

Four Goals of Tax Policy – Revisited

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Harvard economics professor Greg Mankiw articulated four goals that policy analysts consider when thinking about tax policy and systems ([link](#)):

1. **Efficiency:** The tax system should distort incentives as little as possible (and, in the case of externalities and Pigovian taxes, correct incentives when necessary).
2. **Intergenerational equity:** The tax system should raise enough revenue so current generations do not unduly burden future generations.
3. **Egalitarianism:** The tax system should try to achieve a more equal distribution of after-tax incomes.
4. **Stabilization:** The tax system should help maintain the economy at full employment.

If we're ever going to get the tax reform we need, we're going to have to rethink these goals. Allow me to take a crack at it.

EFFICIENCY

Our tax system has considerable flexibility. Well-meaning politicians, supported by voters and prevailing wisdom, make constant adjustments in tax laws and rules, all with the goal of correcting problems or encouraging behaviors. All good, right? Wrong.

Because our tax system has such flexibility, politicians are under constant pressure to grant exemptions, credits or deductions. Think of the “distorted incentives” that have evolved as a result:

- Wealthy and powerful interests are **highly motivated** to seek tax breaks. They spend vast sums on lobbyists, public relations efforts and political campaigns to secure favorable tax treatment from politicians. Their endeavors corrupt our political process. The benefits they receive are at the expense of ordinary taxpayers.
- Politicians are **highly motivated** to fulfill the tax break requests of the wealthy and powerful. Each time they do, their own power and influence grows, as does their resilience at the polls, which is funded generously by the interests they serve. There are politicians who resist these pressures, but they are few in number and tenuous in job security.

- Ordinary taxpayers are **highly motivated** to protect any perceived tax benefits they have. Over time, politicians have addicted them to the current system with credits and deductions, which they fight to keep at all costs. As a result, few taxpayers will support meaningful reform if it affects “their tax break” – witness the complaining at the prospect of no deduction for mortgage interest.
- All taxpayers are **highly motivated** to see their tax burden shifted to others. They know politicians have the power to accommodate their demands. The result is a constant struggle over who pays taxes, which drives class warfare and vicious partisanship, all to the detriment of long-run political stability.

I recognize that being able to adjust the tax code to support worthy goals or curb undesirable behavior is enormously appealing. But in our political system, such flexibility has been abused greatly, with serious consequences. As they say, it’s nice to have a cocktail, but if you’re an alcoholic, you just can’t. So, as painful as it will be, we simply must purge flexibility from our tax code. Period.

I would thus restate Tax Policy Goal No. 1 as follows:

- 1) ***Efficiency.*** The tax system should be incentive-neutral. It should have no preferences, deductions or credits other than a single deduction to ensure that the poor pay no tax. Politicians should not have the flexibility to grant petitions from individuals or entities to have their taxes lowered at the expense of other taxpayers. Because the pressure to grant such petitions will be enormous, this inflexible, incentive-free tax code should be enshrined in a Constitutional Amendment so that it cannot be easily changed, as mere legislation can be today. In other words, “set it and forget it.”

INTERGENERATIONAL EQUITY

Well, that’s an appealing idea. Let’s borrow from future taxpayers to pay for spending today. This might be OK for roads and other infrastructure that will in fact be used by future taxpayers. But the reality is that borrowing from future taxpayers has gotten completely out of hand. Today, our federal and state government debt totals around \$9 trillion, more than \$79,000 per average U.S. taxpayer. If we include unfunded entitlements like Social Security and Medicare, the total is nearly \$70 trillion.

Politicians are borrowing to meet the demands of current voters because (1) they can and (2) there’s no political cost in doing so since future taxpayers can’t yet vote. The implications for intergenerational equity are profound. Soon, the delayed burden on future taxpayers will become so great that the long-term viability of our economy and democracy will be in serious question. We must not allow this happen.

So, I agree with the goal of intergenerational equity, but the wording of the goal, as Professor Mankiw has it, is far too weak. We need to make it a lot harder for the government to borrow. If current taxpayers want spending, current taxpayers should pay. How about this:

- 2) ***Intergenerational equity.*** Federal spending should be balanced with taxation. Increases in government spending, whether because of new spending or because prior commitments cost more than expected, should be offset with higher taxes. Only in a true emergency, which should require certification by a four-fifths vote of Congress and approval by the President, should borrowing be permitted. Because the pressure to borrow will be enormous, this balanced budget requirement should also be enshrined in a Constitutional Amendment. In other words, “no borrowing unless it’s really, really urgent.” (*N.B. – I recognize that the current level of deficit spending and debt will require phasing this in over time*).

EGALITARIANISM

It is the Holy Grail of much social policy. But just how egalitarian is our current, progressive tax code? Not very, I’m afraid. Let’s see how the rich are doing.

It is true that high marginal tax rates force some to pay a lot in taxes. Ask anyone with W-2 wage income how hard it is to avoid high taxes, particularly now that the Alternative Minimum Tax (AMT) hits so many.

But the really rich seem able to avoid paying high rates. Take Warren Buffett, one of the richest men in the world. He announced last year that he was taxed at 17.7 percent on his 2006 taxable income of more than \$46 million, while his receptionist was taxed at 30 percent. “I don’t have a tax shelter,” he declared, emphasizing that he paid his taxes in compliance with current tax law.

Mr. Buffett has long criticized the inequities of our tax system. I submit that a major source of the unfairness he disdains is the tax code’s complexity. The truly rich, who have skilled accounting and legal resources at their disposal, can take full advantage of this complexity. The result is that wealthy people like Mr. Buffett pay nowhere near the top marginal rate of 35 percent, while many less wealthy wage earners do. Raising tax rates, which some politicians claim is necessary to promote “egalitarianism,” will not affect the tax bills of the truly rich.

What about the poor? While Mr. Buffett is paying 17.7 percent, the average minimum wage worker is not paying much less. Take a hamburger flipper at McDonald’s. Including the share paid by his employer, he pays more than 15 percent in Social Security and Medicare taxes on the very first dollar he earns. Americans for Tax Reform says that “for three-quarters of Americans, Social

Security – not federal income taxes – takes the biggest bite out of every paycheck.” What’s egalitarian about any of this?

If we want egalitarianism in our tax code, we need to make some changes. First, let’s recognize that multiple tax rates don’t do much to ensure that the rich pay more. In fact, they encourage manipulation, as the rich work to keep their various sources of income (e.g., capital gains) taxed at lower rates. Instead, we need a single rate tax that replaces all other taxes, and we need to apply it to all incomes and income earners (individuals, companies, trusts, foundations, meg-churches, everybody) above a certain income level. No one should be able to manipulate their taxpayer status to avoid paying. And we need to set the exemption level so that the bottom 15 percent of taxpayers pay no tax. Adopting this reform will promote egalitarianism in the sense that taxpayers will feel that everyone is paying their fair share, and not less.

As an aside, a single rate tax will have an additional benefit. Thanks to the balanced budget requirement in (2) above, politicians will have to vote either to cut spending or raise the tax rate, which will provide single-point accountability that voters can understand and measure. Multiple increases in the tax rate to cover higher expenditures should create a broad and powerful constituency for spending reform.

Now, many will claim that a single rate tax is insufficiently redistributionist, and that we must have progressive rates. I counter that multiple rates invite manipulation by the wealthy and offer too much opportunity for abuse. If we want to redistribute income, **we should do it through spending, not the tax code.**

I recognize that even with this argument, more should be done to fully promote egalitarianism, and attract political support from those who fear that a single low rate might be a giveaway to the rich. The fact is that the income rich will always be able to avoid triggering taxable income. So even if they can’t manipulate their affairs to lower their tax rate, they can do it to lower their taxable income.

To get the very rich to pay taxes like the rest of us, we need another kind of tax – an asset tax. This tax would apply to the gross value of assets and work much like a property tax. Unlike similar taxes tried in other countries (e.g., Swedish or Irish wealth taxes), this tax would apply only to the largest (i.e., top 10 percent) asset concentrations and therefore should be easier to administer. Such a tax will ensure that the asset rich, as opposed to the merely income rich, contribute to the tax burden, which will enable a lower income tax rate for ordinary taxpayers.

So, I agree with the goal of egalitarianism, but I would restate the goal Professor Mankiw has articulated to ensure that we actually accomplish this:

- 3) ***Egalitarianism.*** We need to adopt a single rate income tax system that replaces most existing taxes and exempts the bottom 15 percent of income

earners. We need an asset tax, applied to the top 10 percent of asset concentrations, to ensure that the asset rich contribute meaningfully to the tax burden. These two reforms will promote egalitarianism by:

- a) Removing the poor from the tax rolls
- b) Ensuring that the income rich cannot manipulate their affairs to pay a lower rate
- c) Requiring the asset rich to contribute to the tax burden
- d) Compelling rich entities and institutions that do not now pay taxes to begin doing so, thereby lowering the tax burden on ordinary taxpayers

Because the pressure to introduce multiple rates, or exempt taxpayers from paying the tax, or tinker with the asset tax rate or level at which it applies will be enormous, the single rate tax and asset tax should also be enshrined in a Constitutional Amendment. In other words, “every income earner above a certain level pays the same rate, with an additional contribution from those with truly substantial assets.”

STABILIZATION

Maintaining the economy at full employment is a worthy and proper goal. But permitting use of the tax code to do so requires flexibility that we simply cannot allow, for the reasons I described. Thus:

- 4) ***Stabilization.*** Government leaders are welcome to use any lever they can to achieve economic stability and full employment, except the tax code.

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I invite comments. Please contact me.

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