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# TAXATION AND INEQUALITY

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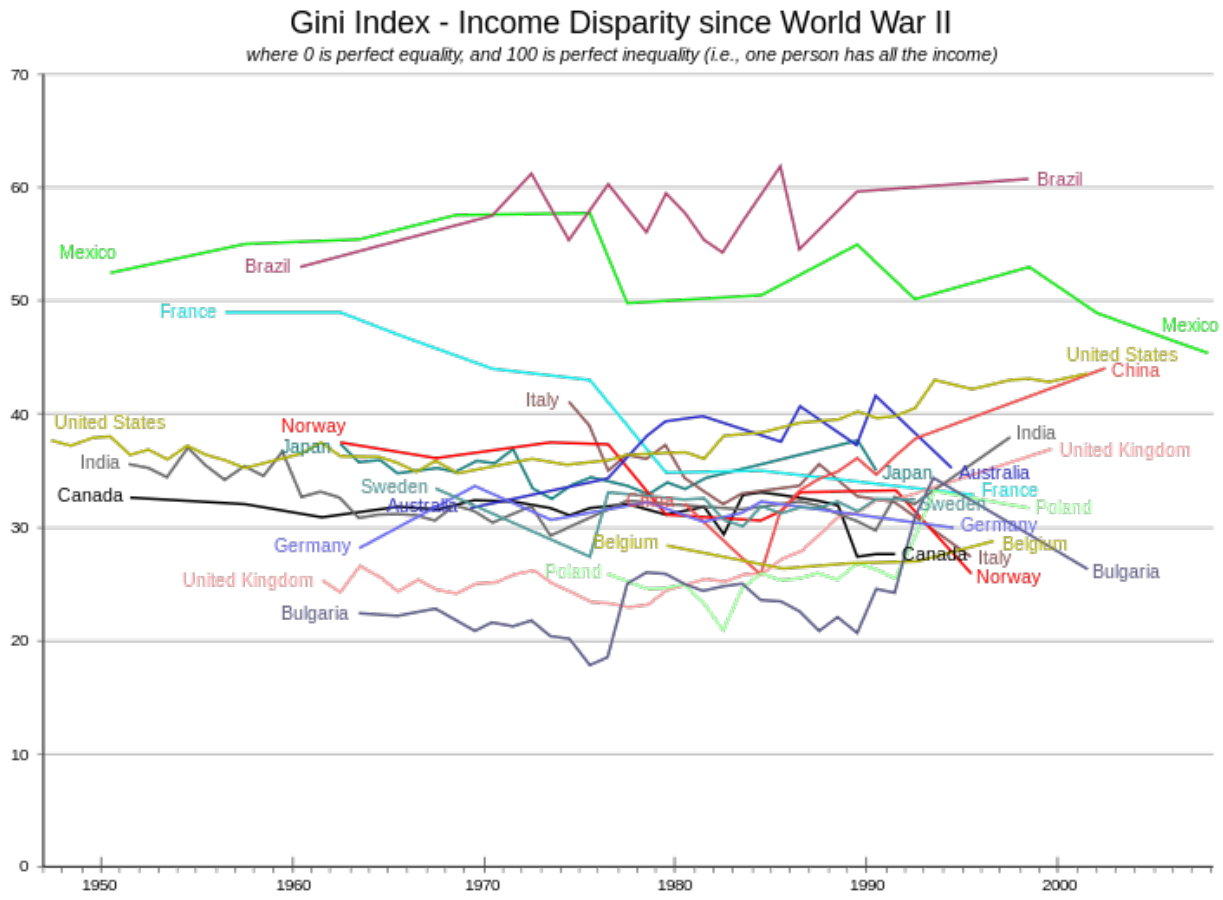
## ABSTRACT

The United States currently has one of the highest levels of inequality in the OECD, as measured by the Gini coefficient before taxes and transfers. In addition, numerous scholars have shown that social mobility in the United States is significantly lower than it was in the period between 1945 and 1970, when inequality was also declining. The combination of these trends is dangerous because it risks transforming the US into a society where small elites capture most of the gains, a pattern in which growth cannot be sustained over time (Acemoglu and Robinson 2012, Zingales 2013). The level of inequality in the US after taxes and transfers are taken into account is much lower, but it is still higher than in most OECD countries and the trend is still for inequality to increase. This paper explores how the US tax system can be used to counter these trends and concludes that the key is not to increase taxes on the rich (although some reforms in this direction can be adopted), but instead to adequately fund and even strengthen the social safety net. The only way to do this in the medium to longer term is to adopt a VAT.

The United States currently has one of the highest levels of inequality in the OECD, as measured by the Gini coefficient before taxes and transfers. The US Gini coefficient before taxes is 0.49, measured on a scale in which 100 is perfect inequality (one person has all the income) and 0 is perfect equality. This is about as high as China (although China's Gini is rising faster than the US) and lower than some developing countries like Brazil. But it is higher than most of the other members of the OECD, and it is also higher than many developing countries (e.g., India).

Table 1

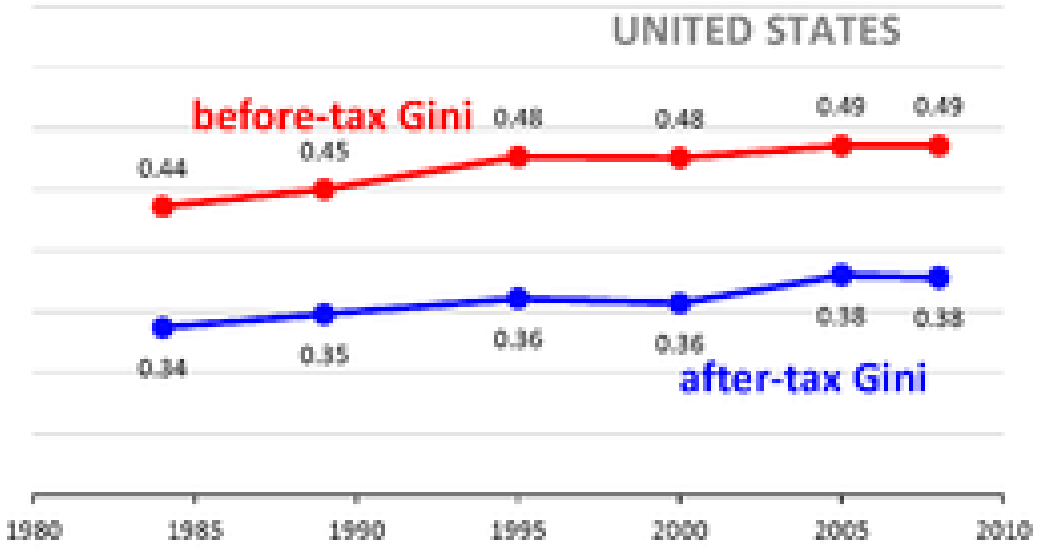



This level of inequality would not matter if social mobility in the US were high, because in that case every US child could achieve the "American dream." However, a recent OECD study pointed out that "[m]obility in earnings across pairs of fathers and sons is particularly low in France, Italy, the United Kingdom and the United States, while mobility is higher in the Nordic countries, Australia and Canada." (OECD 2010, p. 183). The US ranked third from the bottom among the twelve countries studied. The main reason was that the US ranked first in the influence of parental background on student achievement in secondary education (OECD 2010, Fig. 5.3). In general, the OECD found that intergenerational social mobility tends to be lower in more unequal societies (OECD 2010, Fig. 5.10).

Numerous scholars have shown that social mobility in the United States is significantly lower now than it was in the period between 1945 and 1970, when inequality was also declining (Frank, 2014). The combination of these trends is dangerous because it risks transforming the US into a society where small elites capture most of the gains, a pattern in which growth cannot be sustained over time (Acemoglu and Robinson 2012, Zingales 2013). As Acemoglu and Robinson demonstrate, societies with "extractive" institutions tend to stagnate in comparison with societies with "inclusive" institutions. Moreover, as Zingales points out, the US used to be more inclusive but is now becoming more extractive as established elites use their financial resources to lobby for and capture economic rents. A classic example is the tax treatment of the labor income of hedge fund managers as capital gains taxed at half the rate.

How does taxation enter into the picture? The level of inequality in the US after taxes and transfers are taken into account is much lower, although it is still higher than in most OECD countries and the trend is still for inequality to increase:

Table 2



The striking fact visible in the data above is that the trend line is the same from 1984 to 2008, i.e., the Gini coefficient moves more or less in parallel before taxes and transfers and after taxes and transfers are taken into account. This pattern suggests that while the US tax and transfer system clearly has a progressive impact as a whole, the impact is probably due more to transfers than to taxes.

This conclusion is surprising because compared to other countries the US relied heavily for revenues on individual income taxes throughout the relevant period, and those taxes are quite progressive. In 2001, the top 1% of the US population by adjusted gross income paid 33.89% of federal personal income tax, and the top 5% paid 53.25% (by comparison, the bottom 50% of the AGI distribution paid less than 4% of total income taxes collected). This is a significant increase from 1994, when the top 1% of taxpayers only paid 28.7% of federal personal income tax. In 2004, even after President Bush's tax cuts, the top 1% still paid 32.3% of federal individual income taxes and the top 5% paid 53.7%. In 2008, the top quintile paid 94.6% of federal individual income taxes, the highest percentage since 1979 (IRS 2013).

Given this level of progressivity, it is striking that the US Gini after taxes increased steadily during the entire period from 1983 to 2008, in parallel to the before tax GIni. Moreover, if one examines the movements of the top individual tax rate in that period, one can see quite dramatic fluctuations: It went from 50% in 1983 down to 28% in 1986, then gradually up to 39.6% in 1993, then down to 35% in 2001, and back to 39.6% in 2012. The capital gains rate went up from 20% in 1983 to 28% in 1986, then down to 20% in 1997, then down again to 15% in 2003, and up to 20% in 2012. None of these changes seem to have made an impact on the after-tax Gini.

Thus, while I have advocated increased taxation of wealthy individuals, and especially raising the capital gains and dividend tax rate back to where it was in 1986, I do not believe that answer to increasing inequality is more progressive income taxation. High rates of income taxation raise familiar problems such as increased tax avoidance, choosing leisure over labor, and potentially emigrating to low-tax jurisdictions (Avi-Yonah, 2013). While the US top individual tax rate is lower than that in some OECD countries, those countries typically have lower rates on capital income, which is highly concentrated at the top of the income distribution. This fact suggests that the US does not have a lot of capacity to raise the tax rate on the rich further in a globalized world; certainly the 70% top marginal rate of 1980, or the 94% tax rate of the 1950s, appear unlikely to return when the rich can easily move to other countries, give up their US citizenship, and enjoy much lower rates.

But there is little doubt that the US tax and transfer system has a very significant impact on inequality: It reduces the US Gini by about 10 points, which is more than the difference between the pre-tax Gini of the US and Sweden. So if it is not the progressive tax system that does the work, what does? The answer must be the much-maligned "entitlements": Social Security, Medicare and Medicaid. These programs are very progressive because while only Medicaid is means tested, their benefits are more important to the poor, while the funding comes from progressive taxation of labor income (although in the case of Social Security the funding could be made more progressive by eliminating the income cap).

Thus, the key to reducing inequality in the US is to bolster the social safety net. We should at least maintain current benefits and possibly increase them. In particular, Social Security should be

strengthened since most baby boomers do not have nearly enough saved for retirement (and many have seen their savings decimated by the Great Recession). The Affordable Care Act has strengthened health care, but it will probably require more funding to support insurance for persons with pre-existing conditions and the poor if not enough young, healthy people sign up for the exchanges.

Moreover, strengthening the social safety net is important to sustaining growth. Open economies tend to have stronger safety nets, because the gains from having an open economy tend to impose risk on the people who lose from globalization, so that a strong safety net is in a democracy a precondition to obtaining widespread political support for openness, which in turn produces growth (Avi-Yonah, 2000). Thus, if we want to avoid the pattern that led to the end of the first era of globalization a hundred years ago, we need to maintain a strong safety net lest the US public vote for protectionism, decreased immigration, and less tolerance for the "creative destruction" of technologically inspired growth.

How can the US safety net be financially sustained in the long run? The answer cannot be more deficit financing, for two reasons. First, this just means passing the buck to our children, which seems both unfair and risky: As the population ages the number of working age adults to seniors (the dependency ratio) will decline in the US as it already did elsewhere, unless we are willing to accept much more immigration, which carries its own risks (Collier, 2013). Second, much of the US Treasury debt is held by China, and that is exactly how the UK lost its position as a great power after World War II: Too much of its debt was held by the US, which was able to dictate terms.

Nor is the answer raising the income tax. There are not enough rich people to support the safety net, and as stated above the rich can adjust to higher rate by avoiding taxes, working less, or moving. Nor would it be wise to increase the income tax on corporations (they can move even more easily than the rich) or on the middle class, since they already carry heavy burdens and cannot afford to bear the entire load (Warren and Tyagi, 2003).

Another reason why the social safety net cannot be financed by increased taxes on labor (either income or payroll taxes) is inter-generational equity. The benefits of Social Security and Medicare flow to the old, while income and payroll taxes are borne by the young. In addition to the dependency ratio concerns raised above, it seems unfair (and will certainly appear so to many young voters) to transfer so much from the young to the old.

Thus, in my opinion the only solution is to enact a Value Added Tax (VAT). This proposal has been developed in detail elsewhere (Avi-Yonah, 2010). For present purposes, a VAT has an important advantage: Unlike income and payroll taxes, consumption taxes do not discourage work, and because the old as well as the young consume, they are borne in significant part by the principal beneficiaries of the social safety net. In addition, VATs are used in over 150 countries and have a demonstrated capacity to raise revenues even with far weaker tax administrations than the IRS.

The main objection to a VAT is its regressivity. But Social Security, Medicare and Medicaid are inherently progressive programs: They benefit the poor much more than the rich. Enacting an additional consumption tax on top of the existing income and payroll taxes is not a move toward a regressive tax system if the revenues are dedicated to funding the entitlement programs. After the financial crisis,

most baby boomers do not have nearly enough savings for retirement. Cutting benefits and raising the retirement age are the wrong way to deal with people who have worked their entire life with the expectation that these programs will provide in their old age. But we cannot put the entire burden on the young. A broad federal consumption tax is the only fair way forward, and it will go a long way toward reducing the inequality that threatens our future.

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