies of government agencies, and so on. But the starting point in every case should not be determined by establishing an arbitrarily small amount of tax to collect, and then treating government like an institutional Procrustes, whose only responsibility it is to amputate the welfare of our fellow citizens to suit that amount.

We cannot embrace every generous impulse, because in many cases the return on investment, in the broadest sense, is too low, relative to its social and economic costs. But by looking at the actual state of economic health of millions of Americans (not to mention their physical health), by comparing the US experience to the mix of public goods furnished by other developed economies, and by reviewing the economic literature on the deadweight loss of taxation, the inescapable conclusion emerges that we can do better for our fellow citizens, which in the long run also means doing better for ourselves.

There is an important predicate underlying this conclusion that compilations of data and economic research cannot teach, because it is a point of elementary civics. This predicate is that all of us who are citizens of this great country are in it together, and that our national policies must reflect the understanding that the happiness of our society depends on the collective happiness of all of us. Our political liberties generally are secure and unthreatened, except in the off-kilter imaginations of some, or in the impulse to suppress the political rights of those Americans who are thought to be inadequately propertied to exercise their constitutional political rights. What is more generally threatened is the recognition that all of us stand on equal footing as citizens.

This book has argued that the contrary view, encapsulated as market triumphalism, is a flawed pastiche of abstract economic nostrums and unhealthy political claims. It is the marriage of a belief in the infallibility of private market outcomes and the claim that our political liberties depend on laissez-faire economic policies. But markets are not always perfect, market freedoms and political freedoms are not identical, and political liberties can exist without the most fundamentalist sort of laissez-faire policies as a prerequisite.
Market triumphalists’ imaginations run riot, in directions that are simultaneously paranoid and self-centered. They see around the corner the impending collapse of social order, always predicated on the same anti-democratic instinct: the shirtless and rootless masses (all of whom happen to be fellow citizens) will fasten on the taxing power as the way to take from the rich and give to themselves, thereby killing the golden goose while grabbing a few eggs. This is why market triumphalist rhetoric is so fixated on taxation, to the exclusion of the goods that taxation purchases. But as billionaire philanthropist Eli Broad recently pointed out, “We are the only country in the developed world without large national labor or socialist parties, and it’s unlikely that many Americans ever are going to be converted to the notion that it’s sinful to be wealthy. What we all need to continue to believe, and to act on, is the conviction that it’s wrong and socially destructive for the rich to forget those who still can use a hand up.”

At every turn, market triumphalists seek to impugn the genuine political rights and liberties of others, and to paint themselves as the intended victims of self-defeating “leveling down.” The result is that they are quick to sacrifice their fellow citizens’ claims to genuine equality of opportunity, as reflected, for example, in comparable levels of investment in their children’s health and education. They do this by denying the legitimacy of government investment or insurance in general, and by claiming that all existing programs are marked by irredeemable design flaws, administrative incompetence, and participant fraud.

Very recently, for example, Richard Epstein, some of whose views have already been described, wrote an extraordinary commentary effectively claiming that the Constitution prohibits public investment or insurance programs. As discussed in Chapter 2, the Constitution provides that “[t]he Congress shall have Power to lay and collect Taxes, . . . to pay the Debts and provide for the common Defence and general Welfare of the United States.” Epstein wrote:

The clause is not a catchall that sweeps in every objective under the sun. Federal taxes are meant to fund only a short list of public—i.e. nonexcludable—goods that only the central government can provide . . . .

The proper interpretation of the clause raises thorny questions about whether, for example, the United States could provide disaster relief that benefits some but not all states. President Grover Cleveland thought that the answer was an emphatic “no” in 1887 when he vetoed the Texas Seed Bill, which allocated $10,000 for Texas drought relief. Under the Constitution, he did “not believe that the power and duty of the General Government ought to be extended to the relief of individual suffering which is in no manner properly related to the public service or benefit.”

Indeed, the vital element in this clause is that it prohibits any transfer payment from one group of individuals to another, as those cannot serve the “general welfare of the United States.”
Grover Cleveland is not often proffered as a paragon of constitutional interpretive genius, and in the period since 1887 we have witnessed hundreds of disaster relief acts and similar legislation that have contradicted his claims. But more fundamentally, Epstein misapprehends both the taxing power and the meaning of the “general welfare of the United States.”

People like Epstein recoil at the taxing power because it is in fact constitutionally unconstrained, within the bounds of rationality (and a few trivial limits), and the only remedy for oppressive taxation is to vote the rascals out. The Supreme Court made this point, for example, in 1888—the year following Grover Cleveland’s veto of the Texas Seed Bill:

The judicial department cannot prescribe to the legislative department limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon persons; but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected.1

Many other cases since have made essentially the same point.

No one’s welfare is enhanced by having resources simply taken away (the tax side in the abstract). As a result, there is no general welfare advanced through taxation viewed in the abstract, other than the oddball Pigovian tax case (that is, a tax aimed at curing a market negative externality, like pollution). Moreover, money is fungible: tax A cannot logically be said to fund Spending B, because taxes all flow into one pot, whence funds are disbursed on spending programs. (Even the so-called trust funds operate in this manner, as Chapter 6 explained.) The Constitution’s reference to the “general welfare of the United States” therefore logically describes its third power enumerated in the quoted sentence, which is to spend the money raised by taxes in ways that provide for the country’s general welfare.4

Epstein claims that the Constitution’s grant of Congressional power “prohibits any transfer payment from one group of individuals to another, as those cannot serve the ‘general welfare of the United States.’” But to write this is to deny both Supreme Court jurisprudence and the meaning of “insurance,” unless his only point is the trivial one of reminding readers that taxes must first flow into the Treasury, and then out to a group of individuals, rather than being forcibly paid directly from one group to another.5 Only some insureds have insurance claims in any given year, but every insured benefits from the existence of that insurance. This is why Grover Cleveland was wrong in 1887, and why there was so much well-deserved anger at those members of Congress who sought to block the Hurricane Sandy relief bill: the federal government of the United States offers, through disaster relief and similar measures, de facto disaster insurance to all regions of the United States. And more directly, the “transfer payments” that
Epstein finds offensive in fact are social insurance programs from which all of us, even Epstein, benefit, because the programs exist for all of us, should our circumstances change.

So, too, government investment enhances the welfare of all, regardless of its geographic location. Does anyone seriously claim that the Hoover Dam did not enhance the general welfare of the entire country, even though most of us do not live in Nevada or Arizona, which it straddles? Similarly, Congress determined that the investments in the financial sector at the height of the financial crisis, or the investments in the automobile sector, would advance the welfare of the entire United States; having made that good faith determination, at that point the constitutional criteria were satisfied.

Market triumphalists lie awake nights waiting for the mobs to tax them into penury—and yet it has never happened. Our democracy is in this respect more functional than market triumphalists give it credit for. And by the same token, the market triumphalist agenda is fundamentally more anti-democratic than is generally perceived. It is their success in disguising their self-centered, slightly paranoid, and anti-democratic impulses behind the garb of concerned deficit hawks or protectors of our moral backbones from the siren call of cushy unemployment benefits that make them the villains in the story I have told.

THE PURSUIT OF HAPPINESS

I began this book by summarizing the moral philosophy of Adam Smith, a man who has become the adopted mascot of a contemporary social movement that would disgust him. As Chapter 2 developed, Smith understood the human inclination to strive for more things, but also understood the ultimate futility of this as an ordering principle for a life well led. To Smith, “happiness” was the goal of life, a sentiment shared generally with other eighteenth-century enlightenment scholars. But happiness did not mean whatever floats your boat, to put things in a more modern idiom. To Smith, happiness was a long-term state of tranquility, obtained “through moral education, habituation in moral rules, and a reasonable arrangement of social institutions and life,” which when generally practiced yielded a society dominated by “the general prevalence of wisdom and virtue.”

Closer to home, Thomas Jefferson worked squarely within this then-contemporary focus on happiness as an ordering principle of life, and incorporated it into our Declaration of Independence, when he wrote, “We hold these truths to be self-evident: that all men are created equal; that they are endowed by their creator with unalienable rights; that among these are the pursuit of happiness.” The Declaration continued, that “it is the Right of the People…to institute new Government, laying its foundation on such principles and organizing its
powers in such form, as to them shall seem most likely to effect their Safety and Happiness."

Jefferson did not choose the term “happiness” at random. Among other sources, he appears to have read The Theory of Moral Sentiments closely, and in fact recommended Smith’s book in a famous reading list that Jefferson prepared for his brother-in-law, Robert Skipwith, in 1771. And his emphasis that a new government should be constituted so as to be most likely to effect its citizens’ happiness certainly echoes Smith’s statement in The Theory of Moral Sentiments that governments “are valued only in proportion as they tend to promote the happiness of those who live under them. That is their sole use and end.”

Many scholars have considered the influence of The Wealth of Nations on post-Revolutionary American thinkers, including Jefferson. (That book, of course, was first published in London in 1776, and therefore had no influence on Jefferson’s worldview at the time of the Declaration.) The Theory of Moral Sentiments has not received as much attention. Nonetheless, the book was widely known in pre-Revolutionary America. For example, a New York bookseller listed it for sale in 1761 (two years after its first publication in England), and a comprehensive survey of American libraries found the book in 17 out of 92 pre-Revolutionary booklists. This might not sound like a very broad dissemination, but in fact only a handful of contemporary moral philosophy books were more widely held; Hume’s Essays appeared in only a few more lists; Hutcheson’s A System of Moral Philosophy in a few less.

Perhaps the best window into the importance of The Theory of Moral Sentiments to pre-Revolutionary American thinkers is a strange pamphlet published in 1764 by Arthur Lee, one of six American patriot brothers from Virginia. Lee lived a large portion of his life in Europe; he earned a medical degree at Edinburgh and a law degree in London. Lee was a well-known advocate in England for the Colonies’ rights before the Revolution, and was one of three American commissioners (along with Benjamin Franklin) representing the interests of the United States in Paris during the Revolutionary War, where in the standard accounts he proved himself to be thoroughly disagreeable and unable to work with Franklin.

Lee’s 1764 pamphlet, written while he lived in London, was titled An Essay in Vindication of the Continental Colonies of America from the Censure of Mr Adam Smith, in His Theory of Moral Sentiments. It was a response to a passage in The Theory of Moral Sentiments in which Smith described African slaves in the Colonies as possessing “a degree of magnanimity, which the soul of his sordid master is scarce capable of conceiving. Fortune never exerted more cruelly her empire over mankind, than when she subjected those nations of heroes to the refuse of the jails of Europe…. In response, Lee penned an argument that was intended to defend the honor of Americans of European descent; in doing so, Lee produced a document that was simultaneously vilely racist and a call for the
elimination of slavery (on the theory that slavery corroded the moral fiber of the slave owner).

What is interesting about Lee’s otherwise rightly forgotten pamphlet is that Lee begins by apologizing for having taken so long to respond to Smith, whose book had first been published four years earlier: this speaks to the importance generally accorded to The Theory of Moral Sentiments. More directly, Lee writes of Smith’s book: “[Smith’s] ingenious theory of morals has, very deservedly, gained the world’s esteem; and I am sorry it should contain anything so unworthy of its general character. I am sorry, because I admire it, and wish I could have esteemed its author.” In short, The Theory of Moral Sentiments was a book that educated Americans read in the 1760s and 1770s, and it is perfectly plausible to imagine that Jefferson, among others, found in it some inspiration for his own applied moral philosophy.

It often is claimed that Jefferson’s famous phrase in the Declaration of Independence guarantees only the right to “pursue” happiness—rather like chasing a butterfly—not to obtain it, and therefore that the Constitution guarantees only equality of opportunity. From this, the conclusion somehow is drawn that modern social insurance programs are unnecessary, apparently because they create too much undeserved happiness. This common claim is an anachronism, of course, as Jefferson’s sentiment did not appear in the Constitution at all. More important, and as this book has been at pains to develop, equality of opportunity often does not exist in our society, as when we inexplicably make public investments in the education of children in direct rather than inverse proportion to their family’s affluence. But it nonetheless is worth considering for a minute what Jefferson might have been driving at, as a way of connecting the American political tradition back to Smith’s important work on moral philosophy.

The academic “pursuit of happiness” literature is vast, and includes at least two books dedicated entirely to the phrase’s history and explication. It turns out that the phrase is straightforward to interpret, except for the words “pursuit” and “happiness.” Actually, that oversimplifies matters—in Jefferson’s context, scholars also disagree about “we hold” and “self-evident.” The literature is complicated by a larger debate over the extent to which Jefferson’s Declaration is inspired almost entirely by John Locke’s emphasis on natural rights and the political philosophy of “liberalism”—meaning respect for an individual’s autonomous decisions—or whether there is also a flavor of classical “republicanism” at work—meaning the state as a paramount entity, in whose governance citizens participate, whose civic values are inculcated through education and social mores, and through which citizens realize their full potential. I wish only to make two points.

First, “pursuit” does not have to mean a chase for an ethereal will-o’-the-wisp. When we play the game Trivial Pursuit, we use the word in its alternative meaning, of a current avocation (or in this context, a pastime)—a path or practice on
which we currently are embarked. Arthur Schlesinger, among others, through careful consideration of then-contemporary uses of the word, convincingly argued that Jefferson used “pursuit” in this sense of a current practice, not a distant hope. As Schlesinger points out, the same long sentence in the Declaration in which the phrase “the pursuit of happiness” appears concludes with the statement that it is a government’s present duty to the governed “to effect their safety and happiness.” If your guru tells you to “follow your bliss,” she is sending you on a voyage of self-discovery, in which the voyage is the point. So, perhaps, also with “pursuit.”

Second, Jefferson probably used “happiness” in ways close to Smith’s use of the term, as a state of tranquility reached through a life of virtue. In 1819, Jefferson wrote to a friend and neighbor, William Short, of his admiration for the philosophy of Epicurus (“I too am an Epicurean”), and attached to that letter a distillation of what he took to be the essence of Epicureanism, which he identified as having been prepared around 1789—admittedly, after the Declaration, but nonetheless at a time that sheds some light on his thinking. His bullet-point summary of the moral philosophy of Epicurus began:

Moral Philosophy —

• Happiness is the aim of life.
• Virtue the foundation of happiness.
• Utility the test of virtue.

One modern scholar summarized the moral foundations of Jefferson’s construct of happiness as follows:

[B]y defining freedom as “freedom in all just pursuits,”…Jefferson was emphasizing that freedom was license to do not anything at all in order to attain one’s “greatest happiness” but only what was consistent with the moral sense of justice….This emphasis on freedom in the context of morality in the pursuit of greatest happiness demonstrates that morality was an essential ingredient in Jefferson’s idea of happiness…. [M]oral behavior fulfilled the moral nature of man, and Jefferson expressed this idea when he said, “And if the Wise [would] be the happy man, as these sages say, he must be virtuous too; for, without virtue, happiness cannot be.”

Jefferson, of course, did not mean to impute any particular religious code to the word “virtue.” He was famously opposed to imposing his religious views on others, and as it happens he saw the Bible as a “tradition” rather than the literal word of God. But “virtue” did imply education and socialization along the same lines that Smith outlined: that is, our happiness rests on virtue, and virtue in turn is a learned skill. Jefferson thus did not limit us to one mode of expression. Our unalienable right to the pursuit of happiness means the right to pursue our own
bliss, as guided by our internal guru, *provided* that we have a well-developed moral compass to point the way.

For this reason, public education was for Jefferson an essential component of good government, and the only basis on which democracy could prosper. Henry Steele Commanger neatly summed up the relationship in Jefferson’s thought between happiness, virtue, and education:

> How odd that the term enlightenment in Europe should refer to a program imagined by philosophers. . . , while in America it meant popular education. “Enlighten the people generally,” said Jefferson, and . . . “no other sure foundation can be devised for the preservation of freedom and happiness. . . . Preach a crusade against ignorance; establish and improve the law for educating the common people. Let our countrymen know that the people can protect us against the evils of misgovernment.”

All the founding fathers were educators. . . . Greatest of them all was Jefferson, who planned a complete educational system for Virginia, wrote educational provisions into the ordinances governing the West, and built the University of Virginia. . . . where else in the western world do you find anything like this?24

The sad answer to Commanger’s rhetorical question is, not necessarily in the United States, any more. In 2013 the Kansas state legislature slashed public spending on education 16.5 percent below 2008 levels, while passing an income tax cut benefiting mostly higher income residents. A state trial court ruled that the current level of funding violates Kansas’s constitutional requirement that the state make “suitable provision” for public education, and ordered Kansas to raise its per-student spending from $3,838 to $4,492, but in response the governor appealed. News accounts at the time reported that, if the trial court’s decision were to be upheld, “legislators are threatening to amend the state’s Constitution by removing the requirement for ‘suitable’ school funding and to strip Kansas courts of jurisdiction to hear school finance cases altogether.”25

Fiscal policy—the objects of our collective spending, and how we choose to finance those activities—is a window into our fiscal soul, and the view right now is disquieting. Homo Economicus struts across center stage of our public discourse, declaiming that science commands that unalloyed market outcomes cannot help but be optimal. The Growth Fairy hovers over the scene, threatening that efforts to increase investments in ourselves will force her to withdraw to a more hospitable land, never to return. When the Pope observes that perhaps that trickle-down economics stuff doesn’t seem to be working, he is attacked as a know-nothing Marxist. And poor Adam Smith, professor of moral philosophy, remains a captive of those on whom life has showered affluence, and who revel in confusing their good fortune with great virtue.
We all are Americans. We all deserve to pursue our own happiness, but this promise that binds us as a country requires as a precondition more than simply being neither incarcerated nor a serf. We can afford to do better. We can afford to be better citizens to one another.

When will we honor Adam Smith and Thomas Jefferson? When will we choose to govern ourselves in ways that are most likely to effect the happiness of our whole society?