Reflections on Taxation in Support of Redistributive Policies

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The fundamental role of tax policy is to raise revenue to finance expenditures. This may seem like a truism, but much of a discussion nowadays is framed around an alternative, corrective, role of taxation. In this note, I discuss what (I believe) focusing on the revenue role of taxation implies for policy instruments that U.S. policy makers should consider when embarking on funding any expansion of the welfare state.

The line between spending and taxation is not always bright – Earned Income Tax Credit operates through the tax code but is a form of a transfer program, and "tax expenditures" encompass many types of tax breaks that are economically close (and sometimes equivalent) to direct spending. The United States falls on the side of strong reliance on tax expenditures. For example, tax preference for employer-sponsored health insurance appears to be a tax break, but subsidizes health spending similarly as direct subsidies might.

Issues like this make looking at progressivity of the tax code in isolation, without thinking about the spending side, incomplete and potentially misleading. Even more so, focusing on progressivity of any single tax instrument is not particularly appealing. For example, a carbon tax by itself is likely mildly regressive but a carbon tax coupled with carbon dividend is progressive. A carbon tax compensated by changes in income taxation to offset its regressivity could be even more progressive. For these reasons, I (and many other economists) tend to think about progressivity of the tax and transfer system as a whole rather than progressivity of each individual piece separately.

With that in mind, I will take as given that there are desirable ways to spend that would have strong progressive aspect to them. Some that I find particularly appealing include investments in children, especially in early childhood interventions; direct (preferably with no strings attached) transfers to the most needy; or addressing looming problems with financing of Social Security and Medicare. Such progressive forms of spending require financing.

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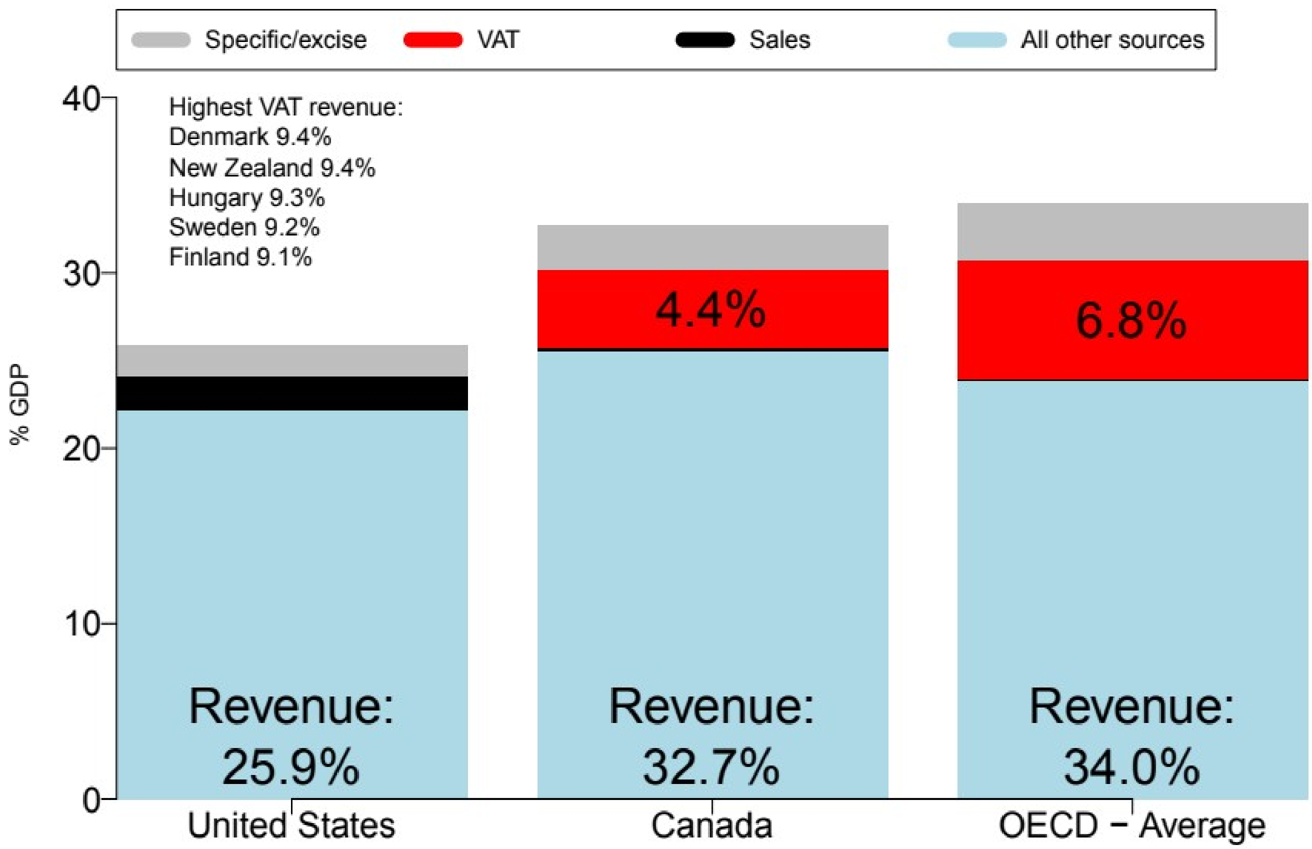
Taxation elsewhere

One way to think about how to raise funds is to think about taxes that don't yet exist. The other one is to look at what countries that raise more money and spend it much more progressively than the U.S. do. These two approaches happen to lead to the same place: the Value Added Tax (VAT).

I will rely on the data from the OECD (2019) for 2016. It will not surprise anyone that the U.S. collects less revenue than the OECD average – 25.9% of GDP (accounting for all layers of the government), relative to 34% on average among the OECD countries. The neighboring Canada collects 32.7%. What accounts for this 8.1% (relative to OECD) or 6.8% (relative to Canada) difference? The elephant in the room is the VAT. OECD countries collect on average 6.8% of GDP using this tax. Canada relies on it relatively weakly – just 4.4%. Some countries – Denmark, New Zealand, Hungary, Sweden, Finland collect more than 9%.

Figure 1: The role of VAT, sales, and excise taxation

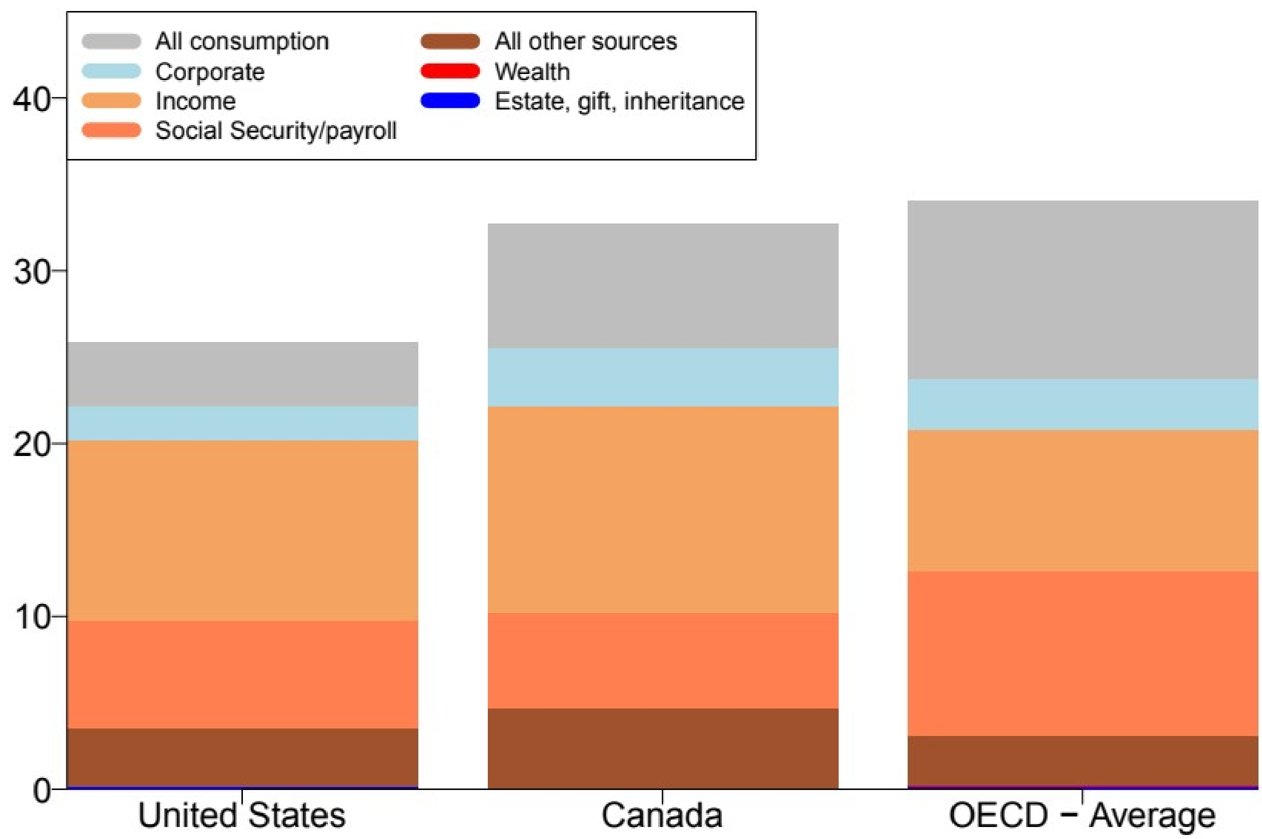


Source: Data for 2016 from OECD (2019)

This is interesting by itself because VAT is not a very progressive instrument. It is a tax on consumption imposed mostly at a flat rate, though often accompanied by preferential rates on some goods and by exemptions. A flat tax on consumption might be neither progressive nor regressive if the base is comprehensive and one takes a very long term view (a short term perspective would render consumption taxes less progressive than an income tax, because propensity to consume varies with income). Practical implementations though often leave some forms of consumption out for a mix of administrative and policy reasons. Often (though to a varying degree) this includes health care, education, parts of housing consumption, charity, all of which likely push toward regressivity. Such exemptions are not inevitable – New Zealand taxes over 90% of consumption at statutory rate through VAT (OECD 2018, Table 2.A.7) – but are common (the average OECD country collects 55% of what a hypothetical comprehensive consumption tax would collect at a statutory rate). Exemptions of necessities may partially compensate for that, but there is obviously a tradeoff between base and revenue. At the end of the day VATs are at best mildly progressive and yet countries with much more progressive spending patterns than the US rely on them heavily.

If not VAT, then perhaps there are other components of the tax system that are much more progressive? As Figure 2 illustrates, the US raises more revenue through personal income and corporate taxes than the OECD average and a little bit less than Canada. This suggests that there may be opportunities to raise more through these taxes and I will comment on some priorities below. Still though, the US is not out of line in its reliance on personal income and corporate tax and even reductions after 2017 reform will not change this pattern.[i]

Figure 2: Composition of revenue



Source: Data for 2016 from OECD (2019)

The third large, next to consumption and income taxes, category of taxation are payroll taxes that predominantly fund social insurance programs. Relative to the OECD average, the US relies less on payroll taxes, and it uses them a bit more than Canada does. Payroll taxes are a close cousin of consumption taxation – in fact, there is a theoretical similarity between the two, because both are imposed on the present value of earnings and consumption which should be equal to each other absent additional considerations. The additional considerations here are interesting. A new tax on consumption taxes consumption out of pre-existing wealth, so that it is effectively a one time tax on wealth. A tax on consumption taxes consumption out of supernormal returns, something that a payroll tax does not. Both of these suggest that payroll taxation is even less progressive than consumption taxes and yet countries with much more progressive policies than the U.S. rely heavily on this form of taxation.

Finally, the newcomer on the U.S. political agenda – a wealth tax – plays virtually no role anywhere.

Clearly, pursuing redistributive policies does not necessarily require that all of the tax code needs to be progressive. In fact, I hope that this discussion makes it clear that countries that pursue much more redistributive policies than the U.S. get there by raising a lot of revenue through means that are at best mildly progressive and rely on very broad bases that involve taxing all individuals. Given that the U.S. already has a decent reliance on the payroll tax, that leaves VAT as the major revenue source that could bring the country in line with patterns seen elsewhere.

Why are VAT and payroll tax so important as revenue raisers? Economists (with some notable exceptions) have not been traditionally too concerned with administrative issues, but this is exactly where these revenue sources shine. By involving businesses and leveraging arm's length transaction either between employers and employees or between businesses, these are contexts that naturally give rise to ability to institute well-functioning information reporting regimes that make tax evasion hard. Furthermore, by taxing well-defined and broad bases, policy makers reduce opportunities for tax avoidance.

Fixes to existing U.S. taxes

The VAT is the missing piece of the U.S. puzzle of tax policy that, in my view, is necessary to consider as a way of financing any large increases in government spending. It is not, of course, the only reform worth considering. Given political focus on inequality at the top, what are the options there?

The 2017 reform had a number of provisions that were questionable. I will highlight one that was costly, regressive and with little economic justification: a 20% income tax deduction for qualifying pass-through businesses. Repealing this one should make a bucket list of immediately possible tax changes. Beyond fixing some of the most egregious loopholes and tinkering with marginal tax rates, what are the other major reform direction?

I am doubtful that wealth tax is a good idea, for both economic and administrative reasons. I'm skeptical, especially given experience elsewhere, about its revenue-raising possibilities. I am not convinced that its the best tool (or even a good one) for addressing political power, dynastic wealth, monopoly power, or other sources of rents. In each of these cases, there are alternative direct instruments – political reform, estate tax, anti-trust policy, or capital taxation. I provide a longer discussion of these issues in Kopczuk (2019).

Although I am skeptical of desirability of a wealth tax, the estate and gift tax system is important for limiting intergenerational transfer of inequality. Broadly speaking, weaknesses of the existing estate and gift tax system follow from four problems. First, valuation is difficult and uncertain.[ii] Second, interaction with income and especially capital gains taxation has major problems. Third, treatment of charity creates avoidance opportunities. Fourth, gift and estate taxes are integrated, but in a very imperfect fashion.

The estate tax is not and is unlikely to ever be a major source of revenue. Still, addressing some of the valuation problems and better integration of gift and estate taxes are important issues if one wants to make this particular part of the tax system work better.

Problems with capital gains taxation and charity, on the other hand, extend well beyond the estate and gift tax context. In my view, these are two of the largest weaknesses in the existing U.S. personal income tax system. The fundamental problem with capital gains taxation, as currently implemented, is that it is based on realization: capital gains are taxed when sold. Deferral by itself creates a disparity between capital gains and other forms of capital income that are taxed on accrual and thus creates an advantage to represent income in tax advantaged form.

A particularly pernicious form of deferral is step up in basis at death: assets held until taxpayer's death avoid capital gains taxation altogether (see Kopczuk, 2017 for a discussion). This is not a rational policy – in fact, it appears that it originally happened without much foresight, effectively by administrative mistake (Zelenack, 2018) – and it has obvious alternatives of constructive realization of capital gains at death or carryover of the original basis. The availability of step up makes capital gains revenue-maximizing rate lower than it would be otherwise, partially explaining why taxing them at rates equal or at least much closer to personal income tax rates is controversial. Eliminating step up is an obvious first step up in improving taxation of capital gains.

The second direction is to weaken deferral advantage. There are ways to defer taxation even when there are natural realization events (eg., like-kind exchanges) that serve no good economic purpose. Separately, some assets can be relatively easily taxed on accrual basis. The difficulty and the reason for taxing realizations is two-fold: lack of valuation and liquidity. Most obviously, publicly-traded assets can be taxed on accrual (mark-to-market), because regular valuation is straightforwardly possible. Extending accrual-based taxation to assets where regular valuation is possible is a natural reform direction. When valuation is not possible or when liquidity is an issue, there are two alternative solutions. One is to accrue a notional tax liability to be settled at realization. Another one is to implement a form of "retrospective capital gains taxation" (Auerbach, 1991) that eliminates the deferral advantage.

The existing capital gains tax rules also interact with charity. A gift of appreciated capital gains to a charity has two tax benefits. First, it is another way to escape capital gains taxation. Second, despite the lack of tax recognition of income, it can still be used for the purpose of claiming a charitable deduction for personal income tax purposes. This is an egregious policy with no good purpose.

However, beyond this particular issue, there are many other questionable aspects of treatment of charitable contributions. On the tax side, charitable contributions give rise to personal income and estate tax deductions. The value of these deductions is a function of marginal tax rates so that higher income taxpayers receive a higher marginal tax subsidy for their contributions to charity. It is hard to think why a subsidy to contributions to a public good should depend on who makes the gift (Schizer, 2015). A more rational system, that would still subsidize giving, would replace a deduction by a tax credit. This does not exhaust tax-related problems with charity though. Some of income and estate tax planning involves structuring gifts to charity in a tax-advantaged fashion (eg. charitable remainder trusts). Many charitable gifts blur a line between private and public, because they involve benefits to donors – it applies to gifts that come with influence over future direction of a charity (eg., board memberships), non-pecuniary benefits from controlling a foundation, gifts to universities that may involve prestige or benefits to children, conservation easements that may benefit neighboring properties etc. It is also not clear why society should direct its scarce subsidy dollars to particular (even if desirable) pet causes favored by rich donors. Finally, and going beyond charity to a more general ecosystem of tax exempt entities, the existence of tax exempt entities creates arbitrage opportunities (eg in the context of carried interests) and potential tax responses (eg. one reason for having an entity-level corporate tax is to guarantee taxation of otherwise nontaxable investors). I do not have answers for how exactly charity should be reformed in the U.S., but we are long overdue for rethinking this important aspect of public policy.

Conclusion

Financing redistributive policies elsewhere is done by heavily relying on taxes that are not very progressive: payroll taxation and VAT. The U.S. does not have a VAT and I find it hard to imagine significant increases in government spending without introducing it. There is also, obviously, room for some changes in the rates of existing taxes. What I find more appealing though are changes to existing taxes that would simultaneously raise revenue and improve fairness and coherence of the U.S. tax system. Chiefly, they involve reforming how capital gains are taxed to reduce possibilities for deferral and changing treatment of charity.

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i As an aside, thinking about income and corporate taxes together for the purpose of such comparisons is appropriate because countries vary with respect to the breadth of their corporate income taxes: in particular, the US taxes unusually large share of business incomes through personal income tax (pass-through businesses) making its corporate tax appear smaller than such taxes elsewhere.

ii This a weakness shared with wealth taxation too, though taxation at death when assets change hands anyway should make valuation easier, because estate disposition often involves valuation anyway.