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The Tax Conundrum: A Trade-Off Between Growth and Fairness

Richard A. Epstein

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One of the great political divides in the United States concerns the role of the state in redressing income inequality across individuals and groups.

Recently, the outspoken conservative commentator Dennis Prager noted that in one representative debate during the 2016 presidential campaign, the words, "Wall Street", "tax," "inequality," and "wealthy" were used 59 times by Democratic candidates.

In contrast, "ISIS," "terrorism," "free," "debt," "liberty," and kindred terms gathered a scant 10 mentions.

The choice of words reflects legislative priorities. As Michael Tanner of the Cato Institute observes, the Democratic position resonates broadly in the electorate given the increasing inequality of wealth. By noting the diminishing marginal utility of wealth, progressives hope to increase social welfare by taxing the rich in order to support the poor.

Today, the top 1 percent of taxpayers, who earn just under 20 percent of total individual income, also pay just under 40 percent of all individual income taxes. So ironically, redistribution programs depend on continued successes at the top.

In light of the relatively low economic growth and prolonged wage stagnation of recent years, what price is presently paid for the increase in social equity?

Right now, the Republican tax reform will take minor steps to reduce tax progressivity. The GOP's policy does not stem from any deep conviction that richer individuals pay higher rates because they receive greater services from government.

Quite the opposite: Government expenditures have moved smartly in the opposite direction, toward income and wealth transfers through Social Security, Medicare, Medicaid, unemployment insurance, food stamps, and more.

There have also been declines in infrastructure spending, which benefits rich and poor alike.

It is therefore important to step back from the current controversies and ask whether responding to inequality of income and wealth should continue to receive pride of place.

At the philosophical level, the basic debate boils down to a choice between the classical liberal position that seeks to maximize the total size of the pie, and the egalitarian position that seeks to

reduce the differences in the size of the slices by combining progressive taxation with redistributive spending policies.

It is important to spell out the implications of both positions in both the short and the long run.

Under the classical liberal tradition, the emphasis is on growth, by making Pareto improvements or changes in the tax scheme that generally leave each person better off and no one worse off.

The Pareto constraint ensures that all social programs will create net social gains by supplying such public goods as defense, courts and roads—but it also says little about the distribution of those gains.

Ideally, to stabilize the political environment, those gains should be fixed across individual citizens in proportion to their own investment in the system, so that each person gets the same return on public investments as on private ones.

This regime creates the minimum disconnect between public and private investments. It also reduces wasteful political competition for a larger fraction of the gains from cooperative activities, and thus tends to maximize the total gains from collective schemes, while honoring an entrenched notion of fairness that holds that no person should get a disproportionate share of the gain from well conceived social adventures.

It furthermore simplifies the administration of any income tax because there is no longer any need to put into place complicated rules against income-splitting between parties or income-shifting over time, which are commonly used to minimize the brunt of the flat tax.

To be sure, by design, any flat tax necessarily increases the absolute differences in wealth between given individuals.

Consider a program in which a social improvement worth $220 is funded by $110 in taxes. The person who pays $10 in taxes ends up with $10 in gains. But the person who puts in $100 ends up with $200 in gains. Hence the absolute gap in wealth rises rises from $90 to $180.

Yet from a dynamic point of view, these economic consequences are not as stark as they seem. The absolute increase in the size of this gap assures that those persons who do make it up the income ladder will continue to garner an ever larger fraction of the social surplus that comes from their own larger contribution.

Nor, critically, are distributional consequences of this tax regime as dire as these simple numbers suggest.

First, the only feasible tax base comes from some combination of income and wealth. But most people attach equal or greater weight to their *non-pecuniary assets*, such as personal happiness, health and family satisfaction, than to their financial ones. But those former ones are beyond the power of any government to tax.

The distribution of such non-pecuniary assets (which depends only in part on economic wealth) is much tighter than the distribution of wealth. Thus, consider the distribution of gains in life expectancy over time across all income levels—it has increased roughly from 47 years in 1900 to about 76 years in 2000.

More specifically, increases in life expectancy for the black population has averaged 35 years for men and 41 years for women, compared to increases in the white population of 28 years for men and 31 years for women.

Those gains are not concentrated in the top one percent. Though it is still better to be rich than poor when it comes to longevity, the gains are widely distributed through the population.

It is not as though the rich can now live to be 200 years old. Similarly, simple vaccines and medicines available to no one in 1900 are widely distributed today, so that the increase in life expectancy is paralleled by a decline in morbidity for all groups of the population.

Second, the exclusive focus on income received ignores the importance of consumer surplus—the amount by which people value goods over the price that they pay for them. In other words, billionaires like Jeff Bezos, Bill Gates, and Mark Zuckerberg get only a small fraction of the social gains produced by their innovation.

The lion's share goes to the ordinary people who access new technologies or buy low-cost goods at a fraction the total value that they receive from those products. Yet those gains, because not realized in cash, are systematically excluded from the overall social calculus.

Third, for technical reasons, the traditional measures of income inequality overstate gaps between the rich and the poor. The distribution of income and consumption are not identical.

There are major formal and informal income transfer systems—notably charitable giving and intra-familial transfers—that typically narrow the consumption gap between top and bottom.

Indeed, that result still holds under a flat income tax devoted exclusively to public goods, because it is highly doubtful that a person who earns $1,000,000 in income each year gets 100 times the benefit from public expenditures as a poor person.

The egalitarian position emphasizing growing income inequality has given rise to the current discontent. Philosophically, the initial function of taxation and regulation has shifted from *maximizing* the size of the pie to *minimizing* the gap between rich and poor individuals.

The strongest justification for that position is that it takes advantage of the diminishing marginal utility of wealth, which holds that redistribution can improve social utility even when, by design, it reduces social wealth. The great risk of this approach is that the resulting social losses could be steep.

To take a variation of the original example, the egalitarian could, in principle, support a social change that reduces the wealth of the rich person from $100 to $70 if it increases the wealth of the poor person from $10 to $11.

Few people would wipe out $30 worth of wealth from one person in order to add $1 in wealth to another. But the challenge for the egalitarian is to offer some general approach for how wealth should be transferred by taxation (as opposed to charity). This is hard to do because no one knows how quickly utility diminishes with wealth.

The preferred approach, therefore, is first to try to minimize social losses by seeking to give poorer people a larger share of the gains from sensible social projects. But doing so turns out to be far more difficult than expected. Increasing progressivity risks hampering wealth creation.

Lowering taxes somewhat should produce higher levels of growth but lower levels of redistribution. The political tendency, therefore, is just what we observe: locking the individual tax rates where they are, and seeking to get social gains by lowering corporate rates and deregulating other areas of the economy.

Indeed, the first order of tax reform is to make sure that the individual tax rates do not become more progressive. But a bolder and more sensible program is one that cuts top marginal rates in order to stimulate growth increases that will counteract the wage stagnation at the bottom.