

The Pragmatic Case for Reducing Income INEQUALITY

BY ROBERT H. FRANK

When Hillary Clinton, John Edwards, Barack Obama, and other advocates of a stronger social safety net ground their arguments in moral terms, their case is solid. But moral arguments alone are often insufficient to persuade affluent voters to accept higher taxes. Here I will argue for an expanded social safety net on purely pragmatic grounds. As I will explain, a more effective safety net would benefit not only the low-income citizens who receive services from it directly, but also the more affluent citizens whose higher tax payments would be necessary to support it. The reason is that income inequality has prevented us from adopting efficient solutions to many problems that affect rich and poor alike.

A case in point is the regulations on auto emissions we adopt to promote cleaner air. Because these regulations increase car prices, legislators in most jurisdictions exempt older vehicles to avoid imposing unacceptable costs on the mostly low-income motorists who drive them. Yet the cost to society of this exemption far outweighs its benefit for the poor.

For example, although fewer than 10 percent of the vehicles in Los Angeles are more than 15 years old, these cars account for more than half the smog. Exempting old cars thus necessitates much stricter regulations for new ones. But the cheapest ways of reducing emissions from new cars have long since been adopted. Meeting air quality targets by further tightening new-car standards is several times as costly as meeting those targets by eliminating the exemption for older vehicles.

By raising taxes on high-income motorists, the government could pay for vouchers that would enable low-income motorists

to scrap their older vehicles in favor of cleaner used cars of more recent vintage. The required taxes would be much smaller than the resulting savings from not having to adopt such costly standards for new vehicles. Both rich and poor motorists would win.

If everyone could be made better off by the policy change just described, why hasn't it been implemented? In recent decades, potent anti-government rhetoric has made it difficult even to discuss such proposals, let alone adopt them. This rhetoric rests on two claims that anti-government conservatives hold to be self-evident. One is that government spending is always and everywhere wasteful, the other that it is morally illegitimate for the state to transfer resources from rich to poor.

A proposal to levy higher taxes on the affluent to pay for a vehicle buyout program for the poor runs up against both claims. If I were running for office and made such a proposal, conservatives would pounce. They might say, "Frank thinks the

bureaucrats in Washington know how to spend your money more wisely than you do!" Or, "You worked hard for your money. You can make charitable contributions if you want to, but the government has no right to take your money by force and give it to the poor!" With voter opinion increasingly shaped largely by 15-second sound bites, these have proved extremely difficult slogans to run against.

Yet the claims on which these slogans rest are shaky at best. Government is often wasteful, yes, but so are actors in other sectors. For example, the privately organized health insurance system in the United States delivers worse outcomes at substantially higher cost than the government-managed single-payer systems in virtually every other industrial country. But proposals to adopt a single-payer system would require higher taxes and increased benefits for low-income citizens, steps that reliably unleash the full power of anti-government rhetoric. ("Socialized medicine!!") So for now, we remain saddled with a system that everyone agrees is dysfunctional.

The claim that taxpayers have a moral right to spend their pre-tax incomes as they see fit also has considerable rhetorical force. But it, too, collapses under scrutiny. If government couldn't compel tax payments under penalty of law, there could be no government. With no government, we would have no army. In short order, we would be invaded by some other government's army and then be compelled to pay taxes to that government.

All countries have governments with the power to compel tax payments. Under our constitution, citizens have the right to spend their *post-tax* incomes as they see fit, provided they do not violate the law. But our elected representatives are empowered to vote on what services the government should provide and how taxes should be collected to pay for them. It is ridiculous to insist that the government has no right to tax and transfer.

The real question isn't whether the government knows how to spend our money more wisely than we do. Rather, it's how we as a society want to apportion our scarce resources between public and private spending. As our current practices in the health care and emissions regulation domains demonstrate clearly, the insistence that government cannot tax and transfer often prevents us from achieving outcomes that would be better for every citizen.

Similar examples abound in other domains. In the realm of antipoverty policy, for instance, most economists agree that raising the earned-income tax credit would be the most efficient way of increasing the living standard of the working poor. Barack Obama, John Edwards, and Hillary Clinton propose to expand this program aggressively. The program employs general tax revenues to support income subsidies to those whose earnings fall below a given threshold. Its compelling advantage is that, unlike a higher minimum wage, it does not discourage hiring. But proposals to increase the earned-income tax credit would require higher taxes on the affluent.

Because the most efficient antipoverty policy is deemed politically unfeasible, many economists supported the 2007 legislation that raised the minimum wage for the first time in a decade. But this was less than a complete victory for the working poor. For unlike an increase in the earned-income tax credit,

an increase in the minimum wage not only limits job creation for the least-skilled workers, it also raises the prices of goods they produce. Overall, it would have been cheaper to raise the earned-income tax credit.

Anti-government rhetoric has also prevented the adoption of energy policies that would produce better outcomes for all. For example, economists of all political stripes have argued that a stiff tax on gasoline would relieve traffic congestion, reduce greenhouse gases, accelerate the development of energy-saving technologies, and reduce dependence on foreign oil. But it would also impose significant economic hardship on low-income families, making it necessary to increase transfer payments to those families. Both the tax on gasoline and the transfers to low-income families, however, are prime targets for anti-government rhetoric. ("Social engineering!!") So gasoline taxes continue to be far lower in the United States than in other industrial countries.

Whatever else it may have accomplished, potent anti-government rhetoric of recent decades has sharply lowered the income tax rates on the nation's wealthiest families. It is an iron law of politics that when an interest group wins favorable treatment from the government, it will fight bitterly to protect its gains. Accordingly, the prospect of making the tax system more progressive to pay for an expanded social safety net may seem naive.

Yet a careful reading of the evidence suggests that even the wealthy have been made worse off, on balance, by recent tax cuts. The private benefits of these cuts have been much smaller, and their indirect costs much larger, than many recipients appear to have anticipated.

On the benefit side, tax cuts have led the wealthy to spend more money, in the seemingly plausible expectation that doing so would make them happier. As social scientists increasingly recognize, however, well-being depends less on how much people consume in absolute terms than on the social context in which consumption occurs. As the economist Richard Layard has written, "In a poor country, a man proves to his wife that he loves her by giving her a rose, but in a rich country, he must give a dozen roses." The rich are spending more, but the effect has often been just to raise the bar that defines adequate.

On the cost side of the ledger, the federal budget deficits created by the recent tax cuts have had serious consequences, even for the wealthy. For example, they have led to cuts in federal financing for basic scientific research that threaten the very basis of our long-term economic prosperity.

Large deficits also threaten our public health. Thus, despite the increasing threat from micro-organisms like *E. coli* 0157, the government inspects beef processing plants at only a quarter the rate it did in the early 1980s. Poor people have died from eating contaminated beef, but so have rich people.

Citing revenue shortfalls, the nation postpones maintenance of its highways and bridges, even though doing so means having to spend two to five times as much on repairs in the long run. Poor people died when the I-35 bridge over the Mississippi collapsed in Minneapolis in August, but so did rich people.

Deficits have also compromised the nation's security. In 2004, for example, the Bush administration reduced financing for the Energy Department's program to secure loosely guarded

nuclear stockpiles in the former Soviet Union by 8 percent. And despite the rational fear that terrorists may try to detonate a nuclear bomb in an American city, most cargo containers are not inspected before they enter our nation's ports.

To their credit, the leading Democratic presidential aspirants have proposed allowing Mr. Bush's tax cuts for top earners to expire as scheduled. That step alone, however, won't be nearly enough to put our fiscal house in order. But is it reasonable to expect more sweeping changes, in light of the obvious political risks of proposing painful tax increases in an election year?

Actually, a surprisingly simple remedy is at hand. By replacing federal income taxes with a steeply progressive consumption tax, we could erase the federal deficit, stimulate additional savings, pay for valuable public services, and reduce overseas borrowing—all without requiring difficult sacrifices from taxpayers.

Under such a tax, people would report not only their income but also their annual savings, as many already do under 401(k) plans and other retirement accounts. A family's annual consumption is simply the difference between its income and its annual savings. That amount, minus a standard deduction—say, \$30,000 for a family of four—would be the family's taxable consumption. Rates would start low—say, 10 percent. A family that earned \$50,000 and saved \$5,000 would thus have taxable consumption of \$15,000. It would pay only \$1,500 in tax, about half what it pays under the current tax system.

As taxable consumption rises, the tax rate on additional consumption would also rise. With a progressive income tax, marginal tax rates cannot rise beyond a certain threshold without threatening incentives to save and invest. Under a progressive consumption tax, however, higher marginal tax rates actually strengthen those incentives.

Consider a family that spends \$10 million a year and is deciding whether to throw a \$2 million coming-of-age party for its daughter. If the top marginal tax rate on consumption were 100 percent, the party would cost \$4 million. The additional tax payment would reduce the federal deficit by \$2 million. Alternatively, the family could scale back, throwing only a \$1 million party. Then it would pay \$1 million in additional tax and could deposit \$2 million in savings. The federal deficit would fall by \$1 million, and the additional savings would stimulate investment, promoting growth. Either way, the nation would come out ahead with no real sacrifice required of wealthy families, because when all spend less on parties, the result is merely to redefine what must be spent to mark a special occasion.

Without displacing any urgent private purchases, a progressive consumption tax would generate sufficient new revenue to fund Barack Obama's proposal to replicate the Harlem Children's Zone, creating Promise Neighborhoods in twenty cities across the country; to fund Hilary Clinton's proposal to create American Retirement Accounts for every citizen; and to fund John Edwards' proposal to create 1 million "stepping stone" jobs over the next five years.

A progressive consumption tax would also reduce the growing financial pressures confronting most families. Top earners, having received not only the greatest income gains over the last

three decades but also substantial tax cuts, have been building larger houses simply because they have more money. Those houses have shifted the frame of reference for people with slightly lower incomes, leading them to build larger as well. The resulting expenditure cascade has affected families at all income levels.

The median new house in the United States, for example, now has over 2,300 square feet, over 40 percent more than in 1979, even though real median family earnings have risen little since then. The problem is not that middle-income families are trying to "keep up with the Gateses." Rather, these families feel pressure to spend beyond what they can comfortably afford because more expensive neighborhoods tend to have better schools. A family that spends less than its peers on housing must thus send its children to lower-quality schools.

Some people worry that tax incentives for reduced consumption might throw the economy into recession. But total spending, not just consumption, determines output and employment. If a progressive consumption tax were phased in gradually, its main effect would be to shift spending from consumption to investment, causing productivity and incomes to rise faster.

Should a recession occur, a temporary cut in consumption taxes would provide a much more powerful stimulus than the traditional temporary cut in income taxes. People would benefit from a temporary consumption tax cut only if they spent more right away. In contrast, consumers who fear that they might lose their jobs in a recession are often reluctant to spend temporary income-tax rebates.

Failure to address the current fiscal crisis is not an attractive option. With baby boomers retiring and most voters now favoring universal health coverage, budget shortfalls will grow sharply. Annual borrowing from abroad, now more than \$800 billion, will also increase, causing further declines in the slumping dollar. And the personal savings rate, which has been negative for the last two years, will fall still farther, causing future reductions in economic growth.

The progressive consumption tax is perhaps the only instrument that can reverse these trends at acceptable political cost. It has been endorsed by a long list of distinguished economists of varying political orientations. It was proposed in the Senate in 1995 by Sam Nunn, the Georgia Democrat then serving his final term, and Pete Domenici, Republican of New Mexico, who called it the Unlimited Savings Allowance tax. In short, this tax is not a radical idea.

Although the Bush tax cuts for the nation's wealthiest families threaten American economic prosperity, they have done little for their ostensible beneficiaries. Even purely in terms of self-interest, they would have fared much better if the same money had been spent to repair our aging bridges. And they would fare better still if we replaced the federal income tax with a progressive consumption tax and used some of the resulting revenue to fund the safety net programs proposed by Clinton, Edwards, and Obama in this issue. ☆

Robert Frank is the Henrietta Johnson Louis Professor of Management and Professor of Economics at Cornell University.