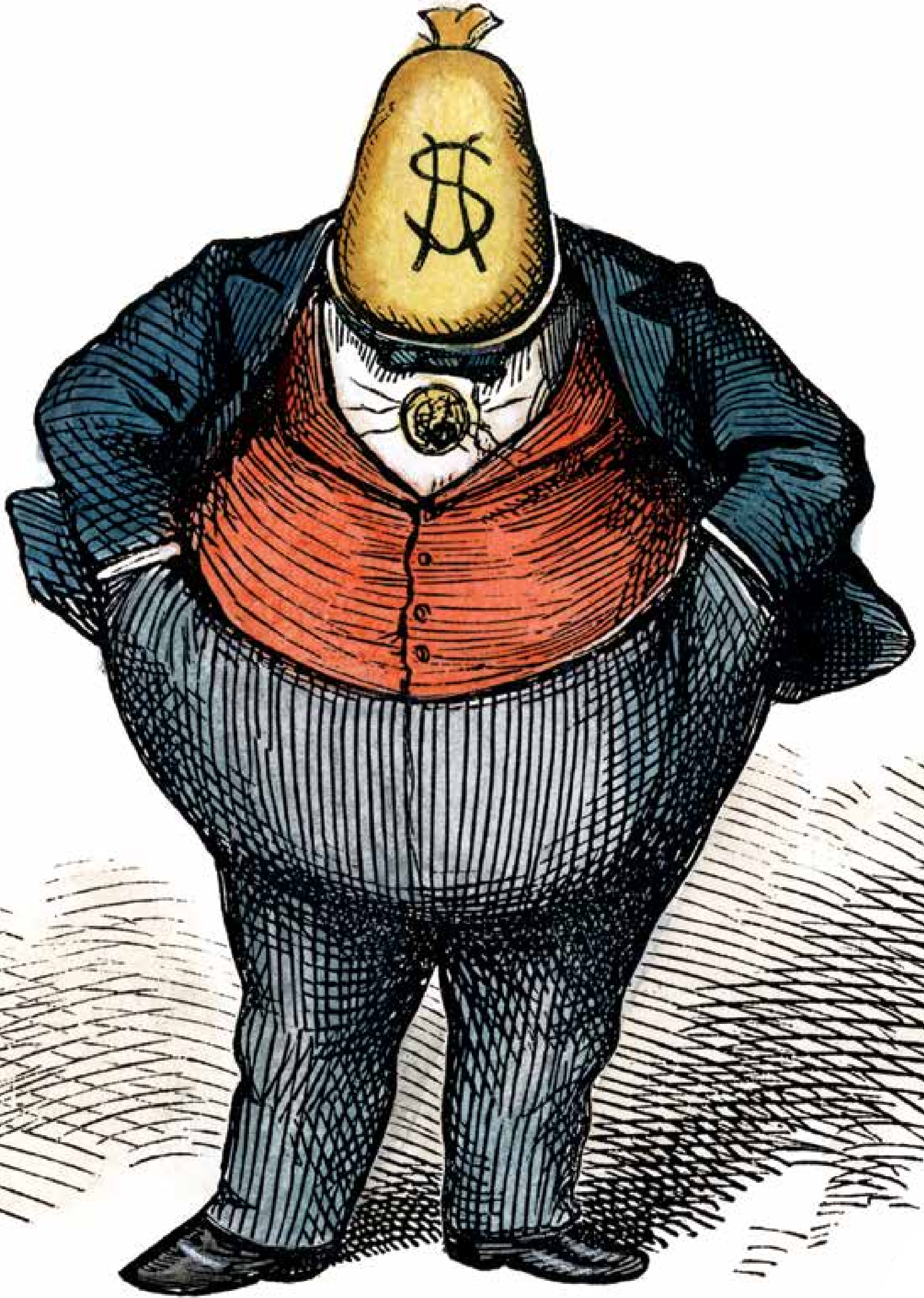

Taxes, Government Transfers AND Wealth Inequality

BY EUGENE STEUERLE

Though neither has made his tax returns available to the public, Jared Kushner apparently paid no taxes in recent years, while then-candidate Donald Trump bragged about a similar feat during the 2016 presidential election. A president who seems proud he doesn't pay taxes is certainly unusual. But it's hardly news that, at least with respect to taxes, rich people are treated differently than you and I. For example, there's no reason to believe that Warren Buffett was anything but honest when he reported an adjusted gross income of just $11.6 million in 2015 – or about one-fiftieth of 1 percent of his wealth.

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Often lost in the outrage, though, is the threat to growth and democracy posed by government policies that, on the one hand, give the already-affluent an easy path to accumulating capital, while on the other placate the rest of us with policies that encourage us to consume at the expense of personal savings and self-improvement. Much attention has been paid to the toxic consequences of rising inequality exacerbated by tax breaks for the wealthy. But I would argue that the increasing diversion of government spending away from opportunity-building programs to income supports is also undermining social comity and, ironically, locking in wealth inequality. Curing what ails America in this regard requires attention to both.

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THE TANGLED WEB

Most people, it's safe to say, understand that the rich are getting away with something on taxes. But, it's probably also safe to say, they're not sure just what. That's understandable, because the rules by which one can legally avoid taxes are anything but transparent.

Start with the reality that a very large share of the return from wealth is hidden or takes the form of capital gains that are accrued but not realized for tax purposes over much, if not all, of the life of the wealth holder. Then, at death, deferred and unrecognized capital gains are exempted from income tax altogether.

But that's only half the problem. While individuals and corporations choose (or are legally required) to recognize taxable gains only when they sell their assets, they almost always immediately deduct interest and other expenses, using a strategy the accountants, lawyers and economists who toil in these fields call tax arbitrage. Everything from tax shelters to the low taxation of multinational companies tends to be tied at least in part to arbitrage.

In fact, the article in *The New York Times* on the Kushner tax-avoidance ploy missed an important aspect of the maneuver. The story emphasized depreciation allowances – the IRS formula for the rate real property loses value – which, after accounting for inflation, have not been all that favorable to real estate investors. However, combine deductions for depreciation with deductions for interest on the one side with the non-recognition of capital gains on the other, and now you've got a sure-fire recipe for tax avoidance.

The tendency to accrue capital gains but not expose them to taxation is especially relevant for those who accumulate great wealth. On average, they (or some ancestor) became rich by performing two somewhat uncommon

GENE STEUERLE, a former deputy assistant secretary of the U.S. Treasury, is the co-founder of the Urban-Brookings Tax Policy Center and creator of the blog The Government We Deserve.

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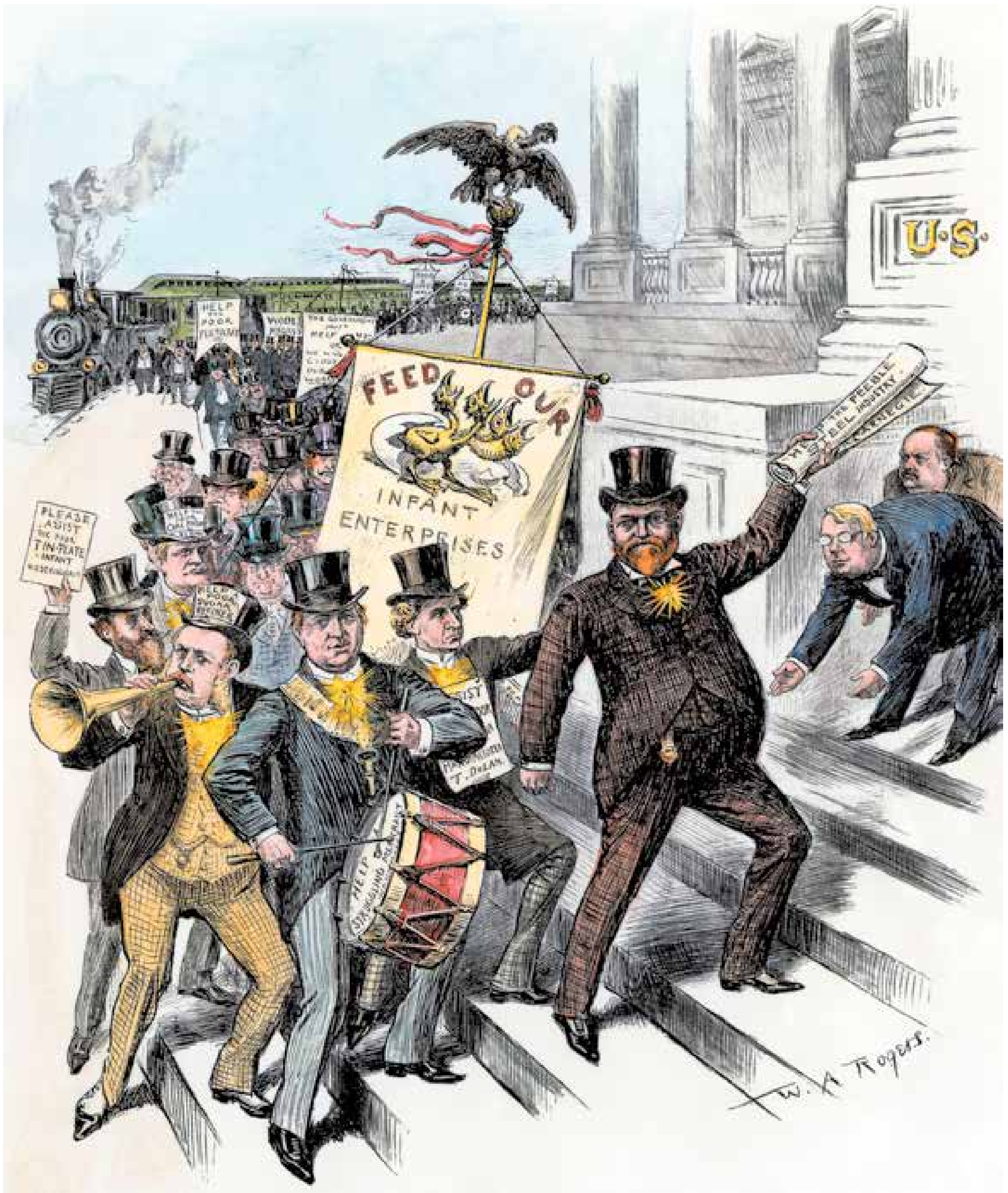


NORTH WIND PICTURE ARCHIVES/ALAMY STOCK PHOTO

acts. First, they saved (or invested through borrowed dollars) a much larger than average share of their income. Second, they achieved returns on their net investments that were well in excess of the average real rate of return of 6 or 7 percent enjoyed by the typical stock investor. The many billionaires born into middle-class families couldn't have become so rich otherwise.

While savers in other income classes seldom do as well as the rich, some of the same wealth-building tools are available to those

near the middle and even bottom of the income distribution. They can achieve higher-than-average rates of accumulation and lower-than average rates of taxation when they hold onto assets like stocks, homes and other real estate that typically produce higher returns than bonds or bank deposits and are blessed with favorable tax treatment.

Note, too, that when you and I borrow and deduct interest on our homes while simultaneously putting money into retirement accounts that defer tax liability, we are engaging in tax arbitrage.

But the data suggest that the path to accumulation eludes most low-income households and most middle-earners. They typically (a) save only a small share of their income, (b) are more likely to pay high interest rates when borrowing, (c) can take little or no advantage of interest deductions because of the ways the tax laws are written, and (d) hold what savings they have in forms that pay little (or even less than zero) interest. Even those who do eventually gain $100,000 or $200,000 in wealth in the form of home equity or in a retirement account earning, say, 5 percent may never reap more than $1,000 or so in tax savings annually.

SLACKER NATION?

The ways Uncle Sam affects wealth building by middle- and low-income individuals are more various and, I would argue, more insidious, than these individuals' lack of opportunities to exploit the tax breaks enjoyed by the wealthy. The best way to see this is to follow the money.

Government policy makes it increasingly attractive to spend money on personal consumption while encouraging both borrowing and dropping out of the work force through early retirement or disability. Meanwhile (as detailed below), the federal government puts a small and ever-decreasing share of its spending and tax subsidies into efforts that promote mobility through development of marketable skills.

This sustains a vicious cycle. Without gains on the skills front, most people never achieve the level of income that makes it practical both to save and (as important) to bear the higher short-term risk inherent in investments that yield premium returns in the long run.

Together, these combined trends – high accumulation rates for the affluent who can benefit substantially from tax preferences for capital income along with low accumulation rates and significant consumption incentives for most of the non-wealthy – explain a good deal about government's unintentional role in supporting, if not increasing, wealth inequality.

I believe that any effort to reduce economic inequality that has a hope of viability requires addressing both sides of this wealth equation. However, that can happen only if it is preceded by a fundamental reordering of the political landscape, as neither Republicans nor Democrats see how their excessive emphasis on respective agendas of lowering taxes on capital and increasing subsidies for consumption are part of the problem, not the solution.

CAPITAL MATTERS

A digression – albeit an important one. In a country immersed in the often-empty debate about whether capitalists are job creators or blood suckers, perspective about the role of capital is often lost. All economies require people, enterprises or governments to create and hold onto wealth. Without capital accumulation, we would still be a nomadic society, trying to forage for food off the land – or, as likely, raiding our neighbor's stockpile.

ESTIMATED PERCENTAGES OF THE AFFLUENT REPORTING VERY LOW RATES OF RETURN ON THEIR WEALTH

	SHARE OF TAXPAYERS REPORTING NET TAXABLE CAPITAL INCOME OF:		
WEALTH	<1%	1-2%	<2%
$2–5 million	38%	30%	68%
$10–50 million	33%	23%	55%
$100 million or more	38%	22%	60%

NOTE: Net taxable capital income = total income reported such as dividends, interest and capital gains (after preference rate expressed as an exclusion.
SOURCE: Jenny Bourne, et al., "More Than They Realize: The Income of the Wealthy," *National Tax Journal* (2018).

Moreover, returns to capital and returns to labor have usually gone hand in hand because increases in capital have usually increased the demand for labor.

All governments own some capital. I suppose somewhere there are Ayn Rand acolytes who would like to see cities sell their traffic lights to private interests and lease the equipment back, but I will ignore them. The larger truth here is that broad-scale government ownership of the means of production has a very poor track record, particularly in complex, advanced economies that must rely on market-based pricing to allocate resources efficiently and on private incentives to drive innovation and productivity.

All this is to say that economies must nourish and protect private capital accumulation if they are to prosper. And there's just no getting around the reality that a vibrant democracy must grapple with the tensions created by both the need to accumulate wealth and the demand for a just distribution of the power and freedom that wealth – not just income – provides.

HEADS THEY WIN, TAILS WE LOSE

In a recently published study, Jenny Bourne, Brian Raub, Joseph Newcomb, Ellen Steele and I found that even in the boom years after the turn of the millennium, most wealthy individuals reported an effective taxable return on their assets of less than 2 percent. That is, for each $1 million of wealth, they reported taxable dividends, interest and capital gains totaling less than $20,000. Meanwhile, close to 40 percent of filers with more than $100 million in net worth in 2007 reported taxable incomes of less than 1 percent of their wealth.

I came up with similar results for the 1970s and early 1980s. One study found even lower returns reported by a select group of owners of businesses and farms subject to estate tax, and another found that net income from capital reported on all individual tax returns was less than one-third of total capital income actually generated in the economy.

In bygone days, however, income from wealth was, at least in theory, subject to much higher tax rates, with individual income rates as high as 50 percent and 70 percent. Yet in 1978, Martin Feldstein and his colleagues – and many researchers since – showed that higher tax rates are offset at least in part by lower reports of capital income, largely because the timing of realized capital gains is highly discretionary.

The owners of capital still paid their dues back then because capital income was also taxed at an earlier stage through corporate income taxes.

Indeed, corporate taxes generally exceeded total individual income taxes on both capital and labor until World War II. Revenues from corporate taxes waned thereafter and are scheduled to drop to about 15 percent of individual tax collections by 2027.

The estate tax also once served as a collection point – albeit with delays. The estate tax rate grew substantially in the Depression and World War II years, reaching a top rate of 77 percent with an individual exemption level of

just $60,000 from 1942 to 1976. But like other forms of capital taxation, it has since attenuated. By 2018, the estate tax was buffered by an exemption of $11.18 million and was levied at a top rate of just 40 percent.

Taxes on labor income, by contrast, have increased significantly. While revenues from individual income taxes haven't varied much as a proportion of GDP since World War II, Social Security taxes have grown significantly.

But policies promoting wealth accumulation go far beyond taxes. The Federal Reserve and assorted financial services regulators subsidize borrowing through protection of banks from bankruptcy, insurance of individual bank deposits at low premiums, and, in recent years, the maintenance of borrowing costs close to zero. Those efforts naturally favor people with wealth since they can more easily access loans at competitive rates.

Close to 40 percent of filers with more than $100 million in net worth in 2007 reported taxable incomes of less than 1 percent of their wealth.

The statutory rate that applies to most labor earnings has risen from 3 percent in 1950 to 15.3 percent since 1990. (Note, by the way, that while the tax is collected 50-50 from employers and employees, economists widely agree that the burden on the former is offset entirely by lower wages.)

Neither economists who favor higher taxes on capital nor those who support lower rates much like this hodge-podge system. Why, they ask, should some income from capital be double- or triple-taxed while other capital income is not taxed at all? Why should tax arbitrage games provide a positive return to investors even when it is hard to identify any overall return to society? In my own work, I find that allocation of capital to unproductive investment, especially as enhanced by tax avoidance, to be a significant cause of economic stagnation.

Whereas the system once tended to tax individuals on their capital income at higher rates than on their labor income, today it does the reverse. Indeed, under the 2017 tax law, the new top corporate rate is 21 percent, while the top individual statutory rate is 37 percent.

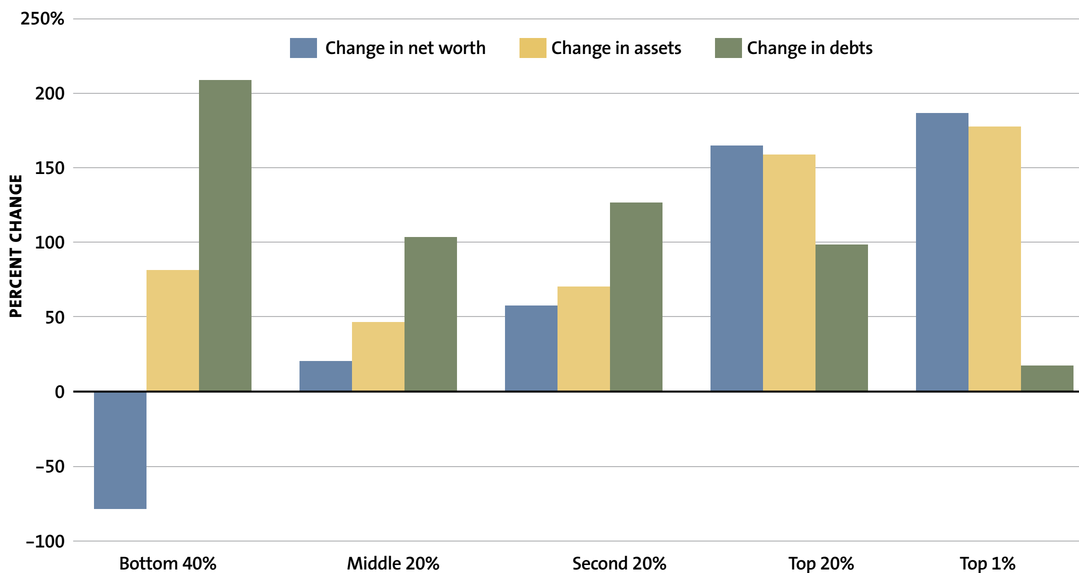
This is not to dismiss the value of these policies in preventing financial collapse in 2008 and promoting recovery thereafter. But it should not be forgotten that one unintended effect has been to promote the concentration of wealth.

MEASURING INEQUALITY

To understand what has been happening to the relative position of the non-wealthy, we need to dig a little into the numbers. Wealth has always been highly concentrated at the top – much more so than income. In 2016, Ed Wolff discovered that the bottom two-fifths of households in terms of wealth had, on average, accumulated less than $3,000. The middle fifth averaged $101,000, while the second fifth averaged $298,000. The top fifth averaged a rather amazing $3,044,000. That last figure is misleading, though, since most of the wealth within this group was in the hands of the top 1 percent. Indeed, this cohort holds about 40 percent of total wealth in the economy.

Trends in debt tell another story. From 1983 to 2016, debt grew faster than gross assets in households except for those near the

CHANGE IN NET WORTH, ASSETS AND DEBTS BY SELECTED WEALTH CLASS, 1983–2016



SOURCE: Author's tabulations of 1983 and 2016 Survey of Consumer Finances

top of the wealth pyramid. For instance, those in the middle fifth enjoyed a 71 percent increase in assets offset by a 127 percent increase in debt. Only in the top two-fifths did assets grow faster than debt.

Now consider the distribution of income. People often lump together wealth and income in analyzing inequality. Yet, the richest individuals in terms of income are not the same as the richest in terms of wealth – and, perhaps more important, government policies affect wealth and income concentration differently.

While there is a lot of debate about what constitutes income, there is consensus on two points. First, as the media have widely reported, the distribution of income earned in the market, such as wages and dividends, has become more unequal. Second, and not so widely reported, government policies have gone a long way toward narrowing inequality of income available for consumption through both progressive taxation and progressive transfer programs, including Medicare, Social Security and SNAP (a.k.a. food stamps). The numbers vary with the measure of income used.

But the bottom line is clear.

Indeed, President Trump's Council of Economic Advisers recently used the fact that the distribution of consumption expenditures is less unequal than the distribution of pre-tax income to argue that existing measures overstate poverty. The CEA report was controversial both because measures of consumption themselves are more problematic than measures of income, and because the report used the analysis to justify support for more work requirements in transfer programs – a *cause du jour* among Congressional Republicans. Still, I think it fair to say that the core conclusion is correct: consumption is more equally distributed than income.

That said, the better news about the trend in consumption inequality or after-tax after-transfer income doesn't diminish the signifi-

cance of growing disparities in market incomes, in indebtedness, in the failure of today's young adults to accumulate wealth along the track of previous post-war generations – and in the lack of progress by blacks and Hispanics to narrow the wealth gap with whites. It's plain that while federal government tax and transfer policies redistribute significant amounts of income and consumption, they have done little in recent decades to narrow the distribution of wealth, and may even have made it less equal.

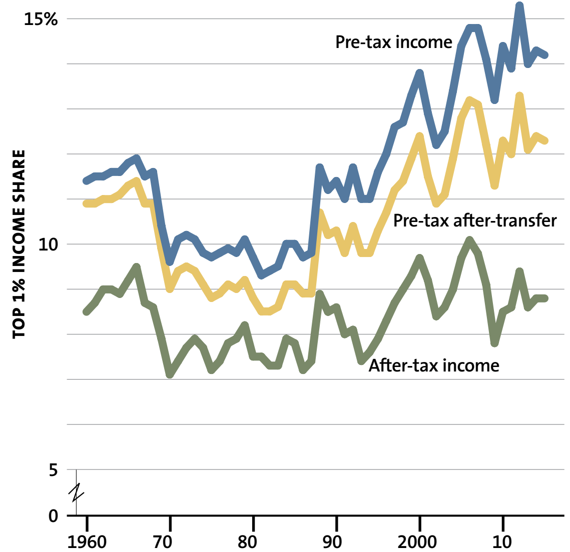
PROFLIGACY AS PUBLIC POLICY

THAT PROMPTS THE QUESTION OF WHY. IN one recent study, I found that federal initiatives to promote opportunity, such as the Earned Income Tax Credit, apprenticeship programs, early childhood education and health care for the young, have never been a large part of the budget and are scheduled to decline as a share of GDP. Even those opportunity-related subsidies that do grow, like tax incentives for retirement savings, are not broadly inclusive since the main benefit – deferral of taxation – is of little use to those in low tax brackets.

The benefits from tax breaks for homeownership are also concentrated on those with incomes well above median. Moreover, the breaks can work to encourage borrowing at the expense of wealth accumulation since homeowners often take out home equity loans to finance more consumption.

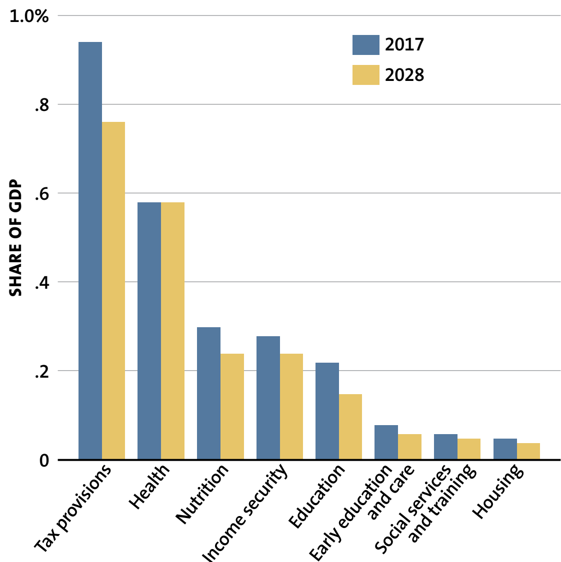
For 12 years, my colleagues and I at the Urban Institute have regularly published a report called Kids Share, which includes an estimate of the extent to which Uncle Sam supports programs for children. Today, subsidies per child are only about one-sixth the level of subsidies per senior citizen. Moreover, unlike spending on seniors, benefits for kids are scheduled to decline. Meanwhile, pressures at state and local government levels, largely from health care inflation and underfunded public employee pensions, are

SHARES OF INCOME EARNED BY THE TOP 1 PERCENT



SOURCE: http://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf. Calculations by Gerald Auten and David Splinter

FEDERAL EXPENDITURES ON CHILDREN AS A SHARE OF GDP, 2017 AND 2028 (FORECAST)



SOURCE: *Kids' Share 2018* (https://urbn.is/2RJmYeo)

HISTORY REPEATS ITSELF.—THE ROBBER BARONS OF THE MIDDLE AGES, AND THE ROBBER BARONS OF TO-DAY.

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squeezing K-12 education spending and other investments in youth.

It's not that the government doesn't aid those with less means. But almost all of these transfers support consumption, and only indirectly promote opportunity. Moreover, as noted above, they inhibit saving.

Consider the extent to which the largest of these programs, Social Security, has encouraged people to retire while they could still work.

Because of longer life expectancy and, until recently, earlier retirement, a typical American now lives in retirement for 13 more years than an American who retired in 1940 when Social Security first started paying benefits. That's a lot fewer years of earning and saving, and a lot more years of drawing down personal wealth.

Health care programs play a more ambiguous role in this context. They promote mobility to the degree that they make us more capable of working and earning income. But the largest health program, Medicare, supports earlier retirement. Moreover, prime-age adults on means-tested Medicaid lose eligibility if their incomes rise much. By the same token, most disability programs discourage recipients from easing back into work. And they are very expensive.

A WAY FORWARD

If we care about the distribution of wealth as an issue distinct from the distribu-

tion of consumption (and we should), we need to address how public policy affects the wealth of the non-affluent as well as that of the affluent. Taxing wealth without encouraging its formation can reduce economic growth without broadening its distribution. That said, there are numerous ways to make taxation of the wealthy fairer without materially affecting growth.

For example, a strong case can be made to tax capital gains at death, at least for the very wealthy. This would reduce the inequality of wealth distribution without much affecting incentives to create capital. Note, too, that this change would reduce the current incentive to sit on accumulated wealth for a lifetime, opening opportunities for reallocation that increased productivity. Another priority: limits on tax arbitrage that allow expenses such as interest to be fully deducted even while avoiding taxes on capital gains and other tax-deferred income.

Taxes matter in this context when it comes to the non-wealthy, too. Shifting at least part of the burden of the income tax to a tax on consumption would encourage savings (and wealth accumulation). But the real action on the non-wealthy side of the equation is with transfer programs.

Consumption support is a part of the safety net of all affluent, civilized societies. But it's important to remember that the design of transfer programs has had unintended consequences for the distribution of private wealth – as well as the political power that wealth creates – in the long run.

Annual federal, state and local government spending from all sources, including tax subsidies, now totals more than $60,000 per household, of which about $35,000 is in the form of direct supports for individuals. Thus, a typical child born today can expect to receive about $2 million in direct supports from government. In the meantime, government has (a) scheduled a reduction in its funding for them as children, when it would help most in developing human capital, (b) shackled young adults with $1.4 trillion of student debt without a corresponding increase in earning power, and (c) offered little to bolster the productivity of workers.

Any number of programs could have a place in encouraging economic mobility, among them beefed-up access to job training and apprenticeships for non-college goers; wage subsidies that reward work; subsidies for first-time homebuyers in lieu of subsidies for borrowing; a mortgage policy aimed more at wealth building; and promotion of a few thousand dollars of liquid assets in lieu of high-cost borrowing as a source of emergency funds – you get the point. All these efforts would need to be tested continually for performance and success, including adopting designs that generate high returns relative to costs.

REALITY CHECK

It would be naïve to assume that any of this would be easy. Republicans seem committed to reducing (not increasing) taxes on the wealthy, while Democrats reflexively support redistribution to those less well off, even when the program design reduces incentives to save and work. Both parties unite effectively to disfavor investments with longer-term payoffs.

But harder times ahead may create an opening for change. My reading of history has convinced me that fundamental shifts in fiscal policy will soon be forced upon us by ballooning budget deficits. Greater equalization of wealth could result from that reform, but only if we shift gears to give priority to opportunity in both our tax and transfer systems.